

**CREDIT AND COLLECTION STRATEGIES
IN A
COMPETITIVE ELECTRIC UTILITY INDUSTRY¹¹**

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As electric utilities move into an increasingly competitive environment, they will be called upon to give renewed attention to eliminating unnecessary expenses. One source of expense can be traced to the nonpayment of bills. The word "nonpayment" is intended to incorporate several situations: (1) persons who make *no* payments; (2) persons who make *partial* payments; and (3) persons who make *late* payments.

Adequately addressing nonpayment problems on a utility's system requires a sophisticated analysis. It is insufficient to simply say that "if a person does not pay their bill, we will disconnect their service." This type of approach will, in both the long-term and short-term, increase a utility's expenses and decrease a utility's revenues. Both of these impacts are detrimental to the nonpaying customer, to the utility, and to the rest of the customers the utility serves.

In fact, a utility who is appropriately addressing nonpayment problems should not have "a" credit and collection strategy. It should have *many* credit and collection strategies. This is true for two reasons:

First, a utility should have many credit and collection strategies because there is no single population of nonpayers. Instead, there are many different types of nonpayers. Each type of nonpayer may require a different approach to credit and collection. A person who does not pay because they simply cannot afford to pay, for example, should be treated differently than a person who *can* pay but does not. A person who has a substantial mismatch between household income and expenses should be treated differently than a household whose income might possibly be sufficient to pay their family bills with a somewhat better family budgeting. To treat each of these groups in an identical fashion will ultimately be ineffective. In addition, it will waste money, both by incurring unnecessary and ineffective expenses and by costing the company revenue that it should have collected. This, of course, harms the utility's

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competitive position.

Second, a utility should have many credit and collection strategies because the costs that different groups of nonpaying customers impose on the system, either individually or collectively, will differ. If a utility has *many* customers who pay 30 days late, in other words, and only a few customers who pay 180 days late, the large group of customers who pay only "a little" late may in fact impose greater costs on the utility. Rather than spending significant credit and collection dollars chasing the "bad" customers, in this situation, it may be more cost-effective to accelerate the 30-day payments to 15-day payments. The need of a utility is to appropriately balance the cost of the type of collection employed, and against whom, versus the gains from remedying the nonpayment problem caused by each particular group of nonpayers. The goal is not to collect the most money possible. The goal is to gain the greatest net revenue return possible, defining net revenue return as "revenues collected minus collection expenditures."

Both the types of nonpayers and the means to balance collection revenues and expenses are discussed below. As will be evident, they are related concepts.

TYPES OF NONPAYERS

There are at least eight groups of non-paying customers which a utility should consider in designing credit and collection strategies.

First, there are the households who do not pay because they have an absolute mismatch between household income and expenses. These are the very poor. They struggle to meet basic living needs. No amount of budget counseling, no type of deferred payment arrangement will help them. They need a break on their bills.

Second, there are the persons who do not pay because they live on the edge of economic viability. With careful budgeting, so long as they experience no unusual expenses, they make do with current month-to-month expenses. The simplest problem, however, ranging from a broken appliance (such as a TV or refrigerator) or a disabled car, will push them over the brink into an inability-to-pay. These people find it hard to recover, when they are required to pay past-due bills along with current bills.

Third, there are the customers who have marginal, but adequate, resources to meet all of their month-to-month expenses if they budget carefully. To the extent that these customers are non-payers, they may need skills training, such as budget counselling. This group has the desire to pay, and the ability-to-pay if given some assistance.

One should note that Groups 2 and 3 are those for whom Budget Billing might be appropriate. While these customers might be able to afford average bills out of current income, they have insufficient resources to pay the high winter heating bills; however, they also have insufficient resources to "save" for future liabilities.

Fourth, there are the customers who, for whatever reason, have become so far behind on their bills, they give up. While these folks may have the financial means to pay current bills today, they do *not* have the means to pay both their current bills and the significant arrears which they owe. Since, these customers properly reason, they will be treated no differently if they owe \$100 than if they \$500, they make no effort to pay their past due bills.

