

Regulatory Compliance and Risk in the Utilities Industry

Facilitating Compliance through Technology

Executive Summary

The growth in legislation and other compliance issues governing utilities is one of the most pressing, and potentially costly, challenges facing this industry. Building a culture of compliance requires every level of a utilities organisation to understand its responsibilities internally, and within domestic and international markets.

A strategic approach to operational risk, customer-facing processes, systems security, and industry regulatory compliance will generate a greater return on investment. Above all, utilities organisations will be able to align their companies with industry trends, add value to the business, and compete successfully in increasingly aggressive markets.

A survey conducted by Finextra Research, conducted on behalf of Microsoft at the end of 2004, reveals that these trends are uppermost in the minds of senior executives responsible for regulatory compliance in utilities companies worldwide.

When asked to name the biggest compliance challenge, 75 per cent cited industry regulations. Operational risk came second with 50 per cent, while complaints management and customer-facing processes racked up the third-highest score with 35 per cent.

When it comes to achieving compliance, most companies identified in-house teams as the most important resource, followed by law-firms, consultants, and technology vendors.

Nearly all are using technology to support compliance and a growing number are implementing new solutions that address specific areas of concern including security, document and record management, risk management, and business performance management. Traditionally, in many companies boards of Directors and Chief Executive Officers (CEOs) have regarded these disciplines as largely separate functions.

Above all, these solutions can deliver more value to the business than just achieving compliance and satisfying regulators including:

- Optimising controls and related processes.
- Improving accountability throughout the enterprise.
- Integrating financial reporting and internal control processes.
- Redirecting compliance efforts away from risk aversion and towards risk intelligence.

When implemented intelligently and integrated with existing systems, compliance technology can support an integrated response to operational risk and external agencies, reducing costs associated with these areas and increasing the overall competitiveness of the business. The information contained in the integrated response will in almost all cases help managers make better decisions at a lower cost.

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1. Facing Compliance

The U.K. electricity, gas, and water industries are facing unprecedented levels of regulatory compliance in an increasingly fast-moving business environment. Not only are they exposed to the harsh atmosphere of competition and enforcement, but on an almost daily basis, management and boards of directors are being asked to absorb and anticipate significant regulatory requirements and then implement them in a cost effective way.

Utilities companies also compete in an increasingly global marketplace as well as a crowded domestic sector. Mergers and acquisitions and cross-border alliances have created an industry that is a world away from the nationalised industries and state monopolies of the last century.

U.K. directors of compliance or heads of regulation must take account of edicts from domestic regulators, including:

- OFWAT¹, the economic regulator for water and sewerage services in England and Wales.
- OFGEM², the regulator for the U.K.'s gas and electricity industries.
- Department of Environment Food and Rural Affairs (DEFRA).

OFGEM has two primary duties: to promote competition by creating the conditions which allow companies to compete fairly and customers to make informed choices; and to regulate those areas of business where competition is not effective. This is generally achieved by means of price controls and the monitoring of formal standards, to ensure value for money and good service.

Compliance managers must also comply with new regulations that apply to most industries including:

- Sarbanes-Oxley Act of 2002³ (SOX) in the United States.
- Basel II Capital Accord, European Union (EU) directives.
- Other regulatory drivers such as the U.K. Data Protection Act, the U.K. Freedom of Information Act, the U.K. Financial Services Authority, new global accounting standards, such as International Accounting Standards (IAS 39), and the U.K. government's 2005 Electronic Records Management requirements.

Building a Compliance Culture

Perhaps the greatest common challenge for utilities companies — apart from industry regulations, operational risk, and complaints management — is the development of a culture of regulatory compliance, with each level of the enterprise understanding its role and responsibilities towards industry regulation and other international drivers.

Whether a company is a global or domestic player in the marketplace, a strategic approach to the pressures of operational risk, customer-facing processes, systems security, and industry regulatory compliance, will generate:

- A greater return on investment (ROI) on compliance expenditure.
- Improved productivity.
- Ability to differentiate organisations from other businesses.

