



# **Achieving Significant O&M Reduction with Risk Informed Budgeting**

**Tim Schlimpert**

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The utility industry is undergoing dramatic change as new technologies, such as solar and batteries, threaten to disrupt the traditional utility generation model and may have a dramatic impact on revenues. At the same time, costs are increasing as interest rates rise, distribution systems are reworked to adopt two-way flow of power, and customer expectations drive the need to support new channels for information and transactions. Combined, these trends are placing significant pressure on earnings.

To address these pressures, utilities frequently look to traditional cost cutting methods to meet financial performance objectives: flat percentage or across-the-board cuts in base budgets, staff reduction or deferred project spending. While these traditional methods may achieve some results, a more analytical approach to optimize spending will help ensure the right funding is applied to the right efforts at the right time.

Risk Informed Budgeting is an analytical approach to budgeting where the timing, amount and consequence of every budget line item is challenged. In our experience, an effectively implemented Risk Informed Budgeting program can produce 10% to 15% savings in routine budgets, even after implementing other cost reduction initiatives.

## The Deficiencies of Traditional Budgeting

Traditional budgeting is most often conducted in the form of incremental budgeting where the new budget is based on changes to a previous budget with a plus or minus percent correction to achieve stated financial targets. This incremental approach to budgeting is easy to implement and adapts to future years with simple percentage adjustments. Used in cost cutting, executives issue an incremental percent or total reduction amount as an edict implemented by the budgeting organization. While this approach usually produces some results, the magnitude of results are typically limited by the surface level nature of the approach. Additionally, those issuing the edict often feel they left something on the table.

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Traditional budgeting is also characterized by the lack of detailed budget reviews and challenges. The lack of detailed reviews tend to build in overspending through institutionalized expenses such that once it's in the budget, it's there forever. Recurring spending becomes part of the operational budget paradigm, making these costs more and more difficult to remove. As a result, overspending is perpetuated from year to year.

## Risk Informed Budgeting

At its core, Risk Informed Budgeting, based on MCR's approach to Zero Base Budgeting, requires budget owners to provide risk justification for all budget requests. In a sense, it is the antithesis of the more traditional incremental budgeting process, which embeds a continuation of the past without real scrutiny.

The value of Risk Informed Budgeting flows from the detailed scrutiny of every budget dollar, examined in a manner focusing management on what is really needed to operate the station in a safe, reliable and efficient manner. It challenges the status quo. It accepts history as a guide but not as a justification. It forces a deep understanding of why each cost center does what it does, the value it brings to the overall objectives of the station and the consequence of not funding a specific budget line item. But achieving this benefit requires some hard work. Risk Informed Budgeting is labor intensive, requiring significantly more resources than normally devoted to the traditional budgeting process. It requires more thoughtful effort by each cost center proposing a budget, and more work by the person or team reviewing budget requests and taking on the task of scrutinizing costs. It creates more data to manage, generates more questions to answer, and requires more decisions to be made. However, it's a low-risk investment which produces significant returns.

A successful Risk Informed Budgeting solution is built around three critical components:

- **Structure:** a well thought-out, formal structure defining how budgets should be organized and presented
- **Challenge:** an effective approach to challenge or question each budget as it is presented
- **Tools:** a set of tools and a database to manage, sort and report the budget on a real-time basis as it is reviewed and as decisions are made

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## The Risk Informed Budgeting Structure

In order to consider risk during budget reviews across a utility, it is critical that every cost center's budget be developed and justified in a structured and meaningful way. An effective Risk Informed Budgeting structure will have enough dimensions to allow for a robust review from multiple angles. Like all types of budgeting, Risk Informed Budgeting starts by organizing all budget dollars by the organization responsible for the budget and by cost element (e.g., labor, overtime, materials, contracts, etc.). But Risk Informed Budgeting goes beyond these typical dimensions, necessitating all budget dollars to be organized into a variety of categories to support the intense review that will be required.

