Implementing an Enterprise Risk Management Framework Lowers Capital Costs, Improves Budget Performance

L.D. Hollingsworth

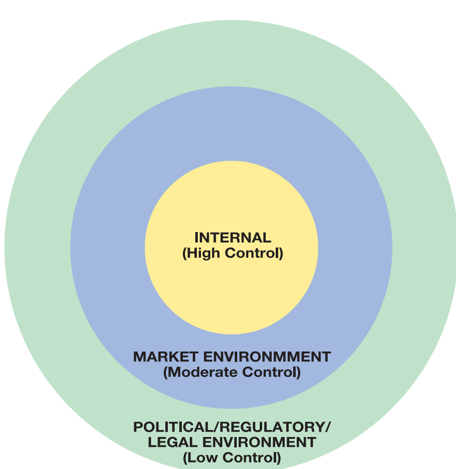
Water utilities across the United States face significant challenges for the future. Continuing growth of communities they serve requires planning for future water needs today. Your communities are counting on you and your staff to make the right decisions in planning for the future. Risk-based decision making, including risk-adjusted allocation of capital, operational risk reviews, and incorporating risk management reporting into your management and board, are necessary steps for your continued success.

Significant capital requirements are necessary to build the necessary infrastructure to acquire, transport, process and treat, and secure water for the future. Some utilities are planning capital investment in the hundreds of millions of dollars. The sources of funding and the rating agencies are looking at the financial condition of the utility and, just as important, the management team and the quality of its decisions and decision-making process.

An unsettling reality of the post-9/11 world is that those who are responsible for public infrastructure needs such as electric and water utilities are responsible for safety and security. Business continuity planning and event scenario analysis are a necessary part of your utilities risk management program.

Risk Based Decision Making

An integrated enterprise risk management (ERM) framework allows for efficient risk-based decision making and provides a streamlined process for evaluating opportunities for your organization. An enterprise approach to managing risks involves ALL functional or operational divisions or departments. Each employee is encouraged to participate in the ERM process and bears responsibility for looking at his or her role and responsibilities in the context of organizational risk management. With this empowerment of frontline employees, risks can be identified at their source. Unforeseen risks can negatively impact capital budget performance.



Benefits for the organization accrue with effective risk identification, measurement, and management by using risk mitigations strategies. ERM and its organizational benefits should be a key focus on an enterprise-wide basis, not an afterthought. One of the most important aspects of a successfully implemented ERM program is the discipline it brings to the organization's decision-making process and, just as important, day-to-day activities.

Creating a "Risk Aware Culture"

One of the key benefits of implementing an ERM framework is that it provides an opportunity for managers to create a risk-aware culture within their organization. Leaders of the organization should set the tone from the top. The CEO or general manager can set a powerful example by embracing ERM and serving as its champion in the organization.

This internal focus and awareness of risk has beneficial effects outside of the organization. Rating agencies are reviewing organizations closely looking at areas involving "risk focused" decision making and whether a "risk inventory and risk assessment" has been performed recently. Strong credit ratings translate to lower cost of capital for your organization.

Enterprise Risk Management Framework

Implementing an ERM framework accomplishes this goal. The key to successful risk management is to be able to understand and manage various sources of risk, ultimately under an enterprise-wide framework. For an enterprise risk management program to be complete, it must be built around a framework that addresses the following five elements:

- Organizational Objectives
- Risk Tolerance
- Risk Inventory
- Portfolio Management
- Risk Control Infrastructure.

L.D. Hollingsworth is a senior director in the Orlando office of R.W. Beck Inc., a consulting engineering firm.

Organizational Objectives

It is critical to articulate goals, strategies, and objectives that provide guideposts defining the appropriate ongoing operations and portfolio management activities an organization will undertake. It is also critical to develop best-estimate financial forecasts and realistic budgets that are the basis for setting expectations, determining corporate risk tolerance, and evaluating the effectiveness of risk management strategies.

