Concentration not competition: the state of UK consumer markets

Scott Corfe

Nicole Gicheva

Social Market Foundation

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FOREWORD FROM THE SPONSOR

TSB was created to bring more competition to banking and ultimately make banking better for all UK consumers. But the problems consumers face in banking can be found in the markets that people rely on the most.

In the sectors that matter the most to consumers, a handful of big, established players have a stranglehold on the market. These high levels of concentration are resulting in poor consumer outcomes and reducing the incentive for some of our biggest companies to keep fit to compete on a global scale.

I am not talking about the little luxuries of life here. As this report makes clear, in eight of the 10 most important markets – essentials like gas, electricity, groceries and banking – the big boys have got a vice-like grip. In many of these markets, the situation is getting worse.

In banking for example, the Social Market Foundation has found that despite TSB's growth and a large number of new entrants, the personal current account market is more concentrated than it was prior to the financial crisis, with the market dominated by the five largest banks. The report also shows that despite the introduction of the Current Account Switching Service four years ago switching levels remain minute.

The problems consumers face in banking are not isolated. Across the markets people rely on the most consumers are often lumbered with the wrong product at the wrong price, are penalised for shopping around and are prevented from voting with their feet and switching providers.

It's time for change: it's time for consumers, not dominant businesses, to be put at the centre of the markets that people rely on most. This will be good for consumers, ultimately good for the global competitiveness of the companies themselves and good for the competitiveness of the UK economy

That is why I am delighted that the Social Market Foundation has produced this report, which so clearly sets out the need for change. Rather than write a series of isolated market studies, the Social Market Foundation has, for the first time, looked across the markets that matter the most to consumers, to identify common themes.

The report shows there is an intimate connection between high market concentration, low levels of competition and poor consumer outcomes. It finds that poor consumer outcomes arise as a result of high levels of concentration such as poor customer service, low levels of trust, underinvestment, supernormal profits and of course higher prices.

Crucially, it identifies the key drivers of market competition, setting out clearly to Government and regulators the key problems they need to tackle to make markets work better for UK consumers.

If consumers are given greater power, complacent businesses will no longer be able to take them for granted and will become fit for competition.

This report demonstrates that opening up markets to more competition will not only benefit those individual consumers with more choice, better service and lower prices, it has profound effects on the wider economy as well. If businesses are forced to learn these lessons at home they will become more dynamic and better able to compete on a global platform. Ultimately that will mean a stronger and more vibrant UK economy that works for everyone

Paul Pester
CEO, TSB Bank

EXECUTIVE SUMMARY

The UK's economic status quo is at a critical juncture. Faith in a largely "free market" settlement is increasingly in doubt, as household incomes are squeezed and many fail to see economic growth translating into an improvement in their day-to-day lives. Perceived corporate excesses, such as high profits and prices, have led to a growing belief that the system is rigged, with the benefits accruing in the hands of a small elite at the expense of the ordinary UK household.

In this environment, it is more important than ever that consumer markets work well and deliver good outcomes for households. If they don't, markets risk being replaced with state ownership as the electorate loses faith in private enterprise.

This would, in our view, be the wrong path for the UK to go down. At their best, free and functioning markets are a driving force of job creation, innovation and prosperity. They expand consumer choice and keep prices low as companies compete to win and keep customers. New "challengers" who enter markets can place pressure on incumbent businesses, pushing them to offer better prices and invest to improve their services.

All too often, however, consumer markets see custom concentrated in the hands of a small number of large companies. That's bad for customers and bad for the wider economy: where companies don't have to fight hard to win and keep their customers, they face less pressure to reduce prices and to increase quality, to invest and to innovate. That is, concentrated markets are often uncompetitive.

This SMF report provides new insights into the state of consumer markets in the UK. In particular it examines the extent to which the UK's consumer markets are competitive and concentrated and the impact this is having on consumer outcomes. We explore the extent to which consumers could see significant gains, such as lower prices and higher levels of customer service, if markets became more competitive.

The analysis examines the following 10 key consumer markets, which collectively account for about 40% of all consumer spending – cars, groceries, broadband, mobile telephony, landline-only phone contracts, electricity, gas, personal current accounts, credit cards and mortgages.

In order to deliver for consumers, these markets need to by dynamic. Yet most are controlled by just a handful of companies. Our analysis of market concentration has found:

- **Eight of the ten consumer markets examined were "concentrated"[i] in 2016, meaning they are dominated by a small number of large companies.** Only cars and mortgages can be considered unconcentrated consumer markets.
- **In telecommunications, market concentration is high and it has increased over the past decade with respect to broadband and mobile telephony.**
- **The personal current account market is *more concentrated* than in 2007 with the market dominated by the five largest banks.** This is despite recent entrants into the market.
- **The gas and electricity markets have become *less concentrated* since the early 2000s, with a number of new entrants in the sector.** However, the market remains dominated by the "big six" energy companies.
- **Concentration in the groceries market has *declined* in recent years.** The rise of Aldi and Lidl in recent years has eroded the market share of the "big four" supermarkets and reduced industry concentration.

Our analysis has found that the lack of competition in these markets is resulting a range of negative outcomes for UK consumers:

- **Lack of choice** - in concentrated markets, consumers may not have access to the diversity of product and service choices that they would like.

i On the Herfindahl-Hirschman Index (HHI) measure of industry concentration

- **Poorer customer service and lower levels of trust** – we identify a link between higher levels of market concentration and lower levels of customer service and trust in markets.
- **Higher prices** – where markets are more concentrated, consumers often face higher prices.
- **"Supernormal" profits and underinvestment** – Where competition is weak, company profit margins are likely to remain higher than would otherwise be the case. The presence of supernormal profits contributes to an unequal distribution of wealth and income in the UK, raising questions around social justice and fairness.

  Further, where companies face only limited competitive pressure because their market is concentrated, they are less likely to spend their money on things that might allow them to offer a better, cheaper service or product to customers. Instead of investing and innovating, UK corporations often sit on substantial cash reserves, a trend we believe is being exacerbated by market concentration.

We identify seven key drivers of concentration and a lack of competition in consumer markets in the UK:

1. **Barriers to entry in markets** - high fixed costs and regulatory/licencing requirements deter new entrants into consumer markets.
2. **Barriers to scaling up** - for example, energy companies face significant environmental and social obligations once they exceed 250,000 customers. Regulatory and licencing requirements for financial services firms can deter entrants from providing new products and services.
3. **Bundling and gateway products** - bundling of services has become much more prevalent in the telecommunications sector. Similarly, the dominance of dual fuel energy tariffs may undermine competition in the gas and electricity markets. Bundling can decrease the likelihood of an individual switching supplier for a given product, given the need for them to "unbundle" and choose new products for other services.

In banking, personal current accounts may act as a "gateway product", with individuals more likely to opt for a loan, credit card or mortgage from institutions with which they hold a current account.

4. **Low switching rates** - Low switching rates make it much harder for new entrants to significantly grow their market share. For example, data from Bacs show that less than two per cent of current account holders switch accounts each year.

5. **Incumbent advantages** - For example, in the retail sector, incumbent firms have significant supply chain bargaining power, allowing them to purchase goods and services at a lower price than a new entrant to a market. This can make it difficult for a new company to compete on price with a larger firm.

6. **Natural monopolies** - There are some industries where there is an inherent natural tendency towards monopolies or limited competition. For example, rail transport often inherently lacks consumer choice given the challenges associated with having multiple train providers on a given route. The introduction of competition in these instances may actually lead to inefficiencies compared with a monopoly situation.

7. **Uncompetitive sub-markets** - An example of this is "mortgage prisoners" who are unable to switch mortgage - for example, because they are in negative equity. These individuals can find themselves facing relatively high interest standard variable rate (SVR) mortgages which they are unable to switch out of.

This report is the first part of a research project that will conclude in early 2018. The purpose of this report has been to analyse the level of competition and concentration in UK consumer markets, and the consequences for consumers. The next report will consider the ways in which policymakers and others can reduce concentration, encourage competition, and get a better deal for consumers.

CHAPTER 1: INTRODUCTION

The economic and social settlement that exists in the UK is at a critical juncture. Brexit and the 2017 general election have raised questions about the extent to which markets, left largely to their own devices, can provide good outcomes for consumers. Many have interpreted the outcomes of these votes as a rejection of a "free market" settlement that is not working for a significant portion of the population – both in terms of providing good work and value for consumers.

At their best, free and functioning markets are a driving force of job creation, innovation and prosperity. They expand consumer choice and keep prices low as companies seek to win over customers. New 'challenger' entrants place pressure on incumbent businesses, generating dynamism and investment.

All-too-often, however, consumer markets are concentrated in the hands of a small number of large companies, with a lack of choice and barriers to switching supplier. Inertia among households does not help either, with low switching rates leaving consumers often sticking with poor value telecommunication, banking and energy contracts. Low switching rates may be driven, at least partly, by a lack of transparency around pricing and the ease with which consumers can switch to another supplier. Many individuals may not be adequately informed, for example, when they are shifted from a fixed rate tariff to a more expensive variable rate tariff.

As such, the economic ideal of "perfect competition" frequently bears no resemblance to reality.