In the case of public companies, managers authorising expenditure need to assure stakeholders, especially shareholders, that sound business practices are in place. After all, they are spending other people's money, not their own.

Utility enterprises in the U.K. and elsewhere in Europe are often faced with large and complex organisational structures. In addition to the complicated business issues that they normally face, such as load forecasting, trading operations, and complex data-collection systems, utilities need to be alerted to ongoing changes in regulations, and ensure that they are positioned to exploit opportunities in as many markets as possible.

In pursuit of their ambitions to deliver value to their customers at an affordable price, they inevitably experience enormous challenges in the areas of data collection, data management, information processing, and dissemination.

1 www.ofwat.gov.uk

2 www.ofgem.gov.uk

3 The Sarbanes-Oxley Act takes effect from June 15 2005

The Challenge of Disparate Systems

Technology can solve the problem of disparate systems and accelerate the development of a new compliance culture. Unfortunately in many companies, management and the board have traditionally viewed disciplines such as operational risk, complaints management and customer-facing processes, risk management, and industry regulatory compliance, as largely separate functions. More often than not they use different technology and are managed independently. Many organisations lack a single view of their critical information or see it simply as an integration problem.

In some utility companies the unintegrated approach is now creaking under the burden of growing regulation and added pressures from external agencies. Increasingly, utilities companies suffer from accountability and communication vacuums, which can adversely affect the reputation of a company as well as its stock market valuation.

Key Issues around Compliance

A proactive rather than just a monitoring approach to compliance is the desirable outcome, but any organisation reviewing compliance and risk management processes should start by asking a number of fundamental questions:

- Is our existing compliance and risk management system heavy on manual processes, but lacking in substance or automated delivery mechanisms? Put bluntly, are we confident that we are breaking no laws, telling no lies, and pricing according to the demands of the marketplace?
- On the other hand, are we spending too much to comply with regulations? Are we focusing on internal controls, financial reporting, and disclosure at the expense of other risks to the enterprise's reputation including taking stock of new sources of regulation?
- Our compliance culture may meet the letter of the law, but is it meeting our commitment to corporate social responsibility? Are we confident that a sustainable culture of compliance is taking root at every level of the organisation?
- Is our policy towards compliance proactive or merely reactive? Are we sure that we are managing all our risks in an integrated way by making sure that our managers

and boards of directors take a single view of all relevant information, or is key data still scattered around in different silos?

- Do we have appropriate escalation, reporting, and remediation procedures in place to identify and resolve compliance issues in a timely way?
- Are we sure that we are fit for purpose in managing new regulations with scalable technology as new initiatives impact on our industry?

Looked at in this way compliance is undoubtedly challenging for most utility companies, but many are using it as a major opportunity to invest in their businesses for long-term benefits.

Adding Value to the Business

Utilities are not alone in facing these new challenges. Increasingly, across all industries there is a growing realisation among management and boards of directors that a new approach is required to manage operational risk, systems security, risk management, complaints, and industry regulatory compliance.

Organisations that integrate these functions will not only gain peace of mind, but effectively protect themselves and in fact create added value through reduced operational costs and improved collaboration across their business.

By embracing a new vision of compliance, companies will gain in reputation as well as add value to their business. Compliance-related business changes are not only a defensive measure to mitigate risk, but also an offensive strategy to unleash companies' often hidden repositories of data assets. In the socially responsible utility company, compliance also becomes something that concentrates on compliance as an outcome, not simply a monitoring activity.

These vitally important themes have clearly emerged from the independent Microsoft® Survey on Regulatory Compliance in the U.K. conducted in December 2004⁴. It showed that compliance officers are increasingly concerned about integrating disciplines that have—until recently—often been regarded as separate functions.

