

Industry research report
September 2009

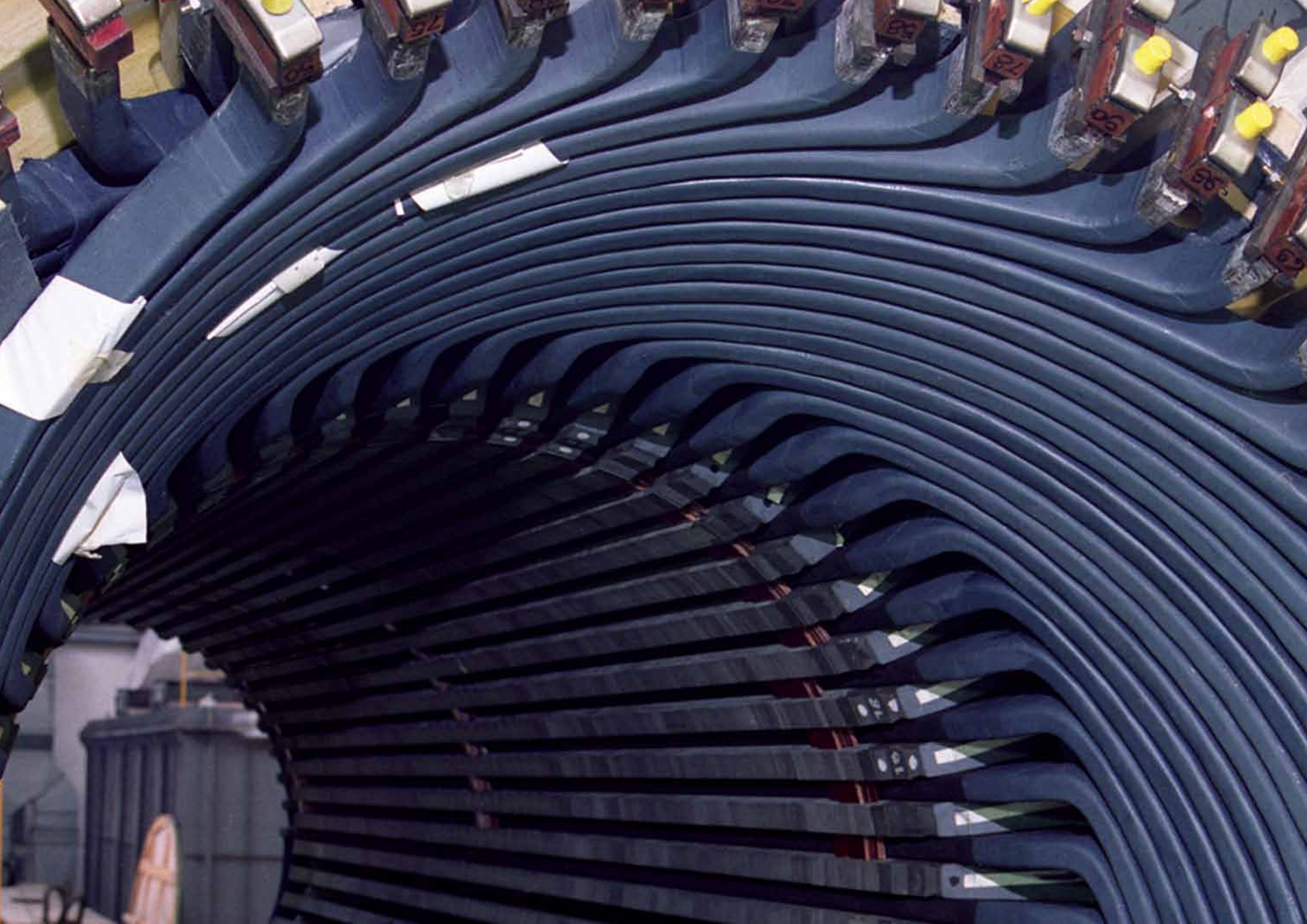
MARSH



MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

New risk management insights in the power and utilities sector





Introduction

The main research for this survey was carried out not during the initial panic reaction to the crisis, but as the dust was beginning to settle – during March and April 2009. It reflects not the immediate reflex reactions of organisations caught up in the whirlwind, but the beginnings of a considered, long-term reaction to the current state of the world economy now that uncertainty and recession have become the new reality rather than an impending threat.

That is what makes this research so valuable. For example, many organisations' immediate reaction during the last quarter of 2008 was to employ safe, short-term expedients, deleveraging and cutting costs wherever they could. However, our survey shows that on reflection, very few organisations (just 4% among Power and Utility industry respondents) are persisting with cuts in risk management budgets, and over a third are actually increasing budgets.

Another example of the difference between the period in which the crisis was breaking news and where we are now is the attitude towards insurers. When we were conducting preparatory interviews to help design the main questionnaire, there was extensive media coverage of the uncertainty surrounding the liquidity and future of some major insurers. By the time we conducted our large-scale survey of 705 senior businesspeople, many organisations had closely reviewed the situation, their exposure and their response. Thus in our survey only 29% of participants (across all industry sectors) are concerned about their insurers, whereas 58% are concerned about customers and 36% about suppliers. The results would probably have been different during the uncertainty of the last quarter of 2008.

The Power and Utilities industry emerges as a cautious industry, with a prudent, long term view of risk management. More confident than most industries in its ability to weather the storm, it still shows a marked increase in risk adversity, with the larger respondents showing a more conservative attitude than the smaller ones. As an essential public service industry, it will have a fundamental role in the return to economic stability, and then to prosperity, during the coming months and years. Risk management, now more than ever, is seen as a critical element in the sustainability of a profitable and stable future.

Our series of reports sets the basis for best practice, explaining what organisations in seven industries and across twelve countries are doing and what the effects of their actions may be. In this Power and Utilities report we look specifically at the reactions, attitudes and intentions of the industry sector. I believe this report will be a useful instrument for decision makers in every area of the Power and Utilities industry.



Mark Pollard
Head of Industry Practices
Europe, Middle East and Africa

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Executive highlights

To examine how organisations are responding to the downturn, Marsh commissioned the independent research agency Ipsos to conduct a survey of changing attitudes to risk management across European organisations. Over 700 organisations were interviewed across twelve countries and seven industry sectors; of these, 56 are in the power and utilities sector¹. This comprehensive study of the European power and utilities (P&U) sector examines the industry's immediate risk management concerns, its confidence in its ability to manage these, and reviews how P&U companies plan to address risk management in the coming months.

The current downturn in the global economy has been swift and severe. It raises important questions about how organisations conduct their business, and how they assess and manage risk. It also poses two fundamental and interconnected threats for the P&U industry and these have clearly influenced the themes that emerge from our *"New risk management insights"* survey.

The first is a short-term decline in demand driven by falling industrial activity across the region. While the P&U industry customer base is spread across all industries, smoothing and diluting some immediate recessionary risks, it is heavily regulated, a public service industry in effect, with statutory obligations preventing many companies from withdrawing their service or supply in the event of non-payment.

The second fundamental threat of the downturn is the lack of available investment capital, a symptom of this bank-led recession, and a reluctance on the part of many project developers and operators to incur more debt at this time. Not only can this delay power projects in the near-term, it can also have significant bearing on the long-term outlook for the industry, namely its ability to meet long-term demand expectations while reducing CO2 emissions, increasing energy efficiency levels, and investing in renewable energy and clean technologies as set by the European Union's 2020 targets.