The consequences of this are clear to see, with consumers facing higher prices and worse customer service as a result of a lack of effective competition. Price discrimination in markets is rife, with the most vulnerable, least engaged consumers often facing the highest prices. "Supernormal" profits in uncompetitive sectors of the economy also raise questions of social justice, given the implications for income and wealth inequality.

The case for tackling this is compelling, not least because the existence of unfair markets undermines broader faith in markets. Unless markets become fairer and provide better outcomes for consumers, there is a risk of this paving the way for a raft of anti-business measures or even the outright abolition of markets – through nationalisation of industries.

Tackling problems with the status quo will be challenging and there is a risk of well-intentioned policies generating bad outcomes. An energy price cap, for example, may end up further reducing competition in the electricity and gas markets by making it even less likely that consumers will switch supplier.

Intervention needs to be well thought out and evidence-based, rather than providing shoot-from-the-hip "solutions". This report aims to provide some evidence to form the basis of an appropriate policy response, shedding a light on the state of markets in the UK.

In particular, the research considers the extent to which markets are both competitive and delivering a "good" set of outcomes for consumers, such as reasonable prices and high levels of customer satisfaction. Numerous measures of market concentration and competitiveness are used and compared. We find that concentration and competition are intimately connected concepts in consumer markets – where market concentration is high, competitive forces tend to be weak, leading to worse outcomes for consumers.

The report also considers the underlying drivers of a lack of competition in consumer markets, providing insights into possible policy solutions for the problems we observe.

This report is part one of a broader study examining concentration and competition in consumer markets. The second part of the research will draw on the findings presented here and consider, in more concrete terms, the appropriate policy response from government.

The structure of the report is as follows:

- **Chapter 2** presents the findings of new SMF analysis of industry competitiveness and concentration. Market concentration is compared across markets and over time.
- **Chapter 3** examines the causes of low levels of competitiveness in consumer markets.
- **Chapter 4** examines the economic and social consequences of a lack of competition in consumer markets.
- **Chapter 5** draws conclusions from the preceding analysis.

CHAPTER 2: COMPETITION IN CONSUMER MARKETS

This chapter examines the extent to which consumer markets in the UK are competitive and concentrated in the hands of a small number of businesses.

The analysis shows significant variations in competitiveness and concentration across markets. In addition, trends over time vary markedly across sectors. While some markets, have become less concentrated in recent years, others have become increasingly dominated by a small number of firms. In particular, we find evidence of increased market concentration in parts of the telecommunications industry.

The analysis examines the following 10 consumer markets:

- Cars
- Groceries
- Broadband
- Mobile telephony
- Landline-only phone contracts
- Electricity
- Gas
- Personal current accounts
- Credit cards
- Mortgages

We examine these markets as they cover some of the most important elements of consumer spending in the UK. Together, we estimate that they account for about 40% of total consumer expenditure.[ii] As such, the performance of these markets has a significant impact on consumer welfare.

Measuring industry concentration and competition

There are numerous ways of measuring the extent to which consumer markets are concentrated. In this research, we consider three separate measures of market concentration, which are based on the relative market share of different industries in the UK:

ii Analysis based on ONS Family Spending data for the 2015/16 fiscal year. Covers expenditure on food & non-alcoholic drinks, alcohol (consumed at home) & tobacco, car purchases, mortgage payments, electricity, gas & other home fuels, phone & broadband subscriptions and bank & building society charges (including credit card charges).

- **The Herfindahl-Hirschman Index (HHI)** - calculated as the sum of the square of company market shares. A HHI score of 10,000 relates to a perfect monopoly where one firm controls the entire market. Using the HHI, we can classify markets into three types:

    1. **Un-concentrated markets** – those with a HHI below 1000

    2. **Moderately concentrated markets** – HHI between 1,000 and 2,000

    3. **Highly concentrated markets** – HHI above 2,000

    These thresholds are in line with those in the European Commission's guidelines on the assessment of horizontal mergers – Commission notice (2004/C31/03).

- **The CR1 ratio** - the market share of the largest firm within a consumer market.
- **The CR4 ratio** - the market share of the four largest firms within a consumer market.

Unlike the CR1 and CR4 ratios, the Herfindahl-Hirschman Index considers the relative size of the market shares of different industries. For example, a consumer market with four firms each holding 25% market share will have a lower HHI score than an industry where one of the four firms has a market share of 50%. The CR4 ratio does not take into account such variations – its score would be 100% in both instances. In this sense, the HHI can perhaps be seen as a broader and more complete measure of the extent to which a consumer market is concentrated.

At this point, it is worth making an important distinction between *concentration* and *competition*. A concentrated market could be regarded as competitive if there is intense price and quality competition between the small number of firms that dominate an industry, and if barriers to entry in a market are relatively low. It would not be unreasonable to expect a "concentrated but competitive" market to provide good outcomes for consumers.

Given this, in the analysis that follows we also consider the extent to which the relative ranking of businesses within consumer markets has changed over time, to provide some insights into the extent to which markets are competitive. In a competitive market, we would expect the relative position of different companies to change regularly over time, as companies refine their product offers to gain a higher market share.

The findings of the analysis

The current state of consumer markets

Market concentration varies significantly across the consumer industries examined in this research, but what is clear is that eight out of ten of the markets considered suffer from market concentration.

In the consumer market for fixed line-only phone contracts, BT had a market share of about 80% on the latest data. It is by far the most concentrated of the industries we have considered in this research, on each of the three measures of market concentration.

Gas is the second most concentrated consumer market on the CR1 measure of concentration, reflecting the high market share of British Gas, which stood at about 35% in 2016. However, on the broader CR4 and HHI measures of concentration, broadband and mobile telephony are the second and third most concentrated consumer markets, reflecting the dominance of a handful of companies in these sectors. Telecommunications industries thus occupy the top three most concentrated consumer markets, on these broader measures of concentration.

We note a significant gap between market concentration in the gas market and concentration in the electricity market. The gas industry is notably more concentrated than the electricity industry, reflecting British Gas's high market share.

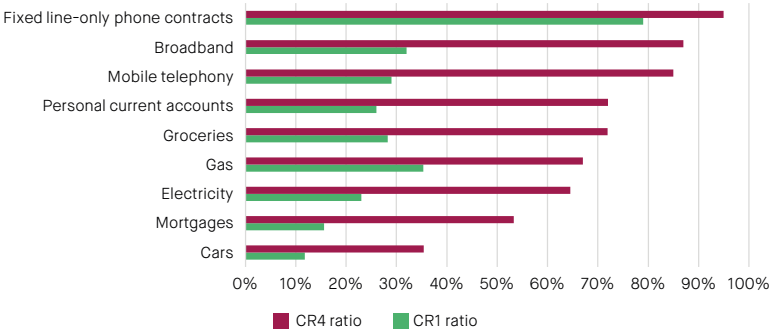
We observe variations in industry concentration within the financial services industry, across product categories. The personal current account market

is the most concentrated of the financial services products considered in this research, on the HHI measure, followed by credit cards. Both of these consumer markets are "moderately concentrated" under the HHI thresholds mentioned earlier. With respect to personal current accounts, outside of TSB all new entrants over the past decade have only managed to achieve a collective market share of just over 1%.[1]

In contrast, the mortgage market is not concentrated, with an HHI score of less than 1,000 in 2016.

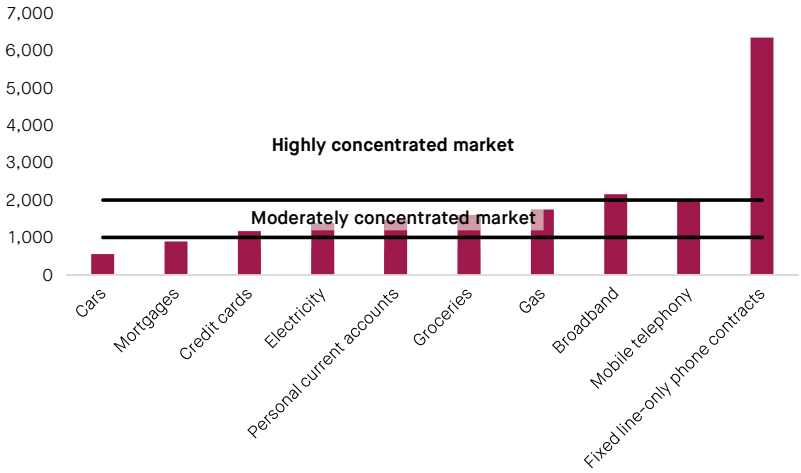
On the latest data, the new car market is the least concentrated consumer market on each of the three measures of concentration considered in this report. The most commonly sold new car brand, Ford, had a market share of just 11.8% in 2016.

Figure 1 Estimates of industry concentration in consumer markets, CR1 and CR4 ratios, 2016



Source: SMF analysis. Mobile telephony figure relates to 2015, given data limitations. CR1 and CR4 data for credit cards are unavailable.