⁴ The survey was carried out by Finextra Research on behalf of Microsoft strictly according to local data protection laws. The privacy policy can be viewed at www.microsoft.com/info/uk-en/privacy.htm

2. Regulatory Compliance in Utilities Survey Findings

The *Microsoft Survey on Regulatory Compliance in Utilities* involved a range of businesses in the electricity, gas production, and distribution sector, water distribution and production, and waste disposal industries. Many of the companies surveyed operate cross border and through subsidiaries in Europe, North America, and Asia Pacific. The senior executives who responded personally to the survey included heads of regulatory compliance, regulatory compliance officers, financial controllers, heads of internal audit, and customer operations managers.

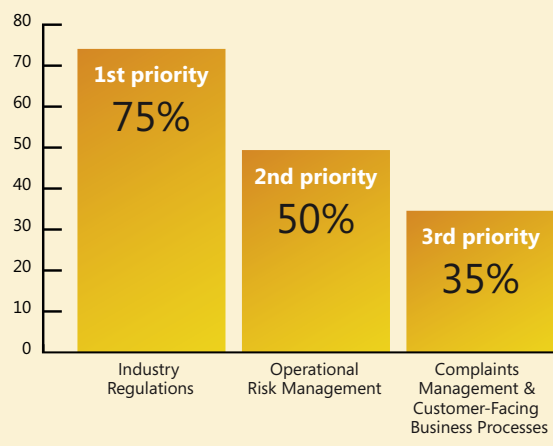
Greatest Compliance Challenges

Not surprisingly, the vast majority of the businesses that responded positively considered central compliance officers, line-of-business managers, and heads of operations to be very important in managing compliance in their organisations. Asked to rank the three biggest compliance challenges, the respondents cited the following:

- 75 per cent of the respondents opted for industry regulations as the most important challenge, with many of them specifying OFGEM and OFWAT as far as the U.K. is concerned.
- Operational risk management was second with 50 per cent of the respondents selecting it as the biggest problem after industry regulations.
- Complaints management and customer-facing business processes was third with 35 per cent of the respondents choosing it as the last of their big three challenges.

Reporting and accounting standards also figured in some of the responses, together with systems security, archiving and retrieval of documents, and corporate governance. At least one company singled out developing a culture of compliance throughout the enterprise as its biggest single challenge.

In order of priority, what are your three biggest compliance challenges currently?



Industry Regulation

Asked to rank the most important industry regulations, the respondents cited the following:

- OFGEM and OFWAT was rated very important at board level for more than 80 per cent of the respondents with the rest describing it as important for their boards.
- There was a mixed response on EU directives as being very important at board level with more companies choosing data protection and corporate compliance.
- Financial regulation and international accounting standards were considered very important to around 50 per cent of the respondents at board level.
- Nearly all the companies in the survey said they are using staff training and process change in tandem with investment and changes in technology to address their compliance challenges.
- Most companies ranked in-house teams as the most important means of achieving regulatory compliance, with law firms next, followed by consultants and technology vendors.
- Nearly all considered that IT was an important tool for ensuring regulatory compliance, especially for the audit trail.

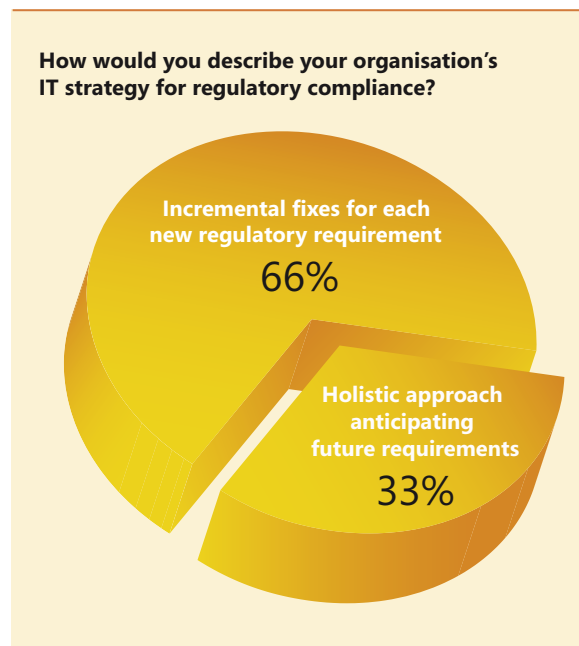
Strategies for Compliance

When asked to describe their organisation's IT strategy for regulatory compliance:

- One-third of the sample said they were taking a holistic approach to anticipating future changes from their industry regulators and elsewhere.
- However, the rest of the respondents admitted that they used incremental fixes for each new regulatory requirement.

There was no pattern discernible in particular industry sectors. For example, water and waste-disposal companies were no different to electricity producers and distributors.

The respondents were evenly divided into two camps—those that were using existing systems to meet regulatory changes and companies that planned to introduce new systems. The vast majority of companies surveyed considered that their current infrastructure supported their compliance needs, with a few conceding that it needed more work, and only one admitting that it performed poorly.



3. Key Enablers for Risk Management and Compliance

A string of corporate failures in recent years, including Enron, have generated an ever-changing regulatory environment for the utilities and energy industry. The survey found that technology—coupled with culture change involving staff training and process change—are the best enablers for success in compliance and risk management. They can help satisfy shareholder expectations and secure the future of the enterprise. In some cases, much of the technology and expertise already exists within the company, but too often it resides in silos and isolated pockets of the business.

For example, over the past decade, e-mail messaging has become critical to many businesses. But for many utility companies, management of e-mail messaging as business records has not kept pace with its importance to the enterprise and the compliance culture. Many companies still archive and retrieve e-mail on an ad hoc basis.

Few have clearly defined policies about using messaging and what sort of data is to be transmitted, or how to keep data that may be required later by the industry regulator. Many utility companies are only now realising that they need systems to store e-mail messages in a searchable, retrievable format.

Callum McCarthy, Chairman of OFGEM, has stated that the basis of a good regulatory relationship is the 'no surprises principle'—a desire to avoid giving unexpected shocks applied mutually between regulator and regulatee. This principle would certainly have been broken if TransAlta, a Canadian energy utility had been reporting its \$24 million spreadsheet error in the U.K. In the face of increasing regulatory oversight it has become a growing challenge to retain the enormous value in end-user computing applications, particularly spreadsheets, while developing improved forms of risk management.

Secure E-Mail Archiving and Retrieval

Regulations such as SOX have highlighted the need for all industries to maintain, store, and secure data including electronic messages for several years, depending on the requirements of the regulator.

Technology companies such as VERITAS (KVS)⁵ provide an out-of-the-box solution with the ability to archive or journal messaging data sent within an organisation and to and from external systems. Utility companies, such as npower, the biggest U.K. supplier of electricity, use it to search and retrieve archived data quickly.

Such a solution eliminates the need for personal folders (.PST files) and gives users the option to quickly retrieve data. For npower—before it implemented the solution—backing up personal folders daily, plus using Microsoft Exchange Server stores was putting a great strain on its network and wasting valuable time for administrators.⁶

Products such as this can help utilities companies by providing additional capabilities to meet requirements for lifecycle management of critical data and to protect against business risk.

Because of mailbox size limits, users at npower often stored e-mail messages in high-maintenance personal folders, leading to the need to search multiple sources for important compliance messages or documents.

In the case of VERITAS Enterprise Vault, all messages in the archive are stored both in their original .msg format and in either plain text or HTML format. Users can browse the archive and view messaging by using Microsoft Internet Explorer from any workstation if they have the correct access permissions.

Client access is provided through familiar interfaces such as Microsoft Office Outlook® 2003 and Microsoft Office Outlook Web Access for users both online and offline. Using a flexible Web-based tool, an administrator can assign roles to users to control data access and retrieval. In all utility companies, access to data should be controlled and audited so that this function is not abused.