Budget categories can be used to define the type of work to be performed, the supported business objectives, the alignment with regulatory recovery, and the criticality of expenditures, to name but a few category examples. During implementation, budget categories provide an indication of an organization's ability to influence the timing or amount of any budget line item. Organizing all budget dollars across multiple categories provides significant insight to the anticipated value from the requested dollars.

For example, consider a budget category defined as the "Type of Work." Some typical Types of Work might include:

- **Regulatory:** supports compliance with specific regulatory requirements
- **Plant operations:** supports safe and reliable station operations
- **Industrial safety:** supports the safety of all employees

In addition to defining the type of work to be performed, these categories also begin to suggest the degree of latitude for funding a specific budget request. Looking across budgets for the entire station, these Type of Work categories support discussions about how spending fits with a plant's overall strategy and priorities. Typical Risk Informed Budgeting initiatives define about a dozen Type of Work categories.

A second example of a Risk Informed Budgeting category is Criticality. Criticality categories might include:

- **Critical:** funding is required for continued operation of the business function; management has little to no control over these expenditures
- **Enhancing:** funding will enhance safety, reliability, operational, regulatory, business or organizational effectiveness; management has some control over these expenditures

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**Organizing all budget dollars across multiple categories provides significant insight to the anticipated value from the requested dollars.**

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- **Discretionary:** funding may enhance safety, reliability, operational, regulatory, business or organizational effectiveness; management has complete control over these expenditures

It is important to note the assignment of budget request to Risk Informed Budgeting (RIB) categories is not a prioritization of those requests. Rather, it is a way to assess where there is flexibility in the budget to adjust the timing and/or the amount of O&M spending. In practice, some “low flexibility” category requests will be funded, while funding for some “high flexibility” category requests will be reduced or delayed.

## The Challenge Process

Organizing budgets by cost center and cost element, as well as by categories such as Type of Work and Criticality, is important but not sufficient for an effective Risk Informed Budgeting process. In fact, without a robust conversation about each budget request, the categorization of costs is little more than a paperwork exercise producing no measurable impact.

The discussions about budget requests during a Risk Informed Budgeting process is by necessity a challenge process – that is, it is a process requiring each organization to present its budget requests and defend those requests in the face of direct challenges to the submission. This process should not be an adversarial encounter, but it does need to be a serious, direct and pointed conversation in order to come to a common understanding of the necessity of the budget requests.

The challenge process is built around direct questions about budget dollars and budget categories (e.g., Type of Work, Criticality). Examples of direct questions, which are the centerpiece of this process, include the following:

- Is this really a regulatory requirement? Can you show me the regulation?
- Do we have to do this next year? What is the impact of a delay?
- The underlying assumption of this budget request is the manufacturer’s maintenance guidelines; what have other plants experienced with this equipment?
- Is this request really critical? Haven’t other stations around the country addressed this issue in a different and more cost-effective manner?
- Is this the most cost-effective approach? What alternatives were assessed?
- Why do we have varying budget requests across the station regarding travel costs, membership fees, office supplies – all of which are supposed to be controlled under a common set of policies?

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**In the end, a good challenge process creates consensus about what needs to be spent in the coming year and why.**

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There are several options for conducting the challenge process. It can be handled by the plant's financial organization, the plant's executive team or a middle management budget team, to name but a few options. Whichever option is selected, it is important to recognize the amount of time required to review each budget request in detail, to meet with each organization, to scrutinize each request, to follow up on questions and to review all requests in a holistic manner. And perhaps most important, whomever handles to challenge process must ask difficult questions, stand up to less than clear responses, push for alternatives based on industry knowledge, and make difficult decisions.