Figure 2 Estimates of industry concentration in consumer markets, HHI score, 2016



Source: SMF analysis. Data point for personal current accounts relates to 2015, while data point for credit cards relates to 2014, given data limitations

Trends over time

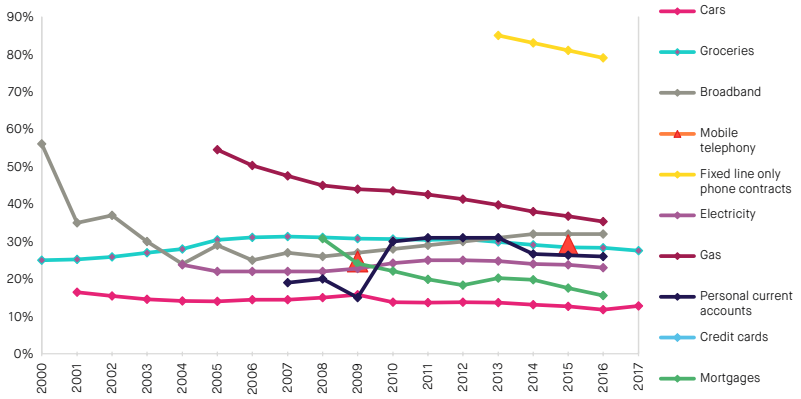
We just showed that the overwhelming majority of the consumer markets examined in this research are concentrated. But to what extent has this changed over time? Are consumer markets becoming more or less concentrated? How do trends vary across markets? It is to these questions that we now turn.

Overall, our analysis, graphed in Figure 3, Figure 4 and Figure 5, suggests that trends in concentration vary across consumer markets:

- The gas and electricity markets have become less concentrated since the early 2000s, with a number of new entrants in the sector.

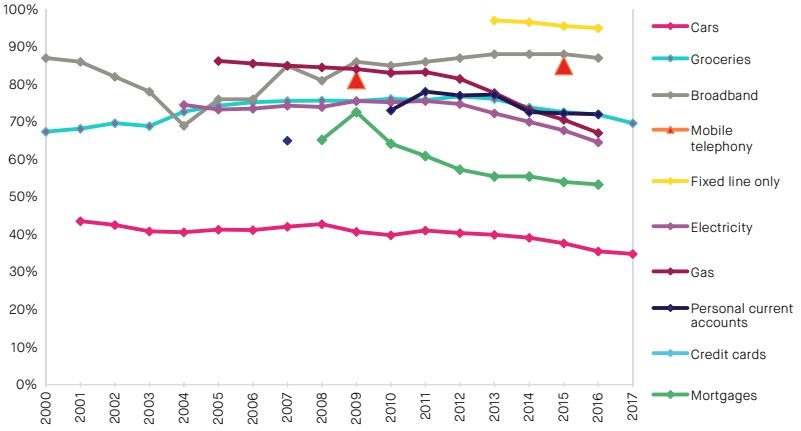
- Concentration in the groceries market has followed an "n" shape since the early 2000s. Tesco's market share peaked at about one third in 2007. The rise of Aldi and Lidl in recent years has eroded the market share of the "big four" supermarkets and reduced industry concentration. A price war among supermarkets has created a more competitive market in recent years.
- The personal current account market became significantly more concentrated during the financial crisis, given consolidation in the industry – in particular, the merger of Lloyds TSB and HBOS. While there have been a number of small new entrants to the market in recent years, on the HHI measure the personal current account market remains more concentrated than in 2007.
- The markets for credit cards and mortgages have become less concentrated since the financial crisis. The mortgage market has gone from being a moderately concentrated market to an unconcentrated market on the HHI measure. This may reflect a number of factors, including new entrants into the mortgage market as well as a "price war" between incumbent providers over mortgage rates, which may have encouraged individuals to remortgage with a different provider.
- In telecommunications, market concentration has increased over the past decade with respect to broadband and mobile telephony. Mobile telephony became notably more concentrated following the merger of T-Mobile and Orange into EE in 2010. The HHI for fixed line-only contracts has diminished over time, but it remains by far the most concentrated consumer market considered in this research.

Figure 3 CR1 ratios over time



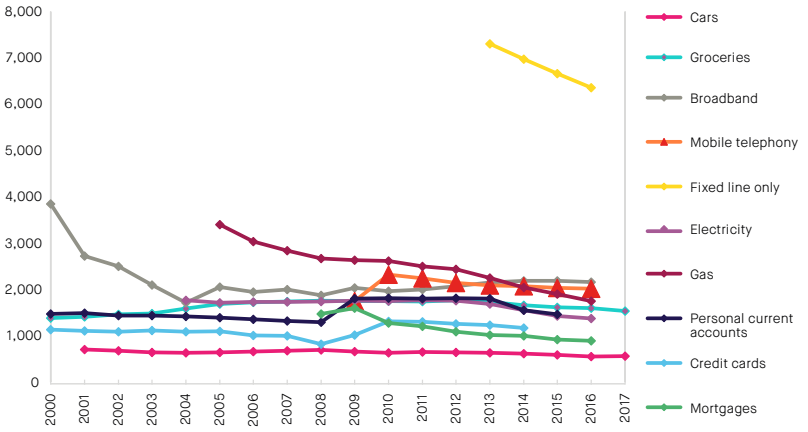
Source: SMF analysis. Time periods are not consistent across consumer markets, reflecting data limitations. 2017 figures reflect currently-available data for groceries and cars.

Figure 4 CR4 ratios over time



Source: SMF analysis. Time periods are not consistent across consumer markets, reflecting data limitations. 2017 figures reflect currently-available data for groceries and cars.

Figure 5 HHI scores over time



Source: SMF analysis. Time periods are not consistent across consumer markets, reflecting data limitations. 2017 figures reflect currently-available data for groceries and cars.

Markets are concentrated. Are they also uncompetitive?

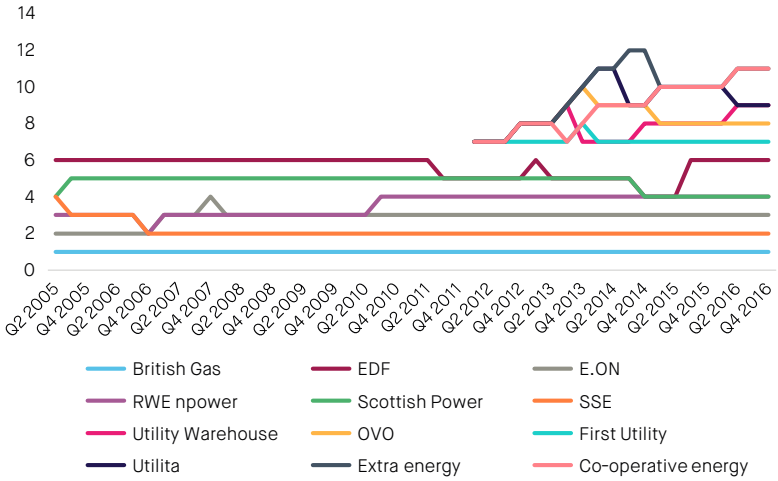
Concentration and competition are not the same thing, nor do they need to coincide with one another. Having said that, there are reasons to believe that market concentration is likely to be a reflection of weak competition.

One gauge of how competitive consumer markets are is the extent to which companies climb up and move down the market share "league table". In a competitive market, it is reasonable to expect fairly regular changes in ranking between companies, as those lower down the league table gain market share by improving their service offer in terms of pricing and product quality. In an uncompetitive market, rankings of companies are likely to be relatively rigid, reflecting advantages held by some firms, a lack of consumer switching and barriers to market entry. In such circumstances, it may be difficult or impossible for smaller companies to significantly grow their market share, even if they develop a compelling and well-priced product offer.

In this sense, most of the consumer markets examined in this research are relatively or very uncompetitive, as well as being concentrated.

In energy, British Gas/Centrica has consistently had the largest market share for electricity and gas. Its market share lead in electricity has increased since 2004, though its lead for gas has diminished. While new entrants into the utility markets have reduced the market share of the "big six" energy companies, these established firms for now enjoy a substantial market share lead over the new entrants. Furthermore, the relative ranking of the big six energy companies does not change regularly over time, suggesting little in the way of competitive forces. For example, this is illustrated below in Figure 6 which examines the gas market.

Figure 6 Ranking of gas suppliers, in terms of market share



Source: SMF analysis

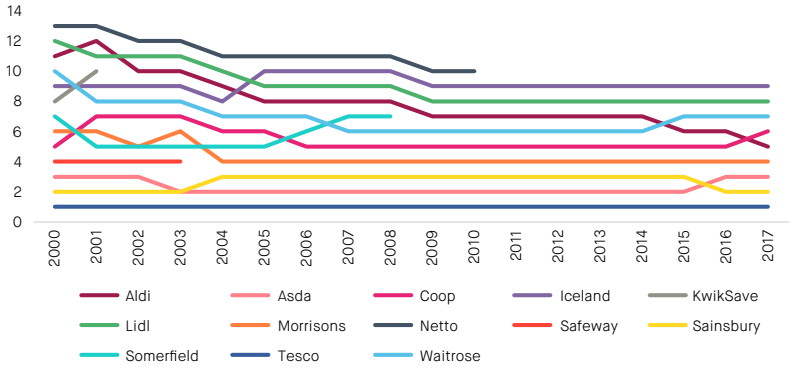
In telecommunications, BT has a substantial market lead in fixed-line only phone contracts, with a market share of about 80%. Competition is extremely weak, given that the demographic of fixed-line only customers disproportionately consists of relatively vulnerable consumers – in particular the elderly and those on low incomes. These individuals are likely to be less engaged with markets and less inclined to switch supplier. Indeed, the lack of effective competition in this market has led Ofcom, the telecommunications regulator, to impose a price cut for landline-only customers.[2]

There are signs that the broadband market has become less competitive in recent years. Consolidation in the industry has reduced the number of large players in the market and two firms – BT and Sky – had a combined market share of 55% in 2016. While Sky has managed to triple its market share since 2007 and move from the fourth largest broadband supplier to the second largest supplier, the relative rankings of the top four firms in the broadband industry have not changed since 2014. Sky's ability to increase its relative rank may reflect the impact of bundling its broadband service with pay TV packages, rather than straightforward competition in the broadband space. As we discuss in the next chapter, increased use of bundling has the potential to significantly curtail competition in consumer markets.

