

AEMC draft implementation advice for the  
shared market protocol: A governance analysis

21 July 2015

Ref ALS:563068

Doc ID 301306763/v1

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## AEMC draft implementation advice for the shared market protocol: A governance analysis

This report provides an independent analysis of the merits of the AEMC draft proposal<sup>1</sup> to give the NER Information Exchange Committee (**IEC**) the governance role of developing and maintaining the shared market protocol (**SMP**) to facilitate efficient communications between consumer-dealing energy service companies.

We were engaged for this task by AEMO on terms that allow it to share this report with the AEMC.

### Summary and conclusions

The objectives of the SMP are ultimately competition and immediately effective communications and reduced barriers to entry. These are public interest (regulatory) objectives that are vulnerable to any inconsistent desires of incumbent market participants.

Key benchmarks of good regulatory governance are the achievement of objectives, efficient operations, effective change management and appropriate management of conflicts of interest.

We believe that the AEMC proposal for governance of the SMP, with the currently contemplated features of IEC's role, falls short of the benchmarks.

Specifically:

- The governance regime will not be unambiguously focussed on a sufficiently clearly stated objective;
- The proposal involves a material risk of failing to fully attain the SMP objectives noted above;
- Decision-making will be inefficient, with decisions not made in a sufficiently simple, timely and accountable manner;
- The decision-making making process faces the prospect of being ineffective and unworkable;
- If the process fails to deliver, a review and refresh of the process would be slow and difficult to accomplish; and
- Conflicts of interest are not minimised nor mitigated and managed to the maximum extent possible.

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<sup>1</sup> AEMC 2015, *Implementation advice on the shared market protocol*, draft advice, 25 June 2105 ("AEMC proposal"). Terms defined and acronyms used in the AEMC proposal have the same meanings in this report.

## Methodology

We have considered the character, function and objectives of the SMP as part of the regulated energy market in Australia, in order to characterise and analyse the function proposed to be conferred on the IEC.

The COAG Energy Council and the AEMC regard the SMP as an important element of a comprehensive package of NEM reforms that seek to promote market outcomes in the long term interests of consumers. In that sense the SMP performs a regulatory or quasi-regulatory function, if a similarly efficient communication framework for the market would not emerge without intervention through the NER or the National Energy Retail Rules. The AEMC proposal characterises the IEC's role as a governance role. We concur with that characterisation insofar as governance is broadly expressed as the arrangements and practices that enable a decision-maker "to set its direction and manage its operations to achieve expected outcomes and discharge its accountability obligations."<sup>2</sup> Given the function of the SMP and the ongoing role of developing and implementing it, we have therefore approached this exercise as one of governance of a regulatory body.

In our analysis we have been guided by broad regulatory governance principles and practices, including the expression of them by COAG in its publication *Best Practice Regulation – A Guide for Ministerial Councils and National Standard Setting Bodies* (COAG 2007) and by the Australian National Audit Office in its *Better Practice Guide Public Sector Governance – Strengthening Performance Through Good Governance* (ANAO 2014).

Accordingly, we considered the fundamental elements of both **best practice regulation** and **good governance**. Both flow from the regulatory objectives or organisational mission. Both involve elements concerned with decision-makers' duties, capabilities, processes and freedom from inappropriate influences. One or both are concerned with inputs such as the decision-maker's appointment, composition, tenure, qualifications, experience, resources and conflict procedures.

Importantly, both best practice regulation and good governance share some fundamental output benchmarks, which we have for this report grouped and labelled as:

- Achieving objectives;
- Operational efficiency;
- Change management efficacy; and
- Management of conflicts.

These are explained briefly in each relevant section below.

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<sup>2</sup> Australian National Audit Office 2014, *Public Sector Governance – Strengthening Performance Through Good Governance*, Better Practice Guide, June 2014, page 7.

Our first step was to consider the objectives of the SMP and the risks to attainment of those objectives. We then considered our four output benchmarks of good regulatory governance.

To assist our abstract analysis we also undertook a critique of novel aspects of the current form of the IEC (acknowledging, as AEMC does in its document, that some of those potential concerns are sought to be addressed in the AEMC proposal). That historical analysis is set out in the Appendix to this report.

