

# AEMO GOVERNANCE REVIEW

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FINAL

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# 1 Executive Summary

## *About AEMO*

The Australian Energy Market Operator (AEMO) is an independent organisation working in the long-term interests of Australian energy consumers by developing and operating markets that offer affordable, safe and reliable energy supplies.

AEMO was established by the Ministerial Council for Energy (MCE), now the Standing Council for Energy and Resources (SCER), as an operational entity by 1 July 2009. AEMO operates on a cost recovery basis and fully recovers its operating costs through fees paid by market participants and network service providers. To reflect its not for profit status, AEMO is a company limited by guarantee under the Corporations Act (2001).

AEMO has a unique membership structure, with membership split between government (60%) and industry (40%). In this context, AEMO's 'members' are effectively its owners and have similar powers as shareholders in a Corporations Act company other than as varied by the AEMO Constitution. Two key differences from shareholders that members of AEMO do not have are the:

- Ability to benefit from ownership through dividends or other financial returns (consistent with a company limited by guarantee and AEMO's not for profit status); or
- Power to appoint Board directors. Members of AEMO have the ability to endorse Board candidates but the ultimate power to appoint is through Ministers and the SCER.

These limitations are set out in the AEMO Constitution and are not related to the allocation of membership rights. Rather the allocation of membership rights to both industry and government is aimed at providing appropriate governance over AEMO as it fulfils its functions.

AEMO has a key role as the operator of gas and electricity markets, both of which are of high commercial value and provide critical services to the community. In dispatching and settling these markets, market participants need to have confidence that AEMO will act competently and independently, consistently applying the market Rules. In operating the physical power system and managing emergencies, governments need to have confidence in AEMO's capability to act to maintain power system security and reliability. A wide range of stakeholders rely upon AEMO for the range of investment and planning information related to energy markets. The interests of the industry and the government in AEMO's good governance are recognised in its shared membership.

AEMO's shared ownership structure presents both advantages and challenges for its operation; issues that were considered at length prior to AEMO's commencement. On the one hand, some parties (notably industry participants on the supply side) were of the view that industry membership affords the energy sector participants a potentially greater degree of accountability to those who use and pay for AEMO's services and the potential for improved responsiveness to the needs of market participants, enhanced transparency of operations and greater independence from any particular market participant or government stakeholder. On the other hand, some parties, particularly end users and government stakeholders, perceived that government membership of AEMO could provide greater protection and improved accountability to end users (who are the ultimate beneficiary of its services), and greater independence from any particular market participant.

Where it is important for all organisations to carefully manage risks associated with conflicts of interest, the nature of AEMO's functions require Board directors that can capably operate with industry specific and often technical matters. The AEMO Constitution sets out clear criteria on the selection of Board directors that help to manage these risks; specifically including that the board can consist of between five to ten directors, a majority of which, including the chair, must be independent directors.<sup>1</sup> The independent skills based board was instituted to provide an effective

<sup>1</sup> The Constitution sets out criteria against which a director can be considered as independent in 'Schedule 2 – Directors' independence, skills and experience.

balance to these corporate challenges,<sup>2</sup> helping to strengthen the robustness of its decision-making processes.

The ownership mix and the skills based board selection process therefore provide value and confidence to the wide range of AEMO stakeholders. Combined with its not for profit and membership without equity status, these features of AEMO's corporate structure present a unique arrangement from a number of perspectives; the company operates in a way that is consistent with other Corporations Act companies, costs are minimised, and the full range of skills are brought to bear through membership of the Board.

### *Governance review*

As part of the implementation plan for AEMO a commitment was made for these arrangements to be reviewed after three years of operation. Following an internal review of the corporate governance arrangements currently in place, which built on feedback received from members and gained through operational experience, AEMO submitted recommendations to the Standing Council for Energy and Resources (SCER) for noting.

This paper sets out a series of minor amendments AEMO considers will improve the effectiveness of its existing governance processes. AEMO intends to progress these amendments together with its members later this year.

AEMO welcomes feedback from stakeholders and interested parties alike on this review and on the options noted for further consideration. Feedback is sought by Friday 30 August

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<sup>2</sup> With Board appointments made based on a skills matrix.

## 2 Background

The Australian Energy Market Operator (AEMO) is an independent organisation working in the long-term interests of Australian energy consumers by developing markets that offer affordable, safe and reliable energy supplies. Created by the Council of Australian Governments (COAG) and developed under the guidance of the Ministerial Council on Energy (MCE), AEMO strengthens the national character of energy market governance by drawing together under the one operational framework responsibility for electricity and gas market functions, National Electricity Market (NEM) system operations, management of Victoria's gas transmission network and national transmission planning, across eastern and south-eastern Australia.

AEMO carries out the electricity functions previously undertaken by the National Electricity Market Management Company (NEMMCO) with respect to the NEM and the planning responsibilities of the Electricity Supply Industry Planning Council (ESIPC, South Australia). Additionally, AEMO assumed the retail and wholesale gas market responsibilities of the Victorian Energy Networks Corporation (VENCorp), Retail Energy Market Company (REMCO), Gas Market Company (GMC) and Gas Retail Market Operator (GRMO). As part of its gas market functions, AEMO is responsible for the operation of the Short Term Trading Market (STTM), (with hubs now operating in New South Wales, South Australia and Queensland), which sets a daily wholesale price for natural gas. Following MCE approval, AEMO was operational by 1 July 2009. AEMO was established by the MCE to operate on a cost recovery basis and fully recovers its operating costs through fees paid by market participants.

Its membership structure was set up as a split between government and industry,<sup>3</sup> respectively 60 and 40 per cent, with a commitment made for this arrangement to be reviewed after three years of operation. AEMO carried out an internal review of aspects of its corporate governance, which built on feedback received from members and gained through operational experience, with recommendations noted by the SCER earlier this year. This paper sets out a series of minor amendments AEMO considers will improve the effectiveness of its existing governance processes. AEMO intends to progress these amendments together with members later this year.

It should be noted that the corporate structure for AEMO is different to the other energy market institutions. The AEMC is a statutory body created under South Australian legislation and the AER is a constituted body within the ACCC, which is a statutory corporation under commonwealth legislation. As a Corporations Act company the corporate governance arrangements for AEMO are different in terms of obligations and responsibilities. For example, AEMO is subject to the duties imposed under the Corporations Act and the common law.

## 3 Corporate Governance

Corporate governance is 'the system by which companies are directed and controlled'.<sup>4</sup> It involves regulatory and market mechanisms, and the roles and relationships between a company's management, its board, its shareholders and other stakeholders, and the goals for which the corporation is governed.<sup>5,6</sup> Effective corporate governance influences how an organisation is managed, valued and perceived and by its stakeholders, internal and external.