The groceries market has gone through three distinct periods since the early 2000s. We believe the groceries sector was relatively competitive in the early 2000s. Asda was able to gain a (modest) market share lead over Sainsbury's and Morrisons overtook the Coop, for example. However, we believe the market became relatively uncompetitive over the period 2004-2014. In part, this may have reflected consolidation in the industry – for example, the acquisition of Safeway by Morrisons and Netto stores by Asda.

The ascent of Lidl and Aldi post-2012 drastically changed the groceries market. Aldi in particular overtook Waitrose and the Coop to become the fifth largest supermarket in the UK in terms of market share. As we discuss later on, this re-introduction of significant competition in the groceries market has benefitted consumers in terms of lower prices.

Figure 7 Ranking of UK supermarkets, in terms of market share

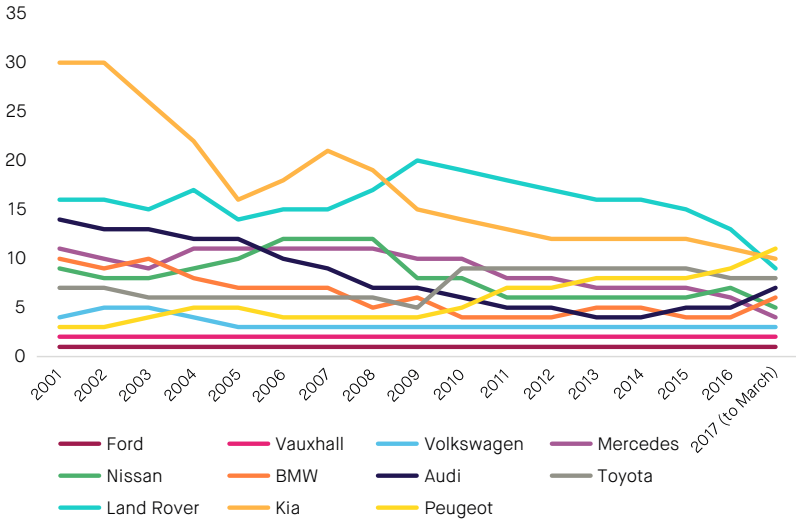


Source: SMF analysis

The car market was the least concentrated consumer market we examined, and it appears to be competitive, with firms regularly changing relative position in terms of market share. While Ford has consistently had the largest market share over the time period covered in our analysis (since 2000), it is a modest proportion of the total car market. Furthermore, companies in the automotive industry regularly gain and lose ranking in terms of market share. For example, in 2001 Peugeot was the third most popular UK car manufacturer in terms of new sales, yet in 2016 it was only the 9th most popular. Kia went from being the 30th to the 11th most popular car brand over this time period, and Mercedes went from 11th to 6th place.

The significant scope for car manufacturers to offer product differentiation, compared with rivals, may be a key reason why this consumer market is so competitive. In markets such as gas, banking, electricity and telecommunications, the scope for product differentiation is much more limited, which may curb the extent to which competition can be effective.

Figure 8 Ranking of selected car manufacturers, in terms of market share for new sales



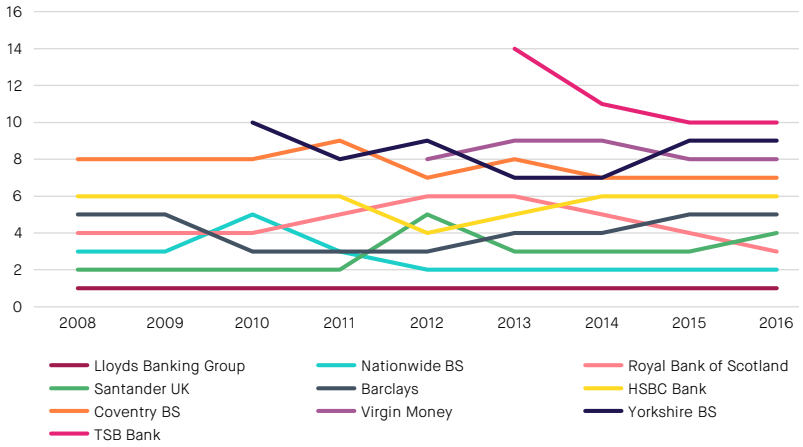
Source: SMF analysis

The banking sector has experienced a series of consolidations since the 1960s, the latest of which include the acquisition of HBOS by Lloyds and the mergers of Abbey, Alliance & Leicester and Santander. As a result, five key players now dominate the retail banking market: Lloyds Banking Group, Barclays, HSBC, RBS and Santander. The recent separation of TSB from Lloyds has led to a marginal fall in the level of market concentration, however the "big five" remain the largest providers of personal current accounts and mortgages.

Advancements in financial technology (fintech) have lowered the barriers to entering the retail banking market and attracting customers, and have resulted in the creation of digital banks such as Starling and Atom, but the majority of these new entrants are currently only able to offer a limited set of products. Further, low switching rates mean that, for now, competition is relatively weak, with the rankings of large players in the industry remaining relatively rigid, in terms of market share.

The mortgage market has performed better than its current account equivalent on our three measures of market concentration. Further, it seems to be a relatively competitive market. Although Lloyds Banking Group has consistently been the largest new mortgage lender over the time period examined (since 2008), there have been variations elsewhere in the top 10.

Figure 9 Ranking of the top ten mortgage providers in 2016, by market share



Source: SMF analysis

Overall, there is a link between the extent to which a consumer market is concentrated and the extent to which it can be regarded as competitive. Where markets are concentrated, the relative position of companies in terms of market share tends to show little variation over time. In contrast, in unconcentrated markets such as the automotive industry we regularly observe companies climbing up and moving down the market share league table.

CHAPTER 3: THE CAUSES OF UNCOMPETITIVE MARKETS

In the last chapter, we showed that several consumer markets in the UK are concentrated, and in some instances very concentrated, with a small number of companies accounting for the overwhelming majority of the market. Further, we showed that markets are often uncompetitive, with new entrants struggling to make significant inroads into consumer markets.

Here, we consider the causes of uncompetitive, concentrated consumer markets, drawing on a range of existing datasets as well as a nationally representative YouGov consumer survey commissioned as part of this research.

1. Barriers to entry in markets

Barriers to entry are likely to play a key role in determining the level of competition that exists within consumer markets.

When the fixed costs associated with entering an industry are high, it can be difficult for a new firm to enter a sector. For example, this is likely to be the case in the telecommunications industry, given the infrastructure requirements for providing such a service. Regulatory compliance costs in the financial services industry also act as a barrier to new entry. In contrast, industries such as retail have much lower barriers to entry.

Government policy creates barriers to entering markets. For example, households have only one choice of water supplier at a local level at present, as a result of the government's policy stance.

However, this need not be the case and government can remove barriers to entry in markets such as water, paving the way for competition in the sector. Since April 2017, businesses, charities and public sector bodies in England have been able to choose their water supplier rather than rely on a supplier with a regional monopoly. Such a water market operates in a similar way to the markets for electricity and gas. There is no reason why the consumer water market could not adopt a similar model.

2. Barriers to scaling up

Another barrier to competition is specific challenges that a new entrant may face in scaling up to a size that enables it to compete more effectively with incumbents.

An example of such barriers to scaling up is regulatory requirements which can often increase significantly as companies get bigger. The costs associated with meeting these regulations can limit the ability or indeed the willingness of firms to expand. In the energy sector, for example, several social and environment obligations take effect when a gas/electricity supplier has 250,000 domestic customers or more, and supplies more than 400 gigawatt hours of electricity or 2,000 gigawatt hours of gas to domestic customers.[3]

Similarly, in the financial services space, licencing and regulatory requirements related to the provision of different products can act as a barrier to expansion.[4] Capital and liquidity requirements, money laundering regulations and consumer protection regulations could also potentially limit the ability of new 'challenger' brands in the financial services industry to scale up.

3. Bundling of goods & services and gateway products

As touched on earlier in our discussion of developments in the telecommunications industry, we believe that another factor impacting the level of competition in consumer markets is bundling of goods and services. A number of telecommunications companies now offer broadband, television and mobile telephony service bundles.