Impact of the economic downturn is limited; responding cautiously

A picture has emerged of a confident industry, but mindful of the longer-term impact that the downturn may bring. Its confidence, second only to that of the life sciences industry in our survey - see Figure 1 on page 4 – seems well-founded: future demand is assured and there is a pervading sense across the industry that the downturn is a momentary blip in its growth curve.

Many are confident that their existing risk management processes will address near-term organisational risks. Yet despite this apparent confidence, the industry also demonstrates a high degree of conservatism. There is a heightened risk consciousness across the industry with three quarters of participants believing that risk is now seen as more important across the senior levels of their organisations and 66% reported that they have reviewed, or are in the process of reviewing, their approach to risk management.

Indeed, 45% of those surveyed say the downturn has led to a reduction in risk appetite – only the financial institutions industry demonstrates a greater increase in risk aversion (52%). But even for those less risk averse, management and boards are demanding tighter controls, improved communication and reporting flows, and deeper and closer analysis into investment projects and opportunities.

¹ Marsh's Power and Utilities practice covers vertically integrated nationalised industries, transmission and distribution companies, portfolio and nuclear generators, privately financed independent power projects (IPP) and combined heat and power (CHP) projects, as well as renewable energy suppliers including hydroelectric, wind, biomass and waste-to-energy organisations. Although the survey respondents include some utilities companies, in many cases the respondents are engaged with different parts of the Power and Utilities industry sector.

The results at a glance

(Percent of respondents in respective industries)

	CMT	FI	LS	PE	P&U	RCB	T	Overall
Impact of downturn perceived to be greatest	51	64	14	35	21	30	54	41
Reviewed approach to risk	71	83	60	54	66	67	73	69
RM at senior levels is now more important	85	87	65	56	73	66	77	74
Risk aversity among Board	36	52	33	25	45	36	40	38
Retaining more risk	18	13	13	22	16	23	22	18
Very confident in RM processes	25	20	26	22	36	34	32	27
Increased budget for RM	36	47	38	25	36	29	30	34
Group causing most concern	Customers 69	Customers 68	Customers 43	Citizens 54	Customers 48	Customers 55	Customers 62	N/a
Priority risk - free choice	Credit 36	Credit 41	Credit and liquidity 12	Credit 10	Credit 43	Credit 36	Credit 26	N/a
Most significant risk	Credit 69	Business Continuity 59	Cash flow 78	Environmental 73	Power price 66	Cash flow 76	Cash retention 75	N/a

Key: Red indicates highest percent of respondents, blue indicates lowest percent of respondents.

CMT: Communications, Media and Technology, FI: Financial Institutions, LS: Life Science, PE: Public Entities, P&U: Power and Utilities, RCB: Retail and Consumer Brands, T: Transport

Changing near-term priorities – focussing on the value-chain but operational risk still prevalent

With the contraction in the availability of finance and the highly leveraged balance sheets of many organisations, it is not surprising that immediate concerns focus on working capital, cash flow and the wider value-chain. Customer risks are of significant concern to the sector, with 48% expressing concern for this group. Furthermore, organisations are looking at margin volatilities and exposures across all areas of the business, including primary operations and support services, and are looking closely at better understanding and managing not just their customers, but clients and suppliers also.

While near-term focus will continue to be on financial and macroeconomic concerns – credit risk for example was highlighted by 43% of respondents as an ongoing concern over the next 18 months – organisations are facing these concerns alongside strategic and operational risks. We asked participants to rate the significance of eight industry risks, stripping away the immediate economic focus. The results confirm that operational risks have by no means dissipated.

Large organisations – an observation

In this industry there is a significant split between the reactions of the larger companies, with their more sophisticated risk management, and the smaller ones. In every case the larger companies are more concerned and conservative in their reactions: 80% of smaller companies say their industry will be less affected than others; for larger companies the proportion is 62%. Boards have grown more risk averse in 62% of larger companies and 34% of smaller ones. And the downturn has prompted a review of risk in 81% of larger companies but only 57% of smaller ones. Concern also about the risk associated with customers, suppliers, partners and insurers is significantly higher among larger companies. Insurers, for example, are a cause for concern among 43% of larger companies but only 14% of smaller ones.

Building-out risk management infrastructures

Over a third of participants that we surveyed expect risk management budgets to increase over the next 18 months, at a time when many organisations are reducing costs and budgets. This is partly driven by the expectation that insurance rates will harden; however, equally important is investment in risk management information systems, training and even headcount.

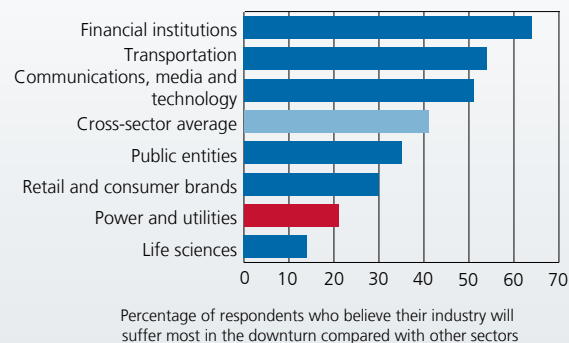
This building-out of risk management infrastructures reaffirms changing attitudes and commitment to robust risk management at the very top level. Although confident overall, the P&U industry continues to review the wider economic environment cautiously.

1. The impact of the downturn

Confidence levels high...

When asked about the economic downturn, 73% of participants say that the P&U sector will be less impacted than other industries (see Figure 2) – a level of confidence surpassed only by the life sciences industry. This confidence seems well founded: future demand is assured, and there is a pervading sense in the industry that the downturn is a blip in an otherwise smooth growth curve. Yet despite this confidence, a significant proportion – 21% – are less optimistic.

Figure 2: P&U companies believe the downturn will have less impact on them than other industries



...but the sector is not immune

The downturn poses two fundamental and interconnected threats for the P&U industry. The first is a short-term decline in demand, for which there is significant evidence. The industry's customer base includes every sector and consumer group. In some ways this is a strength, spreading and diluting recessionary risks. Exposure to segments that lead going into recession, such as consumer brands, is offset by the influence of customers in sectors that feel the effects of a downturn only later, such as healthcare, food and other consumer staples. This wide customer base limits the impact of a fall in demand but can increase P&U companies' exposure to payment defaults and arrears.

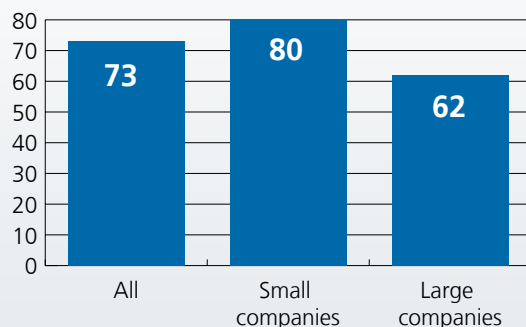
The second fundamental threat is the apparent contraction in the availability of finance, a consequence of the bank-led recession. Our survey of financial institutions, "New Insights into Risk Management for Financial Institutions", confirms that banks and financial institutions are indeed scrutinising capital projects more closely and are generally more conservative in their lending. But banks are still re-financing and lending to projects with secure revenue streams and finance is still available for projects such as power plant construction and grid improvements. Some project developers and operators however may be reluctant to incur more debt at a time when there is increased focus on de-leveraging balance sheets. As a result, some will be facing delays in current and planned projects.