⁵ For more information www.veritas.com/kvs

⁶ Interview with Andy Broome, Technical Support Manager, npower

Electronic Document and Record Management

Compliance should now be seen as an opportunity for utility firms to improve their understanding of their customers' needs and to streamline their business processes.

Technology solutions which combine electronic document and record management (EDRM), workflow and collaborative working, can provide them with the tools they need to achieve this.

The storage of unstructured data and the need for integrated (EDRM) systems are major requirements for utility companies. Technology companies such as Meridio⁷ are developing industry-leading EDRM software that is designed to transparently integrate with the familiar applications of the Microsoft Office System, ensuring that enterprises implement state-of-the-art EDRM with minimal additional infrastructure costs and training.

Solutions such as Meridio's provide integration functionality that supports the development of comprehensive e-business solutions by harnessing all the enterprise content needed to underpin line-of-business applications, such as enterprise resource planning (ERP) and customer relationship management (CRM). Meridio is working closely with major utilities companies, including Scottish and Southern Energy (SSE), which it is helping to provide customers with transactional services through the Internet.

This software has proven to be particularly effective for customers with large-scale document management requirements, and for those who need an EDRM engine that can integrate easily with a range of applications across the enterprise, including legacy systems, ensuring that all the business content is properly managed. It fits naturally as the central repository for all business-critical documents, supporting the exploitation of those documents within internal and external business processes, permitting interoperability of all departments, systems, and Web portals.

An EDRM engine provides a platform for organisations that need to introduce electronic records management in support of new compliance requirements, such as the U.K. government's 2005 Electronic Records Management requirements, the Freedom of Information and Data Protection Acts, SOX, Basel II, and other legal and regulatory requirements.

Proactive Risk Management Solutions

E-mail messaging and archiving is one prong of an integrated compliance and risk management strategy for any utility company. End-user computing (EUC) applications provide additional challenges.

Perhaps highest on the list of EUC applications are spreadsheets. These are ubiquitous in business because of their flexibility and familiarity. Unfortunately these very same values mean that it is easy for them to enter the business-critical information supply chain without conscious approval. Once there, for example in trading, risk management or accounts, their very flexibility becomes a source of risk. As a result many organisations are looking to become more proactive by removing spreadsheets from their critical business processes. The reality, however, is that since business needs are always greater than the capability of central systems, it is virtually impossible to eliminate the spreadsheets that fill this gap.

For energy trading in particular the evolution of the market in terms of products and competition means that spreadsheets are essential. However, compliance with IAS 39 and SOX, requires enterprise auditability and robust controls which cannot be delivered with native Excel. Even the most wealthy investment banks have struggled to eliminate spreadsheets in the trading and risk management of derivatives or hybrid financial products, so it is difficult to see how utilities, with more limited budgets and complex deals involving physical commodities, can be expected to do so.

ClusterSeven's product XiGence, presents one of the current market solutions to this problem. It delivers enterprise spreadsheet management, providing auditability and risk management as well as a deep vein of business intelligence from information that would otherwise be virtually inaccessible in old versions of spreadsheet files.

The ClusterSeven solution performs like a CCTV camera on parts of the business where problems may exist in compliance or operational risk. For the first time an organisation can store all of its critical information in a database where it can be used for pricing analysis or future trade-making opportunities. The result is all round benefit to the business.

⁷ More information on www.merido.com

Traders can make bolder trades and better use of historical information while staying compliant and minimising operational risk.

The ClusterSeven solution can be deployed in days with negligible impact on existing business processes while also providing a platform for major process efficiencies and business advantage.

Business Performance Management

To add value to their businesses, utilities companies also need to address the broader compliance requirements with business performance management (BPM) solutions. They not only need to view financial and operational data from different parts of the organisation clearly and easily, but also to deliver flexible reporting and analysis from this information.