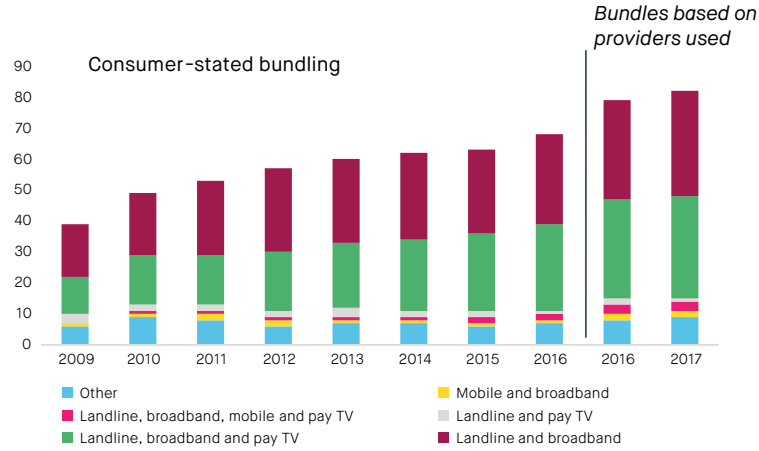
This bundling potentially undermines competition by increasing the frictions associated with switching suppliers. For example, an individual with a broadband and pay-television subscription bundle may have to change their television package in order to change their broadband package. The additional inconvenience that this creates has the potential to "lock in" customers, reducing switching and entrenching the strong market position held by some companies.

Another channel through which bundling may increase industry concentration is through increased entry costs for a company to compete on a level playing field with established firms. For example, a company wishing to truly compete with Sky and BT in the broadband space may now need to have a credible pay TV option in order to be able to win over a significant number of customers. Rather than being seen as distinct markets, consumers may be increasingly viewing broadband, pay TV and telecommunications as one holistic market of telecommunications services.

Survey data from Ofcom provide insights into the prevalence and dramatic growth of bundling with the telecommunications industry. In 2017, just over eight in ten households (81%) are estimated to purchase at least two of their communication services together, from the same supplier.

As Figure 10 shows, a key driver of increased bundling in the telecommunications industry is a strong rise in the proportion of households with landline, broadband and pay TV bundles.

Figure 10 Take-up of bundled services, %



Source: Ofcom Communication Market Report 2017. Note that methodology changes in 2016 and 2017 mean that data are not directly comparable with earlier years. Q. Do you receive more than one of these services as part of an overall deal or package from the same supplier?/ Q. Do you receive a discount or special deal for subscribing to this package of services? (latter question used for "consumer-stated bundling" figures, former for "bundles based on providers used" figures)

Given the frictions to switching created by bundled packages, it is not unreasonable to believe that part of the increased concentration seen in the telecommunications industry is related to growth in the prevalence of bundling.

We believe that bundling of services across a range of consumer markets could become a growing issue in competition policy in the future. With technology firms such as Apple and Google exploring the provision of automotive services, for example, we may start to observe bundled packages accounting for a growing proportion of consumer spending.

Beyond telecommunications, bundling is also seen in the utilities market, with dual fuel tariffs. Dual fuel tariffs, and discounts for using these, may potentially undermine competition in the electricity and gas markets. Research by Ofgem, the energy market regulator, suggests that the majority of domestic consumers are on dual fuel tariffs.[5]

Another factor undermining competition, distinct from product bundling, is "gateway products" – where an individual is more likely to buy something from another supplier from which they already purchase goods and services. This may be the case in the personal current account market, for example, where individuals may be more likely to take out a loan, acquire a credit card or apply for a mortgage from the financial institution they hold a personal current account with.

4. Low switching rates

While low switching rates can simply be a reflection of a lack of choice and competition in a market, they can also be a cause of low levels of competition in an industry. For example, where switching rates are low because consumers are not given the tools they need to find the best products to meet their needs, incumbent companies do not have to work as hard to retain the custom of existing customers. If the time and money costs associated with switching are high, then this can deter effective competition in markets. Low switching rates make it much harder for new entrants to significantly grow their market share.

Switching rates for personal current accounts and utilities, where publicly available data are readily available, are low. Data from Bacs show, as of June 2017, there had been 3.9 million personal current account switches since the introduction of the Current Account Switch Service in September 2013.[6] However, this is a small fraction of the circa 70 million personal current accounts in the UK.[7] Switching data compiled by Ofgem show that only about 15% of gas and electricity customers switched provider in 2016.

Low switching rates in some consumer markets may reflect real and perceived difficulties associated with switching. For example, Ofcom research suggests barriers to switching in the mobile communications sector are significant. Around 2.5 million people who changed mobile provider said they experienced at least one major problem when switching (38%). These included difficulties contacting their current provider (11%), cancelling their service (10%), or keeping their phone number (10%).[8]

While the Current Account Switch Service has made switching more convenient in the financial services industry, false perceptions about the difficulty of switching may be deterring consumers. For example, survey research suggests a significant proportion of individuals (48.1%) do not know if they can switch current accounts if they are using an authorised overdraft, while 14.8% feel unable switch in such circumstances.[9]

YouGov survey evidence commissioned by TSB in July 2017 shows that only 28% of consumers have heard of the Current Account Switch Service – suggesting a broader problem with a widespread lack of knowledge about the service. This is likely to be another factor holding back current account switching rates, especially if existing businesses in the sector are not doing enough to make consumers aware of the benefits of switching.

Policymakers recognise the link between ease of switching and effectiveness of competition in consumer markets, and are taking steps to increase switching rates. In the telecommunications space, for example, Ofcom has this year set out[10] a package of reforms to make it quicker and easier to switch from one mobile phone provider to another. Under the

plans, people and businesses would just have to send a free text message to a provider they wish to leave. Customers would then receive a text back, which includes a unique code to pass on to their new provider who will arrange the switch within one working day. This would mean that mobile customers would no longer have to speak to the provider they wish to leave, which can create barriers to switching, particularly if "hard sell" tactics are employed in a bid to retain customers.

At the same time, however, there is a risk of policymakers intervening in a way that curbs switching in consumer markets. Renewed interest in price caps in the utilities sector[iii] may reduce customer engagement in markets if they believe they are less likely to be paying too much for gas and electricity. Such a policy, while well-intentioned, may end up undermining competition if introduced.

5. Incumbent advantages

Even where barriers to entry and scaling up are potentially quite low, it can be difficult for new entrants to gain a significant foothold in a market. In part, this is due to substantial advantages often held by incumbent large firms in an industry. For example, in the retail sector, incumbent firms have significant supply chain bargaining power, allowing them to purchase goods and services at a lower price than a new entrant to a market. This can make it difficult for a new company to compete on price with a larger firm.

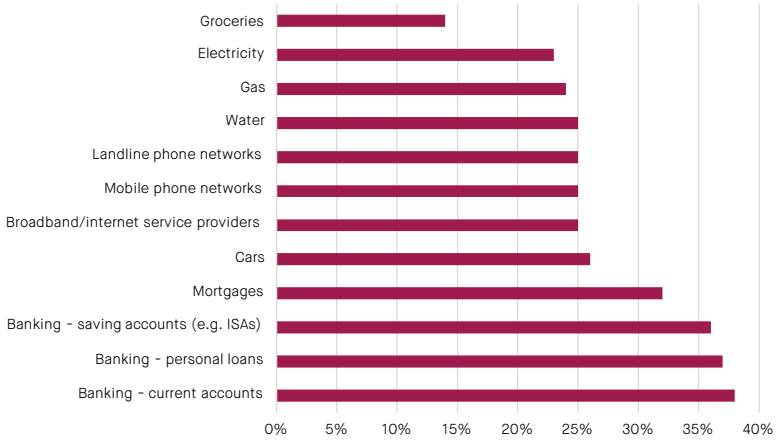
Another advantage held by incumbents is one of information – something that has become increasingly important in an age of information technology and big data. Incumbent companies often hold vast pools of information on customer demographics and behavioural patterns, much of which is private information. This informational advantage can make it harder for new companies to compete.

Trust is also an advantage often held by incumbent firms, whether that be well-deserved or undeserved. New entrants into markets can face an insurmountable challenge in gaining market share if there are widespread

iii For example, as evidenced by a pledge to cap prices in the Conservative Party's 2017 General Election manifesto.

concerns about service quality and safety. YouGov consumer omnibus survey research undertaken as part of this research suggests such concerns are significant, particularly in the financial services sector. As Figure 11 shows, the personal current account market has the highest proportion of consumers (38%) saying they have not and would not use a product or service provided by a company established in the last three years.

Figure 11 % of consumers that have not and would not consider purchasing a product/service from a company established in the last three years



Source: YouGov

The most commonly cited reason for not buying a product or service from a company established in the last three years was concerns over product and service quality, with about half (49%) citing this as a factor.

However, concerns around trust are often unfounded – for example, the Financial Services Compensation Scheme guarantees bank deposits up to a limit of £85,000 per person, per authorised bank or building society, which greatly limits the risks associated with depositing money in a recently established bank. A lack of widespread knowledge of such guarantees may be undermining competition in the financial services sector.

Trust issues with recently established companies are significant among younger age groups. According to the YouGov survey, just under two fifths (39%) of 18-24 years have not and would not consider using a current account provided by a company established in the last three years, higher than the 29% and 31% seen for 35-44 and 45-54 year olds respectively. A significant number of young individuals, perhaps opening a current account for the first time, are therefore likely to opt for an established financial institution over a "challenger" bank. Combined with low switching rates once bank accounts are opened, this can contribute to a lack of competitiveness in the financial services market for consumers.

