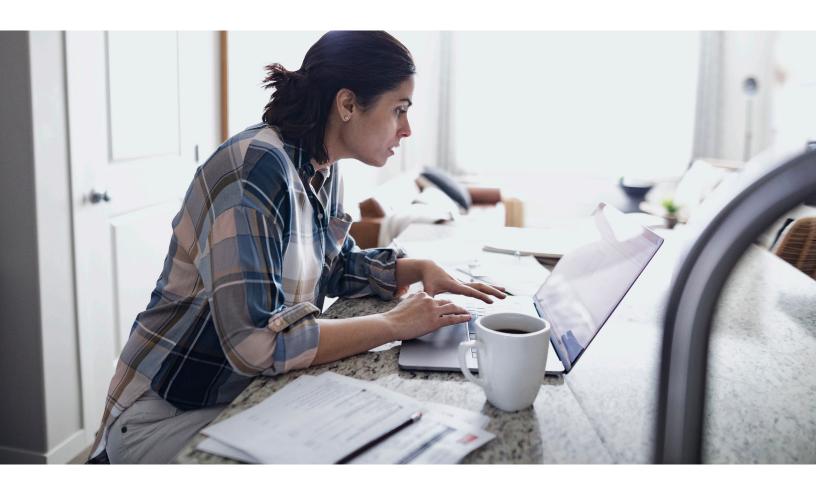# McKinsey & Company

Electric Power and Natural Gas Practice

Getting a grip on bad debt: Practical steps to help utilities boost their resilience

Utilities that reshape their credit and collections processes could position themselves well in advance of a downturn—and see other benefits, such as improving customer experience and loyalty.

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In a tight economic and regulatory context, utilities need to work harder to prevent and manage bad debt if they want to stay competitive and improve their resilience. Experience shows that companies are better at weathering downturns if they have already cleaned up their credit processes and minimized overdue debt, because they are able to move fast to cut costs, protect profitability, and reserve growth capacity.

Non-collectible written-off revenues have risen to up to 2 percent across Europe and North America. Loss of income is becoming a burden on businesses and inhibiting growth, and the situation shows no signs of improving. But utilities can take matters into their own hands. By reshaping their credit and collections processes, they can improve their ability to predict risk, reduce bad-debt charges by as much as 10 percent within a year, and provide a better experience for customers.

The external environment is challenging

Despite continuing economic growth and declining unemployment, household incomes in many Western economies have been squeezed, increasing the likelihood of delinquency and a rise in bad-debt charges. The uncertainties arising from global shocks such as Brexit, trade wars, and a possible recession also pose risks for utilities. At the same time, liberalization and intensifying competition in many markets is resulting in higher levels of switching among customers, sometimes accompanied by bad debt when final bills go unpaid.

In liberalized retail markets, utilities bear full responsibility for debt collection, but their maneuvering room in recovering bad debt is limited by regulatory and political constraints. The focus on maintaining the best customer experience, together with service obligations and provisions such as long grace periods, protection for vulnerable groups, and winter moratoriums, makes it difficult to suspend the service even as a last resort. Public opinion and political pressure act as a further deterrent, and utility companies need to reconfirm to the public

that their processes are fully compliant and adhere to the highest professional standards when it comes to debt collections.

Utilities have barriers to overcome

However, external forces are not the only reason why utilities struggle with bad debt. For many, the problem is compounded by inefficient operating models, a lack of credit-risk strategies, limited availability of tools, and insufficient management focus.

Inefficient operating models. Many utilities have understaffed debt-collection teams and rely on external agencies to fill gaps. Some utilities lack dedicated collections staff and instead allocate the work to generalist call-center agents, who may not have the right training to assess a client's situation and offer the best settlement option. Often, collections work is split between multiple departments or operating companies, resulting in fragmentation, a lack of scale, and inconsistencies in approach. This makes it difficult to establish clear ownership of credit risk throughout the customer life cycle and maintain an adequate supply of staff skilled in credit and risk management.

