Ofcom
making communications work
for everyone

Financing choices of stakeholders: implications for policy

1 November 2018

There has been an increased level of interest in capital structures of certain infrastructure businesses, many of which tend to be subject to economic regulation. There are several reasons which explain this increased interest. First, in some regulated sectors, shareholders have made higher returns than assumed by regulators when setting regulated charges by making greater use of debt financing. Second, the choice of capital structure could reduce financial resilience, and we have seen a number of company failures in recent years (Monarch, Carillion).

We are seeing some regulators respond to these debates. Ofwat recently set out decisions on measures designed to 'put the water sector back in balance'.[1] These include a requirement on water companies with relatively high levels of debt to share with customers some of the benefits perceived to be accruing to equity investors.

The issues Ofwat's decisions aim to address are of relevance to other regulated sectors. While in principle, capital structure choices are a matter for management, there are instances where these choices are relevant to policy-making. This brief statement sets out our views on these issues.

Link between levels of debt and expected returns

In standard corporate finance theory, there is a well-established proposition that, other than the benefits of the additional tax shield, increasing debt in the capital structure should have no real effect on the cost of capital or the value of the firm.[2]

Expected returns to shareholders would, however, tend to increase to reflect the higher risk exposure associated with more debt in the capital structure. With more fixed claims on a company's cash flows, returns to shareholders would be more volatile, increasing their required return. The increase in the required return reflects the increase in risk – hence, on a risk-adjusted basis, there is in theory no additional benefit to shareholders from gearing up.

Nonetheless, if shareholders choose a higher risk-reward capital structure, this could put the financial sustainability of the business at risk. This may be undesirable in the context of a business providing critical infrastructure since more limited financial or operational flexibility could have a negative effect on investment or service quality.

Further, high levels of debt could raise concerns that customers (or taxpayers) may end up bearing some of the risk in case of financial distress. In this case, it may be inappropriate for shareholders to gain from higher returns in good times if this comes at a potential cost to customers in bad times.

[1] Ofwat, "Putting the sector back in balance: position statement on PR19 business plans", July 2018, https://www.ofwat.gov.uk/wp-content/uploads/2018/04/Putting-the-sector-in-balance-position-statement-on-PR19-business-plans-FINAL2.pdf

[2] Brealey, R., Myers, S., Allen, F. "Principles of Corporate Finance", Chapter 18. International Edition.

Implications for setting regulated prices

When setting regulated prices, regulators take a view on the cost of capital and a gearing assumption (the amount of debt as a proportion of the market value of the firm). If there is evidence that an efficiently financed regulated business could support a higher level of gearing, the benefits associated with higher tax shields could be passed on to consumers when re-setting prices (by adjusting the cost of capital appropriately).

When designing charge control remedies (primarily for Openreach's products), we also take a view on the cost of capital and gearing. Therefore, evidence which suggests that a business like Openreach could adopt a lower cost capital structure (due to tax benefits associated with higher gearing), could be relevant for our decisions to ensure consumers benefit from these efficiencies.

Ensuring consumers are not exposed to excessive financial sustainability risks

High levels of debt in the capital structure (relative to the level of business risk) could put financial sustainability at risk, which in turn could undermine service delivery. It could also raise concerns whether this could lead to undesirable costs for customers in times of financial distress. These considerations are relevant not only to companies subject to direct price regulation but also more widely to all businesses providing critical infrastructure.

While capital structure choices are a matter for management and we have no direct powers to influence these choices, we think it is reasonable to expect businesses providing critical infrastructure to consider the wider impacts of their financing choices on delivering good outcomes for consumers and maintaining a financially resilient business over the longer-term.

We will continue to monitor developments in our sectors and consider any implications they may have for future policy. Recent trends in our sectors are summarised below.

Recent experience in telecommunications and broadcasting

When setting price controls on BT's regulated products (which are largely provided by Openreach – a legally separate company within BT Group), we set a notional gearing assumption in order to estimate a cost of capital which feeds into regulated prices. In our regulatory decisions since 2005, we have assumed a notional gearing level of between 30-50% for BT. This notional level of gearing has in part been informed by the actual observed gearing of BT Group, but is also consistent with that of most, publicly listed, UK and European telecommunications providers.

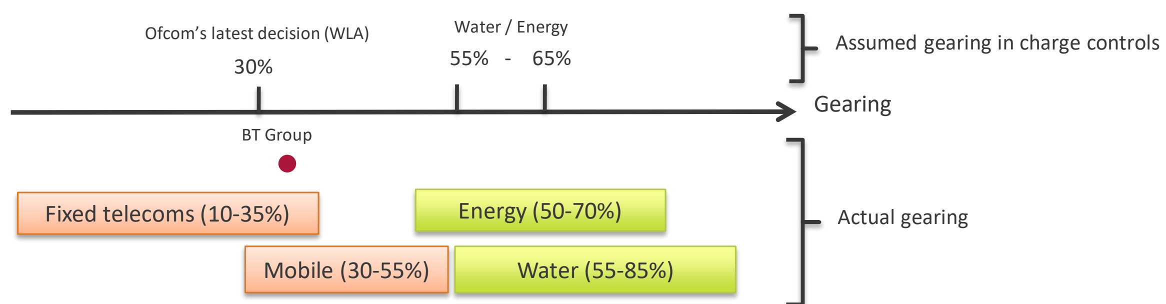
There is no evidence to suggest that BT has geared up significantly in excess of our gearing assumption. In fact, since 2005, BT's debt has remained fairly stable, at between £10-15bn with changes in gearing largely driven by changes in BT's market capitalisation. One reason for this is likely to be that we only regulate parts of BT. By only observing gearing at the BT Group level, it is difficult to unpick the link between our regulatory decisions and BT's debt issuance strategy.

