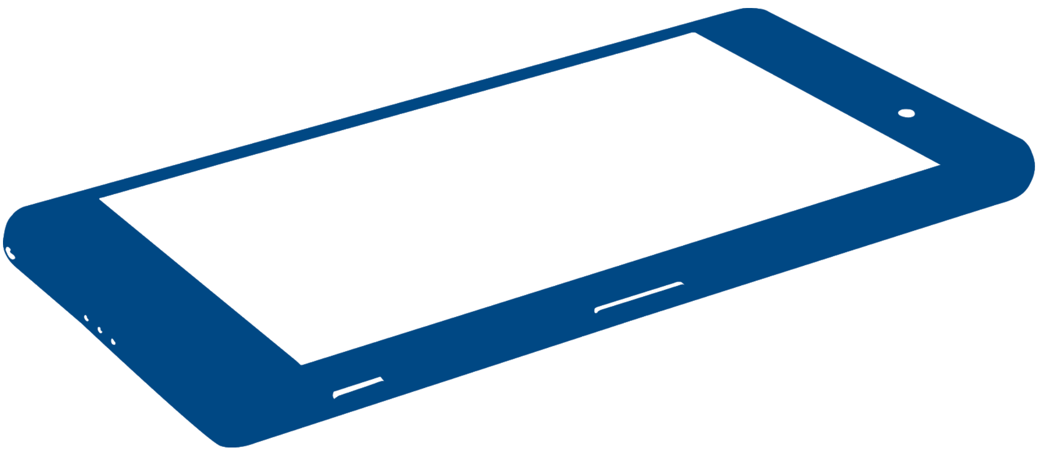
Reviewing Bundled Handsets

How the handset loyalty penalty and lack of price transparency affect consumers



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Summary

Today, most of us sign up to a mobile phone contract that includes the cost of the handset too. This model - high value hardware bundled with a service contract - is almost unique across all consumer markets. Bundling can offer benefits, such as allowing consumers to spread the cost over time, but it also has two major drawbacks.

The first problem - **the lack of price transparency** - arises before consumers sign a contract. By blurring the cost of the phone and data allowances, handset-inclusive contracts make it hard to know what the best deal is. Our research shows that in three quarters (73%) of cases it is cheaper to buy a handset and data separately. But most (55%) consumers who have bought their phone as part of a bundled contract believe that their route is usually *cheaper.* The lack of transparency means that millions of consumers are overpaying.

The second problem - **the mobile handset loyalty penalty** - occurs at the end of the minimum contract period. Consumers who do nothing continue to pay the same original price, despite no longer benefitting from a new handset. 1 in 3 bundled contract consumers go beyond their minimum contract period, equivalent to 4 million people. On average they spend 6 months beyond their minimum contract and face a loyalty penalty of £22 a month. This means that **consumers overpaid by £490 million on their last mobile phone contracts**.

Ofcom has identified the detriment in this sector and is currently consulting on proposals to mandate providers to notify all consumers before the end of their minimum contract period. As part of this process:

- **Ofcom should strengthen its current proposals** by:
    - Requiring providers to send more than 1 notification.
    - Collecting and publishing data on the number of consumers beyond the minimum contract period by each provider.

But notifications and information alone will not be enough to end these consumer problems. Since we reported on the handset loyalty penalty in October 2017, the 3 major providers still relying on bundled contracts have not shown signs of fundamentally addressing the underlying problems. So:

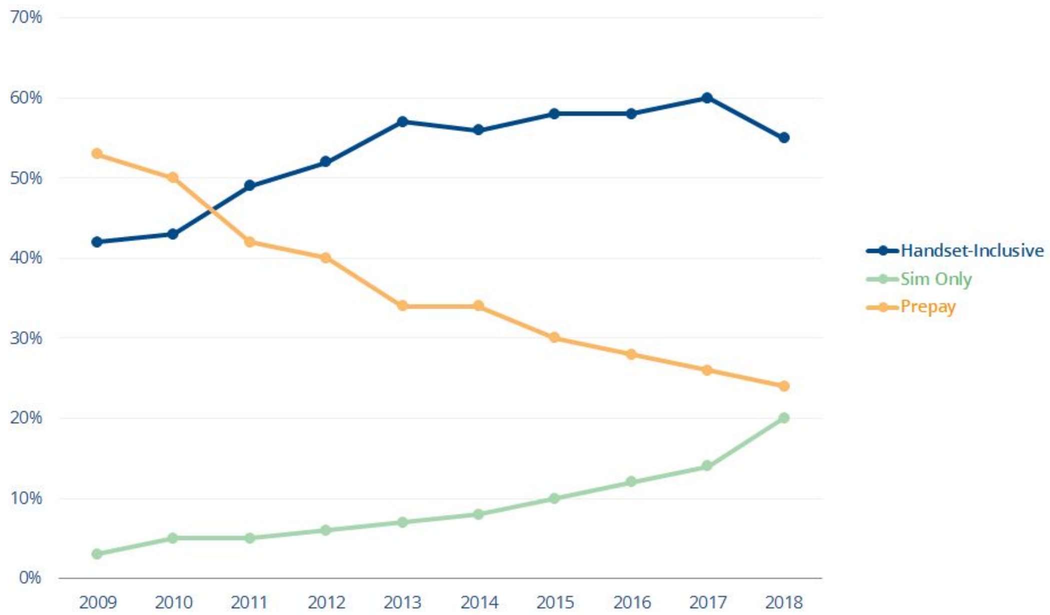
- **EE, Three and Vodafone must stop charging for handsets at the end of the minimum contract period and should provide clearer pricing information**. The split contract model that is already used by other providers in the market can achieve both of these objectives.
- DCMS has been clear that this practice must stop. **The government must intervene if industry cannot develop its own solutions.**

Introduction: The Mobile Market

Smartphones have gone from being a luxury product to being an essential part of everyday life in an incredibly short period of time. Almost 8 in 10 (78%) of us now own a smartphone compared with just 27% in 2011.[1] And in 2017 they overtook both laptop and desktop computers combined as consumers' most important internet connected device.[2]

This rapid growth was possible partly because consumers do not have to pay the full price of devices upfront. Instead they can effectively spread the cost by taking a mobile contract which includes a handset.[3] These handset-inclusive deals grew in popularity as smartphones replaced less expensive 'feature phones', and are currently the most common type of mobile contract.

Fig 1. Handset-inclusive contracts dominate the UK market
UK consumers main phone contract type 2009-2018



Source: Ofcom Technology Tracker 2009-2018

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[1] Ofcom started collecting this in 2011. See Ofcom, Communication Market Report: UK, 4 August 2011. Latest figures from Ofcom, Nations and Regions Technology Tracker H1, April 2018.
[2] 48% listed their mobile phone as their 'important device for internet access' compared to 24% listing laptops and 9% listing desktops. Ofcom, Communications Market Report, 2 August 2018.
[3] International comparisons prove that handset bundling is an important factor in encouraging smartphone take up. In 2006 Finland, which initially banned the bundling of handset and mobile services, had a level of 3G penetration of just ⅓ of the European Union average. After the ban was removed smartphone take up accelerated, to the point were Finland became a EU leader. See Natural Experiments in Mobile Phone Regulation: Estimated Effects of Prohibiting Handset Bundling in Finland and Belgium, 24 May 2014.

Most handset-inclusive deals in the UK are ***bundled*** contracts, which do not distinguish between the phone and the mobile service.[4] The consumer signs a single agreement and pays a single price for both elements of the service. The phone is supplied as part of the package, but there is no information on how much of the monthly bill goes towards the phone. However, these tariffs are clearly designed so that networks can recover the cost of the phone, and both networks' and third party retailers' sales materials concentrate heavily on the handset element.[5]

These deals are an unusual way to buy consumer goods. In other sectors where essential products are paid for in instalments - such as boilers, cars and houses - the transaction is a form of borrowing and the contract supplied is a credit agreement. In other cases where hardware is provided as part of a service contract - such as broadband routers - the products tend to be low value compared to the cost of the overall contract and are often only available from the service provider.