As part of the process for developing AEMO's existing structure, the work of the Australian Securities Exchange (ASX) on the role of effective corporate governance was carefully considered

<sup>3</sup> See Appendix 1 for a list of government and industry members of AEMO.

<sup>4</sup> <http://www.ecgi.org/codes/documents/hampel23.pdf> (Cadbury Committee, 1992) European Corporate Governance Institute.

<sup>5</sup> "OECD Principles of Corporate Governance, 2004". OECD. <http://www.oecd.org/dataoecd/32/18/31557724.pdf>. Retrieved 2011-07-20.

<sup>6</sup> Tricker, Adrian, *Essentials for Board Directors: An A-Z Guide*, Bloomberg Press, New York, 2009, ISBN 978-1-57660-354-3.

and incorporated. In its published work on the role of effective governance structures and processes,<sup>7</sup> the ASX provides the following definition:

*‘Corporate governance is, “the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations.” It encompasses the mechanisms by which companies, and those in control, are held to account.<sup>8</sup> Corporate governance influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised. Effective corporate governance structures encourage companies to create value, through entrepreneurialism, innovation, development and exploration, and provide accountability and control systems commensurate with the risks involved.’ (p3)*

### *ASX Corporate Governance Council*

The ASX convened the ASX Corporate Governance Council in August 2002. The Council brings together various business, shareholder and industry groups, each offering valuable insights and expertise on governance issues from the perspective of their particular stakeholders. Its primary work has been the development of the Corporate Governance Principles and Recommendations, which have been designed to promote investor confidence and to assist listed entities to meet stakeholder expectations.<sup>9</sup>

A key feature of the Council’s recommendations is the ‘if not, why not’ approach. That is, ASX listed entities are required to benchmark their corporate governance practices against the Council’s recommendations and, where they do not conform, to disclose that fact and the reasons why. In this way, entities are effectively encouraged to adopt the Council’s recommended practices, but have the flexibility to adopt alternative corporate governance practices, if its board considers those to be more suitable to its particular circumstances.

Core to the success of effective corporate governance practices, is their flexibility to evolve in the light of the changing circumstances of a company. ASX also notes the following in respect of its recommendations for effective governance:

*‘Corporate governance practices must also evolve in the context of developments both in Australia and overseas. There is no single model of good corporate governance.’ (p3)*

The ASX recommend the following eight principles for effective corporate governance,<sup>10</sup> with each principle holding equal importance:

- Principle 1:** *Fundamental to any corporate governance structure is establishing the roles of the board and senior executives,*
- Principle 2:** *With a balance of skills, experience and independence on the board appropriate to the nature and extent of company operations.*
- Principle 3:** *There is a basic need for integrity among those who can influence a company’s strategy and financial performance, together with responsible and ethical decision-making which takes into account not only legal obligations but also the interests of stakeholders.*
- Principle 4:** *Meeting the information needs of a modern investment community is also paramount in terms of accountability and attracting capital. Presenting a company’s financial and nonfinancial position requires processes that safeguard, both internally and externally, the integrity of company reporting,*

<sup>7</sup> ‘Corporate Governance Principles and Recommendations with 2010 Amendments’, released on 30 June 2010, ASX Corporate Governance Council. <http://www.asxgroup.com.au/corporate-governance-council.htm>

<sup>8</sup> Justice Owen in the HIH Royal Commission, The Failure of HIH Insurance Volume 1: A Corporate Collapse and Its Lessons, Commonwealth of Australia, April 2003 at page xxxiii and Justice Owen, Corporate Governance – Level upon Layer, Speech to the 13th Commonwealth Law Conference 2003, Melbourne 13-17 April 2003 at page 2.

<sup>9</sup> The current version of the Council’s Corporate Governance Principles and Recommendations with 2010 Amendments was released on 30 June 2010 and came into effect on 1 January 2011.

<sup>10</sup> AEMO notes that the ASX are currently in the process of updating these principles. AEMO will review the updated principles once in place and seek to ensure the governance arrangements in place continue to reflect the essence of those principles.

**Principle 5:** *and provide a timely and balanced picture of all material matters.*

**Principle 6:** *The rights of company owners, i.e. shareholders, need to be clearly recognised and upheld.*

**Principle 7:** *Every business decision has an element of uncertainty and carries a risk that can be managed through effective oversight and internal control.*

**Principle 8:** *Rewards are also needed to attract the skills required to achieve the performance expected by shareholders.*

#### *'Fit for purpose' arrangements*

Organisations exist in many and varied forms, be they a privately listed commercial entity, government owned or not for profit (NFP) business. As such, and consistent with the recommendations of the ASX, it is appropriate for governance arrangements to be 'fit for purpose' – a single approach will not fit all.

In this context, although the ASX principles outlined above are a useful foundation, it is also appropriate to consider which issues and items for focus are most relevant for the nature, scale and responsibilities of an individual business. This type of assessment can help to develop a governance structure that is more focused, pragmatic and effective for the relevant organisation.

A board in a NFP organisation will, for example, focus on the strategic direction and performance of the organisation in much the same way as a commercial entity or statutory body, but would likely have a greater focus on working with the CEO to enable the organisation to obtain resources and funding to implement the organisation's strategic objectives and to ensure continued revenue streams.

In carrying out its operations, AEMO has a strong focus on efficiency and has sought to build commercial drivers into its decision-making processes. The overarching National Electricity Objective (NEO) and National Gas Objective (NGO), both in place to facilitate the delivery of efficient markets and operations, are also integral to each of AEMO's functions. However, in part due to the nature of its mixed ownership, it does not have the same focus on securing funding for its operations as a more typical NFP organisation would perhaps do. This reflects the unique nature of AEMO's operations and resulting governance arrangements; where as a result of being an entity designed to carry out a number of specific legislated functions, ensuring continued competence and integrity in carrying out its operations is a key measure of AEMO's success.

## **4 Structure of AEMO**

The following section provides an overview of how AEMO is structured at a corporate level, with discussion regarding the ownership structure, board appointment processes, and internal regulatory controls.