If Openreach was a standalone company able to raise its own finance, it is possible that it would choose a different capital structure, including a different level of gearing to that of BT Group, reflecting the cash flow risk of the standalone business.

While currently we do not have reasons to be concerned with BT's debt levels, we will continue to monitor future developments and consider what implications, if any, they have for our cost of capital decisions.

Considering broader evidence on other companies in our sectors, in general, our stakeholders have lower gearing than those in other regulated businesses. Figure 1 demonstrates this for our key listed stakeholders.

Figure 1 Assumed and actual gearing

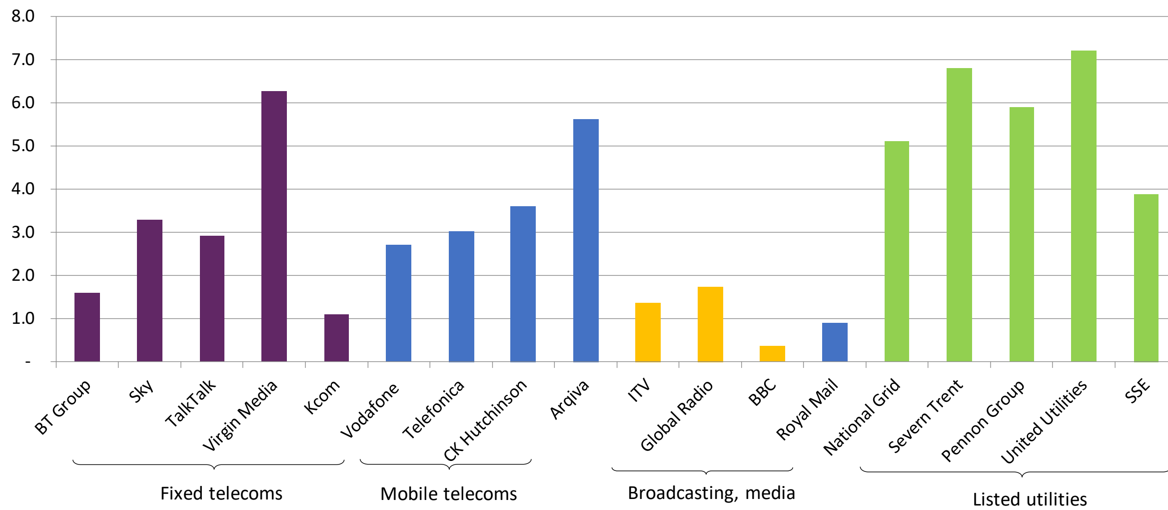


Note: We have used the ratio of debt to enterprise value as our measure of gearing. For water and energy enterprise value is proxied by RAB (the Regulated Asset Base), consistent with how regulators define gearing in these sectors and reflecting the fact that the majority of these utilities are not listed. The analysis of Ofcom stakeholders only covers the key listed entities since it is difficult to derive a comparable measure of enterprise value for the non-listed stakeholders.

Firms facing lower risks can usually sustain higher levels of debt since their cash flows tend to be more predictable. We would expect telecommunication providers to be higher risk than regulated water or energy networks and to have lower gearing. This is reflected in the fact that the listed telecommunications providers have gearing in the 10-55% range while gearing for energy and water companies is typically between 50% and 85%. Part of the difference could also be attributed to the fact that the majority of regulated utilities are privately held, with only a handful of parent companies maintaining a stock market listing.

Another common measure of leverage is debt / EBITDA (which estimates how many years it would take a company to pay off its debt if performance did not change). On this basis, it is also the case that the majority of our key stakeholders have lower leverage than a selection of regulated utilities.

Figure 2 Debt / EBITDA ratio of key stakeholders and selected utilities



Source: Data is from S&P CapitalIQ, at the end of the last available financial year. The ratios presented may not correspond to the figures presented in companies' annual results or press releases. BBC data is for BBC Commercial Holdings Limited. Royal Mail figures are based on gross debt; for all other companies, ratios are based on net debt.

Virgin Media and Arqiva have relatively higher leverage compared to our other stakeholders. Virgin Media is owned by Liberty Global plc, and its credit profile may reflect the overall financial policy of the wider group (characterised by relatively high leverage and a sub-investment grade credit rating). Arqiva holds a monopoly position in terrestrial broadcasting and is privately owned (unlike most of the telecommunications networks). Like some other infrastructure companies with relatively predictable cash flows, it has adopted a securitised structure, which allows it to have more debt in the capital structure compared to a more conventional corporate structure, while maintaining an investment grade credit rating on the majority of its funding.

We have presented evidence on gearing levels of our stakeholders. Of course, gearing is just one aspect of how a business is financed. Other metrics, such as credit ratings, interest coverage ratios, and other factors considered by market participants (including terms and conditions associated with any specific financing arrangement) are relevant in understanding financing choices of a business and its overall financial resilience.