The conflation of service and handset costs can have unfortunate effects for consumers. First, since the contract does not set out a specific price for the phone, there is no point when it is clear that that price is paid off. The consumer therefore continues to pay the handset-inclusive price for as long as they stay in the same contract. Second, the opaque nature of the pricing makes it extremely difficult for consumers to compare the cost of handsets across the market.

In recent years several providers have started alternative ***split contract*** deals, where consumers sign separate agreements for the handset and mobile service elements. The handset element is a consumer credit agreement - a loan for the cost of the phone - which is paid off within an agreed period of time. This arrangement addresses the 2 problems above: the phone has a clearly stated price and once that has been paid consumers' bills automatically go down.

However, networks offering these split contracts currently only make up a minority (37%) of the consumer market and split contract packages are not available to all of their customers.[6] For instance, in our knowledge it is not

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[4] These deals are often called 'Handset Subsidized' contracts in academic literature and official documents. However, as the OECD has said, since "the costs to operators are likely to be fully recovered, with payment simply made over time rather than upfront, it is questionable whether subsidy, in its general usage, is the correct term to be applied." (OECD, Mobile Handset Acquisition Models, 2 July 2013) . We therefore use the more neutral term 'Handset-inclusive' to refer to all deals which include both a mobile phone and service contract.
[5] Citizens Advice, Hung up on the Handset, 1 April 2016
[6] QM2. *Which Mobile Phone Provider do you use most often?* In Ofcom, Nations and Regions Technology Tracker H1, April 2018; Networks only make split contracts available to people who

possible to enter into a split contract through a third-party retailer. Nevertheless, we don't know how many of O_2, Sky, Tesco and Virginmedia's customers are on bundled contracts. We therefore excluded all of their customers from our analysis. In reality, of course, many customers of these providers will also be overpaying.

Table 1. 3 of the 4 largest providers still rely on handset-inclusive contracts

	Bundled Contracts	**Split Contracts[7]**	**Other[8]**
Providers (% of consumer's main phone[9])	Three (10%) Vodafone (14%) EE (25%) / BT (2%)	O2 (22%) Sky (1%) Tesco (8%) Virginmedia (6%)	GiffGaff LycaMobile Legacy brands
Total %	52%	7%	12%

Over the last year both Ofcom and Government have started to consider whether to intervene on the issue of bundled contracts. In particular they have focused on the issue of overpayments, where inertia leaves millions of consumers still paying for a handset that they have already paid off. As part of Ofcom's programme of work on consumer engagement, it is examining the issue of mobile customers continuing to pay the same price after the end of their minimum contract period, where this price reflects the cost of their mobile handset.[10] It is considering appropriate next steps and engaging with industry. Ofcom has recently published a consultation on end of contract and out of contract notifications.[11] Government ministers have also stated their opposition to the handset loyalty penalty.

> *"No one should continue to pay for a product that they have already paid off."*[12]
>
> Margot James, Digital Economy Minister

buy their contracts directly either online or on person. Bundled contracts with all the main networks are still available from third party retailers.

[7] It is not currently possible to enter into split contracts through third parties (eg. Carphone Warehouse), therefore some customers of O2, Virginmedia, Tesco, and other providers that offer split contracts, will not be on split contract deals.

[8] Lycamobile only supply SIM-only contracts (phones can be bought outright). Giffgaff allows consumers to apply for separate financing. Legacy brands such as Orange and T-Mobile (now EE) tended to supply bundled contracts, but have not been included in the analysis as the many of their remaining customers will have taken out deals before the beginning of the smartphone era.

[9] Ofcom, Nations and Regions Technology Tracker H1, April 2018, *Which mobile network do you use most often?*

[10] Ofcom, Helping consumers to engage in communications markets – Update on next steps, 27 April 2018

[11] Ofcom, Consultation on end-of-contract and out-of-contract notifications, 31 July 2018

[12] Hansard, Mobile Phone Contracts, 16 January 2018

"It's only right that mobile customers should be notified when they have paid off the price of their handset, and that their future bills should reflect this. I welcome Citizens Advice's call for better billing information for consumers, and hope that providers will now take the initiative by clearly separating the cost of handsets and tariffs in mobile contracts."[13]

Matt Hancock, at the time Secretary of State for DCMS

This report sets out the consumer harm we have identified and considers potential solutions. Chapter 1 shows that bundled contracts make it hard for consumers to work out the true cost of paying for a handset on contract, and may lead to consumers paying more than necessary for both their handset and their mobile services. Chapter 2 describes the handset loyalty penalty, which occurs when consumers who do not switch immediately at the end of their contract continue to pay towards their phone, despite this no longer being necessary. The final chapter considers solutions, some of which have already been implemented by some providers, such as end of contract notifications and the split contract model.

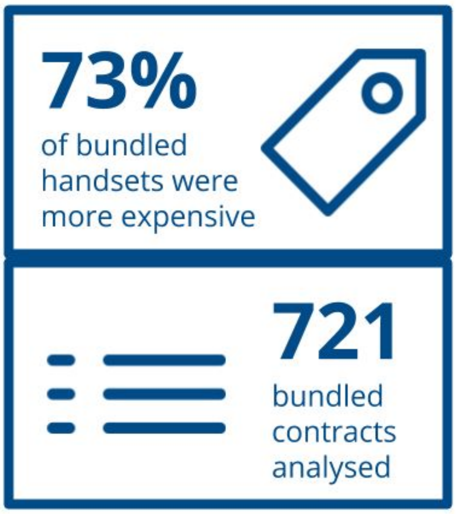
[13] BBC, Mobile companies overcharging customers after contracts end, 20 October 2017

Chapter 1: Bundled contracts make costs unclear

Buying a phone on contract is a significant financial investment. According to Ofcom the average handset-inclusive service costs £35 per month.[14] The overwhelming majority of these contracts will last for 2 years, meaning consumers signing up to a new phone contract are making a commitment to pay on average at least £840. Contracts including the most high end, up to date phones and largest data allowances can end up costing over £2,000 in total.

Buying a handset-inclusive contract also requires a significant time commitment and is a complicated decision. Price comparison service BillMonitor claims to compare over 1 million different available mobile contracts.[15] And this doesn't include consumers' other options to buy their handsets outright from electronics retailers and manufacturers, or second hand.

In the majority of cases, purchasing a new phone on contract is more expensive than buying it outright and pairing it with a SIM-only contract. In our analysis of 721 different bundled contracts, we found that consumers would pay more in almost 3 out of 4 (73%) of cases.



This does not necessarily make all bundled contracts a bad deal: it is usual to pay more to buy products in arrears and many consumers will value the ability to spread their payments. But these additional costs need to be clear if consumers are to make informed choices about whether this is the right purchase method for them.

[14] Ofcom, Pricing Trends for communications services in the UK, 17 May 2018
[15] Billmonitor, www.billmonitor.com/how-it-works, Accessed 5 September 2018

Bundled contracts do not set out the cost of the handset

A defining characteristic of bundled deals is that they make no distinction between the cost of the airtime service (minutes, SMS, and data) and the cost of the phone. The consumer makes a single payment every month, which covers both elements of their deal. Nowhere, in either the up front advertising or the terms and conditions, is there any indication of what proportion of the bill is paying for the service and what proportion is paying for the handset.[16]

One exception to this is the upfront charges which are sometimes required when purchasing contracts which include the more expensive phones. Most providers refer to this charge simply as an upfront cost, but other networks, third party retailers and price comparison sites explicitly call it the 'phone cost' and some even refer to a handset available without any upfront payment as 'free'.[17]

However, these 'upfront' costs are clearly vastly smaller than the actual amounts consumers will pay for the handset. For instance, in the example below a network is selling an iPhone X (64GB) with a 25GB data contract for £82.99 a month after an initial payment of £9.99. The same network sells a 30 GB SIM-only data contract for £24.99 a month, £58 less than the handset-inclusive price. This means that over 24 months a consumer will pay £1,401.99 in order to purchase a new phone alongside their airtime contract.

