

Rethinking Cost Efficiency

In Power and Gas Retail - A Step Change Requires a Systemic Approach



The increasingly competitive landscape in power and gas retail is driving utilities to improve efficiency through cost reduction. Most companies have implemented traditional cost-cutting programs. Although these are valid in some circumstances, many retailers are finding that results quickly follow the marginally diminishing curve. Our experience with some of the leading retailers suggests that other perspectives should be taken into account, exploring new opportunities to build sustainably competitive businesses.

In a world of competitive power and gas retail, running an efficient operation is a must. Spreads are tight, and substantial volumes are required to benefit from economies of scale. Although growth in energy services is a powerful lever for bottom-line improvement, there is simply no substitute for squeezing costs out of the business.

However, cost-efficiency has proved to be elusive for many. Successive waves of cost-cutting have made companies familiar with performance improvement techniques such as process re-engineering, outsourcing and first-call resolution, to name but a few. However, the reality today is that substantial differences in cost competitiveness remain in pretty much all countries.

Each company is unique, and there is no single solution that suits all. Finding the appropriate approach for performance improvement depends on the existing situation, as well as on management's ambition. In situations in which cost improvement potential is concentrated on a key process or particular function, traditional cost-improvement techniques are valid and can deliver improvements. In other cases, companies have gone beyond those and implemented structurally efficient models of operation – for instance, combining centralized operations with high degrees of outsourcing and automation. However, in most leading companies, these opportunities have already been addressed, and further attention is expected to yield only marginal returns. Achieving a step change in cost performance requires a systemic approach.

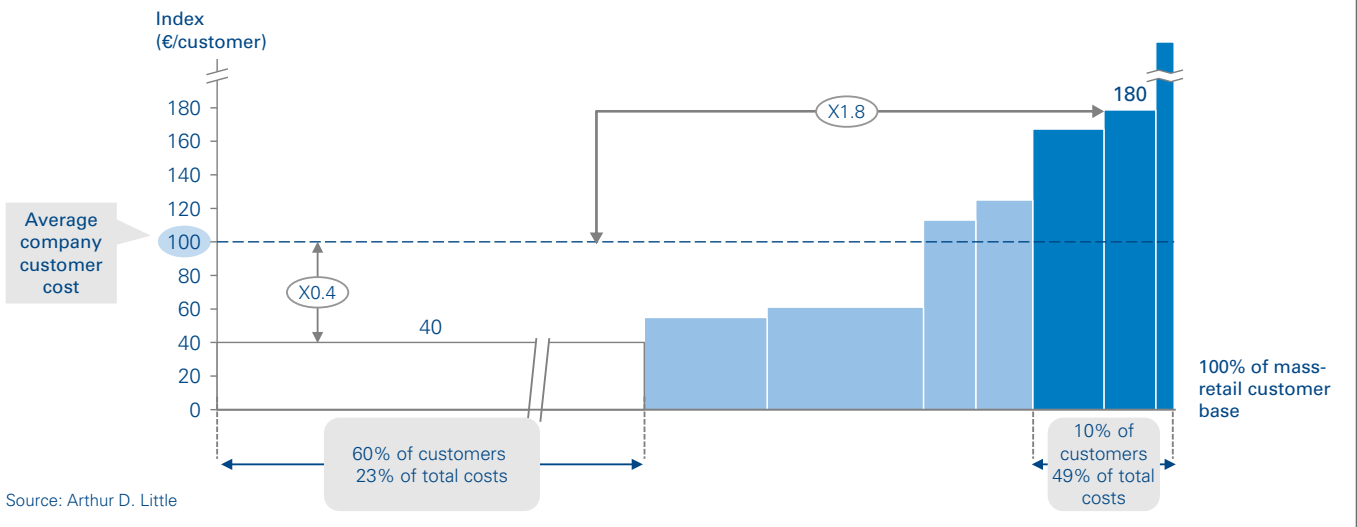
Our experience suggests that in these circumstances, a different perspective – and set of opportunities – can be identified by rethinking some key strategic levers: customer segments, product and service offerings and channel mix. These levers, viewed from an integrated perspective, yield opportunities simply not visible from a process or functional perspective, and open up new avenues for enhancing performance.

Customer segments selection

Marketing functions at power and gas retailers have long used segmentation techniques to the business of selling. These models are well understood tools to attract new customers and manage customer portfolios – i.e. the propensity to churn or potential to upsell – as well as tools to target products and prices. Some have taken these ideas further to quantify customer lifetime value based on standard costs-to-serve, typically to improve margin management and retention actions.

However, it is not common to find these same tools applied to costs-to-serve. Understanding the customers based on the real costs they incur provides a new window on segment attractiveness, and can bring with it a few surprises. Based on this approach, a leading European energy marketer discovered that 10% of its mass-retail customers accounted for 50% of aggregate costs-to-serve (see exhibit 1). And in some departments, these same clients represented as much as 60-70% of the resource's dedication.

Exhibit 1 – Cost-based customer segmentation – typical results



Although the weight of these high-cost customer groups will differ from company to company, they typically combine aspects of the commercial strategy – particularly the focus of the acquisition targets – and customer preferences for channel usage or payment method, as well as process failures.

As our experience suggests, a thorough understanding of the customer segments, their needs and preferences and their perception on service quality, together with the costs such segments incur, is fundamental for decisive action. Companies that focus on understanding these drivers are better able to focus their customer acquisition processes to target the most attractive sub-segments and fine-tune products and services for segments, as well as provide effective feedback on incurred costs to the organization when process failures occur.

