case nineteen

AES Corporation: Rewriting the Rules of Management

TEACHING NOTE

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■ SYNOPSIS ■

Founded in 1982 by two former civil servants, by 2002 AES had grown to be the biggest and most international of the new breed of independent power producers (IPPs). Yet, AES was very different, not only from most electricity companies, but also from almost all the highly successful young companies in America. In an era when most US CEOs had pledged allegiance to shareholder value, AES has explicitly put shareholders in second place behind employee fun and social responsibility. In an era of specialization, AES operated with no functional departments and with specialist functions such as finance and HRM devolved to teams of plant operatives. In an era of entrepreneurial management, AES's top management proclaimed that the primary goal for management was to avoid making decisions – the idea being that decision making should be devolved as far down the organization as possible. Described by the *Wall Street Journal* as "empowerment gone mad," AES had succeeded in blending humanitarian values, fundamentalist Christianity, and environmental care into an organizational system that induced remarkable performance from people.

For most of the 1980s and 1990s, AES performed exceptionally well – strong top-line growth was matched by equally strong bottom-line growth. The result was shareholder returns that made AES look more like a technology stock such as Dell Computer than a boring old power producer. Yet, in mid-2002, AES is in deep trouble. The upheaval, not just in the US energy sector, following the Californian power crisis and the Enron scandal, has broadened into extreme sensitivity over off-balance-sheet financing and deregulated energy markets. Meanwhile, overseas, AES has been hit badly by crises in Argentina, Brazil, Venezuela, and Pakistan, and the falling wholesale electricity prices in the UK.

The AES case provides a fascinating and thought-provoking account of a company whose management and organizational system has rejected most of the tenets that have guided management theory and management practice for the past half-century.

The challenge of this case is to make sense of AES's unusual organizational structure, management systems, and corporate culture: to understand why it has worked so well in the past, to consider its suitability to a new era of risk aversion, overcapacity, and reduced growth opportunity, and to consider whether AES provides ideas and themes that may have broader lessons for management in the twenty-first century.

■ TEACHING OBJECTIVES ■

I use this case to get students thinking about alternative and innovative approaches to strategy, structure, and management systems. Given the heavy emphasis that I place on strategy as a quest for profit, the mere fact that AES has rejected profit as its primary goal and yet has shown exceptional financial performance is interesting in itself.

The case raises some interesting issues concerning organizational structure, human resource management, and competitive advantage. For example:

- Is there a logic in AES's rejection of specialized functions? To what extent is AES achieving higher levels of cross-functional integration at the cost of less-developed internal functional specialization?
- To what extent are the costs of AES's seemingly haphazard and high-risk approaches to management offset by the benefits and exceptional levels of employee motivation and commitment?

- Can AES's approach to management be seen as breaking away from the small-minded and mean-spirited view of the human race that has dominated conventional approaches to organization and management control? Essentially, AES is saying: people are intelligent, innovative, trustworthy, and anxious to do good in the world, but the traditional command and control approach to management assumes that people are stupid, lazy, and selfish.
- How far can a distinctive corporate culture be introduced into widely different national cultures? AES's culture emphasizes individual initiative, the absence of hierarchy, equality, and environmental and social responsibility. Can such a culture be recreated in Brazil, Pakistan, China, and Kazakhstan as well as in the US and UK?
- Can new management styles and processes that are based on decentralization, cooperation, and self-organization perform in tough times, or do challenging circumstances require traditional "command and control" management styles?

■ POSITION IN THE COURSE ■

I typically use this case to finish up the course in the section that looks ahead to new approaches to strategy and management. I accompany this case with the last chapter of the Grant text plus any other readings that look ahead to emerging trends in management.

■ ASSIGNMENT QUESTIONS ■

1. What's unusual about AES's structure, management systems, and leadership style?
2. Has AES's success been because of, or despite, these practices?
3. Given the current challenges that AES faces, should it adopt more conventional management systems and processes, or should it maintain the values, principles, and management methods established by Sant and Bakke?
4. What can other firms learn from AES?