Fifth, there are the customers who have "become poor." These customers might be marked by women who have been recently divorced, widowed or separated. This group might be marked by persons who have recently become unemployed, either through layoffs or retirement. They are not sophisticated users of public benefits and, indeed, do not perceive themselves as being eligible for public assistance. They do not know how to take advantage of fuel assistance programs. Their standard of living is mismatched with their monthly income through no fault of their own. They may have house payments, car payments, and the like which, while consistent with their recent income and resources, places them in significant financial straits today.

Within Group 5, one should distinguish between long-term and short-term loss of income. Someone who has been temporarily laid off, for example, may need only short-term help while a recent widowed customer, or a recently retired person, may need longer term assistance.

One spin-off of Group 5, also, is the group of households who have "become poor" *not* through the loss of income, but rather through the imposition of significant extraordinary expenses. These expenses may involve short- or long-term medical expenses. They may involve the expenses associated with long-term health care. This Group may, but need not, involve low-income households. *Many* people fear the debilitating financial consequences of fighting a long-term cancer, or the debilitating financial consequences of the need to vacate one's home for a long-term care facility.

Sixth, there is a group of customers who have some "external" problem which inhibits their payment. Several types of such problems can be identified. These customers might be functionally illiterate. They may be "linguistically isolated," a term-of-art in the United States which, in the U.S., means that no person over the age of 14 in the household speaks English. They may be physically or mentally incapacitated or infirm. One extremely large group of such customers are those who lack telephone service, and who thus have a continuing inability to contact either the utility or the appropriate social service agencies to arrange help or to seek assistance.

Seventh, there is a group of customers who are simply poor money managers. This group is to be distinguished from Group 3 because the incomes of these customers are not necessarily marginal. The poor money management might be evidenced by high consumer debt, large credit card bills, and other imprudent expenditures which do not allow them to make their month-to-month payments.

Finally, there is the group of customers who *can* pay but won't. Within this final Group, there are two *sub*-classes of customers. On the one hand, there are the customers who are shrewd financial managers. Unless there are consequences with not paying their utility bills, they will devote their monthly incomes to uses which provide them a higher "return," whether it be paying off a credit card

bill or placing their money in a savings account. These customers calculate the gain and make affirmative choices on where to use their money to maximize their gains. On the other hand, there are the customers who, for whatever reason, have "an attitude problem." Perhaps they refuse to pay so as to "punish" big business. Perhaps they refuse to pay because of some perceived "slight" that they have experienced in the past. In both cases, however, there is an ability, but an unwillingness, to pay.

In sum, no single type of nonpayer exists. There are many reasons for nonpayment. To have only one credit and collection strategy is not only bad public policy, it is bad business policy as well. To treat everyone the same will, in many cases, not only be ineffective, but will be counter-productive as well. It will waste expenses and waste revenues.

THE EXPENSES ASSOCIATED WITH CREDIT AND COLLECTION

Credit and collection strategies are not without cost to a utility. An appropriate comprehensive credit and collection strategy will identify and assess the costs associated with each step of the credit and collection process and then make affirmative decisions as to how those dollars are best spent. A credit and collection technique must not only be "effective," in other words, it must be "*cost-effective*" as well.

"Net back" is the preferred measure of the effectiveness and cost-effectiveness of utility credit and collection practices. "Net back," a term coined by the credit management industry in the early 1980s, is the ratio of the *net* dollars returned to a company (the total amount collected minus the total expenses involved with the collection technique) to the gross amount of receivables assigned to the collection technique. The contribution made by the "net back" analysis is that it forces a creditor to take into account the expense of collection, as well as the effectiveness of collection, in considering the cost-effectiveness of collection practices.