With regulators driving companies towards greater transparency and accountability, many companies are turning to BPM applications from vendors such as OutlookSoft⁸.

Many BPM solutions used in the utilities industry, focus on collecting and consolidating data more efficiently, but OutlookSoft research showed that some decision makers felt they were spending too much time on the analysis function, resulting in a lack of time to actually run the utility's business and execute key decisions. This problem has been solved by automating common analytic tasks, such as variance and root analysis.

Audit and compliance features can also give utility companies the chance to adopt new tools to meet regulatory requirements. Data audit trails can be activated by application, category, and component. Balance history can be recorded by user, machine, transaction type and date/time stamp. Audit report information can be stored, recalled, and reported on as needed to maintain optimal process performance and accountability.

OutlookSoft's customers include ENEL, Constellation Energy, Nuclear Management Company and Essent, all of which have adopted a unified approach to BPM that ensures consistency and confidence in the numbers. Business users, from heads of regulation to system administrators, can access OutlookSoft's application from anywhere using Microsoft Office Excel 2003 and a standard Web browser.

In addition to using the system to meet statutory compliance regulations, many of these companies are developing specific applications, both financial and operational, based on their individual compliance needs. These applications can range from score carding/key performance indicator (KPI) measures to track operational risk, call centre service quality and responsiveness, corporate governance, through to applications monitoring environmental analytics or sustainability reporting.

While all these applications differ in their benefits and features they all benefit from being surrounded by the process controls and intelligence provided by the OutlookSoft solution—a key issue in meeting compliance measures. From collaboration and communication right through to the process/workflow control and audit reporting, everyone within the organisation is included in the culture of compliance, leaving no excuses when reporting to the regulatory body or internal regulatory departments.

8 For more information visit www.outlooksoft.com

4. Conclusion

The utilities industry has received a high level of public attention in the past decade, and growing pressure from regulators is likely to increase their visibility to governments, businesses, and the public at large.

So it's hardly surprising that utilities companies want to avoid the negative publicity, fines, and lost business that may result from compliance failure. But to turn this challenge into a business benefit requires careful planning and implementation including a re-evaluation of business objectives:

- The right people and processes need to be put in place.
- Education and training programmes need to be set up.
- Staff must fully understand the risks of non-compliance and what they need to do to avoid it.
- The available technology needs to be exploited to support these changes.

Today, utilities firms must design and build new business process, compliance systems, and organisational structures that not only comply with the law today but are scalable enough to respond to tomorrow's laws. They increasingly need to shift projects and assets to areas most likely to add value to the business.

With this in mind, organisations can leverage compliance as a change agent for both immediate accountability as well as lasting business value. The best way to mitigate risk while improving operational efficiency is to take a bottom-up approach to interpreting data and records from various sources using rules-based engines, business process models, and quantitative analytics.

With the right tools, utilities can deliver the change in culture necessary to put compliance at the heart of the utility business. Like all industries, they need workflow and collaborative working technologies. But there are five key areas where technology can deliver real benefits that address compliance:

- Customer-facing processes and operational risk management.
- Electronic document record management (EDRM).
- Secure e-mail archiving and retrieval systems.
- Enterprise spreadsheet management.
- Business performance management.

Above all, these solutions can deliver more to the business than just achieving compliance and satisfying regulators. When implemented intelligently and integrated with existing systems, this technology can support an integrated response to operational risk and external agencies that anticipates future requirements and reduces costs associated with these areas, increasing the overall competitiveness of the business.

For more information

To find out more about solutions discussed in this document, please go to:

- **Capgemini**
www.capgemini.com/utilities
- **Cluster Seven**
www.clusterseven.com
- **KVS**
www.kvsinc.com
- **Meridio**
www.meridio.com
- **Outlooksoft**
www.outlooksoft.com

If you would like to contact the Microsoft U.K. Utilities team please email:
utindust@microsoft.com

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