Organisations in the P&U industry have to balance many different factors. Current supply and demand must be balanced against future supply and demand. Investment programmes must be balanced against future targets for emissions and renewables, and also against projected demand. And the industry's role as a public service must be balanced against its need to achieve sustainable long-term margins. We can surmise that the 21% of participants who are less confident than their peers are therefore taking a longer-term view on the downturn's impact.

Larger companies more cautious

Looking at the overall findings of our survey, we can see a notable difference in the attitudes of larger organisations when compared with their smaller peers. These companies show themselves to be more concerned about the impact of the downturn on the sector, believing it to be more at risk than others may do. Figure 3 shows that 80% of participants from smaller organisations say that the industry will be less impacted than other sectors, whereas just 62% of larger companies agree.

Figure 3: Percentage of respondents believing the P&U industry will be less impacted by the downturn than others

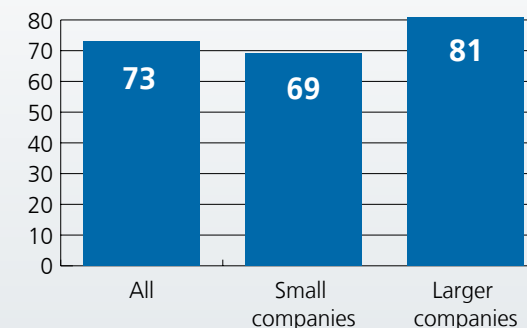


We can speculate on the reasons for this apparent conservatism. The larger a company becomes, the more its concerns move away from short-term survival and towards long-term sustainability. Liberalisation and privatisation across the region have opened up competition; many state incumbents have been broken up and few companies have maintained a monopolistic hold. Competition for resources to secure long-term development is fierce – whether in finance, land, project partners or personnel. And at the same time risk management and modelling tools have become highly sophisticated. Senior management today are much more aware of the industry's place in the broader economy and of the risk of volatility induced by external cycles.

Larger companies' long-term focus, combined with the industry's duty to continue generating and distributing power, may be leading to counter-cyclical investment, as this Dutch finance director explains:

“Even if the market rate is low the subcontractors' need to work is very real, so prices are falling. We are encouraged to launch new works – we are playing the role of a compensator.”
Finance Director, Netherlands

Figure 4: Percentage of respondents (by company size) who agree that the economic downturn has raised the importance of risk management at the most senior levels



Larger companies' conservative approach to the issue is also evident in their direct actions. While almost three-quarters, 73%, of all participants say that the downturn has raised the importance of risk management at the most senior levels, among the larger companies this increases to 81% (Figure 4). We will see more evidence of this when we analyse the sector's response in more detail in section 3 (on page 13).

2. Changing risk priorities

We are only able to take direct measures in so far as we follow on a daily basis the energy consumption of key account holders.

Risk Manager, Germany

We are trying to mitigate our credit exposure [to customers] and better understand their demand levels.

Corporate Risk Director, UK

As we have discussed, P&U organisations' strategic decisions are heavily influenced by the need to balance future demand and supply while investing in the new technologies and processes that are needed to meet changing environmental concerns. With the contraction in the availability of finance and the highly leveraged balance sheets of many organisations, it is unsurprising that immediate concerns focus on working capital and cash flow.

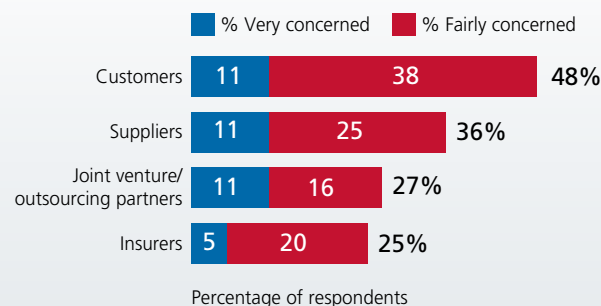
Focussing on the value chain

We asked participants how concerned they are about four different groups: customers (including demand-driven client relationships), suppliers, partners and insurers. Figure 5 shows the results and again illustrates the greater caution or sensitivity of larger companies.

In the case of customers and clients – a concern for 48% of participants – the anxiety is mostly financial, stemming in part from the increasing rate of business failure and growing problems with late payment and customer defaults. Organisations are therefore placing greater emphasis on credit checks and payment deadlines, either by reinforcing existing procedures or by introducing new ones. However, unlike companies in other industries, statutory protection means that many power entities and utilities cannot simply suspend supply for systematic non-payment. Despite their concerns, many are unable to manage the issue as actively as they would like.

The impact of the current recession is far-reaching and organisations are looking at margin volatilities and exposures across all areas of their business, including primary operations and support services. If we had asked a group of power executives about supply a year ago, their immediate focus would have

Figure 5: How concerned are you currently about the level of risk associated with each of the following?²



	% of small companies concerned	% of large companies concerned
Customers	40	62
Suppliers	29	48
Joint venture/ outsourcing partners	17	43
Insurers	14	43

2. Aggregate of 'very concerned' and 'fairly concerned' may differ due to rounding.

“Today we are monitoring the services of all our crucial suppliers – which means those we can’t replace. We identify [possible] failures... so that they can [if necessary] be replaced.

Risk Manager, Belgium

been on the security and continuity of power supply. Today our participants overwhelmingly focus on the wider value chain, including day-to-day consumables, goods and services for maintenance, and support services for internal functions such as IT infrastructure.

P&U companies are making considerable efforts to get to know their suppliers better, evaluating their financial health and, where necessary, identifying alternative suppliers. These actions are more typical of those companies exposed to intense, low-margin competition or of companies who have vast, cross-border supply chains with low margins and tolerances. This is a dramatic change of short-term focus and demonstrates the cautiousness that many power companies are currently feeling. It evidences a desire to reduce volatilities and exposures at every possible opportunity.

Identifying counterparty risks and exposures

Value chains - including conventional supply chain elements but also encompassing all partner contributions, suppliers and systems needed to trade effectively and profitably - are uniquely complex in the P&U sector. This is due in part to the prevalence of joint ventures and

multi-partnering, making it essential that organisations seek advice on risk allocation and liabilities. There is now evidence that this robust approach is also being applied to more informal contracts and ventures – a number of participants highlighted the need for formalising contracts as well as making sure they are correctly insured, often in relation to support service agreements.

The impact of this downturn extends beyond its direct effect on demand levels and bottom lines – there has also been a tangible shift in the scope of risk management. For example, the extent to which insurer relationships need to be managed and monitored has understandably changed as a result of the widely reported concerns about the solvency of some major insurers a few months ago.

While there remains a high level of concern about insurers – larger companies express much more concern about their insurers than their smaller peers, 43% and 14% respectively – this is now seen in the same context as other counterparty risks and there are a number of best practices emerging in this area.

“We are formalising contracts and being more demanding with regard to information, insurance and conditions.