### **4.1 AEMO corporate governance**

Established by the MCE in 2009, AEMO is an independent organisation that operates the energy markets and systems and also delivers planning advice in eastern and south-eastern Australia. AEMO's responsibilities are defined by both Commonwealth and State acts and the AEMO Constitution.<sup>11</sup> Consistent with its Constitution, AEMO develops and publishes a Statement of Corporate Intent each year.<sup>12</sup>

#### **4.1.1 Energy market governance structure**

AEMO operates alongside:

<sup>11</sup> See a copy of the AEMO Constitution, dated 06 September 2012 at: <http://www.aemo.com.au/About-AEMO/Membership>

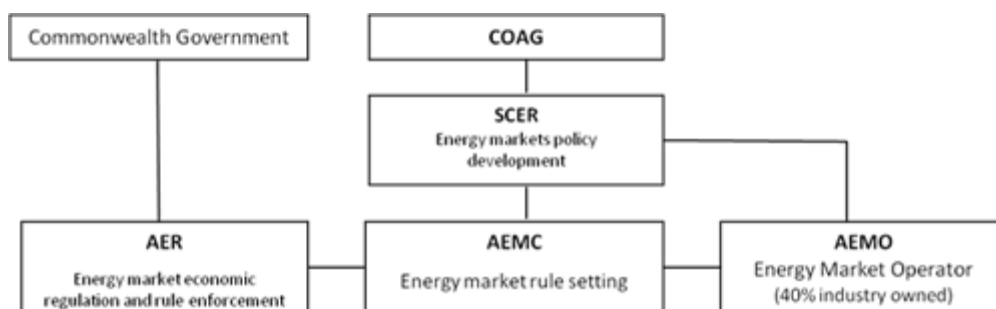
<sup>12</sup> See a copy of the AEMO Statement of Corporate Intent for 2012-2013 at: <http://www.aemo.com.au/About-AEMO/Corporate-Publications/Statement-of-Corporate-Intent>

- The Australian Energy Regulator (AER), which oversees economic regulation and compliance with the national laws and rules, reports on generator bidding behaviour in the National Electricity Market (NEM), regulates electricity transmission and distribution networks in the NEM and regulates covered gas pipelines (in jurisdictions other than Western Australia).
- The Australian Energy Market Commission (AEMC), which makes the rules governing the regulation of the energy markets.
- The Standing Committee of Officials, previously the MCE, now part of the Standing Council for Energy and Resources (SCER), is responsible for developing policies related to the gas and electricity markets.

Collectively, these institutions have assumed most of the regulatory arrangements for the energy industry that were previously the responsibility of state government authorities. The AEMC is responsible to the COAG through SCER, while the AER is accountable to the Commonwealth Government as a constituent entity of the Australian Competition and Consumer Commission (ACCC).

A Memorandum of Understanding between the ACCC, the AER and the AEMC guides interaction between these three bodies and their functions in the Australian energy industry.

Figure 1: Australian Energy Market Governance Structure



#### 4.1.2 AEMO membership

During the development phase for AEMO, the Market Operator Working Group (MOWG) evaluated a range of different ownership options for AEMO, taking into account arrangements for Australia's existing market operators and international experience. The MOWG deliberated over three basic ownership structures – 100% government ownership, 100% 'industry' ownership, and joint ownership shared between government and 'industry'.<sup>13</sup>

There were differing views during deliberations on the most appropriate ownership structure. Industry members of MOWG (typically from the supply side) considered that AEMO should be fully or at least part owned by industry, while energy user members supported government ownership, or at least part government ownership.

Some parties were of the view that industry membership potentially affords the energy sector a greater degree of accountability to those who use and pay for AEMO's services, and the potential for improved responsiveness to the needs of market participants, enhanced transparency of operations and greater independence from any particular market participant or government stakeholder. Alternatively,

<sup>13</sup> In this context, industry is defined as energy market participants (gas producers, generators, transmission, distribution and retailers) and end users of energy.



other parties, perceived that government membership of AEMO could provide greater protection and improved accountability to end users who are the ultimate beneficiary of its services, and greater independence from any particular market participant.

The resulting split, which exists today, sees AEMO membership divided respectively between government and industry; with membership comprising 60 per cent government members and 40 per cent industry members. Government and industry are invited to apply for membership in accordance with the AEMO Constitution, and are encouraged to review the application criteria and associated information.<sup>14</sup>

### 4.1.3 AEMO Board

AEMO is governed by a Board comprised of nine non-Executive Directors, who are appointed by the SCER based on meeting a required skills matrix, and the Managing Director/Chief Executive Officer (who is appointed by the Board).<sup>15</sup> The day-to-day management of the company is delegated to the Managing Director and Chief Executive Officer with support from Board Committees as appropriate. These delegations are documented.

Since AEMO's establishment, there have been four changes of non-executive Board directors, with new appointments made by the SCER (or their predecessor, the MCE), following consideration by AEMO's members.

#### *Board appointment process*

Appointments to the AEMO Board are made when required; with initial Board directors appointed at AEMO's commencement each having the expiry of their terms staggered to aide continuity. If all Board directors meet their full term, there should be some completing their three year term in the middle of each year.

On each occasion, the SCER Appointments Selection Panel, which is an independent panel, will undertake a search and recommend a short list of candidates that best meet the required skill set required of the particular Board position being replaced. The Panel prepares a report making recommendations of proposed candidates for consideration by members at a general meeting of the company. If approved by the members, the Panel's report is submitted to the SCER, which then makes the final decision to approve the appointment (or send back for further candidates).

#### *Board responsibilities*

The Board's responsibilities include but are not limited to:

- Oversight of AEMO's activities to achieve the objectives set out in the Constitution. The Constitution sets out obligations on AEMO to perform each of the functions and exercise the powers conferred on it under various pieces of legislation.
- Setting AEMO's goals and strategy.
- Determining the financial, operational, human, technological and administrative resources required by AEMO to meet its objectives and goals.
- Establishing and maintaining adequate and effective reporting lines and procedures, which enable all material matters and information to be identified and reported to the Board.
- Approving budgets and monitoring compliance with financial reporting obligations.
- Appointing the Managing Director.
- Reviewing and assessing the performance of the AEMO's management.
- Establishing and approving the charters of Board Committees.

<sup>14</sup> Information regarding membership of AEMO can be found at: <http://www.aemo.com.au/About-AEMO/Membership>

<sup>15</sup> See Appendix 2 for details of the current AEMO board members.

- Establishing effective controls and procedures to enable risks to AEMO to be identified, assessed and managed.
- Monitoring compliance with legislative and regulatory requirements including occupational health and safety, equal opportunity, environmental, corporate governance and reporting obligations.
- Reporting to AEMO’s stakeholders.