Managing product and service complexity

A complementary perspective comes from examining in detail the product portfolio complexity. Across the energy industry, product proliferation has become the new norm. It is not just a phenomenon in recently liberalized markets. In the UK, for example, despite being very advanced in the liberalization process, products directed at mass retail customers have continued to proliferate, almost doubling between 2007 and 2011.

Although product innovation via bundles, innovative pricing schemes and promotions are key tools of the trade to differentiate in a commodity market, the associated costs in the process are often overlooked. Management complexity of an ever-growing product catalog in key operating processes – e.g. managing price and promotion updates, customer care, billing and collections operations – is all too often misunderstood, particularly when energy marketers are rushing to introduce a new service or react to a competitor's move.

A recent case experience at a leading utility found out that the IT development required to support the increased product and service complexity represented up to 15-20% of the commercial system's IT CAPEX. Moreover, product complexity not yet supported by IT systems was the root cause of half of the system's interface problems, one-third of the billing incidents and 15-20% of the customer complaints ... and all these incidents required costly manual treatment. (see exhibit 2.)

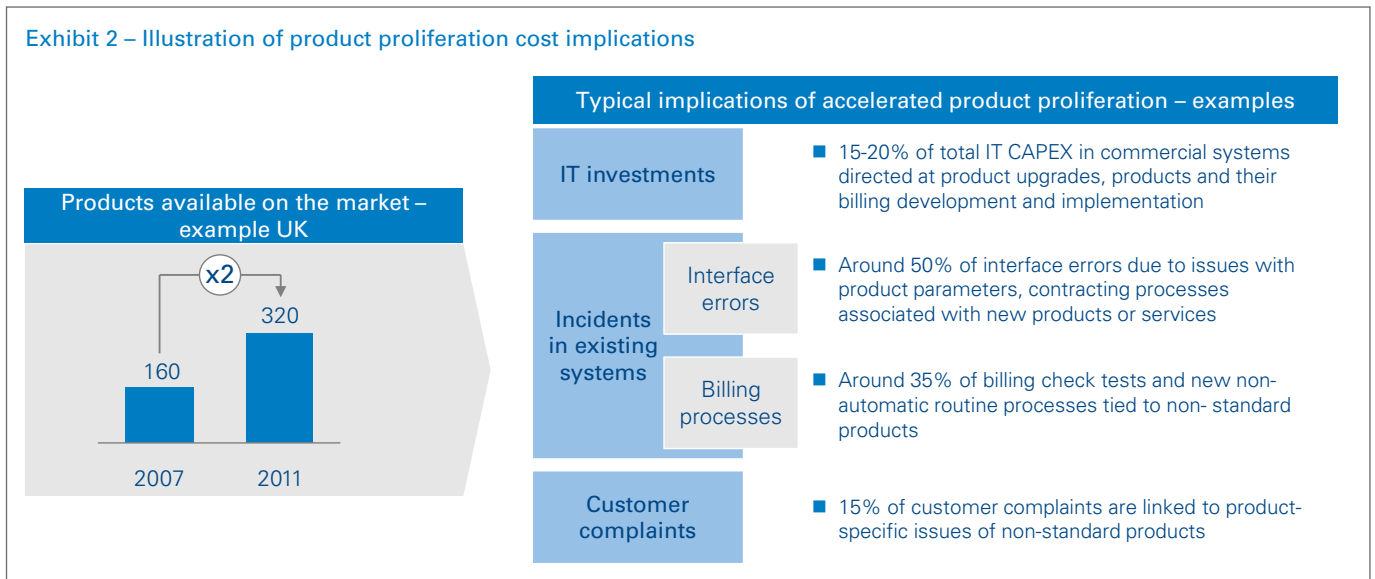
Creating transparency regarding specific product costs is crucial, and yet a surprising number of products that are not economically justified persist. Utilities would do well to seek inspiration from practices in the consumer goods industry on how product portfolios should be evaluated and reviewed to prevent them from becoming unmanageable.

Channel usage and mix

At power and gas retailers, channels are the lion's share of the total costs, representing 35-40% of total cost-to-serve (commodity and regulated costs not considered). Channel mix depends on numerous market-specific factors, and there are no wrong or right answers to the question regarding what the "ideal" model is. In the UK and Scandinavian countries, digital channels dominate and physical outlets are almost non-existent; in southern Europe, physical channels are a key barrier against competition, particularly in "home" markets. Nonetheless, understanding how consumers use – and misuse – channels is a powerful lever to build an efficient platform.

An incumbent retailer recently found out that what it thought was a great success – increasing digitalization of its customer base – was in parallel driving increased usage of its call centers. A thorough analysis showed that these customers were looking for information that was not easily found on the company's web page. The big surprise came when most of these customers

Exhibit 2 – Illustration of product proliferation cost implications



were found to be formerly “dormant,” i.e. long-standing customers that had not interacted with the company for years!

An integrated transformation approach

Defining the right approach for a particular company requires an understanding of the company’s situation, as well as senior management’s ambition and urgency for improvement. Different levers can be of use:

- Traditional cost-cutting efforts deliver improvements in key processes or areas, and can be adequate when inefficiencies are concentrated in few areas of the organization.
- Redefining operating models such as centralization of back-offices, automation of high-volume activities and outsourcing allow building of more efficient models.
- Strategic choices regarding target customers, products and services, and channel offerings are the key to opening up new opportunities to grow and sustain an efficient business.

Substantial value is at stake. Our experience suggests that focusing on the above levers can deliver 20-25% of reductions in cost-to-serve, depending on the specifics of each business design. As companies move from one wave of efficiency measures to another, it is time for senior managers to make strategic trade-offs to structurally improve business profitability.

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Arthur D. Little

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