A related question that we could have posed (or been given), but readers of this report can consider themselves based on our analysis, is whether a governance body such as the IEC in its current or proposed form would in fact be contemplated if it did not already exist. Would it be the body of choice if one had to be established at this current point of development of the NEM?

## SMP objectives and risks to attainment of those objectives

The COAG Energy Council and the AEMC regard the SMP as an important element of a comprehensive package of NEM reforms that seek to promote market outcomes in the long term interests of consumers<sup>3</sup>.

Consumer choice is regarded as paramount to meeting the long term interests of consumers, and the Energy Council is concerned to see a “framework for open access and common communication standards that would support competition in demand side management services available to consumers<sup>4</sup>.” AEMC’s open access advice to the Energy Council recommended a SMP “to facilitate efficient communications”. A SMP is expected to promote competition in the market for advanced metering services by reducing barriers to entry.

In developing its SMP proposal, AEMC has had regard to the National Electricity Objective (**NEO**)<sup>5</sup>. At the core of the NEO are the interests of consumers. One of the four supporting principles of the NEO is competition. AEMC says that the SMP should promote competition.

In summary, it is clear that the objectives of the SMP are ultimately competition and immediately effective communications and reduced barriers to entry.

These are public interest (regulatory) objectives. These regulatory objectives, almost by definition, diverge or tend to diverge from the rational profit maximising objectives of incumbent market participants, particularly those with well established market positions.

The principal risks to attainment of the SMP objectives are:

- protocols not being made;
- protocols not being kept up-to-date with changing circumstances and technology;

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<sup>3</sup> AEMC 2015, p 4

<sup>4</sup> AEMC 2015, p i (also source of other quotes in the paragraph)

<sup>5</sup> AEMC 2015, p 11

- protocols adopting measures that advantage incumbent service providers; and
- protocols not being effective (eg because of not being comprehensive or a technical deficiency).

In turn, a number of reasons could see each risk being realised. The first two risks could be realised by deadlock, inertia or poor productivity of the committee. The first three could be realised if decision-making by committee members is subject to inappropriate influences. The fourth could be realised by any expertise or capability deficiency. All could be realised by a lack of leadership.

These risks are examined in the sections that follow.

## Four key output benchmarks of good regulatory governance

### 1 Achieving objectives

Good governance theory suggests that governance structures should be appropriately designed based on the objectives that the body is to pursue, in a way that allows those objectives to be achieved (while giving due regard to other substantive and procedural imperatives).

We see two major issues regarding whether the SMP objectives will be achieved on an ongoing basis if AEMC's proposal for the IEC is effected. The first is whether there could be tension between the SMP objectives and other IEC mission imperatives. The second is whether the proposed composition of the IEC and the industry perspectives of most of its members pose a risk that the SMP objectives are not pursued to the full extent of the public interest.

Unlike the NEO, the B2B Objective and Principles do not directly focus on a paramount interest of consumers, but are more concerned with relations between principal B2B participants. The B2B Objective is that benefits to those participants should outweigh the detriments. The SMP regime will need to reconcile the NEO and the other guidance given to the IEC. We agree that the current B2B Objective needs deletion but it also should not merge into a replacement set of competing principles. While AEMC contemplates a revision to the B2B Principles, it does not propose a clearly stated overriding SMP objective (just a requirement to "have regard to" the NEO). This is likely to be problematic.

AEMC acknowledges the reasonably held concern by many stakeholders that "an industry decision maker would have conflicts of interest in making decisions that may lower barriers to entry or may benefit the long term interests of consumers."<sup>6</sup> Its response is two-fold. First, it asserts "significant benefits to industry led decision making." Secondly, it considers that the IEC "can be designed in a way that mitigates concerns ...around representation and flexibility to changing market conditions."

We are most concerned by the proposition that industry representation necessarily produces the best decisions. Good governance theory suggests that industry views must be heard, understood and considered, but that those perspectives need to be

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<sup>6</sup> AEMC 2015, p 18

considered together with other perspectives by an independent or impartial regime that is focussed on the objectives at stake.