Chief Financial Officer, Spain

“We have regular meetings and have tried to diversify our risks by multiplying the number of insurers
Company Secretary, France

We have had to redefine our relationships with lenders in respect of insurance risk management, particularly reviewing credit ratings and the financial standing of insurance risk providers.
Insurance Manager, UK

Monitoring your insurers: the importance of real-time information

The financial condition of insurance companies has always been a key consideration in building a strong insurance programme. At Marsh we have a dedicated team of financial analysts with extensive experience of analysing the solvency of insurance companies worldwide – our Market Information Group.

We help our clients to be as informed as possible about the current ratings of the insurance companies they use or are considering using, and keep them briefed on the issues affecting these companies. We do this through our global portal, Market Info on MarshConnect.

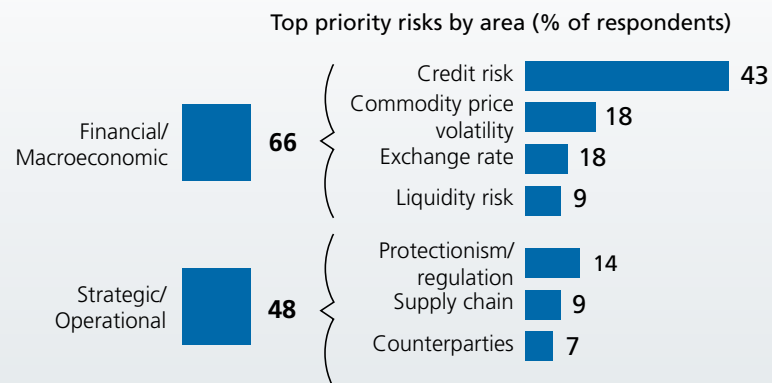
Market Info enables clients to create personalised portfolios of their insurance companies. Through these portfolios clients can see A.M. Best, Standard & Poor's and Moody's financial strength ratings of their selected insurers, as well as proprietary analysis prepared by Marsh's Market Information Group.

Clients can also register for automatic email alerts notifying them whenever their selected insurers' ratings change. This tool enables clients to conduct comparative analysis of their current and historic insurance carriers 24/7, and can also assist with evaluating alternative insurers should a decision be taken to change insurers or reduce proportional exposures.

Credit risk is an ongoing priority

When asked which risks will be priorities for their organisation over the next 18 months, 43% of participants spontaneously mention credit risk, as Figure 6 shows. Although credit is the most frequently mentioned risk across all our industry surveys, a greater proportion of our P&U participants ranked it a top priority. This is consistent with the sector's heightened concerns about cashflow and working capital, and is due in part to its breadth of customer and client relationships.

Figure 6: Over the next 18 months, which two or three types of risk will be priorities for your organisation?



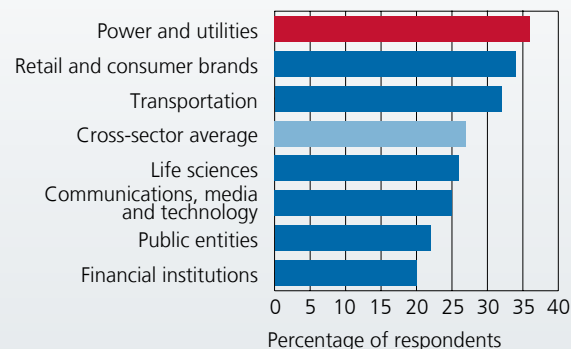
Commodity price volatility, an ever-present risk for this industry given the many constraints, often regulatory, on passing on price increases to customers, is also of critical concern to 18% of respondents. Changes in commodity prices can in turn affect profitability and gives rise to increased liquidity risk, another top mention (9%).

Confidence around existing risk management procedures?

Figure 6 also illustrates that near-term priorities are slightly more focused on financial and macroeconomic risks (66%) than on operational and strategic ones (48%); no-one highlighted traditional hazard risks. However, strategic, operational and indeed hazard risks remain as important as ever. When managed well these can become less of an immediate concern - and the P&U industry has long experience of managing such risks, building up a great deal of expertise in this area.

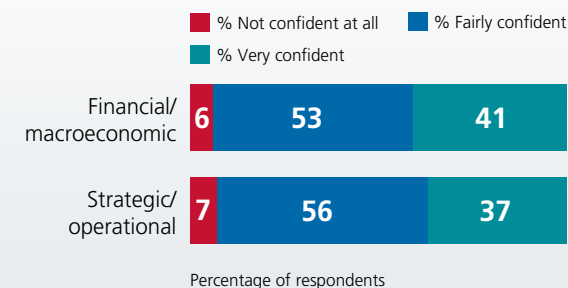
This appears to be supported by participants' confidence in their risk management processes. Of all the industries that we surveyed, P&U has the greatest proportion of participants saying that they are "very confident" in their risk management processes, 36% (Figure 7).

Figure 7: How confident are you that your current risk management processes will fully address the risks that face your organisation?



In line with our findings on near-term priorities, confidence in strategic and operational risks – such as regulation and supply chain – is a little lower than in financial and macroeconomic risks, as Figure 8 illustrates.

Figure 8: Confidence in different risk areas

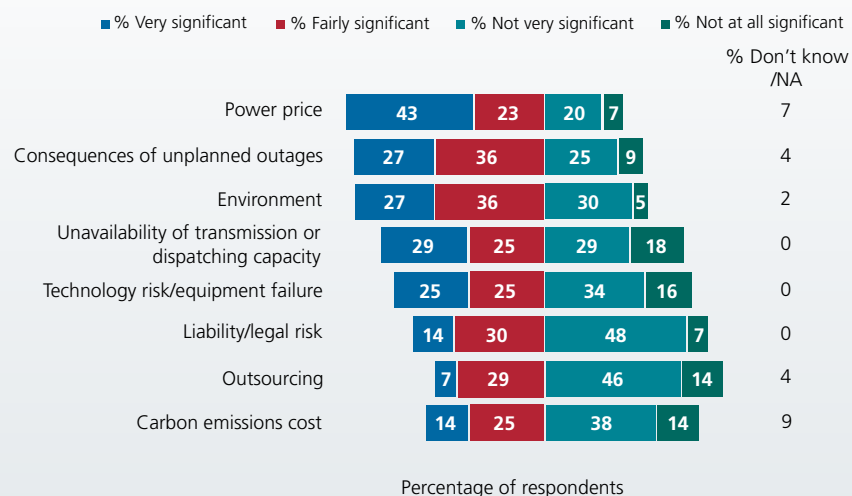


Given the many pressures that might push participants to claim confidence, it is interesting that the majority, 64%, nonetheless express some degree of uncertainty around their current processes. We can only speculate as to why this is the case. It may simply be that this is another indication of the sector's intrinsic conservatism. It may be a result of heightened risk-consciousness and a closer scrutiny of risks. Or it may be a consequence of organisations' focus on and limited options for dealing with the current financial and macroeconomic risks. Strategic and operational concerns will once again become more pressing as the economy begins to recover and companies may believe that they can undertake more direct action to mitigate and manage these risks.

Significant industry risks – some obvious anomalies and omissions

We asked participants to rate the significance of eight industry risks, stripping away the immediate focus on financial and economic conditions. Power price is rated 'very' or 'fairly significant' by the largest proportion of participants – 66% – as Figure 9 shows. Although commodity price volatility is an ongoing industry risk, it is also intrinsically linked to the current economic situation and its high ranking is therefore unsurprising.