Table 2. Illustrative example of additional cost

	Upfront/ 'Phone' Cost	Monthly Cost	Total after 24 months	Estimated Handset Cost
Bundled Contract	£9.99	£82.99 (25GB)	£2,001.75	£1,401.99
Handset + SIM-only	£999.99 (RRP)	£24.99 (30GB)	£1,599.75	£999.99

This sum is not only much larger than the £9.99 'phone cost', but also substantially more expensive than recommended retail price of the phone. In fact over 2 years a consumer buying an iPhone X through this contract will pay

[16] Some do however include a 'total contract price' which includes upfront costs and the monthly payments over 2 years.
[17] EE website refers to both the 'upfront' and 'phone' cost at different points in the purchase process. USwitch's comparison tables refer to 'free phones'. The retail sites *Mobile phones direct*, *Affordable Mobiles*, *Mobiles.co.uk*, all refer to either a 'phone cost' or 'a free phone'.

£402.99 more than if they bought the phone upfront and paired it with an equivalent SIM. This is the equivalent cost of taking out a 35% APR loan over 2 years to pay for the phone.[18]

You cannot predict how much extra buying a phone on contract will cost

As stated above, in the overwhelming majority of cases buying a phone on contract will cost consumers more than the RRP of the handset. However, crucially, these costs are not predictable. How much extra (if anything) a consumer pays varies considerably depending on precisely which contract they choose.

For instance, as the graph below shows, there is almost no correlation between the RRP of a handset and how much more expensive it will be on a contract. Although the newest and highest value phones have a greater tendency to cost more on contract than older and cheaper phones, the scale of this difference varies considerably. An iPhone X can cost up to 82% (£942) more than the RRP or 5% (£57) less depending on the contract chosen. Similarly there are no discernable patterns between networks, or handset manufacturer.

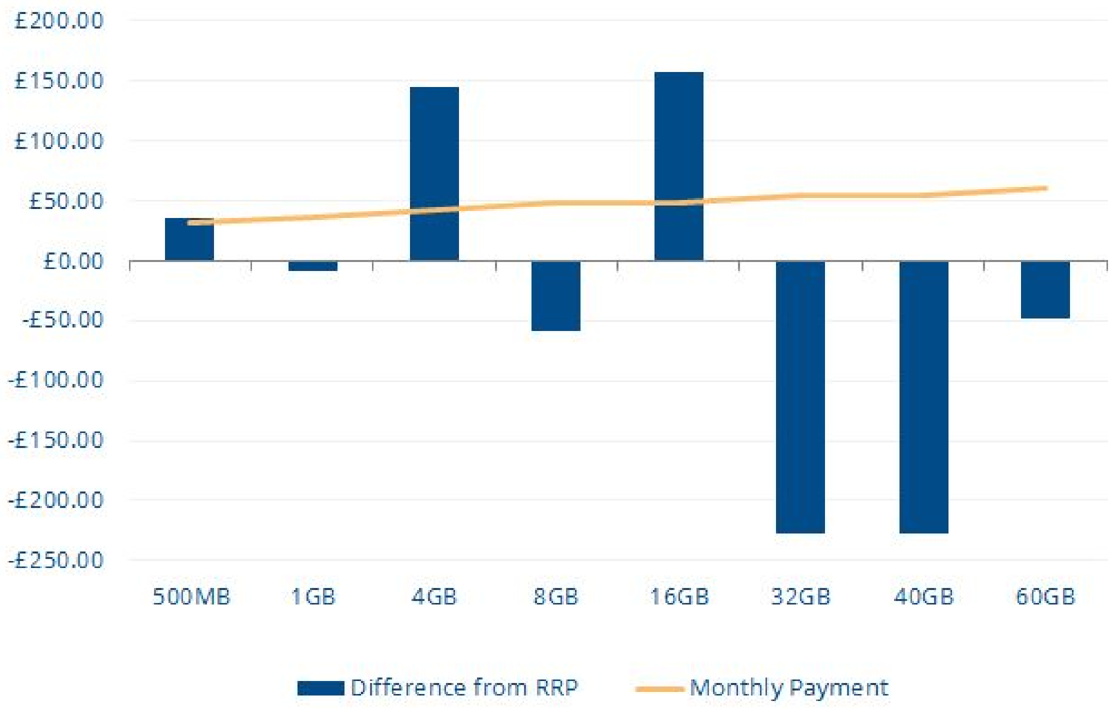
Fig 2. There is little correlation between handset RRP and the additional cost of buying bundled contracts

Cost difference for buying phone through a bundled Contract

[18] Based on borrowing £999.99, repaid in 24 monthly installments of £58.

This high level of variance even applies when a consumer is only considering plans including the same handset from the same provider. The example below shows the cost of seven different contracts from a major network including the iPhone 7. Depending on the amount of data they choose a consumer could pay up to £157 more than the RRP of the phone (with 16GB data), or £227 less (with 40 GB of Data).

Fig 3. The effective cost of the handset varies significantly with data
Cost to consumer of contract including iPhone 7 over 24 months



This high variance means that costs are not only unclear, but there are also no reliable generalisations consumers can use to navigate the market. This is a problem as it is well established that consumers rely on such rules of thumb to navigate complex markets.[19] The alternative - conducting a detailed market wide comparison as we have here - is simply too time consuming and complicated for the majority of consumers, who dedicate an average of just over 8 minutes per week to consumer decisions in *all* essential regulated markets.[20]

Our polling also showed that even the one simple rule that can be identified - that it is generally cheaper to buy a phone outright than through bundled contracts - is not widely understood. When we asked respondents which method

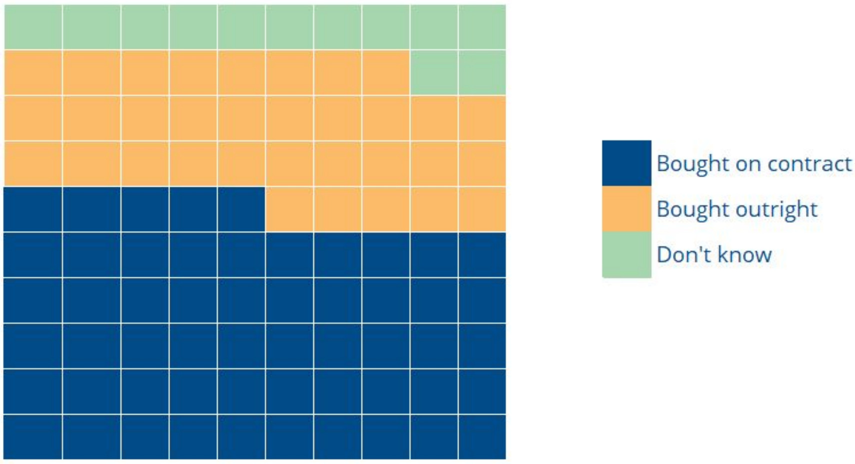
[19] The Behavioural Insights Team for Citizens Advice, Applying behavioural Insights to regulated Markets, 26 May 2016
[20] Our research found that on average people dedicate 76 minutes per week to consumer tasks 11% of which are spent on essential services. Citizens Advice, Against the Clock: why more time isn't the answer for consumers, 25 November 2016

of buying a phone tended to be cheaper overall just under half (47%), correctly, said 'buying a phone outright'. Just over a third (37%) said that it would be cheaper on contract.[21] Consumers whose main mobile phone contract included a handset were much more likely to believe that this was the cheapest way to buy a phone. More than half (55%) selected this option, and less than a third (32%) correctly identified that buying a SIM and handset separately tends to be cheaper.