■ READING ■

R. M. Grant, *Contemporary Strategy Analysis* (6th edn), Blackwell Publishers, 2008, Chapter 17.

■ CASE DISCUSSION AND ANALYSIS ■

1. *What's unusual about AES's structure and management systems and style?* I begin by listing the main features of AES's organizational structure and management systems. For example:
    - No specialist functions. While some senior managers have functional responsibilities (finance, HR), they are not supported by functional departments, and further down the organization (regions, plants) functional responsibilities are devolved to teams of operatives.
    - Lack of hierarchical decision making. Responsibility and accountability exist (e.g., for plant managers) but decision-making authority is widely diffused. AES describes its plant structures as "honeycombs."
    - High degree of outsourcing – lack of internal functional expertise is compensated for by reliance on external specialist expertise, especially in finance.
    - Heavy emphasis on AES's values and goals rather than profit maximization.
    - Strong commitment to the development of its people – AES's personnel are regularly given responsibilities where they have no prior experience but are expected to learn and access relevant expertise.

2. *Has AES's success been because of, or despite, these practices?* At first glance, AES is a company that has sacrificed sound business principles and practices to non-business goals. But what about AES's performance? AES has achieved levels of growth, profitability, and shareholder return that put it at the top of its sector in terms of financial performance. This performance has been driven by remarkable opportunism in bidding on overseas privatization opportunities and outstanding operational performance. In what ways might AES's management practices have supported this superior performance?

- AES's values and HR practices encourage high levels of employee motivation and commitment and very low levels of employee turnover.
- Lack of functional specialism encourages rapid learning and supports high levels of cross-functional integration – critical in a fast-moving environment. How serious are the disadvantages of lack of functional expertise? Maybe not too great – especially since much specialist functional expertise can be outsourced.
- Emphasis on initiative and risk taking greatly increases the company's capacity for growth and increases the speed of decision making. Many of AES's major deals have been negotiated by quite junior personnel – greatly relieving the decision-making burden on the small top-management team.

3. *Given the current challenges, should AES adopt more conventional management systems and processes, or should it maintain the values, principles, and management methods established by Sant and Bakke*? AES faces a capital crunch. The present ratio of long-term debt to equity is about 4:1 – high, but not exceptional. The problem will come if AES is forced into any major asset write-downs or write-offs, or any other extraordinary losses. This could decimate shareholders' equity. Moreover, the ability to service debt could be hit by the deteriorating operating environment. AES's vulnerability has increased substantially following the Enron collapse. Not only does it involve direct write-off of money owed by Enron, but it has completely changed perceptions of deregulated power producers. AES risked being tarred by the Enron brush with regard to off-balance-sheet financing, the recording of revenues from energy trading activities, and its actions during the California energy crisis.

   This current crisis raises some pressing issues for AES. To take the actions mandated by current circumstances – cost cutting, financial restructuring, risk reduction, cash conservation – can the present organizational structure, management systems, and emphasis on non-shareholder goals be maintained? More specifically for Sant and Bakke, does the current crisis require a new top-management team to maintain and restore the confidence of Wall Street and the financial community?

   Beyond these immediate concerns, there are longer term challenges to AES's unique management model:

   - Can AES maintain its culture and informality now that it has grown into a large corporation? Bakke believes that the individual "beehives" can be replicated. AES is adding more geographical divisions – and therefore a need for more formalized top-management coordination and control.
   - Can the AES values and culture work in different cultures? Bakke and Sant firmly believe that AES's values are universal and not a mixture of American Protestantism and environmentalism. This is a good issue on which to enlist the views of overseas students, especially from regions in which AES does business (Latin America, former Soviet Union, China, and Islamic countries).
   - Competition is increasing. More and more companies from different industrial backgrounds are entering power generation. Many of these have resources that AES lacks (e.g., ownership of oil, gas, and coal reserves, pipelines, and downstream presence). So far, AES has experienced little conflict between its values and shareholder objectives, but if margins narrow and the business becomes increasingly cut-throat, this harmony may be difficult to maintain.
   - Bakke and Sant are reaching the end of their careers. They have lived the AES values. What are the implications of their departure, not just for management succession but also for the continuity of a management system that is based on adherence to the values and every employee instinctively knowing what is the right thing to do?
   - The industry is changing. Simply making money from privatization is less easy as the industry is becoming structurally transformed. Establishing competitive advantage may become more complex – for instance, financial engineering may become increasingly important; the generating part of the industry may become less attractive relative to distribution; at the downstream end, synergies between energy, telecoms, and water may become critical. AES may be less well equipped for the new industry environment than other competitors (Exxon, or Duke).