Inferior risk framework and lack of credit-risk strategies. Lack of a comprehensive view on building a strong risk framework and no systematic actions, such as regular benchmarking against global best practices for minimizing customer delinquency and debt collection, are in place. For example, when a utility's customer-acquisition strategy takes little or no account of credit risk, the business could suffer unhealthy growth—expanding its customer base while depressing its profitability. Even when credit-risk strategies and processes are in place, the monitoring of pre-delinquency is often weak, and bad debt is tackled through a single undifferentiated approach. Settlement strategies tend to be inbound and reactive, with few options for managing delinquent customers other than putting them on a path to service interruption.

Limited availability of tools. A few utilities have no credit-scoring models at all; many others have

Exhibit

An effective credit and collections process spans the full customer life cycle.

A bad-debt journey: Strategies and enablers to reduce bad debt

Begin journey	Stage	Strategy to reduce bad debt[1]	Enablers
Acquisition and onboarding	● I need power or gas ● I have signed the contract	● Embed credit risk in customer-acquisition strategy to ensure healthy growth ● Collect customer data from the outset to minimize the risk of losing track and enable outbound omnichannel communication	Clear systems, processes, ownership, and responsibility throughout the customer life cycle: ● IT systems (eg, dialer runs campaigns across multiple channels with an optimal drop rate and routes customers to agent best suited to handle them; collections platform includes a screen that pops up with relevant data when a client calls) ● Performance management and incentive systems with effective key performance indicators for call center, disconnections, etc ● Operating model (eg, clearly define standard processes, regularly monitor compliance, build capabilities, have central unit for credit-risk management across customer life cycle, appropriately size agent force)
Customer monitoring	● I don't receive my bill ● I have issues with paying my bill	Minimize risk of missed payment: ● Identify high-risk customers early on and offer them tailored programs ● Minimize billing errors and bill shock (eg, roll out electronic bills to the entire customer base, continuously analyze invoicing) ● Use low-risk payment methods and penalize late payment ● Educate customers about responsible consumption, consumer obligations, and bad debt	
Collections (early customer delinquency)	● I don't or can't pay my bill ● I don't or can't resolve my delinquent status	● Segment customers by riskiness, demographics, and behavior and maximize conversion rate by adopting differentiated collection strategies with bias toward customer experience ● Adapt collections levers (eg, scripts, offers, objection handling) to the needs of different customer segments ● Increase right-party contact and promise to pay by giving agents in all channels access to full details of the customer they are contacting	
Bad debt (late customer delinquency)	● I leave or I churn	● Segment customers and find the most appropriate exit strategy for each affected customer, with a bias toward fair outcomes and best customer experience ● Sell bad-debt portfolios to investors	

End journey

[1] List is not comprehensive; local regulations are a significant factor.

ineffective models with low predictive power that require delinquent accounts to be manually segmented. Similarly, some utilities have few digital channels for customer interaction, little flexibility in repayment methods, and no options for self-settlement. Even when they operate special programs for low-income or vulnerable customers, they may not offer the programs systematically or take steps to identify customers who might benefit from them.

Insufficient management focus. Bad-debt prevention has seldom figured on the agenda of top executives. Not surprisingly, many collections units suffer from a lack of investment and attention, with leaders focusing on what they see as more exciting topics, such as transformation, innovation, and digitization. In fact, many utilities have grown accustomed to bad debt of 5–7 percent and simply set their prices accordingly, accepting the situation rather than trying to improve it.

Reshaping the credit and collections process

To prevent bad debt, reduce service cost, and optimize long-term customer satisfaction, utilities need to focus on both prevention and debt collection. Bad-debt prevention is not only a financial measure but also helps utility companies to minimize reputation risk from the collections process. The best solution is to develop a well-structured credit and collections process that spans every stage in the customer life cycle (exhibit).

Acquisition and onboarding: Form a clear view of each customer from the beginning. Utilities need to build credit risk into their customer-acquisition strategy and tailor offers to individual circumstances. Riskier customers could be required to pay by direct debit or a prepayment meter, for instance. Utilities should gather and store data meticulously to avoid losing track of customers and make use of external as well as internal data sources to locate customers who leave a property without settling their final bill.