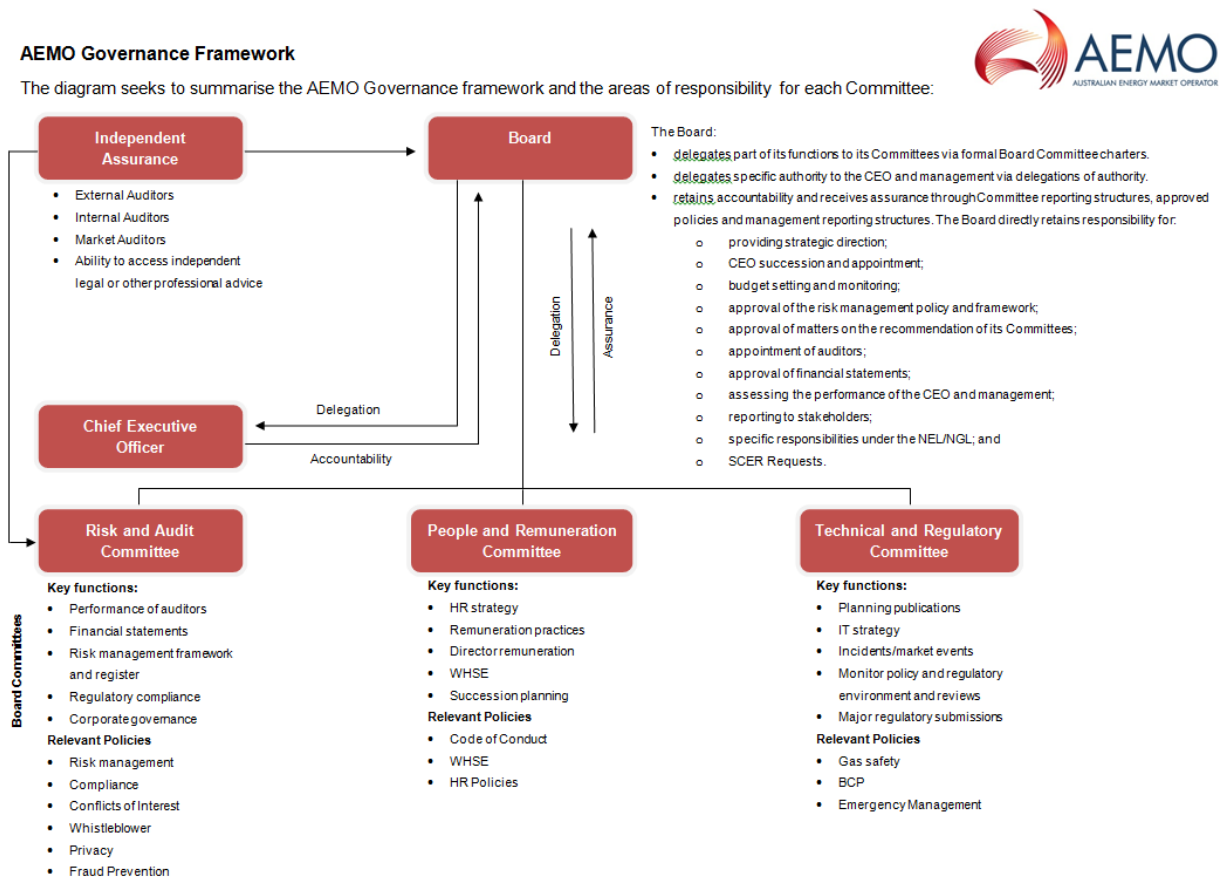
**Board obligations**

The directors on the Board have various obligations arising from the Corporations Act, the common law and the AEMO Constitution. These obligations include:

- Directors must comply with the duties under the Corporations Act and the common law such as the duties to act: in good faith; in the best interests of the company; with care and diligence; and proper purposes.
- Directors must avoid a conflict of interest or duty. To manage any actual, potential or perceived conflicts of interest, the Board has approved a Directors Interests Protocol that specifies the process for the management of conflicts.
- There must be a majority of independent directors on the Board.

The Board has approved various policies and procedures as part of its Corporate Governance Framework. These are illustrated in Figure 2.

Figure 2: AEMO Governance Framework

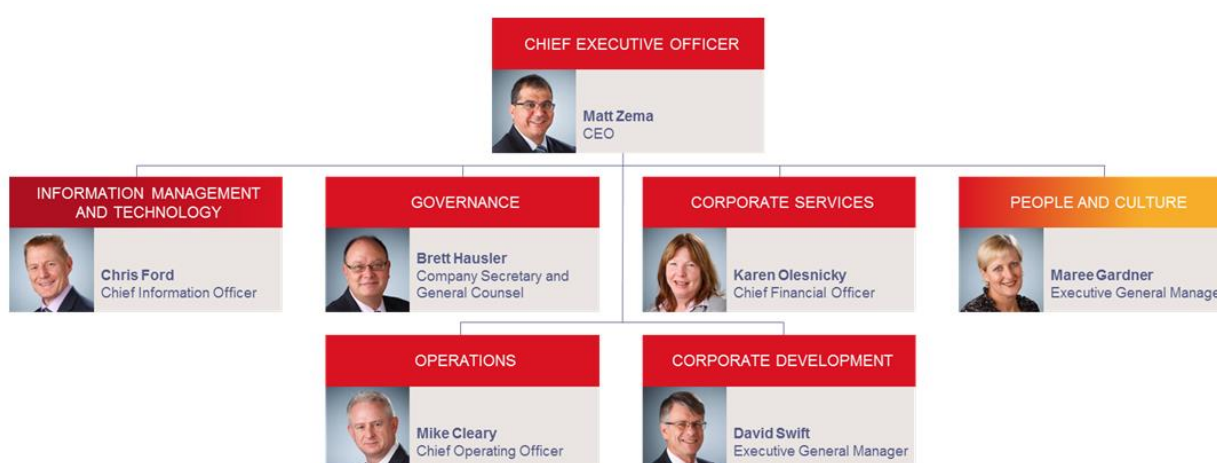


#### 4.1.4 Organisation Structure and Operations

AEMO's operating structure is designed to ensure that the business develops a strong culture of collaboration and accountability that will help to ensure transparency and integrity.

Within the functional work stream the organisational structure reflects a distinction between three types of organisational roles - day to day operations, short term market development and transmission services, and long term strategic planning. These distinctions reflect the shared focus of operations within each energy market and allows for integration of common services and efficiency in engagement with multi-market participants.

Figure 3: AEMO operating structure (as at July 2013)



#### 4.1.5 Examples of other operator arrangements

In establishing and assessing corporate governance arrangements, it is appropriate to consider whether those arrangements are fit for purpose. The 60-40 government-industry shared ownership structure that features at AEMO presents both advantages and challenges for its operation. Combined with its NFP status, these features of AEMO's corporate structure present a unique arrangement; both in a corporate sense, and also when compared to other entities with similar market or system operation functions in different markets.

Other market or system operators carry out their functions under different corporate arrangements, the form of which depends on many factors. For example, Transpower, in New Zealand, is both asset and system owner for the electricity transmission grid and is also a 100% state owned entity. In the United Kingdom, National Grid has an asset and system operation role for both the gas and electricity networks and operates as a publicly listed company. Prior to AEMO's establishment, one of its founding companies NEMMCO, with functions to operate the NEM, was also 100% government owned, with the jurisdictions approving the appointment of directors and each jurisdiction nominating a director for appointment.