AEMC states a belief that “having an industry body maintain the B2B procedures (an updated IEC) is consistent with the NEO.”<sup>7</sup> AEMC’s repeated core proposition is that:

Industry members (and ultimately, their customers) will bear the costs and receive the benefits of decisions about B2B procedures and are likely to make the most effective and efficient decisions.<sup>8</sup>

It cites industry responsibility for determination of suitable communication standards as being common in banking and telecommunications. This is not our assessment of how those industries operate. In banking, the Reserve Bank of Australia and its Payment Systems Board govern the “RITS” which is central to settlement of interbank payment obligations. In telecommunications, the Australian Communications and Media Authority sets obligations owed by carriers to one-another, including in relation to data. In each case industry has substantial input into B2B matters, and in telecommunications there is some deferral to self-regulation, but both regimes are grounded in a clear leadership and ultimate determination role for the regulator, acting in the public interest.

Most remarkably, AEMC asserts that:

Industry is best placed to determine what it wants and is willing to pay for ...

This is strikingly inconsistent with the first governance output benchmark, which is achievement of objectives rather than meeting the wishes of a group of interested stakeholders. AEMC contemplates that industry will be motivated to pursue their interest. Industry members might actually want higher barriers to entry and less competition.

AEMC therefore itself puts the core question of conflict of interest in issue.

AEMC’s response to this acknowledged, even championed, conflict of interest is to assert consistency with the NEO (which is not demonstrated) and to propose expanded representation of other interests on the IEC. Also, while it at one point states<sup>9</sup> that “it is not necessary for AEMO to assess the merits of an IEC decision”, it goes on to state<sup>10</sup> that AEMO should have a “limited veto power” as “an important safeguard” given AEMO’s role as operator of the B2B e-hub.

In our view the AEMC proposal involves a material risk of failing to fully attain the SMP objectives of competition and reduced barriers to entry, because it is proposed that at least 3, and arguably 4, members represent incumbent industry participants and those participants appoint 2 further members who will purport to be independent. The votes of such members are counted in any and all circumstances in a committee to be composed of 10 members in total.

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<sup>7</sup> AEMC 2015, p 13

<sup>8</sup> AEMC 2015, p 13

<sup>9</sup> AEMC 2015, p 21 (5.3.2 Draft recommendations and rationale)

<sup>10</sup> AEMC 2015, p 27



We note that the AEMC proposal gives an array of roles to AEMO in and around the proposed IEC and SMP processes. The extent of these roles and the view that AEMO should have a veto power as “an important safeguard” given AEMO’s role as operator of the B2B e-hub is, in our opinion, instructive.

Ultimately it is essential for good governance that a primary decision-maker be unambiguously focussed on the right objectives, being the primary objectives of the function which it has to undertake. A modified IEC might not do so; it might pursue what industry wants, which might not be the same outcome.

## 2 Operational efficiency

Good governance theory suggests that decision-making should be organised and subject to processes that make best use of capabilities and resources, and make decisions efficiently and with minimum costs and externalities.

As partly outlined in the Appendix, the IEC’s procedures, resourcing and related circumstances are odd, and in practice require support of AEMO. Budgeting and funding is unusual, with registered participants bearing the burden but IEC having less accountability compared with AEMO for its budgeting.

B2B decision-making is a two-step process, requiring AEMO concurrence (to a lesser or greater extent under current and proposed arrangements). The first step has the prospect of being inefficient, with the novel committee membership and deliberation arrangements that are contemplated. AEMO is the e-hub operator but is placed in a reactive position in relation to the development of the SMP. The safeguards against aberrant decision-making are weaker than other NEM decision-making, because the IEC is not subject to judicial review.

With the ‘coalition of interests’ nature of the composition of the committee and AEMO’s veto power, SMP decision-making is likely to be relatively slow. Put simply, the two-step IEC-AEMO decision-making model for the SMP is not as efficient as it could be.

Finally, there is an increasingly important range of retail market operational functions that are vested in AEMO. Having a split of initial decision-making for related functions between IEC and AEMO raises the prospect of lower or slower co-ordination of efficient solutions than if one body and process handled all retail market matters.