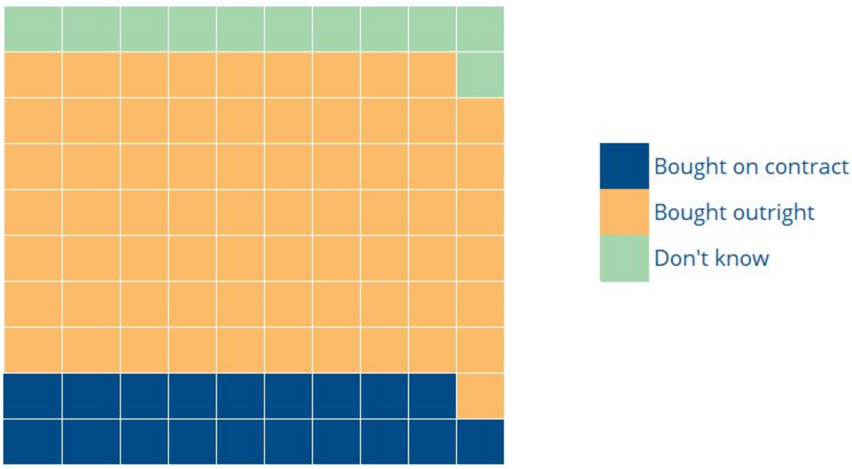
Fig 4. Consumers on handset-inclusive contracts think it's the cheapest way to buy a phone.

Q. Which of the following do you think tends to work out as the cheapest option overall?

Handset-inclusive customers



SIM-only customers



[21] Q. Thinking about buying a mobile phone, which of the following do you think tends to work out as the cheapest option overall? A: Buying a mobile phone as part of a contract including your minutes/data (37%), Buying a mobile phone separately – and getting a separate contract or pay as you go arrangement to cover your minutes/data (47%).

Many consumers may prefer to pay the extra cost of buying a phone on contract in exchange for the convenience of spreading payments - but these results indicate that the majority of people buying a phone in this way do not currently have enough information to make this choice.

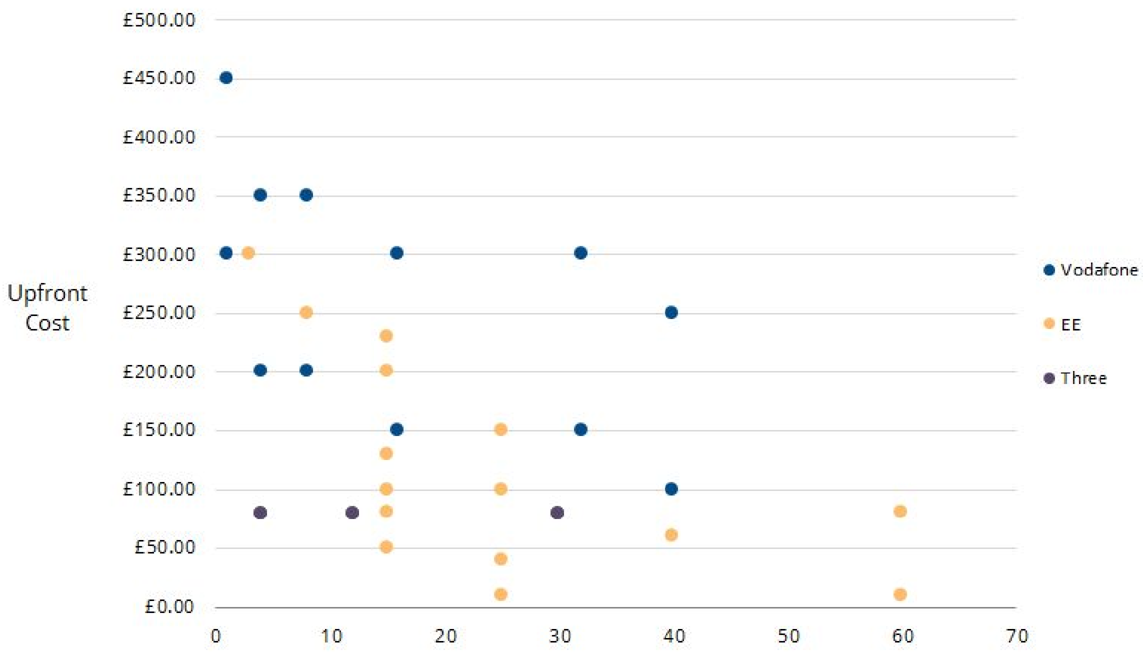
Bundled contract pricing also contributes to the overselling of airtime allowances

The nature of handset-inclusive contracts also contributes to the overselling of airtime contracts. Previous mystery shopping conducted by Citizens Advice found that mobile phone retailers consistently recommended data, calls and SMS allowances far in excess of individual consumers' needs. When asked to suggest a tariff appropriate for an average user, the average package recommended by sales staff cost £23.16 per month, 130% more than the most appropriate plan identified by desk research. One reason identified for this overselling was that sales processes focus strongly on the handset, and that the most expensive smartphones are only available with the most generous airtime allowances.[22]

The way upfront payments are charged may also contribute to this overselling. As Figure 5 illustrates, in general networks charge higher upfront fees for contracts with smaller data allowances. For instance, the upfront phone payment for an iPhone X (64GB) contract with a 1GB per month data airtime from Vodafone was £300. Buying the same phone with a 40GB contract only required a £100 payment. Similarly, EE charged an initial £299.99 for a 3GB contract, but charged as little as £9.99 for a 25GB contract. Three mobile charged a standard £79.99 up front fee for all contracts, with the exception of an 'All you can eat data' tariff which required no up front payment.

[22] Citizens Advice, Hung up on the Handset, 1 April 2016

Fig. 5: Lower data contracts have higher upfront costs
Upfront cost of iPhone X (64GB & 256GB) contracts vs. data allowance



These large up front fees will push consumers towards the higher data contracts for two reasons. The first is practical: the lower the up front fee, the more likely consumers are to be able to afford to pay it the month they buy the phone. The second is behavioural: it is well known that consumers display a ‘present bias’, that is a tendency to put more weight on immediate costs than costs which will be borne in the future.[23] This makes them highly likely to opt for the much lower initial charge even if it will cost them far more in the long run.

[23] The Behavioural Insights Team for Citizens Advice, Applying behavioural Insights to regulated Markets, 26 May 2016

Chapter 2: The Handset Loyalty Penalty

Bundled handset contracts typically last for 24 months, and consumers who wish to leave early can face high exit fees. At the end of the contract, consumers have 4 options if they want to continue receiving a mobile service:

1. **'Upgrade' with their current provider, and receive a new phone in return for signing a new 24 month contract.** Depending on the handset they chose, their monthly bill could either go up or down.
2. **Switch to a cheaper 'SIM-only' deal with their current provider** and therefore pay less for the same service while using their existing handset.
3. **Switch to another mobile provider**, and either receive a new phone or pay less for a SIM-only contract.
4. **Do nothing** and continue to pay the same monthly amount, including original payments towards handset.

The outcomes of these choices fit a pattern we see across consumer markets. Proactive consumers who change their contract either pay less money or receive more than those who do not make an active choice and stay put. We have called this 'the loyalty penalty', and we estimate it can cost consumers almost £1,000 a year across essential markets.[24]

This chapter sets out the scale of the handset penalty using a survey and desk-based analysis. Our methodology is set out in Annex A.