In the American context, PJM, the regional transmission organisation operating the electricity system across a number of states including Pennsylvania and Maryland, has a different ownership structure again. PJM has full ownership by its industry members, with no government stakeholder interest. ISO New England, which operates the electricity system in New England without any asset ownership responsibilities, also has industry (participant) and no government ownership. These examples also reflect the historical experience in the United States where there has not been any previous government ownership (of any significance).

The legislative frameworks relating to those entities are different to those in place for AEMO, and reflect the different regulatory challenges associated with balancing the nature of the functions carried out by each operator and appropriate levels of oversight and customer protection.

When considering whether the current corporate governance arrangements are effective and fit for purpose it is therefore appropriate to consider the nature of AEMO's functions and role in the energy markets.

## 5 Effectiveness of the existing arrangements

In this review the current corporate governance principles developed by the ASX have been used as a basis for assessing the effectiveness of the governance arrangements currently in place at AEMO. Given the nature of AEMO's functions and mix of ownership, some of the principles noted are less relevant to its operation than they would be for a publicly listed company. However, for completeness, each principle has been considered below with discussion in respect of AEMO's operation provided. Note, that where some of the principles are closely related, these have been considered in tandem.

**Principle 1: Fundamental to any corporate governance structure is establishing the roles of the board and senior executives,**

**Principle 2: With a balance of skills, experience and independence on the board appropriate to the nature and extent of company operations.**

The Board structure under which AEMO operates has been developed in accordance with both of these principles. As noted earlier, Figure Two illustrates the clear lines of responsibility for the non-executive board directors, the role and function of committees and the delegated responsibilities of the Managing Director and Chief Executive Officer. This information is also available publicly on the AEMO website.

In respect of Principle 2, the AEMO Constitution requires non-executive board appointments to be made according to a skills requirement matrix. These appointments are made by the SCER, following consideration by members.

The 'nature and extent of company operations' at AEMO are often of a specific and technical nature. As such, having an appropriate 'balance of skills, experience and independence on the board' is paramount to maintaining the strength and robustness of the decision making functions carried out by the AEMO Board. This is important not only for the functioning of the Board, but also for the operations of AEMO itself given that it is the board that appoints the Managing Director/Chief Executive Officer for AEMO.

Confidence of the energy markets in AEMO as an independent and prudent market operator can therefore be undermined in the absence of it having an appropriate mix of well skilled and experienced non-executive board directors. The potential exists for wider reputational risk for AEMO if changes to its governance structure were made such that there was a perception of non-independent (e.g. partisan vs. skills-based) appointments were made to its Board.

### *Options for further consideration*

#### *Length of term*

It may be appropriate to consider changes to the length of terms for board appointments.

Where currently an AEMO Board director can sit for two terms, the length of term being a three year period; there may be merit in allowing for directors to carry out longer periods of service. As directors usually require time to fully understand all aspect of the company's operations, there would be a benefit in extending the term of appointment or the number of terms to leverage off this knowledge, as well as provide additional stability in the Board composition. Balanced against this is the need for new and 'fresh' perspectives, unencumbered by any past 'legacy' issues or decisions, to continue to be incorporated into the decision making process at regular points.

It could be appropriate therefore to consider amending the duration of a board appointment, while at the same time retaining a cap on the number of terms a board director is able to sit for. For example, this could be defined as a two or three term maximum – where the length of term could be defined as a three or four year period.

That is:

- Current: Two x three year appointments (six years in total)
- Option A: Three x three year appointments (nine years in total)
- Option B: Two x four year period (eight years in total)

### *SCER Appointments Selection Panel Process*

Currently the SCER Appointments Selection Panel is involved in the new director appointment process for AEMO (and in some instances the reappointment process).

The Selection Panel's involvement in this process includes: reviewing the candidates provided by the search firm to identify a short-list; undertaking interviews of the short-listed candidates; and preparing recommendations and a report to the AEMO Board and members, and then the SCER, on the candidates recommended for appointment as directors.

AEMO notes that this process differs to the approach adopted more generally by corporations; whereby a Board (or a Board Committee such as a Nomination Committee) would usually identify a short-list of candidates and perform interviews for the purpose of proposing to the company members/shareholders suitable candidates for appointment as a director. This approach may have the benefit of reducing the timeframe for the selection process. A similar option could be considered as a modification to the selection process for AEMO board appointments; i.e. where the AEMO Board would undertake the selection process and then make recommendations to members and to the SCER.

### *Reappointment process*

As part of the existing selection process, a Board director seeking to be considered for a second term currently needs to be reviewed once again by the SCER Appointments Selection Panel. AEMO considers there is scope for this process to be streamlined where decisions relate to the renewal of board appointments.

The current director reappointment process under the AEMO Constitution is as follows:

- a) If all directors eligible for reappointment and are approved by the Chair, the Chair submits a list of reappointments for consideration by the members and approval to submit to the SCER.
- b) If there is a vacancy, or the Chair is not prepared to recommend one or more directors for reappointment, then all directors due for reappointment (and any vacancies) need to be referred to the Selection Panel process.

It may be possible for the Chair to instead make a recommendation in respect of a director due for reappointment to Members on the basis of performance over their first term on the Board. If Members endorse the recommendations of the Chair, these could then be approved by the SCER (as at present), but not need to go through a selection panel process.

Modifications to streamline the process in this way would reflect that the director has already been through a selection panel process, and assessed against the relevant skills matrix, as part of their original appointment process, and have already considered suitable for appointment. Support from the Chair would further indicate that the director is making a valued contribution to the AEMO Board. These modifications could potentially increase the efficiency and timeliness of the reappointment process and thereby reduce the level of uncertainty for the director and the AEMO Board.

### Skills matrix

Further, and consistent with recommendations made by the Productivity Commission in its October 2012 report<sup>16</sup>, and also in line with recent SCER developments to introduce a new energy advocacy body (Australian Energy Consumers Organisation, 'AECO'); AEMO considers it may be appropriate to also consider the level of customer input as part of the board composition.

Although we note there are no restrictions for customer representatives holding positions on the AEMO board, it may however be relevant to consider whether there was scope to better reflect skills and experience relating to customer interests as part of the skills matrix for board appointments. It is likely to be unnecessary to change to the nature of the board structure to one whereby particular interests (either customers or other stakeholders) were 'represented' on the board. However, there may be merit in amending the skills matrix within the Constitution to better reflect, and therefore give appropriate weight to, those with skills and experience relating to customer interest as part of the appointment process.