Ultimately it is essential for good governance that decision-making occur in an efficient process, so that considered decisions are made in a simple, timely and accountable manner.

## 3 Change management efficacy

Good governance theory suggests that governance structures should appropriately facilitate effective change where it is necessary in pursuit of the mandated objective or mission. Put another way, a structure in which necessary change can be stymied fails the benchmark. Governance arrangements must also be dynamic and able to adapt to remain effective if changed circumstances or poor outcomes necessitate change to the arrangements.

For the reasons canvassed above, there is in our view a material prospect that over time SMP changes that could be objectively regarded as necessary are not achieved.

With the 'coalition of interests' nature of the composition of the committee and AEMO's veto power, the prospect of a stalemate in SMP decision-making is more than theoretical. There are two possible places for a stalemate - a deadlock in the committee and a committee decision that does not meet the approval of AEMO (although the grounds for 'withholding' approval in the form of exercise of the limited veto are narrow). Decision-making is likely to be pushed toward the 'lowest common denominator' and inertia or non-innovative protocols are a realistic prospect.

The safeguards against deficient decision-making are weak since there is no mechanism to evaluate the performance of committee members, the IEC is not subject to judicial review and because any push to change the governance arrangements would require amendment to constitutional documents, including the NER, through AEMO and the AEMC. Amendments to the NER are slow and difficult to accomplish. If, as we anticipate, the IEC process fails to achieve the SMP objectives, fixing the problem will be even more difficult.

Ultimately it is essential for good governance that effective, workable, processes are devised with a clear prospect of being reviewed and refreshed if they fail to deliver.

## 4 Management of conflicts

Good governance theory suggests that decision-making bodies' composition, structure and procedures should seek to minimise the prospect of conflicts of interest by decision-makers and should provide mechanisms to mitigate or manage conflicts where they do arise. A typical model is that an individual who is conflicted can have their voice heard but not their vote counted.

The AEMC acknowledges the clear conflicts of members of the IEC, and only proposes two mitigation measures – the addition of further possibly non-conflicted members of the committee and the limited veto of AEMO. We use the word mitigation deliberately. This approach does not minimise the prospect of conflict (arguably it institutionalises it) nor does it manage it. It reduces the maximum potential conflict from overwhelming to just major.

A large block of conflicted members voting can determine the outcome where the other committee members adopt differing positions for other reasons unrelated to the factor driving the conflict.

The limited veto of AEMO does nothing to overcome a conflicted committee decision if the IEC decision is one of inaction when action is necessary.

The limited veto is also a weak and ineffective safeguard generally because of the narrowness of the criteria on which it can be exercised. Although AEMC refers to the veto in its rationale as "an important safeguard"<sup>11</sup>, it also does not propose to broaden the current essentially procedural criteria in clause 7.2A.3(k) of the NER. By way of example, AEMO as operator of the B2B e-hub could have a strongly held and objectively demonstrable view that a proposed protocol would be adverse to

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<sup>11</sup> AEMC 2015, p 27



competition. Despite that, it could not exercise its veto if the IEC did have regard to the (competing) B2B Principles but a majority of members had given paramount weight to minimising costs of compliance for incumbent service providers.

Among many better models of governance would be one that has industry members as non-voting committee members or one with a clear rule that any member with a material interest in a matter not vote on it. In models of corporate good governance, a majority of independent directors is regarded as best practice.

Ultimately it is essential for good governance that conflicts of interest in decision-making are minimised and those that persist are mitigated and managed to the maximum extent that is practical.

Anthony Seyfort  
Partner  
21 July 2015

## Appendix

### Information Exchange Committee (IEC) - Appraisal of current governance concerns and risks

This appendix outlines some unusual aspects of the governance and operating regime for the IEC, which is a novel unincorporated body established under clause 7.2A.2 of the National Electricity Rules (NER).

#### Context

The genesis of the IEC was industry discussion in 2002 in the context of the rapidly expanding regulatory regime for full retail competition in electricity in Victoria. An industry committee was considered to be the best framework for the development of agreed B2B communication protocols, in circumstances where NEMMCO was not considered the appropriate vehicle to bring about those protocols.