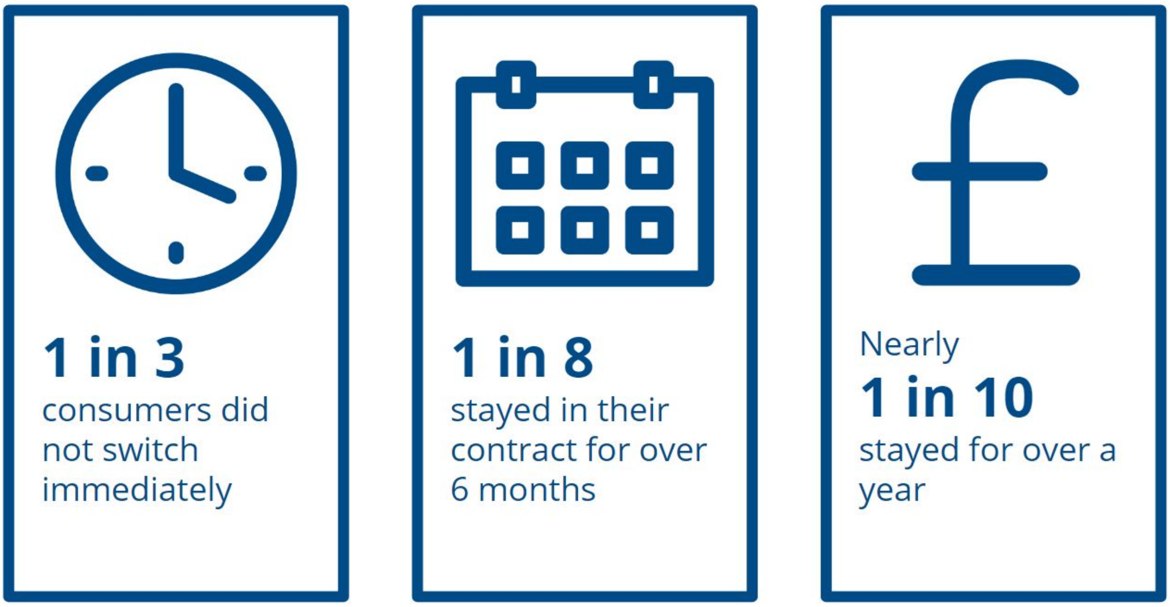
Over a third of consumers do not switch as soon as their contract ends

Not switching immediately at the end of a contract is common. Our survey found that over a third (35%) of consumers had stayed at least 1 month past the minimum term of their last contract. Many stay for substantially longer: just under under 1 in 10 (8%) stayed for over a year.

Across all mobile handset customers surveyed, the average length of time spent outside the minimum contract period was 2 months. However, this average includes people who switched before, or as soon as, their contract ended. Among the 35% of consumers who do not immediately switch, the average overstay is 6 months.

[24] Citizens Advice, The cost of loyalty: exploring how long-standing customers pay more for essential services, 1 February 2018

Figure 6: Length of time consumers spend on expired contracts



Consumers who do not change their contract overpay by an average of £22 a month

The handset penalty is harder to calculate than other types of loyalty penalty. Unlike in other essential markets, consumers' mobile phone bills do not go up at the end of their minimum contract. Instead, consumers are overpaying because they could be receiving an equivalent level of service for substantially less money if they swapped to a SIM-only contract.

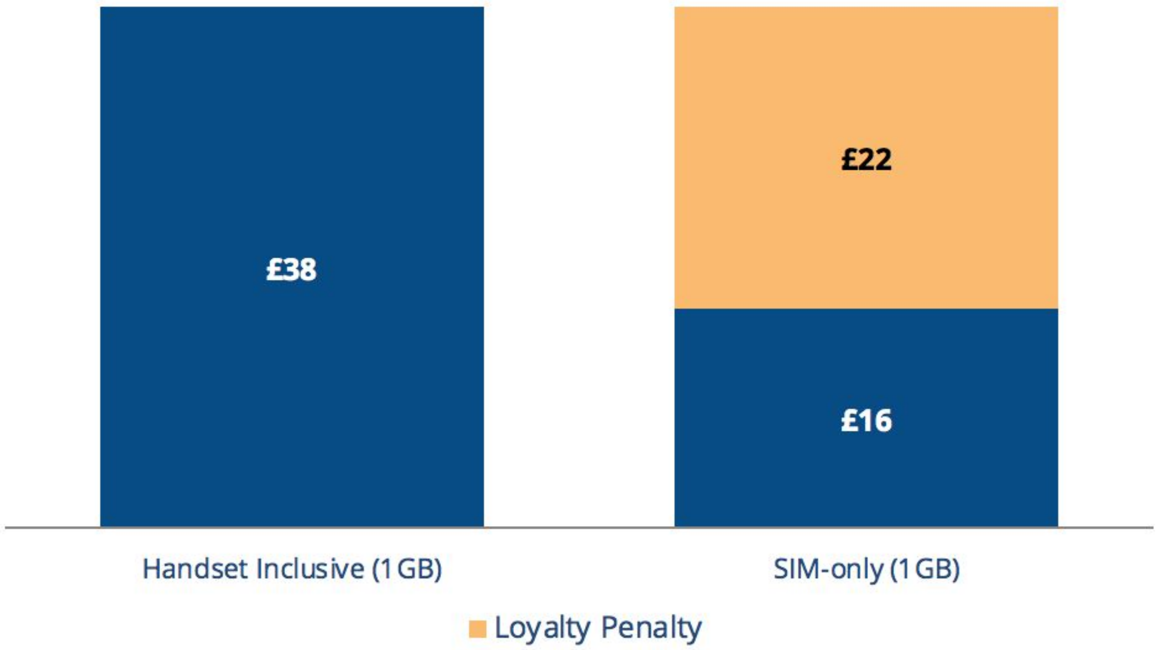
To calculate how much people overpay across the market we started by identifying handsets that could be purchased as part of a handset-inclusive contract by each of the largest main providers in the market.[25] Of these, 8 were sold by all 6 major providers, and an additional 3 were sold by all major providers bar one.

The handsets were a mix of Android and iPhone, with a range of retail price points. In order to simplify our findings, we condensed the handsets into 3 categories, organised by the retail price. This left us with 2 'low-range' handsets (RRP under £300), 5 'mid-range' handsets (RRP £300-£600), and 4 'high-range' handsets (RRP of over £600).

[25] Vodafone, EE, Three, Tesco, Virgin Mobile, O2. Analysing handsets offered by all providers, including those who offer split contracts, allowed us to determine which handset and airtime combinations were most popular and therefore should be included in the analysis. This also enabled us to make cross-provider comparisons.

We then compared the cost of contracts which included these handsets, with the equivalent SIM-only plans.[26] To calculate the penalty we therefore took away the cost of the equivalent SIM-only plan from the total handset-inclusive bill. The amount left is the handset penalty.

Fig 7. Illustrated example handset penalty after minimum contract



Using this method, we calculated an average monthly handset penalty for the 3 main networks who sell single handset-inclusive contracts. Across the 3 providers who charge a penalty, the average monthly cost of handsets surveyed as part of a 24 month contract is £22. Discounting high range models the average monthly cost is £16. As can be seen from the table below, there is not a large variation between providers.

Table 3. Not switching can cost consumers as much as £38 a month
Average monthly handset cost across providers

Handset	**Three**	**EE**	**Vodafone**	**Overall average**
High-range[27]	£34	£34	£38	£35
Low and mid-range[28]	£17	£16	£19	£16
Across all	£23	£22	£25	£22

[26] Contracts were matched by the amount of data provided.
[27] Handsets surveyed: iPhone 7 128/256GB, Galaxy S8 and Xperia XZ Premium.
[28] Low range: Galaxy J3 (2016), Xperia L1, Xperia XA1. Mid range: Galaxy A5, iPhone SE 32GB, Xperia XZ, Galaxy S7, iPhone 7 32GB.