Customer monitoring: Minimize the risk of missed payments, ensure accurate billing, introduce tailored options, and offer information. Utilities should flag high-risk customers as early

as possible and offer them options to avoid missed payments, such as enrolment in a program for low-income households. Bad debt often arises when tenants move out of a property and fail to settle the final bill, or when new tenants are not registered accurately, or when customers switch to another utility after a house move. Fraud is often associated with high-transit properties, for instance, yet few utilities monitor nonpayment by address and take past experience into account when entering into a contract with a new tenant at the same property.

Administrative errors are a leading cause of late payment and nonpayment and can stem from errors in connection information, a failure to update IT systems when temporary contracts are changed to regular contracts; incorrect data in addresses, meter numbers, contracts, or prices; and multiple other factors. Minimizing billing errors improves the customer experience as well as reducing a utility's bad debt. As a first step, utilities should roll out electronic bills across their whole customer base and continuously monitor the end-to-end invoicing process to reduce leakages. In addition, they can offer innovative billing options such as split payments for tenants in a shared property, thereby reducing delinquencies by ensuring that customers who want to pay are not blocked by less compliant

Improving risk prediction through pre- and post-delinquency modeling

A leading North American utility was experiencing rising costs for debt collections and sought to improve its risk scoring and segmentation to reduce charge-offs. It replaced its one-size-fits-all risk-scoring methodology with separate custom-built models for pre-delinquency and post-delinquency accounts. These models used multiple data sources and machine-learning algorithms to generate "value at risk" scores for each customer.

The new models comprehensively outperformed the utility's previous tools, with a 20-percentage-point improvement in statistical power for the pre-delinquency model and a 10-percentage-point improvement for post-delinquency. Better still, the new models provided more accurate segmentation of high-risk customers and needed only three months of data to perform a robust risk assessment, compared with more than a year of data for the old model.

Introducing the models and the new segmentation approach enabled the utility to reduce bad-debt expenses by an estimated 2 to 5 percent, with further gains in prospect from the optimization of its strategy, operating model, and customer experience.

housemates. Utilities can also educate customers about responsible consumption, consumer obligations, and bad debt to prevent "bill shock."

Early customer delinquency: Secure fast repayment where possible and flag customers with issues. Leading utilities segment customers in line with their behavioral profile and the risk they present and adopt different strategies for each segment (for more, see sidebar "Improving risk prediction through pre- and post-delinquency modeling"). They adopt an individually tailored approach to high-risk customers, use a more standardized approach for medium- to low-risk segments, and leave the "self-cure" segment to settle payments by itself to avoid the cost of unnecessary customer contact. Typical ingredients of a tailored collection strategy include value-based call-center routing; a range of settlement offers; scripts with a tone of voice geared to specific groups, such as students; customer-specific incentives and penalties; and a repertoire of objection-handling techniques for agents. Our experience with sophisticated collections practices in the financial-services sector shows that selecting the right strategy, message, and channel to approach a customer gives an institution a better chance of securing a promise to pay while maintaining a positive view from customers.

Default: Find the best way to minimize losses. In case of default, segmenting customers again and finding the most appropriate exit strategy for each of them is critical, with a bias toward fair outcomes and best customer experience. Service suspension, when unavoidable, should be managed through an efficient disconnection process with fair treatment. When employing external debt collectors, it is critical to deploy a third-party policy that meets the highest international standards. The due-diligence review of external vendors should cover the quality of procedures, risk policies, policies for customer interactions, data security, and cyber-policies, especially in cases where they access personal data and other systems through the utility provider. Utilities should segment the customers involved, assign each segment to an agency with an appropriate track record, and rigorously monitor the

agency's performance to maximize recovery while using fair customer-related practices. Similarly, any portfolios sold should also be segmented.

With the right approach, utilities can achieve a rapid improvement not only in collection costs and bad debt, but also in customer experience. Accurate bills, flawless payment processes, and accurately targeted, helpful communications have a positive effect on customer satisfaction. By reducing customer default, bad debt, and service suspension, utilities also reduce their exposure to bad press and reputational risk—something that regulators, in turn, are likely to appreciate.