Risk Tolerance

Through risk tolerance definition, management should specify the amount of uncertainty that the organization is willing to accept in its future financial and operational performance, with particular emphasis on the organization's tolerance for falling short of financial expectations.

Enterprise Management

The organization typically engages in strategic (longer-term) and tactical (shorter-term) transaction, operational, and insurance activities to help keep risk exposures within the organization's risk tolerance and reduce the probability of falling short of financial expectations. The ability to conduct these activities successfully also enables the organization to capture low-risk opportunities that can further enhance financial performance.

Risk Control Infrastructure

Best practices dictate that a collection of internal controls, systems, and operating practices are necessary for the organization to

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achieve the objectives of its risk management program. The risk control infrastructure includes:

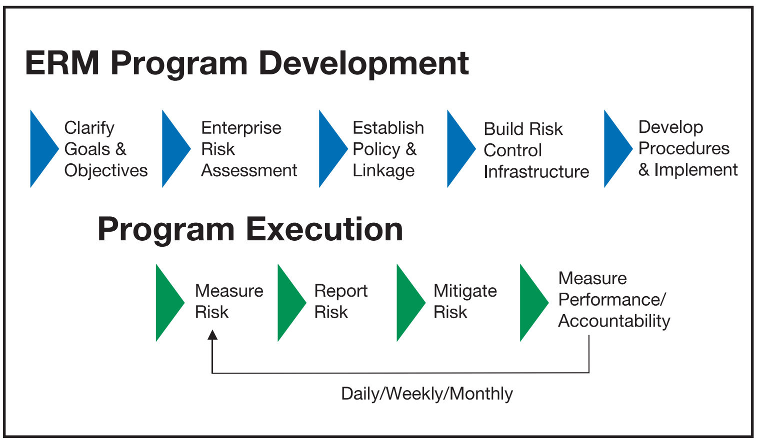
- Policies and Procedures
- Organization Structure and Responsibilities with Clear Separation of Duties
- Limits for Risk Exposures and Transactions
- Position Tracking
- Risk Measurement
- Performance Measurement
- Management Reporting

Where Do You Begin?

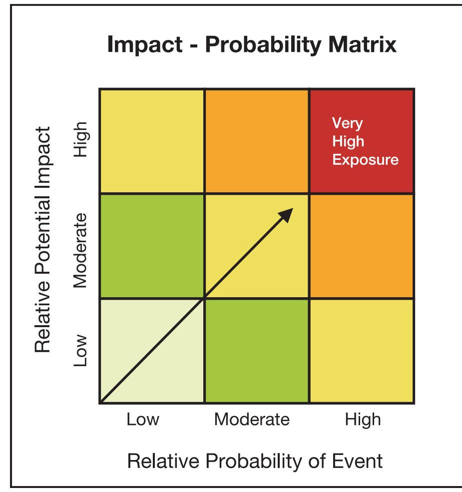
Shown on this page is an ERM program development process. The first steps are to review organizational goals and objectives to ensure that they are clear and properly understood and communicated throughout the organization. The next step is an enterprise risk assessment, followed by policies, risk control infrastructure, and operational procedures.

In order to manage the risks to your utility, they must be identified and assessed through a comprehensive risk inventory conducted by operational units within your organization.

The risks are characterized by type, prioritized via a frequency impact matrix, and reviewed for risk mitigation strategy development, as appropriate. The matrix provides a clear picture of the potential for adverse effects on financial performance.



In today's fast-paced, continually changing environment, your utility is faced with many challenges. Cost-effective, reliable, safe supplies of water for the future are key drivers of your strategy execution.



Understanding risks in your business, making sound management decisions, and creating a risk-aware culture are necessary to your success. Developing and implementing an effective enterprise risk management program will demonstrate to internal and external stakeholders your organization's commitment to managing your community's water supply needs, now and into the future.