For the 35% of consumers who stay past their minimum contract period these charges add up. The average overstay of 6 months will cost a consumer with a low to mid-range handset £96. If their contract included a high-end handset (such as an iPhone or a Samsung Galaxy) they will pay £210 more than necessary.

Table 4. Average loyalty penalty across the market (6 months)

Handset type	Penalty after 1 year	Average penalty[29]
All	£264	£132
Low/mid-range	£192	£96
High range	£420	£210

Total extent of the handset penalty

Ofcom estimates that 1.5 million handset-inclusive consumers pay the handset penalty. This figure is based on survey data which shows that 6% of consumers on a handset-inclusive contract are out of their minimum contract period. According to Ofcom, this means that consumers are overpaying by £330 million *per year*.[30]

This research measures how many people were paying the handset penalty at an exact point in time, and forms the basis of analysing the scale of overpayment on an annual basis. However, it does not include data on how long consumers pay the loyalty penalty for.

We took a different approach, and asked how long consumers waited between their previous contract ending, and their new one beginning. This means our estimates include all consumers who paid more than necessary for their last mobile phone contract, and includes data on how long they overpaid for.

We calculate that 4 million consumers overpaid by £490 million on their last mobile phone contract.[31]

[29] This represents the average penalty paid by those who do not switch before, or as soon as, their contract ends. Including customers who switch before, or as soon as, their contract ends, the average penalty per person is £35 among low and mid-range handsets, £80 among high-range handsets and £50 across all handsets.
[30] Ofcom, Pricing trends for communications services in the UK, 17 May 2018
[31] See Annex B for full method

Older people are likely to overpay for longer

As a result of this penalty, many consumers could be paying over the odds for mobile handsets without knowing it. Older people, in particular, are twice as likely to suffer the loyalty penalty for longer than 12 months. Our research shows that 13% of over 65s stayed on their contract for over a year after the minimum term ended, compared to 7% of under 65s. Over 65s are, however, no more likely overall to go outside of their minimum contract period.

Chapter 3: Developing Solutions

Over the the past year, Government Ministers and Ofcom have noted that bundled contracts lead to large numbers of consumers overpaying. They have identified reducing this as a policy goal. Speaking in a Westminster Hall debate in January the Digital Economy Minister Margot James said: "*I am committed to preventing people from paying too much by remaining on the same bundled contract after the end of the contract period. No one should continue to pay for a product that they have already paid off.*"[32]

Ofcom also recently stated that it was "*looking at the issue of mobile customers continuing to pay the same price after the end of their minimum contract period, where the price reflects the cost of their mobile handset*" as part of its ongoing work programme on consumer engagement.[33] Its annual Pricing Trends report noted that around 1.5 million people may be spending more than necessary by continuing to pay a monthly fee that includes the cost of a mobile handset after their initial minimum contractual period has ended. The regulator also highlighted in its annual Pricing Trends report that consumers on handset inclusive contracts may end up paying more than if they were to buy a handset outright and use it with a SIM-only plan - but has not, so far, suggested that it will take action directly on this particular issue.[34]

This chapter explores policies that would help address the handset loyalty penalty - end of contract notifications and scorecards. It then provides a detailed summary of split contracts, which should address both the handset loyalty penalty *and* the lack of transparency of pricing when consumers are buying a new handset.

Notifying consumers will not be enough to prevent overpayment

In July 2018 Ofcom proposed new rules requiring mobile, broadband, landline and Pay TV consumers to be notified when they are nearing the end of their minimum contract period. This notification would inform consumers of any changes to the price they pay or the services they receive, and let them know their options, including that they could be able to save money. Providers would also have to send a one-off notification to all out of contract consumers.

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[32] Hansard, Mobile Phone Contracts, 16 January 2018
[33] Ofcom, Helping Consumers to Engage in Communication Markets - Update on next steps, 27 April 2018
[34] Ofcom, Pricing trends for communications services in the UK, 17 May 2018

Most mobile networks also already send their customers notifications, and good practice already exists in proactive contact. However, generally these messages are aimed at getting consumers to enter a new contract and secure a new handset. Only one provider explicitly lets its customers know they can save money by switching to a SIM-only deal, and another lets customers know their minimum contract period end date.[35] It is not clear from these notifications that consumers could save money, nor when to switch to a different deal to avoid overpaying once the minimum contract period has ended.

Ofcom's proposals go further than the notifications sent by mobile networks. For instance, they state that notifications should include:

- The date the minimum contract period ends, making it clear that early termination fees will not apply after that period
- The options available to the customer after the minimum contract period has ended, including a message that the customer may be able to make savings by exploring the available options and that they could switch to a SIM-only contract
- The monthly subscription price currently paid by the customer[36]

These notifications will help to inform consumers of the options available to them, and remind them that they could save money. We therefore welcome Ofcom's recognition that there are widespread problems in this market, and their action on notifications.

However, evidence from other markets suggests that notifications have a limited impact on switching rates. For instance, Ofgem conducted a large-scale trial of letters informing energy consumers how much they could save by switching. The most successful version of the letter led to switching rates of 2.9%, up from a baseline of 1%.[37] In the insurance market, putting the previous year's premium on renewal notices caused a 3.2% increase in consumers negotiating their home insurance policy.[38]

Notifications are also less likely to be effective in the mobile handset market because the overall monthly price does not rise at the end of the minimum contract period. The benefits of switching are less tangible than, for example,

[35] Ofcom, Helping consumers to engage in communications markets, 31 July 2018
[36] Ofcom, Helping consumers to engage in communications markets, 31 July 2018
[37] The Behavioral Insights Team for the Cabinet Office, One letter that triples energy switching, 12 February 2018
[38] Financial Conduct Authority, Encouraging consumers to act at renewal, 3 December 2015

the broadband market, where prices rise by an average of 43% at the end of the contract.[39] The incentive to switch is not as strong.

Furthermore, notifications - no matter how well designed - will not be enough to prevent overpayment. Even consumers who know they can save at the end of their contract will not necessarily be in a position to act instantly. As set out above, choosing a new phone contract is a complex decision. People lead busy lives, juggling work, social lives, caring commitments and other consumer decisions. It cannot be guaranteed that the month a consumers' contract finishes will be a month in which they have the time to compare the millions of different contracts available.

Under the current system, consumers who are not in a position to change their contract will continue to overpay until they are able to move. Even if this only takes a month, it will still leave consumers up to £35 out of pocket. Moreover, as shown above, the most vulnerable consumers are the least likely to take action within 12 months of their contract ending. Previous Citizens Advice research has also shown that older consumers and those experiencing financial distress spend the least time on consumer tasks.[40]

Notifications will help some consumers. They will not change the fundamental problem: large numbers of consumers continue to pay far more than others who are receiving exactly the same service.

Scorecards can help address the handset loyalty penalty

The Government recently consulted as part of its Consumer Green Paper on how scorecards could be used across different sectors to improve consumer outcomes.[41] It sought views on whether scorecards could be used to improve outcomes in areas such as price differentials, consumer engagement, service quality, and complaints.

Given the severity of the handset loyalty penalty and the lack of proactive solutions from the industry in the past year, we think there is a strong case to start using scorecards to shine a light on the overall scale of problem and specific providers who are profiting most from the handset loyalty penalty.

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[39] Citizens Advice, Exploring the loyalty penalty in the broadband market, 18 April 2017
[40] Citizens Advice, Against the Clock: why more time isn't the answer for consumers, 25 November 2016
[41] Department for Business, Energy & Industrial Strategy, Modernising consumer markets: green paper, 11 April 2018

Requiring mobile providers to publish data on the number or percentage of customers who have gone beyond their minimum contract period would help increase the incentive for companies to stop exploiting the handset loyalty penalty. Ofcom already draws on these principles when publishing quality of service data, encouraging providers to improve their customer service.[42]

There are a number of ways that providers could stop the loyalty penalty. These include adopting split contract models - set out in detail below - but could also include other solutions developed by the industry. These could be based on principles such as shifting consumers onto SIM-only deals or applying loyalty discounts to cover the original handset payments.

