A. C. Macris Consultants

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Highlights

LEVERAGING RISK

"The true role of management [*we suggest including the term leadership*] is to make risk-taking possible. Executives can't order their staffs to be creative – they have to provide the conditions where creativity flourishes. Such conditions include strong staff morale, the feeling that someone is listening, and the conviction that good work will be rewarded." Edwin Diamond

This issue of UPDATE presents a model that explains the concept of "Prudent Risk" and what it can mean to an organization. A friend and colleague Mr. Rick Bravo, about 5 years ago, introduced us to the concept of Prudent Risk. The focus in this article is not only to present a prudent risk model, but more importantly to discuss creating an environment that embraces prudent risk taking, as well as the recognizing today's business environment is transitional. We hope we can provide a leadership model that achieves the balance of prudent risk in an organization resulting in a competitive advantage.

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Leveraging Risk for Competitive Advantage

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Introduction

As new technologies emerge in a global marketplace, competitiveness increases. To be competitive and successful in this business environment, the issue of risk becomes a much more significant consideration in the strategic focus of the organization. Historically, risk was considered to be negative and even a threat. Leadership did not spend time to understand risk or educate its people on risk management and therefore did not have enough confidence in the organization to use risk as an opportunity. Consequently, in attempts to minimize the negative impact to the bottom line, the easy way to be sure to minimize risk was to eliminate it. *In reality, the elimination of risk (zero risk) always and now more than ever carries with it an incredible cost.*

Historic Perspective

We will use as a classic example for the purposes of this article, the public utility industry. Recognize that this industry is one example but the concepts presented here apply to business in general. To continue with our example, consider the emerging competitive nature of the entire electric/gas utility industry, and that a zero risk philosophy cannot be compatible with the changing business environment. A zero risk philosophy poses a problem for an industry whose culture is such that its functioning was predicated on the monopolistic *(exclusive control by one group of the means of producing or selling a commodity or service*) structure. The focus was on how to function as professionally and accurately as possible. Specifically, in the engineering context, this focus meant making recommendations that reflected improved engineering practices and searching out ways to make things better. The cost of these improvements was not a major consideration. Projects that reflected better engineering, resulting in better reliability and plant performance, escalated. Associated costs were passed along to rate payers/customers (not indiscriminately). As an example, capital project costs (plus the allowed rate of return) are recovered from the ratepayer, regardless of the cost, because of the rate structure. This High cost — Low risk approach has traditionally been the prudent choice for utilities since benefits received from not taking risk were usually passed on to the ratepayers. Recovery of cost from major failures is often disallowed, thereby hurting stockholders. Capital project costs, no matter how high, are typically recovered from ratepayers (plus allowed return), so high cost was not usually a major consideration. As a result, the issue of cost competitiveness was not part of the culture.

With the advent of ecological concerns, along with emphasis on renewable energy sources, the monopolistic environment started to undergo changes. Legislation required public utilities to purchase power from renewable/ resource recovery generating plants. With the de-regulation of the electric generation / distribution industry, a whole different set of rules came into play.

With de-regulation, cost competitiveness became a rather significant issue, and the traditional monopoly is transformed into an oligopoly *(a market condition in which sellers are so few that the actions of any one of them can materially affect the price and hence have a measurable impact on upon competitors)*. This transition sets the stage for the future.

The present business environment is a transitional environment, but not in the sense of transition from one stable place to another stable place. It is rather a transition from one way of thinking and operating to another completely different and certainly less stable environment and way of conducting business.

Time of Realization

The best way to characterize the present environment is one of cultural realization, internalization, and adjustment. The public utility industry is not the only one that carries with it many traditions and cultures. Many of these business traditions and cultures are being challenged. The challenges are extremely difficult to understand and accept since the biggest challenge is perhaps not the tangible change, but the behavioral change. Much of the unrest is due to the people's inability to accept many of the potential changes that are in complete conflict with the traditions and culture of a very long-term successful industry. The present business environment is a transitional environment, but not in the sense of transition from one stable place to another stable place. It is rather a transition from one way of thinking and operating to another completely different and certainly less stable environment and way of conducting business.

Concept of Risk

The concept of risk takes on a different perspective. It is not only "Risk" in its traditional sense, but the new perspective involves the term "Value Added." "Value Added," for the purpose of this article, means that; there is a *value added to the organization which is greater as a result of taking the risk than the level of resources expended, toward an agreed upon goal/objective*.

Prudent Risk and Value Added

The primary issue here is the relationship between the Level of Risk and the Value Added. It is essential to understand this relationship, particularly in the context of changing the way to deal with risk. Rather than attempting to eliminate risk, the new way is to manage and control it. Control of risk then necessitates introducing a new term, "Prudent Risk." Prudent Risk assumes an acceptable level of risk. Prudent Risk has been defined as "Decisions made and actions taken, involving a possible loss or injury, after careful consideration of:

(a) circumstances

(b) potential safety or business results; and,

(c) potential personal consequences [(1)]"

Recognizing the impact risk has on the overall operation and/or business success of a utility, the shift from an elimination/ minimization of risk to the management and control of risk is essential.