Figure 9: How significant will each of the risks mentioned below be for your organisation over the next 18 months?



The low ranking of carbon emission costs is surprising and may be partly explained by our sample including all types of P&U companies, not just generating companies; partly also by the horizon of 18 months which the question stipulated – this falls within the next period of price uncertainty at the end of the second Kyoto period. While long-term expectations for carbon credit prices and demand remain stable, a recent Point Carbon³ study reported the behaviour of respondents from companies with carbon trading operations: 60% said they had scaled down, delayed or cancelled investments in carbon-credit projects as a direct consequence of the economic downturn. Furthermore, lower near-term price expectations, a surplus of carbon credits for trading, and uncertainty still about allocations in phase three of the EU Emissions Trading Scheme (ETS) from 2012 onwards would be expected to cause concern about the carbon cost issue.

We believe that a survey run a year ago would most certainly have produced very different results. But as previously discussed, strategic, operational and hazard concerns have not gone away, and organisations cannot simply choose to ignore them while focussing on financial risks. As we will see in the next section organisations are introducing new resources, processes and tools, and are developing their risk management infrastructure in order to address this new reality of risk.

3. "Carbon 2009. Emission trading coming home." Point Carbon, March 2009. (A survey of over 3,000 companies directly involved in carbon trading, companies with emissions regulated under the EU ETS, and other interested parties.)

3. Risk – the sector’s response

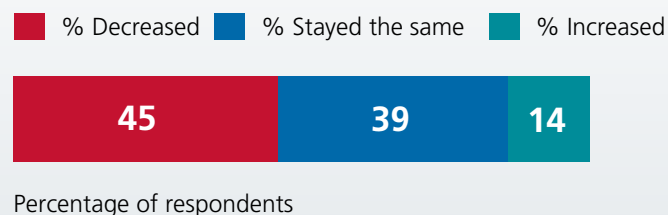
I think that the intercommunication between the risk management and the management board is going to increase.

**In-House Risk Consultant,
Germany**

Heightened risk consciousness and aversion to risk...

As awareness of risk increases, so risk aversion grows – we have observed this to a greater or lesser extent in all the industries that we have surveyed. The P&U sector is no exception: 45% of participants say that their board has become more risk-averse as a result of the downturn (Figure 10). This makes it the second most risk-averse industry in our survey, behind financial institutions’ 52%. This fall in risk appetite is, in part, a consequence of the intimate relationship the industry has with the financial sector – power trading, in particular, necessitates hedging, futures and forwards. Again, larger companies appear to have become more risk-averse than smaller companies, with 62% reporting a fall in risk appetite as opposed to just 34% of their smaller counterparts.

Figure 10: Would you say that the board’s appetite for risk has increased or decreased in light of the current economic situation?



...leading to top-down direct action

This heightened consciousness of risk, and the increased aversion to it, translates into direct action. As we have already noted, two-thirds of participants say their organisation has reviewed, formally or informally, its approach to risk. Figure 11 highlights once more that immediate focus is primarily on financial and macroeconomic areas: 24% of participants say they are examining their financial management processes and 14% are reviewing the solvency of clients and suppliers, for example.

Figure 11: In what areas has the downturn prompted you to review your approach?



We hold meetings jointly with all the corporate functions to understand the cross-relationships in decisions taken to counter the negative impact of the crisis.
Director of Risk, Italy

As awareness of risk increases, so does a need for robust risk management information and improved risk communication (Figure 12). But is this evidence of real, tangible changes in risk management processes?

In fact, our survey does indicate that boards are becoming increasingly active in shaping their company’s attitude to risk. When asked what their board is doing to improve awareness and understanding of risk, 25% of participants report changes to their company’s risk management strategy. Senior management have seen the consequences of unforeseen or badly managed risks, either at first hand or by observing their peers. Coupled with increasing corporate governance and compliance requirements, boards simply cannot afford to take a laissez-faire approach to risk.

Figure 12: What steps are you currently taking or planning to take to improve the way your organisation manages risk on a day-to-day basis?



Spotlight on directors' and officers' (D&O) liability

Changes in legislative and regulatory frameworks are making executive and non-executive directors increasingly accountable for their actions, and this is reinforced by evolving attitudes to and expectations of corporate performance.

The economic slowdown challenges corporate performance, focussing greater attention on the behaviour of directors and officers, and increasing the probability of litigation. The main external changes underlying this increase in directors' personal liability includes:

- Changes in legislation and regulations in the areas of company, competition and employment law, as well as corporate governance
- Increasing powers of regulators, including cross-border collaboration
- Greater focus on communicating information to shareholders
- Greater willingness of shareholders and other third parties to sue
- Introduction in Europe of legislation to allow class and representative actions

D&O insurance protects against losses arising from claims made against individuals as a result of any allegation of wrongful acts committed in their capacity as a director or officer. It provides for defence costs as well as damages, with the defence costs being reimbursed as they are incurred. (Proven fraud or dishonesty is excluded).

The consolidation taking place in many industries has also contributed to a growth in claims. Many arise from corporate transactions such as mergers, acquisitions, management buyouts and initial public offerings. The most frequent causes of D&O claims activity include:

- Stock price volatility
- Mergers and acquisitions when companies are in poor financial condition
- Insider trading
- Overstating revenues or earnings, leading to financial restatements
- Failure to disclose problems relating to the purchase of a subsidiary
- Accounting irregularities
- Late disclosure of information to investors

D&O insurance claims, by their nature, are complex and high profile. Issues may also arise around how circumstances that could give rise to a claim are notified to insurers to preserve the cover for directors if a claim is subsequently made. As a result timely, high quality advice is important.

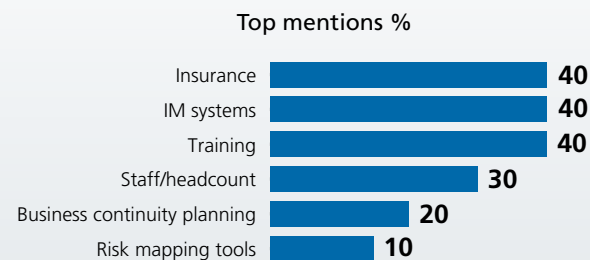
There is particular emphasis on risk management in our company... and an allocation of further resources for risk management.
Risk Manager, Germany

Risk management budgets expected to increase

Further evidence of a real shift in risk attitudes became evident when we asked about risk management budgets. Our survey found that 36% of P&U respondents expect budgets to increase in the next 18 months.

Part of the reason for an anticipated increase in budgets (Figure 13) is a general expectation that insurance rates will increase over the coming months. 40% of respondents expect some of the extra spending to go towards insurance as a result of rising costs or the need for additional and more specialist lines of cover.

Figure 13: Areas of investment for those respondents expecting an increase in risk management budget over the next 18 months



Building-out risk management infrastructures

There is a sense of an industry building-out its risk infrastructure and this is reinforced by participants’ accounts of what is already being done to improve day-to-day risk management. As Figure 13 illustrates, other areas for increased budgetary spend such as investment in information management systems is further affirmation of senior managements’ commitment to robust risk management.