Split contracts automatically end overpayment

Split contracts are a relatively new way of buying mobile phones. Starting in 2014 with O2's Refresh tariff, 3 other major telecoms companies - Tesco, Sky and Virgin Media - now offer these contracts.[43] However, we are not aware of any third-party retailers that offer split contract, which limits the number of consumers who benefit from this new product.

Split contracts consist of 2 linked contracts: an airtime agreement for the mobile service, and consumer credit agreement for the phone. Each has a separate monthly price, and consumers are billed for each separately.

Having separate contracts automatically avoids some of the problems described in the previous chapters. In these deals the handset contract is a loan, which means it has a set time period and defined total cost. Once the handset loan is paid off consumers stop receiving those bills and continue paying for the airtime service only. This means that *no one* continues to pay end of the contract, and the price the consumer is paying for the phone (i.e. the total loan amount) is clear.

Whilst these changes are clearly advantageous to consumers, split contracts are still comparatively new products, and several aspects of the new market should be scrutinised as it develops. First, what effects does making the device plan a credit agreement have on the consumer? Second, is the price charged for the handset good value for money? Finally, what effect does separating service and handset contracts elements have on the length and flexibility of both agreements?

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[42]Ofcom, Choosing the best broadband, mobile and landline provider, 3 May 2018
[43] Major telecoms companies are classified as those whose consumer market share is large enough to appear in Ofcom's Telecoms and Pay TV Complaints Bulletin.

Device plans are loans, and therefore regulated as consumer credit agreements by the Financial Conduct Authority (FCA)

In the split contracts currently on sale, the 'device plan' is a loan for the cost of the phone, which is therefore regulated by the FCA rather than Ofcom. Our conversations with stakeholders suggest that as the law stands, this is the only way such plans can be sold. Furthermore, it is widely thought that for bundled handsets providers can neither state the cost of the handset element of bundled contract or apply a discount to consumers who are out of contract, without therefore also having to adhere to FCA rules.

The FCA system brings specific regulatory benefits - such as stronger consumer protections and ability to offer handset contracts beyond 24 months - and is already used by some firms. But it also raises some questions, including the cost and practicalities of having products under the oversight of both Ofcom and FCA regulations. For example, Three mobile has told us that it believes that dual regulation would require developing new systems to satisfy both sets of regulation, which it thinks would be prohibitively costly and may be confusing to consumers. Therefore, it has proposed that the government should add an exemption into the The Financial Services and Markets Act 2000 (Regulated Activities), which would allow mobile phone networks to sell device plans without being subject to FCA regulation where the device is loaned at 0% APR.[44]

Whilst such a change may ease the way for some networks and third party retailers to offer fairer and more transparent contracts, it is important to note that the FCA's regulations contain some consumer protections which Ofcom's do not. These include, but are not limited to:

- The requirement to assess whether consumers can afford the financial commitment they are taking on[45]
- A mandatory 30 day cooling off period for all credit agreements regardless of the channel used to sign up[46]
- Detailed rules on appropriate debt collection practices[47]

Given that buying a mobile phone contract can be a substantial financial commitment, it is not obvious that consumers should have fewer protections

[44] Conversations with and briefings shared by Three mobile. Under Three's proposals device plans could be exempt if they were under £2,000 and lasted between 24 and 36 months.
[45] See FCA Handbook: Consumer Credit Sourcebook (hereafter CONC), (responsible Lending
[46] Under the The Consumer Contracts (Information, Cancellation and Additional Charges) Regulations 2013 there is a 14 day cooling off period for mobile phone contracts made as distance sales (i.e. by phone or online).
[47] See CONC 7 (Arrears, default and recovery (including repossessions). Ofcom recently extended its General Condition on Debt Collection to the mobile market - however this does not set out detailed guidance on best practice.

than they would when buying any other product on credit. It is also not clear that, should these contracts become more widely adopted, the FCA and Ofcom would not be able to come to an agreement to work together. There may be some merit in having only one set of regulations, this decision should only be made after a thorough consideration of the appropriate level of consumer protection.

Handset loans are interest free, but can still cost more than RRP

All 4 major split contract providers sell their handset contracts as an interest-free loan. This means that the amount consumers pay is the same no matter how long the contract is, or how much they agree to pay up front. However providers can, and do, charge a price that is more (or less) than the recommended retail price (RRP) of the phone. As the table below shows, consumers who buy the latest handsets on these deals can pay between £86 less and a £189 more than if they bought the phone outright.

Table 5. Cost of High Range handsets on split contract (September 2018)

	Handset	Total Cost	Difference from RRP	% difference from RRP
O2	Samsung S9 (RRP = £739)	£653	-£86	-11.6 %
	iPhone X 64GB (RRP = £999)	£1,014	+£15	+1.5%
Virgin Media	Samsung S9	£756	+£17	+2.3%
	iPhone X	£1188	+£189	+18.9%
Sky	Samsung S9	£774	+£35	+4.7%
	iPhone X	£1,020	+£21	+2.1%
Tesco	Samsung S9	£765	+£26	+3.5%
	iPhone X	£1125	+£126	+12.6%

These prices are perfectly legal. RRPs are just that - a recommendation from the manufacturer. Networks can decide their own tariffs, and as long as they charge all their customers the same in total (regardless of the length of the contract or the amount paid up front) the agreement is still an interest-free loan.

Some stakeholders have privately suggested to us that the difference between networks' prices and RRP mean that split contracts are not actually transparent and could lead to consumers being overcharged. Overcharging for goods bought on credit is a problem we have seen in other markets - for instance previous Citizens Advice research has highlighted how some 'Rent to Own' companies use considerably inflated 'upfront prices' to increase the overall cost of their products without inflating the products' APR.[48]

However, it seems unlikely to be a substantial problem in this case. 'Rent to Own' companies are able to charge considerably inflated prices because their customer base consists of consumers who can't afford to buy the product up front or get credit from other sources. By contrast, mobile phone networks aim to serve a much larger market, including consumers who can bear the total upfront costs. They therefore have less scope to raise the total price of their product without risking consumers going elsewhere.

This point is supported by the data above. The maximum additional cost of a iPhone X supplied under the split contract model is 18.9% of the RRP (£189). By contrast, the bundled contract deals for the same handset (which don't have to state the full cost of the mobile contract) can, as an illustrative example, have additional costs of 40% (£401).[49]

The initial effect of the clearer pricing structure of split contracts therefore seems to be that consumers who decide to spread their payments pay less than they would on many bundled handset contracts. However, this judgement is predicated on the fact that the vast majority of networks which offer split contracts have decided to offer the handset agreement to all consumers at the same (0%) interest rates. The introduction of personalised credit agreements could reduce transparency (as advertised prices would only partially reflect what consumers actually pay), and lead to price discrimination according to credit rating.

Split contracts have allowed longer contracts lengths

Under Ofcom's General Conditions a contract for telecoms service can not have a minimum term longer than 2 years. This limit was first placed into the regulations in 2011, after the passage of the European Framework Directive. In part this was a response to a trend of longer mobile contracts as smartphones

[48] Citizens Advice, Hire Purchase, Higher Prices: Problem debt in the rent to own market, 29 November 2016

[49] See Table 2 (page 8).

were rolled out.[50] Since 2011, it has been standard practice for a contract which includes a device to last for 2 years - whereas SIM-only and broadband contracts are commonly available for 12 to 18 months.