**Principle 3: *There is a basic need for integrity among those who can influence a company's strategy and financial performance, together with responsible and ethical decision-making which takes into account not only legal obligations but also the interests of stakeholders.***

To assess how AEMO performs in respect of meeting the essence of Principle 3, it is useful to consider governance structures in place at AEMO that protect the integrity of decision making processes.

In its corporate governance literature, the ASX defines an independent director as follows:

*An independent director is a non-executive director who is not a member of management and who is free of any business or other relationship that could materially interfere with - or could reasonably be perceived to materially interfere with - the independent exercise of their judgement. (p16)*

In respect of board level appointments, the AEMO Constitution sets out detailed criteria on the selection of board members (to be appointed on merit on a skills requirement matrix as discussed above), specifically including that the board can consist of between five to ten directors, a majority of which, including the chair, must be independent directors.

In approving board appointments at AEMO, the SCER (and AEMO's members) will be mindful of the need for selecting directors with relevant, up to date industry or technical experience to ensure that the strategic industry specific nature of its decisions can be taken with confidence.

There is clearly a balance of risk taken in selecting directors with the appropriate and relevant knowledge of the energy industry where, given the relatively small size of the energy sector in Australia, those people would tend to be employed or have interests remaining in other entities within the sector. Appointments therefore need to consider the potential conflicts of interest associated with carrying out duties as a director for AEMO and any other role they may have within the industry.

It should be noted that dealing with conflicts of interest is not an issue specific to AEMO's board structure; the potential for conflicts of interest with non-executive board members and the operational decisions taken by an organisation is an issue dealt with widely at a corporate level. The way in which organisations manage their decision making processes, rather than limiting their appointment processes, can limit the extent to which this is a potential issue for the company.

However, as discussed earlier, given the unique nature of AEMO's role in carrying out a number of legislated functions on behalf of industry stakeholders, industry confidence in both AEMO's competence and its ability to carry out functions with integrity and in an independent manner is important. Stakeholders rely on AEMO carrying out its functions in this manner; for example, with confidence in our ability to manage and dispatch bids, handle commercially sensitive information and carry out accurate settlement processes. AEMO therefore has a strong interest in ensuring

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<sup>16</sup> Energy Network Regulatory Frameworks, Productivity Commission, October 2012.

industry remains confident with its ability to run its operations and that stakeholder interests are well managed.

In respect of AEMO's operations, policies to manage the potential for conflicts of interest are in place and enforced. These policies are available on AEMO's website.

In respect of Board directors, before each meeting of the board, the AEMO chair will ask directors to declare their interest in any of the agenda items to be considered at that meeting. Where members declare an interest, they will be excused for that portion of the meeting discussion and decision making process. Such conflicts of interest are recorded on the minutes for each meeting.

At the staff level, all AEMO employees are also required to disclose all energy sector shareholdings. Some areas of the organisation will involve closer working contact with external stakeholders than others, and therefore the potential for a 'perceived risk' may be greater for some more than others.

These policies therefore involve a balance of 'control measures' (where staff and board directors alike are required to disclose potential conflicts of interest) and of building a culture of openness and transparency to ensure the continued integrity of AEMO's operations and decision-making processes.

It is worth noting that given AEMO's unique mix of government and industry ownership, and the range of functions AEMO is legally required to carry out, the concept of 'considering the interests of stakeholders' is quite different in this context than it would be for a publicly listed corporate entity with shareholder interests to manage. With its broad national focus for the future, AEMO's core objectives are to promote efficient investment in and operation of Australia's electricity and gas markets for the long-term interests of consumers – with respect to price, quality, safety, reliability and security of energy supply.

*Options for further consideration:*

There may be merit in reviewing the current definition of 'Independent Director' within the AEMO Constitution to align the wording with that used by the ASX in its Corporate Governance Guidelines. The definition used by AEMO, although clear, is more prescriptive than the ASX definition and could therefore be streamlined and made more consistent with that more broadly adopted in Australian as corporate practice.

Change in this respect may enable a larger pool of candidates be considered for future Board appointments; a relevant consideration in the relatively small domestic energy market context. Any amendments of this nature would not alter requirements on Board directors to disclose and proactively manage potential conflicts of interest on an ongoing basis.

**Principle 4: Meeting the information needs of a modern investment community is also paramount in terms of accountability and attracting capital. Presenting a company's financial and nonfinancial position requires processes that safeguard, both internally and externally, the integrity of company reporting,**

**Principle 5: and provide a timely and balanced picture of all material matters.**

As an organisation with split government and industry ownership, and a range of legislated functions, AEMO's Board does not have the same commercial drivers in respect of attracting capital investment as other corporate entities. AEMO's role and functions set it apart from other not for profit organisations in this way also; in that AEMO's Board does not need to secure funding in a way that this would be a primary focus of other not for profit entities.

However, AEMO remains accountable to both its members and its wider stakeholders. This is particularly the case as these stakeholders pay AEMO's operating costs as part of their annual fees. The mix of AEMO ownership, with 40% industry representation, also provides implicit oversight and pressure on AEMO to act responsibly in respect of its operating costs. It is therefore incumbent on AEMO to ensure it maintains pressure on effective use of spend.

Since AEMO's commencement, Board directors and senior management have focussed on streamlining a number of corporate areas including its Board and committee governance processes, the establishment of strong internal controls, and identifying and implementing productivity benefits. These benefits are included in and reported as part of the annual corporate budget process. Given the nature of the merger process leading to AEMO's commencement, a key corporate focus has also been on targeting synergies which deliver increased value or cost savings to stakeholders across the business where possible.

The nature of AEMO's role in providing settlement services to the gas and electricity markets, also brings with it significant financial responsibility; where AEMO manages settlement processes involving over \$500M each calendar month. It is clearly imperative from the perspective of maintaining the robustness of market settlement mechanisms that AEMO has clear, timely and reliable reporting processes on all matters relating to the financial health of the market and also of its own operations, as well as exceptionally robust and effective supporting IT infrastructure. In this respect, the interests of AEMO and its industry stakeholders are aligned – where both have a strong interest in ensuring AEMO has the ability to effectively run its operations and therefore that stakeholder interests are well managed.

*Options for further consideration:*

Amendments could be considered in regard of the competencies noted in the skills matrix defined in the AEMO Constitution.

Such amendments could involve references to skills relating to the 'operation or knowledge of network businesses' (gas or electricity) and also the 'operation or detailed knowledge of complex information technology systems'.

Changes in this regard would better reflect the full complement of AEMO business needs and, although the Board is not a 'representative' committee, this would enable Board appointments to be made with perhaps a more appropriate level of consideration given to skills in these areas.