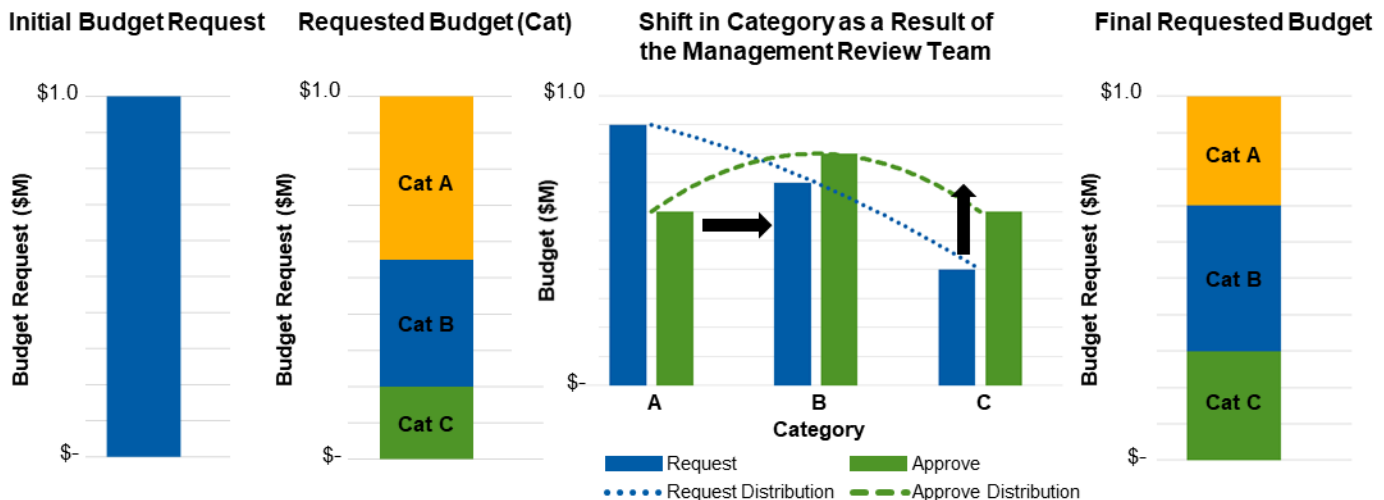
As the challenge process proceeds, budget requests are approved, deleted, reduced and flagged for future focus or added to contingency. Quite often, the Type of Work categorizations are shifted, the initial Criticality selections are changed and the link to station planning goals and objectives are questioned. Exhibit 1 below shows a schematic of how this process works as budget requests are challenged and the dollars move among categories. In the end, a good challenge process creates consensus about what needs to be spent in the coming year and why. By challenging each dollar, the budget can be "reset" to what is truly needed, and away from what was done in the past.

**Risk Informed Budgeting requires a well thought out database and a reporting system to produce answers quickly.**

## Risk Informed Budgeting Tools and Supporting Infrastructure

The final components of a successful Risk Informed Budgeting program are

**Exhibit 1: Challenge Process Illustrative**



the tools and infrastructure required to support successful conduct of the process. The tools required to be in place include:

- A carefully defined **database** to facilitate tracking of budget decisions as they are made and to support uploading the final budget into the corporate budgeting system
- **Budget templates** that clearly define the budget categories, assignment of requested dollars and other required information, organized in a manner consistent with the database
- **Training materials** to clearly inform participants, at all levels, of their role and the tasks they need to perform

Data reporting and control is critical in order to be able to easily answer these important management questions throughout the process:

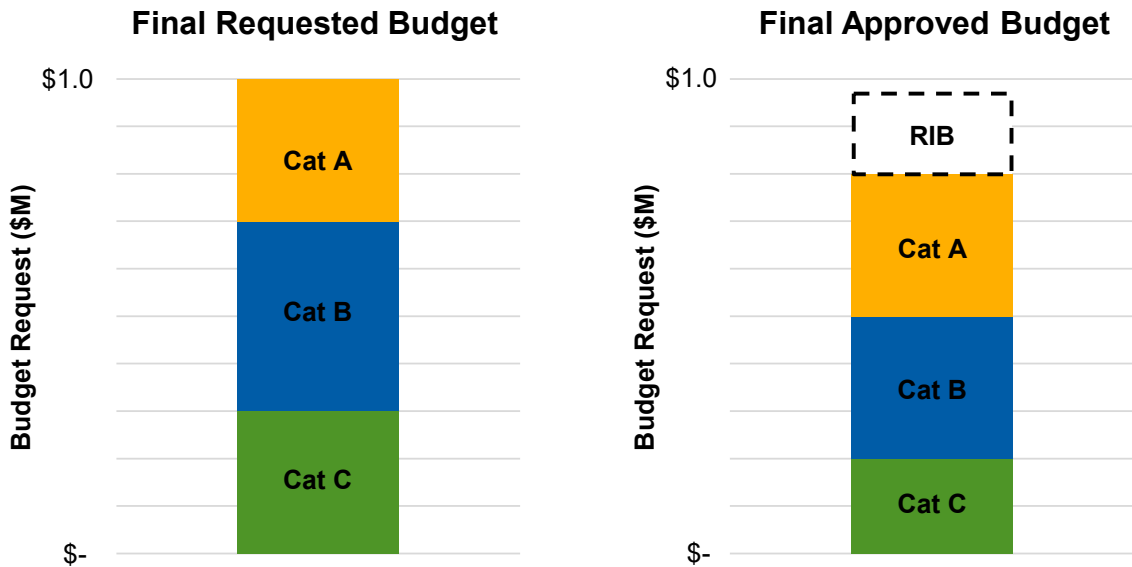
- Where do we stand in terms of approved budget requests and modified budget requests?
- Given the decisions to date, what is our projected budget total vs. target?
- How much are we proposing to spend in each category?
- How many dollars have not been reviewed yet?
- How many dollars are considered “critical” from a budget category perspective?
- What is the shift in dollars by category attributed to this process?
- How are departmental budgets affected by categorization?

Answering these questions and keeping track of the substantial amount of information, while still maintaining congruency with budget and financial platforms, requires a well thought out database and a reporting system to produce answers quickly. Additionally, the ability to upload these data into the corporate budget system and thus avoid reentering budget numbers is critical for an efficient process.

Exhibit 2 on the next page shows an illustrative graphic from a Risk Informed Budget systems reporting tool. The graphic presents the Final Requested Budget by category compared to the Final Approved Budget. The dollars shown in the RIB box represent the amount of cost reductions realized through the RIB process, which can flex up and down as spending decisions are altered.

While the data management and reporting tools are important, it's equally important that participants in the RIB process have a clear understanding


## Exhibit 2: Risk Informed Budgeting System Illustrative



of the program and how it's implemented. Understanding and execution is brought about through training – training all participants whether they are budget owners filling out templates, the budget group organizing and reporting on submissions, or the management team reviewing requests and making decisions. Each group needs to know what its role is, how they fit into the process and the expectations required for success.

### An Investment You Can't Afford Not to Make

To address the ever-increasing financial pressures caused by changing market dynamics. Risk Informed Budgeting is a new approach for the utility industry, which can be used to achieve significant cost efficiency.

Risk Informed Budgeting is hard work. It requires a lot of pre-planning and is only implemented successfully through the efforts of a dedicated team. Is the Risk Informed Budgeting effort worth it for your company? For many utilities, an approach to produce cost reduction results of 10% to 15% seems to be a wise investment – an investment which may become a necessity for survival. Done right, there is no doubt Risk Informed Budgeting may be part of the industry's best hope to remain profitable in a challenging market. 





# Cost Reduction through Risk Informed Budgeting

## BACKGROUND

A large integrated utility in the Southwest was challenged by corporate oversight to operate under affordability goals requiring them to limit electric rate increases to two percent per year while keeping customer's electric bills in the bottom 50 percent of all electric utilities in their state. To achieve these goals, the utility needed to explore new ways to manage its spending in the most effective and efficient manner possible, while considering risk for every budget line item.

Historically, the utility's business units developed budgets based on the previous year while adjusting for expected differences in the upcoming year. They examined operating expenses in the aggregate without the level of detail necessary for effective risk analysis. This approach limited management's ability to drive significant, achievable and lasting benefits.

As the company entered their annual budget cycle, the Chief Operating Officer wanted more transparency and rigor in the budgeting process in order to identify areas for significant cost reduction. With significant O&M cost reduction as the goal, the Chief Operating Officer approached MCR for help.

