

# Should your utility establish a risk tolerance?



**T**he short answer to that question is yes, you really should establish a risk tolerance. It is an important tool for managing your utility.

A utility chief risk officer once said to me, "If we establish a risk tolerance, I am afraid that will be seen as a green light to take risks." In fact, the opposite is true. Setting a risk tolerance clearly articulates the amount of risk that will not be acceptable to the organization.

There is sometimes confusion between the terms risk appetite and risk tolerance, but in reality they represent opposite sides of the same coin, a definition of risk. A risk appetite defines what the organization is comfortable assuming. An organization generally assumes routine risks within its core business, with which it has expertise managing. In contrast, a risk tolerance defines the point beyond which the organization is unwilling to accept risk. In other words, a risk tolerance sets a boundary beyond which risks are not tolerated. Stakeholders see a risk tolerance as a measure of a well-run, disciplined utility.

Risk is theoretical, representing what might happen. Managing to a risk tolerance is therefore managing against unacceptable negative outcomes associated with potential future events. Further, risk events should be considered from several dimensions. The two most common measures are the probability of an event occurring and the impact of that event upon the organization. The probability relates to the likelihood of an event occurring. The impact or severity can be measured from several perspectives, such as reputation loss, financial loss, or scale of injury or physical harm. Risks can additionally be measured from other perspectives, such as the organization's preparedness, the speed of onset of the risk, or the amount of mitigation that can be achieved.

There are a variety of risk tolerances that utilities can implement. Customer-owned utilities use financial risk tolerances to protect against rising customer rates and their abil-

ity to make debt payments and/or city transfer payments, and to ensure positive net income. Investor-owned utilities additionally focus on measures that are of importance to their shareholders, such as earnings and making dividend payments.

In terms of how to implement a risk tolerance, a customer-owned utility could establish a financial risk tolerance in the form of a debt coverage ratio to ensure it has an adequate buffer to make debt payments. A utility that supports its city through a city transfer tax could have a risk tolerance to ensure it can meet its city transfer tax obligation. And a utility could set a net income risk tolerance, monitoring risks that jeopardize its ability to meet a minimum net income target.

Utilities often have more than one risk tolerance in order to include other core principles. Some utilities develop a risk tolerance in the form of customer rate or bill impact. For example, a utility could commit that rates will not rise more than a set percentage. In an environment of increasing focus on protecting data, there is significant reputation risk associated with a breach of IT systems. A utility could establish a tolerance for security breaches to show its commitment to protect data and defend against hacking attempts. Another measure is a safety risk tolerance against injury and risk of life. Many organizations have a safety policy, but a safety risk tolerance goes farther. For example, setting a zero accidents or injuries tolerance clearly demonstrates the organization's strong commitment to safety for employees and the community.

So what is the right size of risk tolerance for any given utility? The simple answer is that it should be what the utility can weather without large negative impact on itself or its customers. For example, how serious would a credit rating downgrade be for the utility? If this is an unacceptable risk, then the utility would size its risk tolerance to maintain or improve its financial ratios (the metrics that rating agencies

monitor). If the utility wants to establish a customer rate tolerance, then the utility would need to manage the risks so that a risk event would not increase rates beyond an acceptable level for customers.