***Principle 6: The rights of company owners, that is shareholders, need to be clearly recognised and upheld.***

As noted, AEMO's unique mix of government and industry ownership, and its range of functions, provide a different context against which to consider the 'rights of company owners', compared to commercial entities with shareholder interests to manage.

With its broad national focus for the future, AEMO's core objectives are to promote efficient investment in and operation of Australia's electricity and gas markets for the long-term interests of consumers – with respect to price, quality, safety, reliability and security of energy supply.

As discussed in respect of Principle 5, AEMO remains accountable to both its members and its wider stakeholders. The mix of government and industry ownership provides implicit oversight and pressure on AEMO to act responsibly in respect of its operating costs, and both transparent and robust in its decision making processes.

*Options for further consideration:*

Before AEMO's commencement, the nature and level of the government-industry ownership split was an issue of contention.

As discussed earlier, some parties (notably industry participants on the supply side) were of the view that industry membership affords the energy sector participants a potentially greater degree of accountability to those who use and pay for AEMO's services and the potential for improved responsiveness to the needs of market participants, enhanced transparency of operations and greater independence from any particular market participant or government stakeholder.

Alternatively, other parties, particularly end users and government stakeholders, perceived that government membership of AEMO could provide greater protection and improved accountability to end users (who are the ultimate beneficiary of its services), and greater independence from any particular market participant.



The current split of 60-40 ownership (government-industry respectively), reflects the outcome of those earlier discussions.

It may be an option to consider adjusting the weighting of the ownership stakes – whether this be to increase the holding for either industry or government members. However, in practice, as long as the percentage of the split retains a sizeable holding for its ‘minority’ members, this should keep suitable pressure on both sets of stakeholders to ensure that all concerns continue to be recognised.

As such, AEMO considers it is likely to be unnecessary to make amendments to the existing split of ownership at this time.

***Principle 7: Every business decision has an element of uncertainty and carries a risk that can be managed through effective oversight and internal control.***

The AEMO Board has delegated certain functions to its Managing Director and Chief Executive Officer (outlined earlier in Figure 2). As noted in Figure 2, to support the Board in carrying out its role, a range of operating committees have also been established, including the Risk and Audit Committee. These committees are made up of representatives from the Board and each have defined remits related to supporting and overseeing specific elements of AEMO’s business operations. A suite of corporate policies have also been developed that are managed and enforced at a senior executive level via these committees.

*Options for further consideration:*

AEMO’s existing legal status limits its ability to build up any working capital. At present AEMO recovers its costs from stakeholders via operating fees. This was an intended limitation as part of the original design for AEMO’s corporate framework.

There may be merit in exploring options to widen the existing parameters to thereby enable AEMO a narrow remit in which to fund additional, and potentially closely defined, activities. This may give AEMO greater scope to consider activities that, although consistent with its ‘Vision’ and ‘Mission Statement’, would otherwise currently be considered as out of scope and not taken any further. Were AEMO to explore or undertake such activities at present this could expose the company to insolvency risk given there would be no recourse (or associated functions) under either the underlying legislation or Constitution to recover costs from participants.

It is worth noting that under the previous governance arrangements in place for NEMMCO, a similar level of flexibility was afforded, thereby enabling NEMMCO a narrow remit to hold working capital to fund additional activities.

While it has been useful to consider the potential for variations in AEMO’s remit as part of this review process, AEMO considers it is likely to be unnecessary to make such amendments at this time.

***Principle 8: Rewards are also needed to attract the skills required to achieve the performance expected by shareholders.***

Given the nature of AEMO’s corporate status, this Principle does not directly translate into AEMO’s situation. However, as an organisation that strives for continuous improvement and also to be an employer of choice, the essence of this principle is implicitly incorporated into AEMO’s policies relating to its people and culture.

At Board level, and as discussed earlier, appointments are made on a skills requirement matrix by the MCE. The Board itself selects and oversees the performance of the Managing Director and Chief Executive Officer. Consistent with most corporations, the Board also has a role in succession planning for the role of MD/CEO.

As an employer, AEMO measures itself against other similar industry or government employers in respect of remuneration packages for employees. The AEMO People and Remuneration Committee of the Board operates to ensure performance is appropriately managed and effectively rewarded across the organisation.



## 6 Feedback

AEMO strives to operate in a culture of continuous improvement. This assessment has provided AEMO with an informal opportunity to review internal processes and governance arrangements at a corporate level.

Having now reviewed these structures over the period post commencement, it is our view that the existing arrangements continue to be broadly fit for purpose. Further, these arrangements, as they currently operate, continue to provide an important balance of oversight by members and stakeholders, as well as the necessary flexibility for AEMO to evolve as an organisation and adapt to changing circumstances in the markets.

As part of carrying out this review we have also noted throughout where we consider there to be potential scope for considering subtle changes to these arrangements in order to gain further benefits as the organisation and markets evolve going forward.

In order to improve the efficiency and effectiveness of arrangements relating to board appointments, AEMO intends to give effect to a number of amendments via relatively minor changes to the AEMO Constitution. These amendments will be progressed with AEMO members later this year.

AEMO welcomes feedback from interested parties, market participants and government stakeholders alike on the views and ideas raised in this paper. Where stakeholders see further opportunities for AEMO to make incremental improvements to its existing arrangements, we welcome the opportunity to consider and/or further develop these.

Any questions or feedback in respect of this paper should be sent by email to David Swift, Executive General Manager, Corporate Development at the following email address:

[david.swift@aemo.com.au](mailto:david.swift@aemo.com.au). AEMO welcomes feedback by close of business on **Friday 30 August 2013**.