## SOLUTION

MCR used its proven Risk Informed Budgeting (RIB) process, originating from our approach to Zero Base Budgeting (ZBB), to help our client reach its spending goals. At its core, Zero Base Budgeting requires budget owners to justify all budget requests from a baseline of zero. In a sense, it is the antithesis of the more traditional incremental budgeting process, which embeds a continuation of the past without rigorous spending scrutiny. The risk-informed approach considers the risk of not funding each individual line item.

We worked directly with our client's management team and budget analysts, guiding them through our RIB process steps:

- Develop a budget item classification framework relating spending levels to specific safety, regulatory and reliability risk factors
- Discuss each budget line item and assign to the risk classification framework
- Facilitate a structured review process guiding senior managers towards a risk-based ranking of all their budget line items
- Facilitate a final ranking process forcing the delineation between line items above and below the target budget funding line

In team meetings, every line manager was asked to challenge their own paradigms of what spending was truly required to operate and maintain their organization. Nothing was taken for granted in the review and all spending was challenged. The approach ensured each line manager's budget submission was prepared with detailed documentation and recognized facts to substantiate all proposed spending.

***“The MCR team was very professional and very driven. I really appreciate their direct approach to engage executives and managers.”*** —Chief Operating Officer

# Cost Reduction through Risk Informed Budgeting

## RESULTS

MCR and the client management team identified opportunities to save \$15 million in O&M expenses (nearly 10% of the reviewed budgets). This reduction put our client on a path to achieve its rate targets and meet the executive leadership's affordability goals. In addition to the expense reductions identified by the RIB process, MCR also identified opportunities for operational improvements, including:

### **Information Technology**

- Optimize the overall information technology portfolio by eliminating excessive legacy applications and controlling new application requests
- Reduce a significant number of contractors used as base load employees to operate and maintain key infrastructure
- Apply better software licensing controls to eliminate vendor-imposed penalties
- Establish a cloud / premise strategy to reduce and optimize application and data management costs
- Create a cost awareness culture among managers who were previously unaware of their actual performance to budget over the course of the year
- Improve project management controls to enhance scope control of many projects

### **Electric Service Delivery**

- Reduce overtime used to complete regular maintenance when driven to do so by capital project workload. Rapid customer expansion drove capital workloads, which with limited resources, created a situation where overtime was used to address both capital and regular maintenance
- Restrict overtime in project implementation with distant completion time horizons. For example, an LED upgrade initiative with a 5-year time horizon was partially completed using overtime

### **Power Production**

- Enhance power production management expertise in operating with an efficient budget and by sharpening skills in effectively managing risk associated with their costs
- Identify additional budget reduction opportunities management had previously not considered

*“Through the course of the project, I quickly came to trust their knowledge and conclusions of our business.”* —Chief Operating Officer

## MCR can help you with your budgeting needs

We reduce and control O&M costs by working with budget owners to justify all budget expenditures from a baseline of zero. Our “challenge process” uses a peer review method to assess the risk associated with each budget line item and determine the ability to adjust the amount and timing of each expenditure within the executive team's risk tolerance.

Contact Tim Schlimpert at  
[tschlimpert@mcr-group.com](mailto:tschlimpert@mcr-group.com) or (847) 323-0926

[www.mcr-group.com](http://www.mcr-group.com)



## **Tim Schlimpert**

[tschlimpert@mcr-group.com](mailto:tschlimpert@mcr-group.com)

Tim is a Vice President at MCR and leads the Nuclear Generation practice. He has more than 30 years of utility industry experience in nuclear power plant operations, maintenance, work control, business operations, process improvement and technology solutions, and has achieved significant performance improvements for his clients. Tim provides the often-elusive connection between corporate strategy, long-range planning/budgeting, work management and technology through industry-leading life cycle management practices.

## **MCR PERFORMANCE SOLUTIONS**

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MCR helps energy companies transform their management and operating performance by enabling significant leaps in performance through integration of deep industry insights and leading-edge information technology.

Tel: 847.323.0926

Fax: 847.562.0077

155 N. Pfingsten Rd., Suite 155  
Deerfield, IL 60015