6. Natural monopolies and network effects

There are some industries where there is an inherent natural tendency towards monopolies or limited competition. For example, rail transport often inherently lacks consumer choice given the challenges associated with having multiple train providers on a given route. The introduction of competition in these instances may actually lead to additional inefficiencies compared with a monopoly situation. As such, Network Rail can be considered a natural monopoly.

Similarly, the Royal Mail distribution network, the National Grid, London Underground and much of the physical telecommunications network can also be regarded as natural monopolies.

The need for standards can also be part of a natural tendency towards uncompetitive markets. For example, the need for computers to network and for users to be able to edit files generated on other computers means that there is a tendency towards monopoly or oligopoly in computer operating systems and software. On social media, there is clear value associated with other individuals using the same platform as you, again creating a drive towards high market shares for a small number of companies. These benefits are what economists refer to as "network effects".

The rise of the digital economy means network effects have become increasingly relevant. This could create huge challenges for governments and regulators in the future, given the ability of network effects to dramatically limit the degree of competition in a market.

7. Uncompetitive sub-markets

Another trend we observe is the existence of sub-markets, where a lack of competitive pressures may be contributing to high industry concentration ratios and in turn worse outcomes for consumers.

One much talked about sub-market is consumers with a low likelihood of switching supplier in the utility market. While "active" market participants readily switch electricity and gas providers when presented with a better deal, a significant proportion of consumers are unlikely to switch even when they are on relatively costly tariffs. The lack of switching limits the ability of new companies to attract customers, curbing competition.

Some sub-markets are uncompetitive because consumers are simply unable to switch providers. A widely-cited example of this is "mortgage prisoners", who are unable to switch mortgage – for example, because they are in negative equity. These individuals can find themselves facing relatively high interest standard variable rate (SVR) mortgages which they are unable to switch out of.

As we discuss in the next chapter of the report, there is clear evidence that, where sub-markets are uncompetitive, companies are able to extract additional profits from some consumers through charging higher prices.

CHAPTER 4: THE CONSEQUENCES OF UNCOMPETITIVE MARKETS

Chapter 2 of this report showed high levels of concentration across a range of consumer markets.

But does market concentration matter? What are the impacts of concentration and a lack of competition on outcomes for consumers? This Chapter seeks to explore the channels through which a lack of competition impacts consumer wellbeing.

We developed a number of hypotheses regarding the potential linkage between industry concentration and competition, and consumer outcomes:

- **Consumer choice impacts** - a lack of competition leads to a lack of choice in goods and services.
- **Customer service impacts** - reduced competition leads to worse customer service.
- **Pricing impacts** - prices are higher when competitive pressures are weaker.
- **Investment and wider economic impacts** - companies invest less in areas such as research & development when competitive pressures are weaker.

The first three of these channels perhaps have the most direct and obvious impacts on consumer wellbeing. Higher prices and poorer customer service have a negative impact on consumer wellbeing, as does restricted choice.

The latter channel has a more subtle impact on consumer wellbeing. A lack of innovation and investment contributes to lower levels of consumer choice. Furthermore, underinvestment in the economy contributes to lower rates of productivity and economic growth, and in turn lower employee wage growth. Cash-hoarding by corporations, rather than investment, also contributes to higher levels of inequality. Ultimately, there is a risk of a lack

of competition generating a "rentier economy" rather than a "competitive economy", with little incentive for large companies to be innovative, offer choice or lower prices.

Impacts on consumer choice

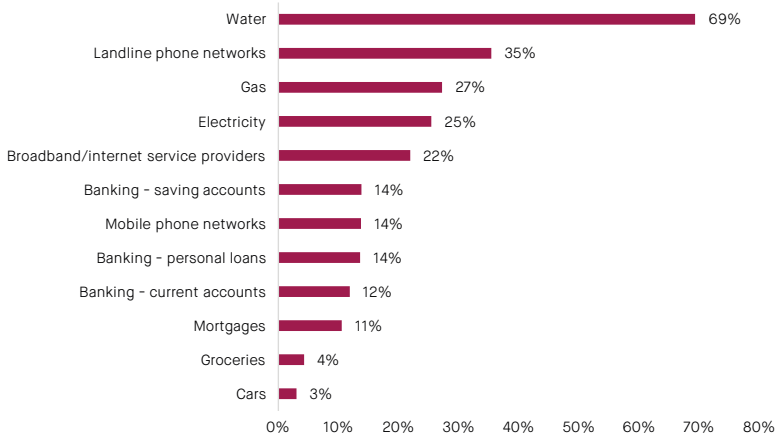
In concentrated markets, consumers may not have access to the diversity of product and service choices than they would like. Indeed, the YouGov survey undertaken as part of this research suggests that this is the case in several markets.

For water, 69% of consumers state that there is no choice or not much choice in the market,[iv] and for landline phone networks just over a third (35%) state this to be the case. This contrasts with just 3% with respect to cars.

While we identified mobile telephony as a highly-concentrated consumer market in Chapter 2, as Figure 12 shows it is relatively middle ranking in terms of the proportion of consumers that believe there is no or not much choice. This may reflect the fact that although there is a relatively limited number of mobile phone networks, each network provides a range of tariffs and phone choices for consumers. Similarly, the groceries market, while dominated by the "big four" supermarkets, is diverse in the sense that each supermarket offers a wide range of products at different price points for consumers.

iv Indeed, this is something of an understatement on the part of consumers, given the presence of regional monopolies in the consumer market (for now). This may reflect a significant proportion of consumers being unaware of the lack of choice available.

Figure 12 Proportion of consumers that believe there is little or no choice in the market



Source: YouGov

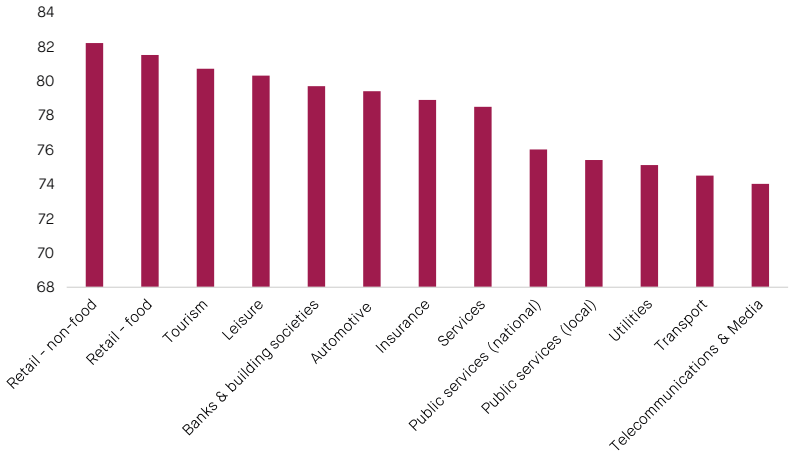
Customer service

One channel through which uncompetitive markets may impact consumer outcomes is through lower levels of customer service and satisfaction. It may be the case that, if a firm knows that its market share is unlikely to be challenged, it feels less obliged to offer a high level of customer service.

The Institute of Customer Service (IOCS) produces a "Customer Satisfaction Index" which provides insights into satisfaction levels in different consumer markets. Two concentrated industries – telecommunications and utilities, rank bottom and third from bottom of the July 2017 index, respectively. Public services, which are often monopoly industries, also rank relatively low in terms of customer service.

While groceries is a moderately concentrated industry, however, food retail has the second highest level of customer satisfaction. This may reflect the fact that, although groceries remain a concentrated industry, it is currently competitive, with a significant degree of price competition taking place between the largest suppliers.

Figure 13 Institute of Customer Service Customer Satisfaction Index, July 2017



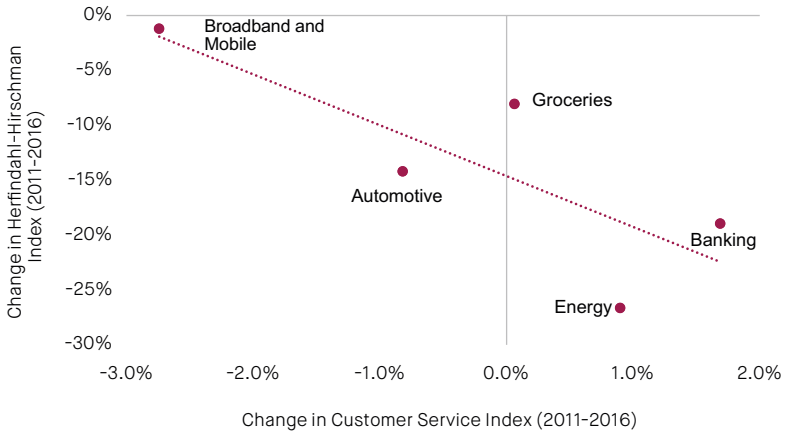
Source: Institute of Customer Service

It is possible that customer satisfaction is relatively low in industries such as telecommunications and utilities because customer engagement is generally infrequent and often for negative reasons. For example, many individuals only contact their utility provider when there is a problem, they want to complain or when they want to leave the supplier for another one – presumably because the alternative offers a superior or better value product. In contrast, consumers engage regularly with the food retail sector, and largely for positive reasons – because they want to purchase goods which improve their quality of life.

