

The Regulator and Dividend Policy

Printed in the Business Monday, April 19th, 2010

During the recently concluded hearing of the Barbados Light & Power Company Ltd.'s (BL&P) application for a rate review, one of the important items discussed was the impact on the company if it was not allowed to earn the requested rate of return.

It was explained that the likely impact of not being allowed to earn the requested return would include (a) not being able to demonstrate to its lenders that it can earn sufficient revenues to repay loans and satisfy investor expectations such as dividend payments (b) curtailment of capital investment such as plant replacement programmes (c) degradation of service and (d) impairment of the fuel efficiency drive.

It is clear that investors, be they shareholders or lenders, finance a company with a return in mind. Lenders often require the repayment of capital with an interest element attached. Investors may not supply a company with much needed finance because of concerns relating to the company's ability to pay dividends and service loans. It should be noted that a company must first cover operating costs and other liabilities before it is free to distribute funds in the form of dividends to its shareholders.

However, once a company makes a profit, it must decide on what to do with those profits. It could continue to retain the profits within the company, or it could pay out the profits to the owners of the firm in the form of dividends. Dividends are payments made to shareholders from a company's earnings, whether those earnings were generated in the current period or in previous periods.

Once the company decides to pay dividends, it may establish a somewhat permanent dividend policy for example 5% or 8% per annum, which may in turn impact investors and perceptions of the company in the financial markets. What the company decides depends on the situation of the company at present and what is perceived in the future.

The dividend decision also depends on the preferences of investors and potential investors. This is because dividends may affect capital structure since retaining earnings increases common equity relative to debt. Capital structure refers to the permanent long-term financing of a company including long-term debt and equity (common shares, preference shares and retained earnings). Financing with retained earnings is cheaper than issuing new common equity. With regard to the BL&P's application, the share of equity in the company's capital structure was high when compared to regulated international and regional companies.

Although there are various theories that explain the relationship of a company's dividend policy and common share value, it should be noted that these theories are often accompanied by constraints that may impact a company's decision to pay out earnings in the form of dividends. These include cash flow constraints, contractual constraints, legal constraints, tax considerations and return considerations.

There are however potential differences in dividend policy between regulated and unregulated companies. Since regulated entities have regulators who monitor and scrutinise the financial activities of the company and report to the public including market participants, company executives may play a reduced role in determining dividend policy compared to unregulated entities. It appears then that the regulatory environment enhances, rather than mitigates, the importance of the executive's role for utilities.

Where the company provides regulated and non-regulated services, corporate structural separation (i.e., through a holding company structure) is a means of segregating risks between regulated utility operations and a company's unregulated activities. In this regard, while regulators can offer input as to appropriate direction, company management has the ultimate say in how best to structure its operations.

It is not being suggested here that regulators should regulate a utility's dividend policy as this is a risky step. The ability of investors to rely on a utility management's expected dividend policy is at the centre of investment strategy within the utility sector. To leave this issue up to review, analysis, and approval by regulators would likely increase investor concerns and thus reduce a utility's value in their eyes. Indeed, the uncertainty that would accompany such interference likely would render the maintenance of a certain equity level a much more difficult task.

In addition, such a move could result in the negative consequence of making access to equity financing, one of a utility's key financing vehicles, more costly and perhaps, in times of stressed conditions, totally unavailable. The mere setting of a required equity level should be enough. This was done in the Commission's Decision where the capital structure approved was 65% equity and 35% debt.

Utility regulators tend to be mindful of putting policies in place today that may limit managerial discretion in the future, instead preferring to monitor the payment of dividends and other discretionary cash flows. This was the case in the recently concluded hearing of the BL&P application for a review of its rates where, considering the revenue requirement, the Commission in its Decision stated that the high dividend payout ratio reflected in the financial forecasts may not be prudent.