There has been, shall we say, a revision of the [risk management] framework...that’s where the board’s attitude to risk has led to changes.
Chief Financial Officer, Norway

Upper management is much more involved in risk management than before. There is more control of financial risks.
Internal Audit and Risk Management Manager, Spain

Increasing centralisation further reflects risk awareness at the highest levels

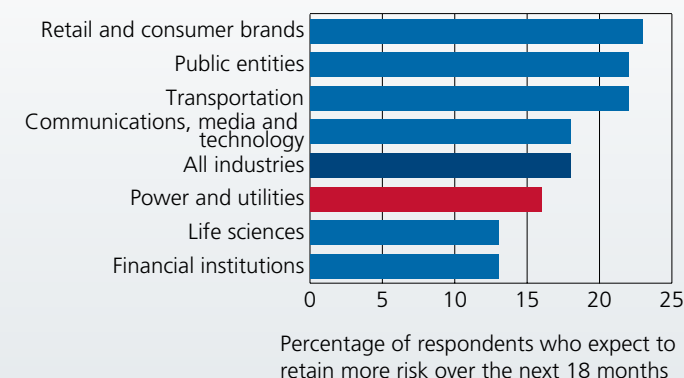
Our survey highlights a slight shift towards centralised risk management within the power sector. The majority of participants, 59%, say that their organisation currently has a centralised rather than a devolved model. Most do not anticipate significant changes to this over the coming months; any shift however is expected to be towards further centralisation (20%).

While this may be another example of increased risk awareness at senior levels, it is also worth noting that participants’ perceptions as to the degree of centralisation in their organisation may simply be a reflection of increased risk communication from senior management. Participants did report changes stemming from alterations in the board’s appetite for risk - 36% said that there are now more controls in place, that there is more reporting, and 6% say investments are now analysed more thoroughly. While these changes evidence heightened risk-consciousness and a desire to manage risk in the most effective and robust way possible, we cannot conclude from them that there has been a real and tangible move towards centralisation in all cases.

To retain or to transfer risk?

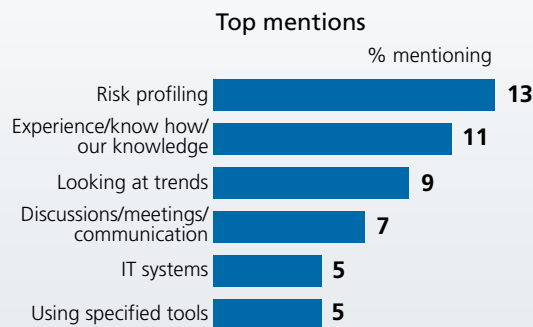
Greater formal analysis and recording of risks allows more informed decisions to be made about how and where to retain or transfer risk. In the case of the P&U sector, the majority of participants, 64%, expect the balance between retention and transfer to remain unchanged over the next 18 months. Figure 14 shows that the proportion expecting to retain more risk (16%) is relatively low compared with other sectors.

Figure 14: P&U companies do not expect to retain more risk on their balance sheets in the next months in comparison to other industries



When asked about the tools and techniques they use to decide on levels of risk retention (Figure 15), relatively few participants mention specific tools or formal processes such as risk profiling. Instead participants talk of informal means such as their experience, with around a quarter saying they don’t know or are not aware of what tools are used.

Figure 15: What tools and techniques have you found most effective in helping to decide levels of risk retention in your organisation?



We don’t have a formalised approach to risk retention.

Head of Internal Audit, UK

This low level of reference to sophisticated risk tools and techniques is a paradox. It contradicts the sector’s heightened risk-awareness and the overall cautiousness that has been apparent throughout our interviews. The P&U sector has long used sophisticated modelling and load-balancing models in its day-to-day operations, and it is unlikely that the sector is failing to employ risk management tools.

Risk by its very nature is volatile and every organisation’s risk profile is constantly changing. It follows that effective risk management tools must also evolve. Some companies may be employing little in the way of formal risk management tools, but many others are doing so as a matter of course and – having evaluated their effectiveness – may be aware that more sophisticated tools and solutions need to be found.

We therefore conclude this report with some recommendations (on page 19) that will enable organisations in the P&U industry to develop further their understanding of the risk management practices and the tools and processes employed by many of their peers and competitors in the sector.

... constant reminder[s] to the business that when they are thinking of risk they are looking at emerging issues. So, as an example, we try to ensure that if there is new legislation and regulation on the horizon, what are we doing to respond to it positively? We also try to monitor best practices and how we are aligned to those practices - are we leading or are we following?

Risk & Insurance Manager, UK

4. Marsh's recommendations

Review how you finance risk

Many companies now recognise that managing risk can create valuable upside in their businesses when it is done effectively. A company that understands how risk might impact its key performance indicators can move more effectively to seize opportunities and drive business performance. The strategies that companies develop for financing risk are an important part of this process. By simply procuring insurance, companies could miss an opportunity to extract better value from capital in their business. In the most serious cases, sub-optimal decisions on financing risk can impact key financial indicators and erode margins.

Recognising this, a growing number of companies are taking a more sophisticated approach to the way in which they finance risk. By better managing their exposure to the insurance market cycle through improved risk management and alternative financing arrangements, companies are reducing the volatility of their risk financing cost base and creating value for their businesses. At Marsh we call this process Risk Finance Optimisation. While this may appear to be a complex process, very often it is more about coordinating the activities of existing functions and individuals, while overlaying more rigorous financial analysis on which to base management decisions.

At Marsh, we recommend that our clients follow a three-step process to ensure that they are making appropriate risk-financing decisions and our workshops are designed to take clients step by step through the process.

- Step 1: Understand the strategy and current position of the business.
- Step 2: Analyse and model the data.
- Step 3: Design and place risk-financing solutions.

It is a strategic process that enables firms to make balanced and objective decisions around the allocation of capital to risk. It starts with a measurement of the value of a company's investment in insurance, similar to any other capital appraisal, and can help ensure that working capital is applied as effectively as possible. Indeed, many of the clients that Marsh has assisted through this process have been able to reduce their total cost of risk, thereby releasing capital back into the business.

The process can be undertaken at any time, however some primary drivers include restructuring or acquisition integration, companies in distress, leadership or management changes, changing insurance costs, a back-to-basics review, or unusual or difficult to place insurance exposures.

Another reason to look closely at how your organisation is financing its risks is the contraction of traditional capital finance such as debt and equity. Can risk or contingent capital be viewed as a third source of finance? Insurance can be used to free up financial resources. Decisions about whether to use contingent capital or own resources depend on the business's risks and its needs. Whether to insure a given risk, and how low to set the deductibles, depends primarily on loss exposure both in terms of frequency and severity; but the strategy also depends on the effective cost of risk capital. Is insurance cheaper than the cost of maintaining contingent reserves?

These very detailed and complex calculations can help to find solutions to ease liquidity problems and increase the resources available for investment. Ultimately, the decision can only be as robust as the management and risk information that is collated within the organisation.

Understand your tolerance and appetite for loss

Risk tolerance or tolerance for loss can be defined as the financial ability to pay for losses (not limited to insurable losses) as a result of risk related events. It is an acceptable amount of financial impairment that can be retained without a material impact on the business. 'Risk tolerance' is about how much a company can financially retain and can be differentiated from 'risk appetite' which is how much risk a company is willing to retain. Understanding risk tolerance will provide companies with a framework to review their overall "pain threshold" based on the impact of a major loss event on key financial ratios.