The impact of a well-designed credit and collections process varies from utility to utility, but we've seen cases where bad-debt related losses have been reduced by 10 percent within a year, and 20 to 30 percent in three years. At the same time, utilities can improve their profits and losses through a reduction in internal and external collection costs and the partial recovery of written-off portfolios via targeted crash programs and portfolio sales. What's more, the careful planning of timely interventions, improved communications, and streamlined processes can enhance the customer experience and help form a more positive public opinion around utilities.

Implementing a next-generation collections operation

Utilities should start regularly benchmarking their debt mitigation and collection processes against global best practices, also helping to demonstrate that they feel responsibility for the community where they operate. Utilities tackling bad debt can improve their collections through several efforts.

Building advanced-analytics capabilities to help identify risks and tailor interventions to individual segments. The use of rich customer data, sophisticated algorithms, and better models and processes enables utilities to predict with much greater accuracy who is likely to default on a bill and how best to secure payment from them. One important source of data is a customer's interactions

with the utility, including calls to its call center, visits to its website, and complaints or queries. By augmenting this kind of internal information with external data from credit bureaus and other sources, the utility can build a 360-degree view of an individual customer's creditworthiness and payment habits. Similarly, adopting a sophisticated approach to segmentation enables the utility to make better-informed decisions and tailor recovery strategies to individual circumstances (see sidebar "Combining early warning with tailored mitigation strategies"). A customer who has just lost their job could be offered a temporary payment freeze or a personal settlement plan; a customer who has moved into a new property, paid no attention to their power consumption, and been shocked by their first bill could be offered a prepayment meter with a built-in debt-clearance function.

Embracing digitization and automation to refine models and processes in credit scoring, segmentation, collections, and restructuring along the full value chain from credit decisions to fraud prevention. Utilities often have considerable scope to reduce operating costs in collection, and sometimes to increase the amounts collected as well. Digitization can offer big improvements in debt-collection efficiency and customer experience. Some leading utilities have designed a complete digital ecosystem for delinquent customers that covers debt overview, payment support, renegotiation, and customer support.

Choosing the right communications channels to improve customers' responsiveness. Experience shows that utilities that approach digitally savvy customers via email or text rather than a phone call can improve payments by as much as 12 percent, for instance. Well-designed customer journeys help prevent bad debt by making it easy for customers to update contact data, switch seamlessly between digital and other channels, and settle their accounts via self-service web tools or a one-click option on a preregistered card. A good settlement option addresses an individual customer's needs, enables automated decision making, creates little or no administrative burden, and benefits utility and customer alike.

Enhancing performance-management and incentive systems. Smart utilities develop an effective set of key performance indicators (KPIs) for collection, monitor them regularly, and link them to employees' evaluation and incentives. The KPIs should also be linked to energy distributors' incentives to ensure they carry out disconnections promptly to prevent bad debt continuing to accumulate. Utilities can introduce huddles, visual display boards, and segment-specific incentive schemes as part of a robust approach to managing frontline performance. Call-center metrics such as percentage of accounts collected should be reported daily, with senior managers reviewing reports every week to detect emerging issues or trends and take rapid action. Good performance by the team

and individuals should be recognized publicly with discretionary payments or other rewards.

Reshaping the organization. Utilities should ensure their frontline workforce is appropriately sized to handle the number of delinquent accounts and the level of risk each segment represents. Organizing agents by segment reduces handoffs, while assigning top performers the accounts with the highest value at risk will aid recovery. For some utilities, a centralized approach may work best, with one team taking responsibility for managing credit risk across the whole customer journey.

Identifying and promoting talent. Utilities should define their ideal candidate profile for key posts using the characteristics of their high performers as a guide. To attract the right talent, utilities should brand roles to reflect the challenges and complexity involved and set out a clear career path with well-defined opportunities for capability building and progression through the organization.

In a tight economic and regulatory context, utilities face challenges in collecting outstanding amounts from delinquent accounts. They can create substantial value by radically upgrading their capabilities for preventing bad debt and maximizing recoveries. By developing a well-structured process that spans the whole life cycle from customer acquisition to delinquency management, they can not only reduce the burden of lost income and high costs but also deepen their customer focus, deliver better customer outcomes, improve their resilience, and boost their earnings.

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