The NER provisions to formalise the IEC were made in 2004, with a nexus to NEMMCO (and now AEMO) so as to provide an institutional framework to “convert” IEC determinations (termed “recommendations”) into “B2B Decisions” that are formally made by the market operator to give them legal efficacy and enforceability under the NER.

In the years since the creation of the IEC, the role of AEMO has developed to encompass a growing range of retail market operational functions in gas and electricity. Those functions are being performed with the benefit of AEMO’s governance structure and consultative practices (such as the role performed by the Retail Market Executive Committee (RMEC)). Further retail market procedures, including those associated with smart meters, have been and are being developed and effected, and the typical institutional arrangements have been for AEMO to determine these with appropriate industry consultation.

In this context, the continuing role and manner of operation of the IEC in making B2B procedures is increasingly anomalous. This appendix briefly examines some attributes of that anomaly beyond the curiosity of a mere historically different regime for an area of decision-making.

#### Narrow and insufficiently guided functions

The NER sets out the “B2B Objective” and “B2B Principles” (Chapter 10). The functions and powers of the IEC (NER clause 7.2A.2(g)), however, make no reference to the objective and principles. Instead, they are simply matters to which each individual member of the IEC “must have regard” in performing his or her duties. To “have regard to” is a weak and low threshold requirement. Under clause 7.2A.3(k) AEMO is bound to approve the IEC’s recommendation unless (among other things) the IEC “failed to have regard to” the objective and principles. This is the same weak and low threshold, arguably providing insufficient safeguard against a substantial disharmony with the objective and principles by the IEC.

The content of the B2B Principles is also a low policy threshold in the context of the development of the retail market in recent years. The principles are concerned with uniformity, efficiency, the avoidance of unreasonable discrimination between existing market participants and the confidentiality of information. They do not explicitly extend to a number of current policy concerns, for example minimising barriers to entry and facilitating business innovation.

## Potential underperformance through decision-making model

The NER requirement for IEC decisions to have the assent of 6 or more IEC members makes the decision-making model one of virtual consensus. While that is arguably good insofar as decisions made have strong industry support, logically it would tend to drive decisions toward the “lowest common denominator” and see difficult and contentious issues unaddressed or unresolved.

## Potentially dubious mandate of elected members

The current IEC election procedures allow each distributor and each retailer or market customer one vote (without preferences) in an election for their category of representatives even if (as usually would be the case) the election is for 3 positions. In effect, the voting system elects the “first 3 past the post”. In circumstances where there are a relatively large number of candidates and relatively few voters, this could produce a very unrepresentative outcome (compared with the voting systems known as proportional representation or preferential voting). In those circumstances the elected members have a dubious mandate from their industry segment electorate.

## An isolated pocket of NEM/NER activity probably immune from judicial review

The decision-making of the IEC is probably not subject to judicial review by the application of principles of administrative law. This is because IEC decisions (or failures to make decisions) are not within the scope of section 70 of the National Electricity Law, which confers a statutory right to judicial review of AEMO and AEMC decisions, failures and conduct, and the role of the IEC is unlikely to be sufficiently of a “public law” nature as to attract a right of judicial review on common law principles.

While AEMO is subject to judicial review, its role in approving IEC recommendations under NER clause 7.2A.3(k) is sufficiently narrow and procedural that an application for review of AEMO’s decision would not provide a springboard to review the IEC’s decision or conduct.

If our view of the common law is correct, the consequence is that B2B Decisions are an anomalous pocket of NEM activity of a regulatory nature that are outside the judicial review regime that the state parliaments intended in creating the NEL.

## A difficult position for AEMO

AEMO is implicated in IEC decisions and bears consequences of the IEC’s existence and conduct, while having no formal influence. In the concerns set out above we have identified some matters in this category. Also, AEMO:

- would be party to any Dispute Resolution Panel proceedings about B2B Decisions if somehow such matters came before a DRP;
- provides administrative support for the IEC;
- facilitates cost recovery for IEC expenses without sufficient influence over those expenses.

While AEMO has developed governance arrangements, consultative practices and is accountable, it is not responsible for important B2B Decisions.