Risk tolerance levels should at the very least be reviewed annually and the basic framework involves several key steps:

- Analysis of key financial ratios such as 'rule of thumb', key performance indicators and covenant requirements.
- Understanding risk appetite.
- Application to analysis of exposures and loss history.

Benchmarking and the importance of best practice

All organisations generate huge amounts of data. P&U organisations in particular collect a significant amount of data for regulatory and financial purposes – but not all maximise the industry intelligence that they have in-house. Risk profiling and evaluation should be an ongoing, dynamic process, not an annual event. Moreover, from working closely with organisations in the P&U sector, Marsh knows that good-quality risk management information can result in significant insurance cost savings.

By working closely with insurance brokers and risk management advisers, organisations can understand best practice and apply it to their data collation and reporting processes. Identifying issues, benchmarking, validating previous decisions and understanding marketplace trends can enable organisations to prove they have a more robust approach and a greater commitment to risk management. Even those who may otherwise be struggling may still benefit from this increased transparency, both internally and externally.

Case studies

A **power client** felt that it had the capacity and the appetite to retain more risk and engaged Marsh to calculate the most appropriate level of self financing for them going forward. Our study revealed that although the company had both the willingness and ability to take more insurance risk, the market conditions would not allow them to allocate their capital to risk efficiently by doing this. Given this position, we found that the captive utilisation was their optimal solution given the size and maturity of the company but that there was scope for it to be further utilised in the future if the right blend of risk and reward could be identified. Coupled with our knowledge of market conditions, the study findings were a critical input to the company's renewal process, helping us to shape the right blend of coverage, programme design and cost. Moreover, the study also identified that the client had a very robust internal audit and risk identification process - the corporate governance aspect to our work meant that the process not only validated what had gone before but also provided a robust justification for the future programme.

An international client was selling part of its **nuclear equipment** manufacturing business to another client with no previous experience in the nuclear sector. Marsh was appointed to set up a stand-alone programme for this unique risk, accessing capacity through a number of ways including State pools. This involved, inter alia, building risk models using actuarial techniques including for risk classes where there was insufficient historical data pertaining to the client. It also included a consideration of the risk philosophy and strategy of both the acquiring company and the acquired subsidiary and review how to best combine them. As well as creating a brand new risk financing programme, the new owner quickly gained a greater understanding of the industry sector and about their new subsidiary.

Methodology

Our survey of over 700 participants in seven industry sectors included 56 in Power and Utilities industry. All contribute to strategic decisions related to their company's management of risk, and Figure 16 shows a breakdown of their job titles.

The companies all have a turnover greater than €50 million (see Figure 17) and were selected using Bureau van Dijk, an international business database. Sampling was random, but we tried to achieve a reasonably even spread over five countries (France, Germany, Italy, Spain and the UK) and two regions (Benelux and the Nordic countries), as Figure 18 shows.

The interviews were conducted by telephone from the Ipsos Harrow telephone centre, in local languages, between 11 March and 19 May 2009.

Figure 17: P&U survey respondents by turnover band (Number of achieved interviews)

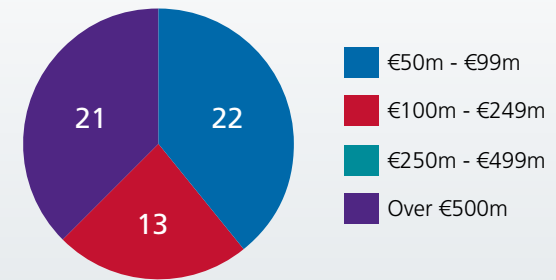


Figure 16: P&U survey respondents by job title (Number of achieved interviews)

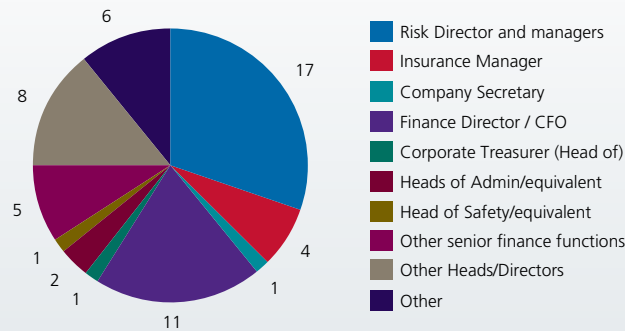
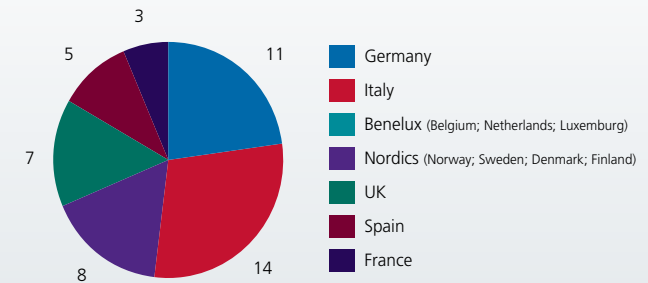


Figure 18: P&U survey respondents by country (Number of achieved interviews)



About Marsh's EMEA Power and Utilities Practice

With over 500 clients in 50 countries Marsh is the acknowledged market leader in the provision of insurance and risk management services to the international power and utilities sector. Our client base encompasses the whole spectrum of power and utilities, including vertically integrated nationalised industries, transmission and distribution companies, Independent Power Projects (IPP), Combined Heat and Power (CHP) projects, as well as nuclear and renewable energy companies. Water, wastewater management and gas distribution also come into the category of utilities