Given this, a more insightful comparison may be to look at how customer satisfaction levels in a particular industry have changed over time. In industries where the market has become more competitive, have customer satisfaction levels increased? We find that here, too, there is some evidence of a link between the concentration of an industry and customer service. The less concentrated an industry has become over time, the more likely it is that customer service has improved, everything else held equal. This is shown in Figure 14 which compares the change in the HHI score for different

industries, between 2011 and 2016, with the change in the IOCS Customer Satisfaction Index score over the same time period.

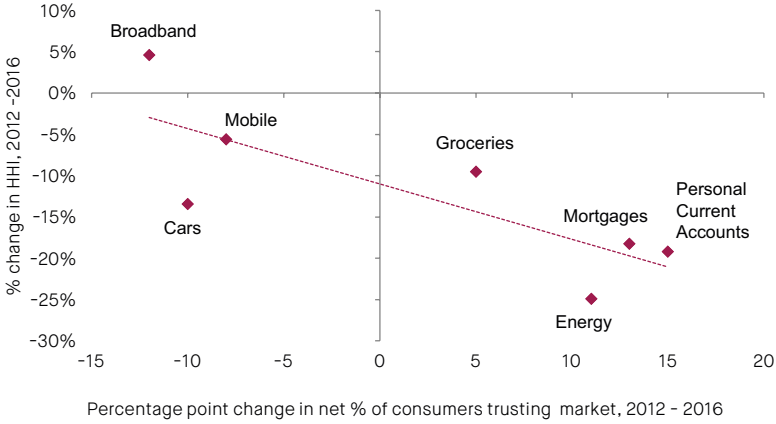
Figure 14 Change in customer satisfaction versus change in industry concentration



Source: SMF analysis, Institute of Customer Service. HHI for "broadband and mobile" is a simple average of the two categories, and the HHI for energy is a simple average of the HHI for electricity and gas.

Furthermore, we also identify a link between how industry concentration has changed over time and how consumer trust in a given market has changed, drawing on time series data on trust compiled by Which?[11] The more industry concentration has declined, the more likely it is that consumer trust has increased. The car industry appears to be something of an outlier here, possibly reflecting the impact of the diesel emissions scandal on trust in the industry.

Figure 15 Change in consumer trust versus change in industry concentration



Source: SMF analysis, Which?

As ever with this kind of analysis, we attach a health warning: correlation does not necessarily imply causation. Many factors impact on customer satisfaction and trust levels, such as pricing dynamics and changes in wholesale costs, prevailing economic conditions and sector-specific events such as the financial crisis and the automotive emissions scandal. Isolating the changes in customer satisfaction and trust solely attributable to changes in market concentration is not possible with the data we have available. Nevertheless, intuitively we expect a link between competition and customer satisfaction, and the available data are indicative of such a link existing.

Pricing impacts

Another channel through which competition impacts consumer outcomes is likely to be price. In a more competitive market, we can expect prices to fall closer into line with the costs faced in an industry, as businesses attempt to capture market share from incumbent players. In concentrated industries, we are more likely to see higher profit margins as businesses have the market power to be able to charge fees well in excess of the costs that they face as a company.

Data back this up, with a number of examples of concentrated industries seeing price rises in excess of what cost pressures would suggest. In addition, there are examples of instances in which increased levels of competition in an industry have contributed to lower prices for consumers. Existing cross country studies also point to a link between industry concentration and the prices faced by consumers.

The personal current account market

As discussed in Chapter 2, the personal current account market became more concentrated following the financial crisis, reflecting consolidation in the banking industry. While there have been a small number of new entrants in recent years, the market remains more concentrated than before the crisis.

Arguably, increased competition in the current account market has contributed to better outcomes for consumers. The net revenue achieved by banks, per main current account, fell from £230 in 2011 to £177 in 2014 (in 2014 prices)[12]. Interest payments to customers increased from £9 to £18.

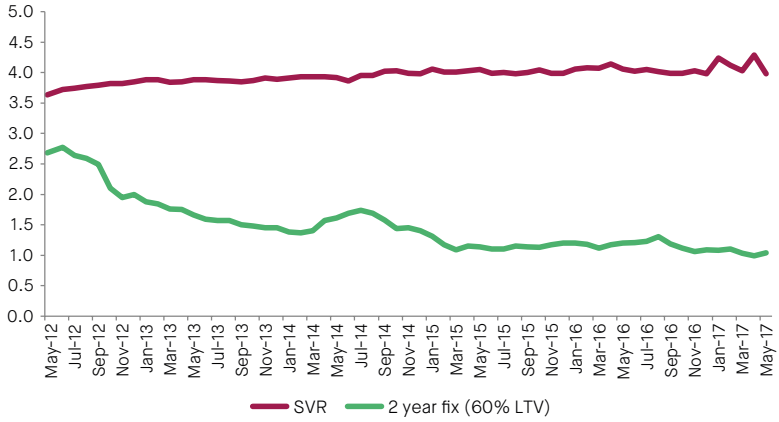
Given that the current account market remains relatively uncompetitive, and recent declines in industry concentration have not brought the market back to pre-financial crisis levels of concentration, substantially greater benefits could be achieved for consumers if the market were to become truly competitive.

Mortgages

Another example of how increased competition has reduced prices for consumers is the UK mortgage market. Bank of England data show a significant decline in fixed mortgage rates over the past five years. This decline in rates can in part be attributable to a significant "mortgage price war" with financial services companies competing to win over customers.[v]

v See, for example, Financial Times (29th November 2014), "Banks Fight Back in Mortgage Price War" and the Times (15th July 2017), "Banks Head for Mortgage Price War"

Figure 16 Average mortgage rate – spread against the Bank of England base rate, %



Source: Bank of England

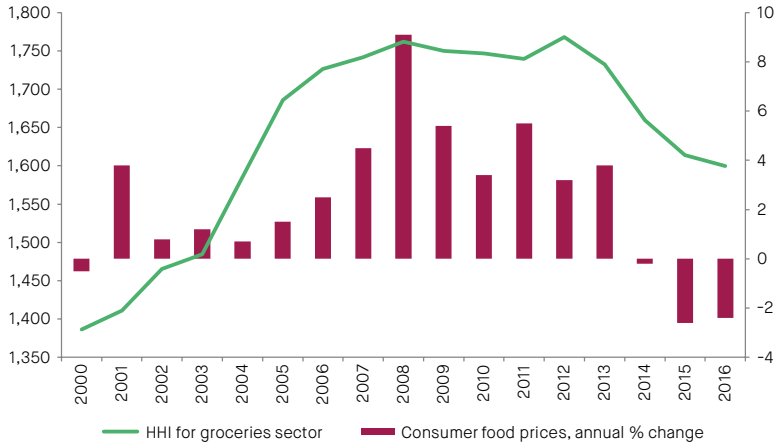
While this is a sign of a competitive market providing good outcomes for consumers, it is important to note that the entire mortgage market is not competitive. In particular, the market of customers with a low propensity to switch and "mortgage prisoners" (such as those in negative equity) is relatively uncompetitive, which in turn has negative consequences for consumers. Because mortgage switching rates are low for these demographics, these consumers are more likely to find themselves on higher interest standard variable rate (SVR) mortgages once their fixed interest terms come to an end. The lack of competitive pressures in this element of the market has probably contributed to a situation in which SVRs have not declined during the recent mortgage price war, as Figure 16 shows.

Groceries

Recent developments in the food retail sector highlight the positive impact that competition can have on outcomes for consumers. Growing competition from discount chains Aldi and Lidl led to a significant supermarket price war, with 2014 seeing the first annual decline in consumer food prices since 2000, according to Office for National Statistics data. Prices fell further in 2015 and 2016.

As Figure 17 shows, there appears to be some link between concentration in the grocery market and the level of food price inflation seen. The recent decline in industry concentration, reflecting effective competition from discount supermarkets, contributed to a decline in food prices. While many other factors, such as wholesale food prices, impact consumer prices, a link with industry concentration seems undeniable in this instance. The much commented-on price war between supermarkets was a key contributor to the decline in food prices seen from 2014 to 2016.

Figure 17 HHI for groceries (left-hand axis) and annual change in consumer food prices, % (right-hand axis)



Source: ONS, SMF analysis

Telecommunications

Cross-country evidence suggests a link between market concentration and pricing in the telecommunications industry. Where markets are more concentrated, prices faced by consumers tend to be higher.

This was explored by Ofcom, the communications market regulator, in its consideration of the impact of a possible merger between O2 and Three. Such a merger would have increased concentration in an industry which is already dominated by a handful of suppliers.

Ofcom noted that Three had been acting successfully as a "disruptive operator" in the mobile communications space, challenging more established firms through innovation and low prices.[13] Ofcom analysis of mobile prices in 25 countries found that prices are on average 10-20% lower in markets with four operators and a "disruptive" player, compared to markets in which there are only three established networks.

As such, there are reasons to expect increased market concentration to lead to poorer value for consumers. Ofcom noted that in Austria, following a merger of mobile communication companies, prices climbed 15%, and by 30% for less "digitally engaged" customers who only make calls and send text messages.

In the UK, less digitally engaged customers with landline-only contracts have also seen substantial increases in prices in recent years. As shown in Chapter 2, the landline-only market is highly concentrated, with BT having a market share of about 80%. Ofcom research[14] shows that 43% of landline-only customers are over the age of 75 and 35% are from lower-income households. 70% have never switched provider.

