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Embattled utilities increase focus on ERM

ERM remains just a compliance function at many utilities, say consultants. By Stella Farrington

Enterprise risk management (ERM) has until now meant little more than 'regulatory compliance' for many utilities in North America and Europe. But markets are becoming more turbulent, and business models more uncertain, making ERM increasingly central to utilities' hopes of success and even survival.

ERM functions have been in place at most utilities for several years, but the majority have not developed beyond the original internal compliance function they were created for, say consultants.

"All large utilities have ERM functions, but a lot of them are little more than compliance-driven exercises," says Soenke Lorenz, a Berlin-based principal at the Boston Consulting Group. "Most firms have come up with an ERM register – a list of severe events that could occur – but it is usually rather standardised. People now want to go beyond that."

Netherlands-based Cyriel de Jong, director of trading and risk management advisory firm Kyos Energy Consulting, agrees: "With a few exceptions, ERM is not well developed in most energy firms and many companies would now like to make improvements to their existing functions," he says.

That may now have to change. First and foremost firms need to address falling revenues and look strategically at their business models, consultants say. Electric utilities have suffered revenue erosion for several years on the back of faltering demand growth, increasing costs and falling prices. Utilities in Germany have been some of the hardest hit due to the proliferation of renewables there. In its 2015 annual filing, Essen-based RWE reported a 12.5% drop in 2015 net income after a 45% drop in 2014. Meanwhile, E.on posted a net annual loss in 2015 of €6.4 billion ($7 billion), its biggest ever, according to analysts. Splitting the company in two and spinning off its fossil fuels business has been the biggest corporate reaction so far to the current plight of utilities.

However, the loss of traditional revenue is forcing all utilities to revisit their business models, to interact differently with customers and to move into new areas, such as renewables generation – all of which involves taking on more risk, consultants say.

"If utilities are to create anything like the revenues of the past they need to take more risks and therefore be smarter in managing that risk," says Berlin-based Michael Kirch, a former Goldman Sachs commodities strategist and now chief commercial officer of Washington Square TecÚologies, a specialist provider of enterprise level trading and risk platforms.

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Paradigm shift

With risk increasing both internally and externally, it is essential that utilities embed the risk function into strategic planning and scenario analysis, consultants say. ERM's more qualitative approach to identifying and analysing fundamental market shifts is a huge boon in today's environment, believes Vincent Kaminski, a professor at Rice University's Jones Graduate School of Business in Houston. He thinks too much reliance is often placed on traditional risk management and modelling, and not enough on building up a broader understanding of what constitutes risk for an organisation and what the impact of it would be.

"You can concentrate so much on modelling a particular deal that you don't see the paradigm shift," he says. "The fact is overnight price vibrations do not usually destroy companies. More disasters have happened because people have missed paradigm shifts in markets."

"ERM is becoming more crucial now due to all the constraints we're facing," says Novera Khan, Düsseldorf-based chief risk officer at Uniper, the fossil fuel and trading firm that was spun off from German utility E.on in January 2016. "If we really want to identify where money is being left on the table we need to take a holistic view of the business."

Aggregating risk at an enterprise level enables firms to identify naturally offsetting risk exposures across business units and avoid, for example, implementing expensive hedges that actually add risk at a corporate level, say ERM managers. An aggregated risk picture also gives firms a better understanding of overall exposures and concentrations, allowing optimal trading or focus on each area or counterparty. For example, if risk is calculated discretely within silos, then lines of credit between counterparties, or the concentration of trade in one particular product or region, could reach limits before they need to, leaving missed opportunities or money on the table, say consultants.

But the scope of ERM goes well beyond the commercial function – the remit of traditional quantitative risk management – to consider any risks an organisation could face, internally and externally, say ERM managers. These could include a broad range of operational risks – anything from the daily risks of running a generation plant, through to staff retention – as well as broader reputational, political, regulatory and event risks. As utilities grapple with existential threats such as the spread of renewables and the growth of distributed generation, identifying strategic risks and potentially disruptive trends is becoming more and more important, say consultants.

Top talent

More evidence of the increased focus on ERM at energy firms can be found in recent hiring patterns at commodity trading houses and utilities, says London-based Mikhaela McDonald, head of Europe, the Middle East and Africa risk at executive search firm Commodity Search Partners. "We're seeing energy firms increasingly hiring people, often from the top consultancies, who have operational and enterprise risk experience across a number of risk verticals and commodity products. Companies are definitely trying to increase their understanding of the impact of different types of risk and looking more closely at things like catastrophic risk." ■