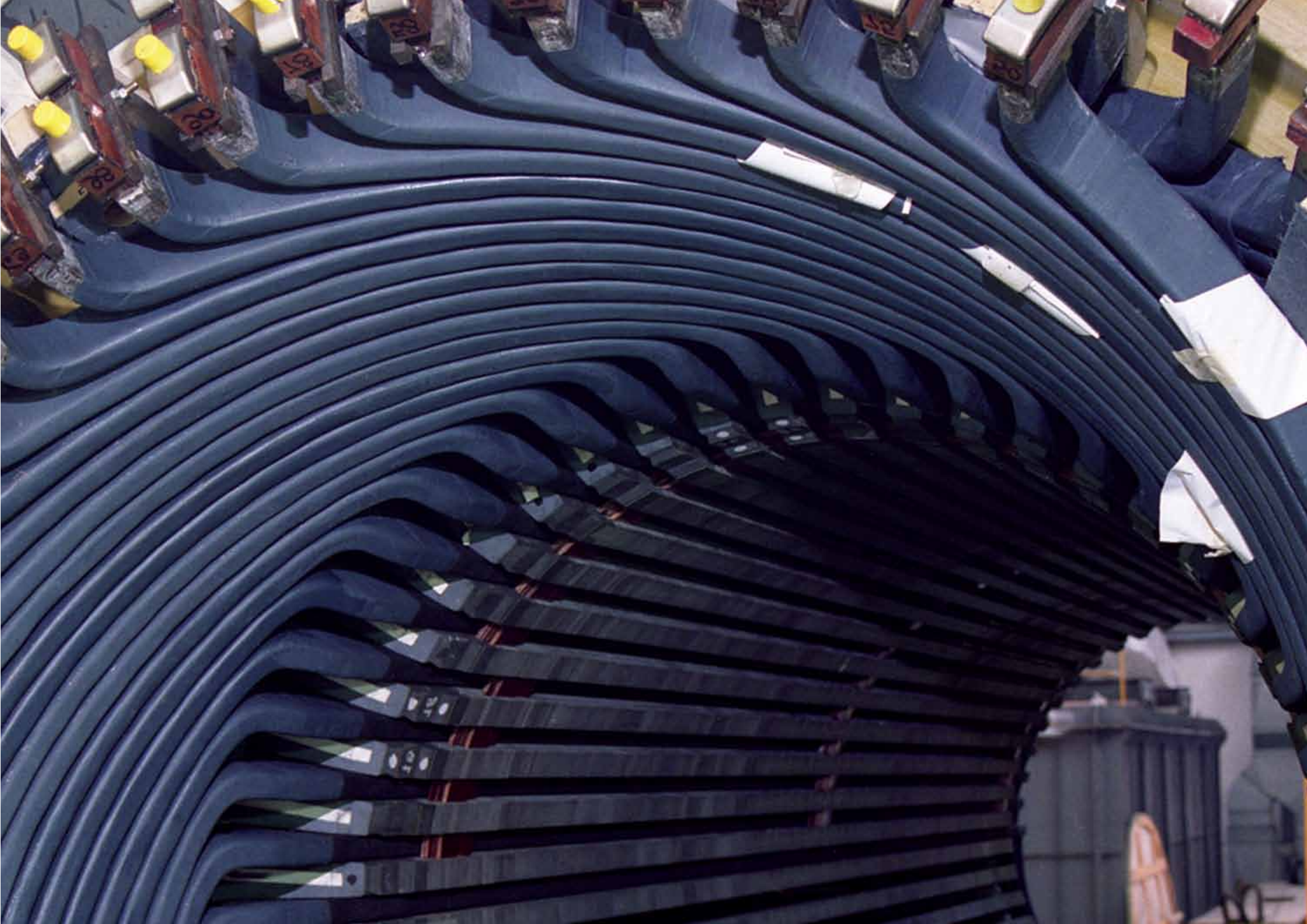
Our industry practice approach allows us to build a unique knowledge of the particular needs of power and utilities companies and to tailor our services and solutions accordingly. Services are delivered through a long established international network of centres of excellence and in-country industry specialists, many of whom have formerly worked in the power industry. These dedicated resources span all relevant disciplines including client servicing, insurance broking, risk engineering and risk management for insurable and non-insurable risk, and offers clients dynamic risk assessment, deep market relationships and bespoke consulting services.

Through our market relationships, industry knowledge and programme design capabilities, Marsh and MMC has a unique and unrivalled ability to assist power and utilities companies in ensuring the optimum combination of risk retention, risk control and risk transfer.

Contacts

Mark Pollard,
EMEA Power and Utilities
Practice Leader,
+39 02 48538 283
mark.pollard@marsh.com

Azerbaijan	Shanin Ahmadov	+994 12 497 5385	shahin.ahmadov@marsh.com
Belgium	Francois-Xavier De Viron	+32 2 674 91 36	francois-xavier.devirion@marsh.com
Botswana	Fritzgerald Dube	+26 7 3188000	fritzgerald.dube@marsh.com
Bulgaria	Ventsislav Stoykov	+359 2 402 0000	ventsislav.stoykov@marsh.com
Croatia	Svanimir Steiner	+385 1 60 60 400	svanimir.steiner@marsh.com
Czech Republic	Jan Marek	+42-022 141-8194	jan.marek@marsh.com
Denmark	Henrik Larsen	+45 4 595 9550	henrik.larsen@marsh.com
Estonia	Mart Mere	+372 681 1000	mart.mere@marsh.com
Finland	Toivo Makynen	+358 9 8677 4220	toivo.makynen@marsh.com
France	Jean-Noel Delabrousse-Mayoux	+33 14 134 5322	jean-noel.delabrousse@marsh.com
Germany	Michael Härig	+49 211 8987 368	michael.haerig@marsh.com
Greece	Dorina Economopoulou	+30 210 817 6004	ioannatheodora.economopoulou@marsh.com
Hungary	Zsolt Ógel	+36 1 881 7238	zsolt.ogel@marsh.com
India	Pranav Patel	+91 22 6651 2931	pranav.patel@marsh.com
Ireland	Guy Banton	+35 31 6048100	guy.c.banton@marsh.com
Israel	Elad Nave	+97 23 638 3006	elad.nave@marsh.com
Italy	Andrea Righetti	+39 02 48538 274	andrea.righetti@marsh.com
Kazakhstan	Andrei Komarkovsky	+73 27 298 0858 Ext. 118	andrei.komarkovsky@marsh.com
Latvia	Kaspars Ummers	+371 7 095 095	kaspars.ummers@marsh.com
Lithuania	Rimantas Chaleckas	+37 05 252-6170	rimantas.chaleckas@marsh.com
Namibia	Panna Van Staden	+264 61 229714	panna.vanstaden@marsh.com
Norway	Christine Stenersen	+47 2 201-1141	christine.g.stenersen@marsh.com
Poland	Michal Gabryelak	+48 22 456 4223	micHAL.gabryelak@marsh.com
Portugal	Jaime Fernandes	+35 121 311 3722	jaime.fernandes@marsh.com
Romania	Anca Dolete	+40 21 232 1874	anca.dolete@marsh.com
Russia	Dmitry Saveliev	+7 495 783 85 26	dmitry.saveliev@marsh.com
	Sergey Samofalov	+7 495 787 70 90	sergey.samofalov@marsh.com
Saudi Arabia	Roger Mattar	+96 61 419 1955 Ext. 163	roger.mattar@marsh.com
Serbia	Zoran Jovanovic	+38 111 313 0409	zoran.jovanovic@marsh.com
Slovak Republic	Barbora Bechnak	+421 2 5920 54 14	barbora.bechnak@marsh.com
Slovenia	Damjan Znidarcic	+386 1 569 21 60	damjan.znidarcic@marsh.com
South Africa	Teresa Gomes-Maduro	+27 11 506 5000	teresa.gomes-maduro@marsh.com
Spain	Miguel Martinez Paniagua	+34 91 4569448	miguel.martinezpaniagua@marsh.com
Sweden	Par Jannesson	+46 8 412 4200	par.jannesson@marsh.com
Switzerland	Robert Kessler	+41 44 387 8866	robert.kessler@marsh.com
	Simon Kuenzler	+41 44 387 8723	simon.kuenzler@marsh.com
The Netherlands	Jacob Strijker	+31 20 5417454	jacob.strijker@marsh.com
Turkey	Volkan Simsekalp	+90 212 355 4444	volkan.simsekalp@marsh.com
UAE	Tony Saada	+97 14 212 9102	anthony.saada@marsh.com
UK	Mark Popplewell	+44 20 7357 5849	mark.r.popplewell@marsh.com
Ukraine	Olga Kubanova	+380 44 490 6369	olga.kubanova@marsh.com



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