## Appendix 1 – AEMO Membership

*AEMO Industry Members (as at 19 June 2013)*

1. Acciona Energy Oceania Pty Ltd
2. AGL Energy Ltd
3. AGL Loy Yang Marketing Pty Ltd
4. APA GasNet Australia (Operations) Pty Limited
5. Allgas Energy Pty Limited
6. APT Petroleum Pipelines Pty Limited
7. APT Pipelines (NSW) Pty Limited
8. Attunga Capital Pty Ltd
9. Aurora Energy (Tamar Valley) Pty Ltd trading as AETV Power
10. Aurora Energy Pty Ltd
11. Aus Gas Trading Pty Ltd
12. Ausgrid
13. Australian Power and Gas Pty Ltd
14. Central Ranges Pipeline Pty Limited
15. CitiPower Pty
16. Click Energy Pty Ltd
17. Delta Electricity
18. Diamond Energy Pty Ltd
19. Directlink Joint Venture (ABN 16 779 340 889)<sup>17</sup>
20. Dodo Power & Gas Pty Ltd
21. East Australian Pipeline Pty Limited
22. EDL Group Operations Pty Limited
23. ElectraNet Pty Ltd
24. Endeavour Energy
25. Energex Limited
26. EnergyAustralia Gas Storage Pty Ltd
27. EnergyAustralia Pty Ltd
28. EnergyAustralia Yallourn Pty Ltd
29. Energy Pacific (Vic) Pty Ltd
30. EnerNOC Pty Ltd
31. Envestra Limited
32. Envestra (NSW) Pty Ltd
33. Epic Energy Holdings Pty Ltd
34. Eraring Energy
35. ERM Power Limited
36. ERM Power Retail Pty Ltd
37. Essential Energy
38. FPC 30 Limited
39. Hydro-Electric Corporation
40. Infigen Energy Markets Pty Ltd
41. Infratil Energy Australia Pty Ltd
42. Jemena Limited
43. Macquarie Generation
44. Marubeni Australia Power Services Pty Ltd
45. Millmerran Energy Trader Pty Ltd
46. Murraylink Transmission Company Pty Ltd
47. N. P. Power Pty Ltd
48. OneSteel Manufacturing Pty Ltd

<sup>17</sup> (Directlink (No. 1) Pty Limited ABN 85 085 123 468, Directlink (No. 2) Pty Limited ABN 87 095 439 222, and Directlink (No. 3) Pty Limited ABN 86 095 449 817 trading as Directlink Joint Venture).

49. Origin Energy Electricity Limited
50. Pacific Hydro Clements Gap Pty Ltd
51. Pacific Hydro Chalicum Hills Pty Ltd
52. Pacific Hydro Portland Wind Farm Pty Ltd
53. Pacific Hydro Retail Pty Ltd
54. People Energy Pty Ltd
55. Powercor Australia Ltd
56. Queensland Electricity Transmission Corporation Limited (trading as Powerlink Queensland)
57. Roverton Pty Limited
58. Santos Ltd
59. South East Australia Gas Pty Ltd
60. SPI Electricity Pty Ltd
61. Tasmanian Gas Pipeline Pty Ltd
62. Transend Networks Pty Ltd
63. TransGrid
64. Vicpower Trading
65. Westpac Banking Corporation
66. WINenergy Pty Ltd

*AEMO Government Members*

1. Commonwealth Government
2. Australian Capital Territory
3. State of New South Wales
4. State of Queensland
5. State of South Australia
6. State of Tasmania
7. State of Victoria

## Appendix 2 - AEMO Board

The AEMO Board was appointed on 1 July 2009. The current Board comprises nine Non-Executive Directors and the Managing Director and Chief Executive Officer.



### **Dr Thomas (Tom) Parry AM – Chairman**

Dr Parry is the Chairman of Sydney Water Corporation and First State Super Trustee Corporation. He is also a director of Powerco (New Zealand) and ASX Compliance Pty Ltd. With over 30 years' experience as an academic, business and public policy consultant and regulator, Dr Parry has extensive experience in regulating utility assets in the water and energy sectors. Dr Parry was the Foundation Executive Chairman of the Independent Pricing and Regulatory Tribunal of NSW (IPART). He was also the Foundation NSW Natural Resources Commissioner.



### **Mr Matt Zema – Managing Director and Chief Executive Officer**

Mr Zema was the Chief Executive Officer of the Victorian Energy Networks Corporation (VENCorp), which was responsible for operating the declared transmission system for gas in Victoria and for the planning, procurement and augmentation of the Victorian electricity transmission network. Prior to joining VENCorp in 1999, he worked in general management roles with PowerNet Victoria, GPU PowerNet and GPU International. He has a long history in strategic planning, asset management, corporate governance, and financial management, gained over two decades in executive roles in the public and private sectors.



### **Mr Ian Fraser (second term to finish in November 2013)**

Mr Fraser currently holds directorships on several listed companies and was the Chairman of the Gas Market Company Ltd. He is a qualified accountant (CPA) with significant operational experience in a number of managing director positions over 13 years and across a broad range of industries.

**Mr Leslie (Les) Hosking**

Mr Hosking was the CEO and Managing Director of NEMMCO 2003–2008 and a director of the company between 1997 and 2003. He is currently a non-executive director of AGL Energy Ltd and Chairman of Adelaide Brighton Ltd. He has over 30 years' experience in the Australian futures industry, including being CEO and Managing Director of the Sydney Futures Exchange Ltd for 15 years, from 1985 to 2000.

**Mr Greg Martin**

Mr Martin is a non-executive director of a number of listed and unlisted companies including Santos Ltd and Energy Developments Ltd. He is the Managing Director of Murchison Metals Ltd. Mr Martin is a previous CEO and Managing Director of AGL and has nearly 30 years' experience in the utilities, energy and energy related infrastructure sectors in Australia, New Zealand and internationally.

**Dr Anthony (Tony) Marxsen**

Dr Marxsen is director of Marxsen Consulting Pty Ltd and Jancomax Pty Ltd and a former director of VENCORP and Sustainability Victoria. He has extensive strategic and operational expertise in electricity grids and information technology and senior experience in a range of industries and particularly in strategic, transformational and operational roles in the energy sector including the National Electricity Market and gas markets. He was made a Computerworld Fellow in 2001.

**Mr Stephen Orr**

Mr Orr joined the AEMO Board in July 2012. Mr Orr is currently Head of Strategy and Regulation Australia for International Power GDF SUEZ and is a director of a number of companies within the International Power GDF SUEZ group. He has extensive senior management experience in the energy industry including power generation, financial markets, energy trading and, through his involvement with a significant second tier business, retail.

**Dr Michael Sargent AM (second term to finish in November 2013)**

Dr Sargent is Chairman of the Lighthouse Business Innovation Centre Ltd, is a director of six organisations, and is a member of the Clean Energy Regulator. He was previously a director of NEMMCO. Dr Sargent has operated his consultancy since 1999 with a particular focus on the IT, energy, environment and utilities sectors. Dr Sargent has 45 years of experience in the utilities industry in Australia and internationally in a number of engineering and operational management roles.

**Ms Jane Tongs**

Ms Tongs is Chair of Netwealth Holdings Ltd and a director of Catholic Care, Catholic Church Insurances Ltd, LCM Calvary Health Care Holdings Ltd, Leadership Victoria Ltd, RUN Corp Ltd and Warakirri Holdings Pty Ltd. She has chaired multiple audit and risk committees and has deep knowledge and experience in risk management, corporate governance and financial services. She was formerly a partner at PricewaterhouseCoopers and a director of several private sector companies and government organisations. Ms Tongs is a Fellow of the Institute of Chartered Accountants, CPA Australia and the Williamson Community Leadership and is a member of the Institute of Company Directors.