



On dividends and market valuations of Australia's listed electricity utilities: regulated vs. merchant

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Australia's National Electricity Market (NEM) comprises a mix of regulated and merchant utilities set within an array of ownership structures. In 2021, only four major utilities were listed on the Australian Stock Exchange (ASX) with the balance either private or government owned. Intriguingly, two of the four ASX-listed firms were regulated utilities, and both were simultaneously the subject of takeover events at ~30% premiums to market closing prices. Regulated utility valuations have reached a peak while merchant valuations are at a 15-year nadir.

Although regulated and merchant segments form part of the electricity supply industry, they own and operate very different businesses. Regulated utilities can be thought of as the *poles and wires* segment – large *asset heavy* infrastructure firms with a Regulatory Asset Base or 'RAB' subject to a form of economic regulation. Annual revenues for regulated utilities are set in five-year cycles by the Australian Energy Regulator with the RAB and regulated rate of return forming crucial variables. Merchant utilities operate in the NEM's intensely competitive wholesale and retail markets and include generation and retail supply – with (re)integration forming the dominant model.

Dividends and market valuations of the listed utilities ran broadly in parallel for much of the past two decades. But a noticeable divergence in trajectories occurred over the most recent few years. More importantly, regulated utility de-listing events mark the end of our ability to continuously observe market valuations in Australia, which has implications for policymakers. The purpose of this article is to make use of available public earnings data and identify drivers that led to the de-listing events of regulated utilities, and the sharp deterioration of merchant firms. Drawing on the 15-year window of directly-comparable half-yearly earnings data (2007-2021), this article sits within the literature on dividend policy and in particular, lifecycle theory.

Key findings are as follows. Both utility segments seek to maintain investment-grade credit metrics and an outworking of this is gearing levels (i.e. debt to debt+equity) of ~65% for regulated and ~30% for merchant firms. Regulated utilities distribute (on average) 100% of earnings to shareholders – a not unsurprising result given large depreciation charges and the overall maturity of such businesses. Merchant firms distribute (on average) 60% of earnings, the differential explained by a 3-fold increase in the volatility of operating cash flows.



For merchant utilities, a decision to change dividends is followed by symmetrical earnings results in future years. That is, a dividend increase (average=12%) telegraphs higher future earnings, higher future asset returns and higher market valuations over the ensuing two years of trade. Such results are consistent with an 'information content' theory of dividend policy (see John and Williams, 1985; Miller and Rock, 1985).

Regulated utilities results are completely *counterintuitive*. When regulated utilities increase dividends (average=9%), future earnings decrease, future asset returns deteriorate but stock prices experience a positive drift. Conversely, dividend cuts are followed by rebounding profits and rising asset returns. These results are consistent with a lifecycle theory of dividend policy (see especially Grullon and Michaely, 2002; Grullon, Michaely and Swaminathan, 2002; DeAngelo, DeAngelo and Stulz, 2006).

Finally, falling interest rates and a tightening of climate change policies in Australia has impacted the segments differently. Merchant fortunes deteriorated as an influx of low-cost renewables entered the market – and low interest rates has produced even lower entry costs – all of which adversely impacts legacy fossil generation fleets. These same forces appear to have triggered regulated utility takeover events – the prospect of rising renewable network connections and interconnectors (i.e. 'growth') inducing substantial takeover premiums.

From a policy perspective, while de-listing ends our ability to observe 'real' market reactions to changes in regulatory policy, the history is clear enough. Despite periodic objections to regulatory decisions regarding returns, the practical evidence confirms regulated utilities outperformed the broader ASX200 index.