Consistent with that philosophy, the following relationship between prudent risk and value added can be defined as such: A Prudent Risk is when the Value Added is greater than the Level of Risk. The dimensions associated with Prudent Risk, are:

Level of Risk
Value Added
Accountability
Prudence

These dimensions are further defined as follows:

Level of Risk is the product of the Magnitude of consequences (MOC) and the probability of occurrence (POC). Therefore Level of Risk (LOR) equals = MOC ***times*** POC

Value Added = Benefit minus Cost

Accountability regarding Prudent Risk is to provide an honest explanation of a party's conduct, decisions and motives and their results.

Prudence is caution or circumspection regarding danger or risk

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The graphic on the last page illustrates the relationship between Value Added and Level of Risk. This representation is qualitative. The shaded area indicates prudence. It is important to note that prudence can still result in a reduced value added by virtue of the increase in cost associated with reducing the level of risk. In contrast, the area to the right of the shaded area does not represent prudence because the increased probability of occurrence becomes unacceptable from a risk perspective.

The challenge becomes to identify and agree on the accepted level of risk and to have the organization working as close as possible to the apex of the model. Furthermore, the shape of the curve is contingent upon the specific circumstances upon which decisions are being made. As an example, the curve could flatten indicating a broad opportunity for decision making well within an area of prudence and potentially several options for maximum value added. In contrast, if the curve is steeply vertical, the opportunity for alternatives is limited and the point of maximum value added is quite well defined.

Leaders only get one chance to make a first impression.

As with all concepts, these must be validated. It is the belief of the authors that models can be created which approximate various situations/conditions that would define the shape of the curve. The specific model is one aspect; the other is the human interaction necessary to identify, and to agree on an acceptable level of risk. Culturally, an organization must be prepared to understand how to deal with a prudent risk that goes wrong. This understanding involves sharing in the accountability. This concept branches out into several other organizational and behavioral issues beyond the scope of this paper. The point, rather, is that structured analysis is required to qualify the family of risk curves as well as to determine the behavioral issues necessary to implement the validated curves.

For an organization to make the transition from a zero risk mentality to one that embraces a prudent level of risk, overt positive and consistent Leadership is essential, meaning that the leadership of an organization not only must establish its position on prudent risk, but it must also establish a climate where people feel that they can take prudent risks, and if those risks do not "pay off" they will not be subject to reprimand or punitive action. If reprimand or punitive action is demonstrated just once after a person takes a prudent risk that does not work out the organization will return to a zero risk mentality. The organization will have little chance of ever making the transition again with the level of success possible with the initial move to a prudent risk culture. Leaders only get one chance to make a first impression. This consequence makes the leadership challenge even greater, and tests the leadership. We are not to inferring that people will be running around an organization doing risky things thereby making management vulnerable, it means that people will feel empowered to be creative, explore new ideas and to test there thinking beyond traditional limits.

Conclusion & How to Supplement

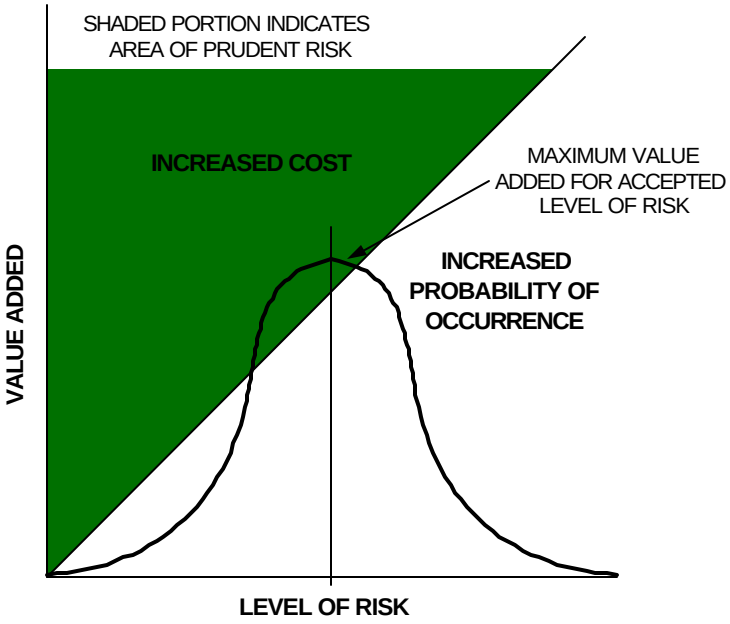
Let us assume that you agree with this article, and the concepts are not much different than what you believed even before you read this article; the logical question is how do you, as a leader, take a zero-risk or an overly aggressive risk organization to the apex of the model. First, it should be thought of as a Human Interaction Project, and a realist plan should be put in place. Some key components of the plan must include:

- Leadership taking the initial risk to change the existing culture.
- Understanding the present risk-taking culture of your organization. (baseline where you are)
- A detailed communication plan (who, what, when. where, and how)
- A high level executive sponsor, who is tenacious, and respected at all levels of the organization.
- A comprehensive interactive training module for all to take part in. (Socratic Dialogue Format)
- Measurable milestones not only project milestones but results focused.
- Design and implementation of an easily retrievable historical database of actual Prudent Risk Taking and the outcomes.

Good luck and keep in mind as you ponder whether to take this challenge the fact that value will be added to the organization not only if you reach the apex of this model but also as you move away from where you are and get closer to it.

Recommended Reading

The following book is worth including in your professional library: *What Leaders Really Do*, by John P. Kotter, published by Harvard Business School Press, ISBN # 0-87584-897-4.



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