There is no such time limit for credit agreements. The majority of networks supplying split contracts have therefore started offering a wider variety of handset contract lengths ranging from 3 to 36 months. Because these agreements are interest-free, changing the contract length does not alter the amount consumers pay in total (as it would with most forms of credit). It can, however make a dramatic difference to the size of individual monthly payments. For instance an iPhone X on Tesco Mobile with 5000 minutes, 5000 texts, and 5GB of data will cost £46.25 a month on a 36 month contract and £108.75 a month on 12 month contract.[51]

Dividing the contracts has also allowed networks to offer variable service agreements, which allow consumers to increase or decrease their allowances (and therefore the price they pay) every month. Such an arrangement has clear advantages for consumers: a lot can change over 2 years of someone's life, including how much data they will need. Variable contracts allow consumers to both increase and decrease their phone usage as their lifestyle and technology use changes. This is a clear contrast to typical practices in the bundled contract market, which give consumers the opportunity to increase, and pay more for, their airtime allowances (through add-ons or permanent contract changes), but do not give any opportunity to *reduce* allowances.

Table 6. Contract lengths on split deals

	Handset contract length options	Variable service contract	Minimum service contract length
Sky	24/30	Yes	12 Months
Tesco Mobile	12/18/24/30/36	Yes	Same as Credit agreement - *"If your service contract period is longer than 24 months, your Early Termination Charges are limited to the first 24 months."*
O2	3 to 36	Yes	Same as Credit agreement: *"Monthly rolling Airtime Plan required for the length of the Device Plan. Pay off your device at any time."*[52]

[50] 24 month deals went from less than 1% of all contracts in 2009 to over 60% in 2014. See Citizens Advice, Calling the Shots, 20 March 2015
[51] Tesco Mobile, Apple iPhone X, Accessed 5 September 2018
[52] O2, Apple iPhone 8, Accessed 14 September 2018

Virgin	24/36	Yes	1 Month rolling

Split contracts therefore create the opportunity for consumers to spread their handset payments more conveniently, and allow them greater control of their airtime allowances.

However, the longer contract lengths could be a cause for concern if they act as a disincentive for consumers to switch network. Currently mobile service elements of split contracts either have minimum terms of 24 months or below, or allow fee-free exit after 24 months. However, as the market develops, we would expect that consumers are made aware when they can switch service contract, and that having time left on their handset credit agreement does not undermine switching.

In conclusion the split contract model has clear benefits for consumers but there are some areas which will require greater scrutiny as the market develops. These include:

- Whether the benefits of ensuring that consumers have standard consumer credit protection - the level of protection they would have when taking out any other form of consumer credit - outweighs any potential confusion caused by having split contracts regulated by both Ofcom and the FCA.
- The interest rates being offered to consumers. If providers start offering personalised interest rates it could greatly increase the cost of phones for some consumers.
- The length of service contracts, and whether longer device plans act as a disincentive to switch after 24 months.

Conclusion

When the iPhone first launched in the UK in 2007 there was only one method by which most consumers could buy it: a contract with O2.[53] By comparison, in 2018 consumers have a vast array of different purchase methods to choose from. They can buy a new phone outright from an electronics retailer, purchase a second hand phone in person or online, or pay in installments through a mobile network.

Handset-inclusive mobile phone contracts remain a popular way for consumers to buy phones. By allowing consumers to spread payments for their device over the length of the contract, they make the latest technology accessible to consumers who would not be able to afford the full upfront cost.

However, the current practice of bundling handset and service elements into a single indivisible contract fundamentally lacks transparency and directly causes consumer harm. Unclear pricing makes it needlessly difficult for consumers to ensure they are getting the best deal for their handset. The merging of contracts also leads over a third of consumers to systematically overpay at the end of their minimum contract deal - costing consumers £490 million over the lifetime of their contracts.

Ofcom has clearly identified the detriment in this sector and is currently consulting on proposals to mandate providers to notify consumers before the end of their minimum contract period. In our view Ofcom **should strengthen its current proposals** by requiring providers to send more than 1 notification and collecting and publishing data on the number of consumers beyond the minimum contract period by each provider.

But notifications and information alone will not be enough to end these consumer problems. Since we reported on the handset loyalty penalty in October 2017, the 3 major providers still relying on bundled contracts have not shown signs of fundamentally addressing the underlying problems. So:

- **EE, Three and Vodafone must stop charging for handsets at the end of the minimum contract period and should provide clearer pricing information**. The split contract model that is already used by other providers in the market could achieve both of these objectives.
- DCMS have been clear that this practice must stop. **The government must intervene if industry cannot develop its own solutions.**

[53] BBC, Apple iPhone Debuts in UK Stores, 10 November 2007

Annex A: Method

This report draws on 2 sources of evidence:

- An online survey of 3,030 adults in Great Britain conducted by ComRes for Citizens Advice, 18-25 July 2018.
- Analysis conducted by Citizens Advice of over 700 different phone tariffs undertaken in August 2017. We examined pay monthly handset-inclusive contracts offered by EE, Three and Vodafone across 12 handsets, and compared them to SIM-only tariffs offered by each provider. The difference between the 2 monthly charges is the monthly loyalty penalty customers pay after their fixed term period ends, unless they move to a cheaper deal. Both Android and iPhone devices were included in the analysis, and the handsets included in the analysis included a spread of recommended retail prices (RRP) - 3 'low-range' handsets (RRP under £300), 5 'mid-range' handsets (RRP £300-£600, and 4 'high-range' handsets (RRP of over £600).

Annex B: Quantifying the mobile handset loyalty penalty

We calculate that 4 million consumers overpaid by £490 million over the lifetime of their previous contract. There are 50,644,000 adults (aged 18+) in Great Britain.[54] Our polling from July 2018[55] found that 43% of GB adults had a handset-inclusive contract as their last mobile deal, leaving 22,004,000. We focused on EE, Vodafone, Three and BT (combined market share of 52%[56]) as the only large networks that do not offer split contracts. This leaves 11,396,000 consumers whose previous contract was a bundled contract.

Our July 2018 polling asked consumers how long they stayed in their contract after the minimum contract period ended.

[54] Estimates of the population for the UK, England and Wales, Scotland and Northern Ireland, Mid-2017, Office for National Statistics. Published 28 June 2018.
[55] An online survey of 3,030 adults in Great Britain conducted by ComRes for Citizens Advice, 18-25 July 2018.
[56] Ofcom, Nations and Regions Technology Tracker H1, April 2018

Table 7: ‘ When did you move from your previous mobile phone package to your current package?’

	%
Switched as soon as or before the contract ended	60%
1 to 2 months after	13%
3 to 4 months after	6%
5 to 6 months after	3%
7 to 8 months after	1%
9 to 10 months after	1%
11 to 12 months after	2%
More than 12 months after	8%
Don’t know	6%[57]

Excluding ‘don’t knows’ (who we conservatively assumed did not pay the loyalty penalty at all), and people who switch either before, or as soon as their contract ended, left us with 35% of bundled contract consumers (3,964,000) who paid the loyalty penalty.

We assumed that consumers stayed for the lower bound according to their answer (so those who reported 1 or 2 months we assumed to have stayed for 1 month outside the contract period, those who said 3 or 4 stayed for 3, etc.) For those who said they stayed more than 12 months, we assumed they switched in the 13th month - in reality we would expect there to be a much longer tail of consumers paying the loyalty penalty for many years. Multiplying the total number of consumers who had a bundled deal as their last contract (11,396,000) by the percentages in Table 7 tells us approximately how many people paid the loyalty penalty for 1 month, 3 months, 5 months. This gave a total number of 22,449,000 months spent paying the loyalty penalty.

Desk analysis of 721 handset deals found the average handset loyalty penalty to be £22. Multiplying 22,449,000 months by £22 per month gives a total loyalty penalty of £493,891,000.

[57] Numbers do not equal 100% because of rounding.