4. *What can other firms learn from AES?* If the 1990s were about exploiting physical and financial assets more effectively, then the first decade of the twenty-first century may well be about exploiting human resources more effectively. How good a job have most companies done of exploiting human energy, creativity, sociability, and the desire to make the world a better place? In terms of Maslow's hierarchy of needs, most companies are focused on the material and financial needs of employees. AES has developed a management system much more oriented around the "self-actualization" of its people. AES may offer lessons for more specific organizational matters – do companies really need so many functional specialists? How far down the organization can decision making be

devolved? Why can't cooperation occur voluntarily? Why do people need to be "managed"? To what extent do company policies and procedures need to be formal and rule-based?

■ UPDATE ON AES ■

On June 18, 2002, AES announced Dennis Bakke's retirement as CEO and his replacement by Paul Hanrahan. The press release read:

> The AES Corporation (NYSE:AES) announced today that its Board of Directors has elected Paul T. Hanrahan as President and Chief Executive Officer, effective immediately.
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> Mr. Hanrahan previously has been Executive Vice President and one of four Chief Operating Officers.
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> The board elected Mr. Hanrahan after Dennis W. Bakke, who had been President and CEO since 1994, announced his intent to retire. Mr. Bakke has been given the title of Co-Founder and Emeritus CEO, and will remain on the Board.
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> "The entire power sector has undergone a crisis of confidence, and investors are demanding change. Although AES has grown a great deal during my tenure, it became clear to me that this is a time for a new CEO," Mr. Bakke said. "Different times require different leaders."
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> Roger W. Sant, chairman and co-founder of AES along with Mr. Bakke, said that the board selected Mr. Hanrahan as President and CEO "because of his demonstrated effectiveness as a problem-solver, his management experience around the globe, and his financial acumen."
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> During Mr. Hanrahan's 15 years with AES, he has held senior executive positions in North America, Europe, Asia, and South America and has served as CEO or Chairman of three of AES's publicly traded subsidiaries.
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> Mr. Hanrahan is a 1979 graduate of the United States Naval Academy, and served in the nuclear submarine service. He received an MBA degree from Harvard Graduate School of Business in 1986.

A number of management changes followed, including the retirement of chairman Roger Sant and the replacement of most of the board members.

The new management team moved quickly to shore up AES's financial position by securing new financing, writing off 10% of AES's assets (including the DRAX power station in Britain and AES's Brazilian businesses), and disposing of businesses to reduce debt. While maintaining its commitment to employee involvement, employee welfare, and social and environmental responsibility, AES's focus shifted almost entirely to financial discipline and strong central control. In February 2003, AES's geographical structure was replaced by a new divisional structure. Two worldwide divisions, Electric Generation and Integrated Utilities were created, each headed by a chief operating officer. A new emphasis on financial management was imposed. This involved a new capital allocation process, more sophisticated risk assessment procedures, and the introduction of comprehensive financial metrics.

In his farewell address, Sant reflected on his work at AES:

> I think that we were right in our belief that when given the opportunity, ordinary people can accomplish extraordinary things. What we also learned is that giving people the authority to make decisions is neither a substitute for providing leadership and training nor a reason to reduce oversight and accountability. Indeed, I believe our notion of decentralization is made more powerful in a framework that provides the strenuous assessment of success and failure. It is with this knowledge of our failures and successes in implementing our AES culture that we embrace the future. Indeed, the reason I feel comfortable stepping down at this time is that I believe the pieces are now in place to successfully rebuild the Company … While performance is our principal focus, our shared values continue to impact every aspect of the Company.
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> In closing, to say co-founding AES has been a fabulous experience would be an understatement. There have been extraordinary people to work with, captivating problems to solve, and opportunities to make a real difference in the world. Of course, our efforts to instill the AES culture did not always succeed, we did not always stay on the course that we charted when we began AES, and at times we took our vision of the AES culture to exaggerated levels. We did not, however – nor will we – cease our efforts to make a real difference in the world. I believe strongly that we can learn from our failures, and continue to use the foundation of our unique culture to increase value for our investors and meet the world's need for electricity. I am glad that as a Board member I will still be a part of overseeing these challenges. (See AES annual report, 2002.)