"Net back" is used as a means to determine the most cost-effective credit and collection tool. The calculation of "net back" involves two components:

- o The first component involves calculating the cost of collection. The cost-of-collection figure is arrived at by dividing the total expenses of a particular collection measure by the total amount of money collected through that measure.
- o The second component is the "collection rate." The "collection rate" is the percentage of money collected of the total subject to collection through a particular collection practice.

A melding of these two concepts --the cost of collection on the one hand and the collection rate on the other-- is what goes into the measure of collection efficiency called "net back."

The concept of "net back" arose in a non-utility context. Based on its net back analysis, for example, one manufacturing credit manager recommended that his firm adopt a "minimum account size" for

certain collection activities. This minimum account size is to bring the company's "cost of collection" to an acceptable level. According to that manager, the cost-of-collection "figure was arrived at by dividing our total legal expenses (court costs as well as attorney fees) on these accounts by the total amount of money collected."

The credit manager stated that the "collection rate" is also an important measure to track, noting that his collection rate has been nearly 80 percent from outside collectors. The "collection rate" is "the percentage of money collected of the total placed" with the outside collection agency. Both of these figures, the "cost of collection,"¹²⁾ as well as the "collection rate," should be available to public utilities.

Calculating the "net back" for particular utility credit and collection practices is relatively easy. Net back, in its simplest form, can be calculated with the following formula:

$$\text{Net back} = \text{Gross Placements} \times \text{Collection Rate} \times (1 - \text{Collection Expense Rate})$$

Thus, \$1 million in gross placements (accounts receivable assigned for collection) will yield a net back of \$134,000, or 13.4%, if the collection rate (percentage of the gross recovered) is 20% and the collection expense rate is 33% (.33).

$$\$1,000,000 \times .2 \times (1 - .33) = \$134,000$$

According to one analyst, using the "net back" concept will help direct collection efforts. He points out that with collection rates and collection costs below 50 percent, increasing the collection rate has a significantly greater impact on the dollars netted back to the credit grantor than does decreasing the cost of collection. "Paying more" for collection, in other words, can be cost-effective if more than offset by an increase in the rate of collection.¹³⁾

In short, "net back" helps a company determine what collection actions yield the highest net return, with the cost of collection being only one of the factors that goes into that calculation. In addition to looking at the *cost* of collection, the analyst must examine the *rate* of collection, as well, and meld the two into a net back analysis. The concept of net back is as applicable to public utilities as it is to more traditional creditors, where it has been in use for years.

SUMMARY AND CONCLUSIONS

In sum, before deciding upon any one or more credit and collection approaches, there are three inquiries a utility should make:

¹²⁾ Using the net back methodology, calculating the cost of collection for a utility would involve determining the cost of a particular collection practice divided by the total amount of money collected by that practice.

¹³⁾ Conversely, paying less for collection is not necessarily "good" if the collection rate is sufficiently adversely affected that the decreased expenses are offset by decreased revenue.

1. A utility should identify the *types* of nonpayers that exist on the system. The company must realize that nonpayers do not represent a monolithic class. There are many reasons for nonpayment. These reasons call for different responses by the utility. A response that may be appropriate to one type of nonpayer may be entirely inappropriate, or even counterproductive, to a different type of nonpayer.
2. A utility should identify both the types of costs, and the magnitudes of those costs, which different types of nonpayers impose on the system. The appropriateness of any particular credit and collection response is governed not only by the reason for nonpayment, but by the level of expenses to be avoided by remedying the nonpayment as well. Again, a collection response that increases revenue and decreases expenses from one type of nonpayer may be ineffective, or even counter-productive if directed toward a different type of nonpayer.
3. A utility should finally identify the "net back" from each of its collection strategies. Simply looking at the amount of money collected is insufficient. To develop a system which is both effective *and* cost-effective, a utility must look at both the cost of collection and the rate of collection. The goal of a utility should be to maximize net returns: revenues minus collection expenses.

Appropriate credit and collection strategies must be sensitive to the reasons for nonpayment as well as the types of expenses caused by the nonpayment which the collection strategy is seeking to remedy.