The lack of competitive pressures in the landline-only space means there have been few incentives for companies to compete on price. Ofcom analysis shows that while wholesale costs of providing a landline service fell by 26% in real terms in recent years, line rental charges faced by consumers increased by 25-49%.[15]

Low switching rates in the utilities market

Understanding the extent to which market concentration in the energy market is impacting consumer prices is difficult. Announcements of energy price rises often trigger accusations of excessive profiteering among energy companies, especially if these occur at times of declining wholesale prices. However, such profiteering is difficult to prove. The costs faced by utility companies extend beyond wholesale energy prices, and the role of forward contracts means the spot wholesale prices are not necessarily indicative of prices faced by firms.

Having said that, the Competition and Markets Authority has indicated that the profit margins in the energy industry are too high and that the "appropriate" profit margin for suppliers, given the value they add to the market, should be about 1.25%.[16] In contrast, Centrica's UK Home profit margin, after tax, stood at about 5% in the five financial years up to and including 2016.[17]

In a more competitive market, we would expect more energy price competition and consequently a decline in profit margins towards the CMA's ideal of 1.25%.

While new entrants and reduced concentration in the energy market have driven down the cheapest fixed rate tariffs available, the gap between the cheapest tariff and the average standard variable tariff of the "big six" energy companies has widened significantly since 2014.[18] As with mortgages, this appears to reflect an uncompetitive submarket of customers who do not actively switch to better deals in the market. While competitive pressures have reduced fixed tariffs faced by customers who are more engaged with the energy market and switch supplier or product, pressures for companies to reduce standard variable tariffs are much weaker. Many of those on these tariffs are unlikely to switch supplier even in the presence of better deals elsewhere. Many consumers on standard variable tariffs may be unaware of the size of the financial gains they could realise from switching supplier or product, possibly reflecting a lack of transparency around energy tariffs compared with some other consumer markets.

Wider economic impacts of concentrated markets

A more subtle way that levels of competition can impact on consumer outcomes is through its impact on the wider economy – most notably in terms of lower levels of investment and innovation, and in turn lower levels of job creation, wage and productivity growth. Further, there are distributional consequences associated with a lack of competition in markets, if it translates into "excessively" high profit margins for business owners.

While profits are a key part of the economy, encouraging innovation and dynamism, excessive levels can be a sign of a lack of innovation and dynamism. As the Economist magazine recently noted in an article about the US corporate environment, "they can signal the existence of firms more adept at siphoning wealth off than creating it afresh … if companies capture more profits than they can spend, it can lead to a shortfall of demand."[19]

In the UK, cash reserves of non-financial corporations stood at a record high level of £660bn in 2016, according to ONS national accounts data. While annual business investment stood at 58% of cash reserves in the year 2000, this more than halved to 27% in 2016. Subdued rates of investment in turn suppress economic growth – leading to worse outcomes for consumers.

While the accumulation of cash reserves and subdued rates of investment reflect a wide range of factors, not least concerns over the UK's long term economic prospects, it is possible that in some sectors cash accumulation reflects a lack of competitive pressures to increase investment. We note that, in the highly concentrated telecommunications industry, ONS data show the sector went from having the fourth highest research and development (R&D) spend in 2007, to the 10th highest in 2015. Between 2014 and 2015 R&D spend in the telecommunications industry fell by £134 million (14%), the largest decrease among the sectors considered by the ONS.

Increased competitive pressures in concentrated consumer markets could play a significant role in translating corporate cash reserves into business investment, given that companies wishing to preserve market share would need to increase spending on product innovation and quality. Consumers would benefit from such business investment through a wide range of channels, including more product choice, higher product quality, as well as the higher wages associated with a more productive economy.

CHAPTER 5: CONCLUDING REMARKS

Some of the most widely-used and important consumer markets in the UK are dominated by a small number of large firms. This has consequences for consumers. The findings in this research show that a lack of effective competition can translate into higher prices, poorer customer service, less choice and possibly lower rates of investment and innovation in the wider economy.

Encouragingly, some consumer markets have become less concentrated in recent years. New entrants in the energy and banking sectors are contributing to a more competitive market. For "active" customers that are willing to switch away from established firms, this is creating tangible consumer benefits. Cheaper energy tariffs are now available due to greater competition. Competitive pressures have increased the average interest customers receive on personal current accounts, though we note that the current account market remains notably more concentrated than before the financial crisis.

Having said that, the majority of the markets considered in this research remain concentrated. Of the 10 markets examined, only two – cars and mortgages - were not "concentrated" last year, on the Herfindahl-Hirschman measure of market concentration. Broadband and telephony are highly concentrated consumer markets.

The causes of market concentration are numerous, including barriers to entry and scaling up, low switching rates and incumbent advantages.

We believe that two drivers of market concentration – bundling and networking effects – will be of increasing importance in the future, creating new and growing challenges for policymakers in their efforts to create more competitive markets. We have seen substantial growth in product bundling in the telecommunications space, with several companies offering pay TV, broadband and mobile telephony bundles. By "embedding" consumers in a company, bundling can deter switching to new entrants in an industry. Bundling is likely to become a growing competition issue in the future, with

tech companies such as Apple and Google expanding into new areas such as automotives. We may also see an increased tendency towards bundling in the financial services sector, as banks attempt to retain customers.

Network effects are increasingly important given the rise of internet-based services. The benefits of using the same platform as others when it comes to software and social media means that these consumer markets are very highly concentrated. The high profits and near-monopoly position of some tech companies is likely to be one of the greatest regulatory challenges of the 21st century, especially given the transnational nature of these companies which means that cross-country collaboration would be needed to create more effective competition.

Building trust remains an ongoing challenge for new entrants into markets, with survey research showing consumers particularly reluctant to use unknown brands in financial services. This is despite significant deposit guarantees that exist to protect UK consumers – suggesting that households are overestimating the risks of using a new bank over an established firm. This may reflect a lack of knowledge about deposit guarantees.

What should be done about a lack of competition in consumer markets? This is something we turn to in the second part of this research, to be published later this year or in early 2018. Ultimately, given varying trends across consumer markets, a one size fits all solution is unlikely to work, though this study identifies some common trends across markets which may justify far-reaching policy interventions. We will explore this in detail in our second report.

APPENDIX: DATA SOURCES

To calculate the concentration and competitiveness measures, we have drawn on a number of data sources, documented the table below:

Table 1 Market share data sources

Consumer market	Market share data sources used in analysis
Automotives	Department for Transport data on new car registrations
Groceries	Market share data collated by fooddeserts.org, owned and hosted by Dr Hillary J Shaw (London School of Commerce) and Dr Julia J A Shaw (De Montfort University) Kantar Worldpanel grocery market share data
Broadband	Ofcom Communication Market Reports, 2004-2016
Mobile telephony	Ofcom Communication Market Reports, 2004-2016 Ofcom "award of the 2.3 and 3.4 GHz spectrum bands", 2017
Landlines	Ofcom, "the review of the market for standalone landline telephone services, provisional conclusions", February 2017
Electricity	Ofgem electricity supply market shares by company
Gas	Ofgem gas supply market shares by company
Personal current accounts	Independent Commission on Banking (ICB), "final report recommendations", 2011 Office of Fair Trading (OFT), "review of the personal current account market", 2013 British Bankers Association, "promoting competition in the UK banking industry", 2014 Competition & Markets Authority (CMA), "personal current accounts: market study update", 2014 Competition & Markets Authority (CMA), "retail banking market investigation: final report", 2016
Credit cards	*Financial Conduct Authority (FCA), "credit card market study: interim report", 2015* *Independent Commission on Banking (ICB), "final report recommendations", 2011*
Mortgages	*Council of Mortgage Lenders market share data for new lending*

The time period covered by these data sources varies, and in some instances we have been unable to acquire data for every single year. We have endeavoured to provide the most comprehensive picture of concentration and competition in consumer markets, given the data available. Where we have been unable to find data, we have sometimes interpolated between data points, or extrapolated.

ENDNOTES

1. TSB “Competition Matters” booklet - http://www.tsb.co.uk/competitions-booklet.pdf
2. https://www.ofcom.org.uk/about-ofcom/latest/media/media-releases/2017/bts-landline-only-customers-set-for-cheaper-bills
3. https://assets.publishing.service.gov.uk/media/576bcb6140f0b652dd0000ac/appendix-8-1-social-and-environmental-obligation-thresholds-fr.pdf
4. See, for example, OFT (2010), “Review of Barriers to Entry, Expansion and Exit in Retail Banking”
5. Ofgem (March 2014), State of the Market Assessment
6. Bacs, Current Account Switch Service Dashboard
7. Competition & Markets Authority (July 2014), “Personal Current Accounts – Market Study Update”
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Concentration not competition: the state of UK consumer markets

Competitive markets are powerful forces which greatly improve the wellbeing of consumers. Firms, vying for greater market share, innovate to drive down prices and improve the quality of goods and services on offer.

This report sheds light on the state of consumer markets in the UK, exploring the extent to which they are “competitive”. It also considers how market concentration has changed over time, and examines the impact this is having on consumers.

Worryingly, the research shows that many consumer markets are not even close to being competitive, falling far short of the “free market” ideal. All too often, consumers face concentration, not competition. This is leading to higher prices, poorer customer service and restricted choice, to the detriment of UK households.

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