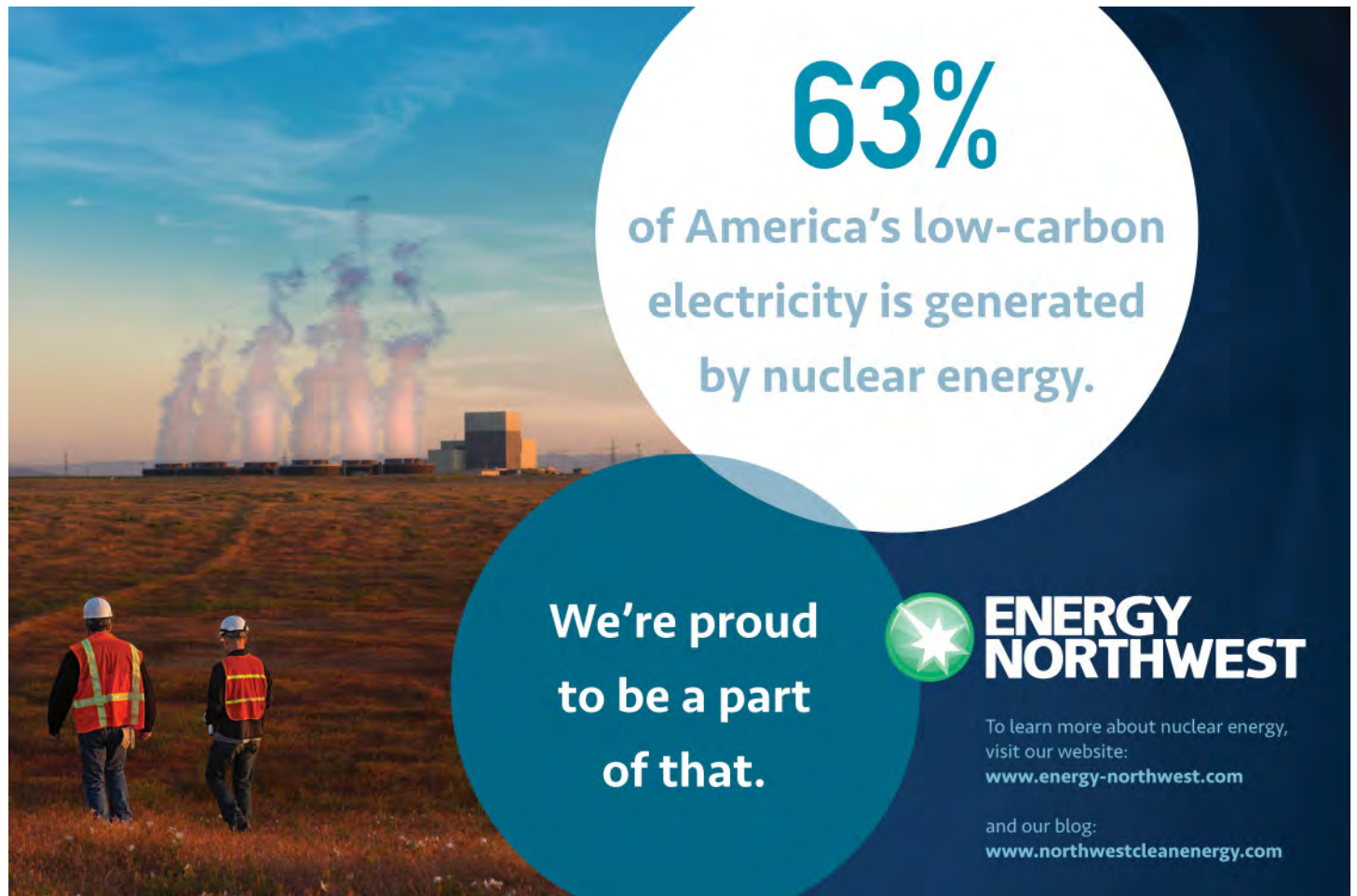
A risk tolerance has to be sized large enough to accommodate routine events. For example, a utility is going to face weather events that are outside of its control. A warmer-than-normal winter season could result in lower customer demand and lower revenues. Storms will add additional costs as the utility restores service to customers, and drier-than-normal weather conditions negatively impact hydro energy availability. Weather variability routinely occurs and should generally fit within the utility's risk tolerance.

There can also be extreme weather events that have a low probability of occurring, but have very serious impacts. In order to protect against the low probability extreme tail events, the utility will want to consider mitigation strategies. For example, to protect against weather events impacting revenues, it might adapt its rate structure to be less reliant on recovering its costs through volumetric sales of power during its peak season. To protect against storm damage, it

might acquire outage insurance for power plants. To protect against very dry conditions, a hydro-based utility might consider buying incremental power supply or making fewer forward sales commitments in the event of extremely dry hydro events.


A risk tolerance becomes an important tool to help the utility examine potential risks and understand where risk mitigation efforts will be needed. It is not as challenging to implement as it seems and the benefits are significant. The risk tolerance provides a benchmark from which management can determine unacceptable risks. It spurs the development of risk mitigation strategies and demonstrates management's strong oversight of the utility. Lastly, it inspires confidence in the utility among its customers, employees, investors, and regulators. **NWPPA**

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