

4 The profitability of cross-Solent ferry services

4.1. In this chapter we consider the profitability of the three principal suppliers of cross-Solent ferry services: Wightlink, Red Funnel and Hovertravel. (The other supplier, Cowes Express, has not been operating long enough to establish a history of profitability and expects to make losses in its first two years of operation.) We then compare the revenues, costs and profits of their most recent available financial years.

Wightlink

4.2. As explained in Chapter 3, Sealink was for some time before its sale to Stena AB the company in the Sea Containers group which operated cross-Solent ferry services. In addition, its subsidiary, Sealink Harbours Ltd, operated certain statutory harbours used for those services. Immediately before the sale to Stena AB on 13 March 1990, however, the reference services business and the business of operating the harbours were purchased for £90 million by Wightlink. Wightlink also acquired from Sealink Holidays Ltd the inclusive holiday business in the Isle of Wight that the latter company had started in 1989. (In 1990 this holiday business accounted for 4.6 per cent of Wightlink's revenue but only 0.4 per cent of its profits before interest.) In the following paragraphs we refer, where appropriate, to the company or companies which at the relevant times supplied reference services and operated the associated harbours as 'Wightlink and its predecessors'.

4.3. Wightlink prepares its accounts to 31 December each year. Until shortly before our report was due to be delivered, the only accounts available to us for the year ended 31 December 1990, the first period in which it supplied reference services, were in draft form. Our consideration of Wightlink's profitability was therefore to a large extent based on these draft accounts. They showed that Wightlink made a profit on ordinary activities of £1.8 million on a turnover of £28 million, with tangible capital employed at the year end of £41.6 million. On 9 December 1991, however, we were sent a copy of Wightlink's statutory audited accounts for the year. These showed significant changes compared with the earlier drafts. The amounts shown as tangible fixed assets had increased from £40.2 million to £57.2 million and the amount of goodwill had decreased from £50.7 to £34.3 million. There were consequential adjustments to the profit and loss account resulting from changes in the amounts charged as amortisation of goodwill (down from £1 million to £0.1 million—apart from the reduction due to the lower goodwill figure, the directors decided that a full year's amortisation would not be appropriate) and depreciation of fixed assets (up from £1.1 million to £1.4 million). As a result the profit on ordinary activities increased to £2.4 million. We discuss the reason for these changes in paragraph 4.11. Summaries of Wightlink's profit and loss account for 1990 as shown both by its draft accounts and its statutory audited accounts are given in Table 4.1.

TABLE 4.1 **Wightlink: profit and loss, 1990**

£ million

	<i>Per draft accounts</i>	<i>Per audited accounts</i>
Turnover	28.0	28.0
Operating expenditure	<u>-20.7</u>	<u>-20.1</u>
Operating profit	7.3	7.9
Exceptional items	<u>-0.4</u>	<u>-0.4</u>
Trading profit	6.9	7.5
Interest payable	<u>-5.1</u>	<u>-5.1</u>
Profit on ordinary activities	1.8	2.4
Extraordinary item	<u>-0.9</u>	<u>-0.9</u>
Retained profit for the year	0.9	1.5

Source: Wightlink.

Notes:

1. The accounts of Wightlink's subsidiary company, Wightlink Holidays Ltd, have not been consolidated.
2. Operating profit in the draft accounts was stated after charging £1 million amortisation of goodwill and £1.1 million depreciation of tangible fixed assets. In the audited accounts the corresponding amounts are £0.1 million and £1.4 million.
3. Exceptional items consist of promotion costs and a payment on termination of a lease.
4. The extraordinary item consists of the amount written off the investment in the subsidiary company following the termination of its ship-chartering trade.

4.4. Summaries of Wightlink's balance sheet position at 31 December 1990 as shown both by its draft accounts and its statutory audited accounts are given in Table 4.2.

TABLE 4.2 **Wightlink: balance sheet position at 31 December 1990**

£ million

	<i>Per draft accounts</i>	<i>Per audited accounts</i>
Tangible fixed assets	40.2	57.2
Investment in subsidiary	1.1	1.1
Other net assets (excluding net borrowings)	<u>0.3</u>	<u>0.3</u>
Tangible capital employed	41.6	58.6
Goodwill	<u>50.7</u>	<u>34.3</u>
	92.3	92.9
Net borrowings	<u>-91.4</u>	<u>-91.4</u>
Share capital and reserves	0.9	1.5

Source: MMC using Wightlink data.

Notes:

1. The accounts of the subsidiary company have not been consolidated.
2. Net borrowings consist of amounts owing to group companies and leasing liabilities, less cash.

4.5. Table 4.3 sets out the results on a current cost basis of the three cross-Solent ferry services and the associated harbours operations operated by Wightlink and its predecessors for the five years 1986 to 1990, as reported to us by Sea Containers. These figures, Sea Containers told us, had been extracted from the relevant management accounts and reconciled with the appropriate audited accounts of Wightlink and its predecessors, except for the fact that replacement cost depreciation had been substituted for the historical cost depreciation in the original management accounts. Sea Containers also gave us additional information concerning this table, as reproduced in Appendix 4.1. This shows, *inter alia*, that the amount of central overheads charged by the Sea Containers group to its cross-Solent ferry operations rose from £1.2 million in 1986 to £2.5 million in 1990. Finally, the results shown in Table 4.3 have been expressed by us as percentages of total revenue.

TABLE 4.3 Wightlink and its predecessors: results of cross-Solent ferry services and associated harbour operations

	Total					Portsmouth-Ryde					Portsmouth-Fishbourne					Lymington-Yarmouth					£'000
	1986	1987	1988	1989	1990	1986	1987	1988	1989	1990	1986	1987	1988	1989	1990	1986	1987	1988	1989	1990	
<i>Revenue</i>																					
Foot passengers	[
Cars/motorists																					
Coaches/passengers																					
Freight																					
Other revenue																					
Passenger catering]
	<u>20,433</u>	<u>22,486</u>	<u>25,595</u>	<u>28,833</u>	<u>31,127</u>	<u>3,092</u>	<u>3,168</u>	<u>3,352</u>	<u>3,720</u>	<u>3,963</u>	<u>11,571</u>	<u>13,122</u>	<u>15,366</u>	<u>17,395</u>	<u>19,041</u>	<u>5,770</u>	<u>6,196</u>	<u>6,877</u>	<u>7,718</u>	<u>8,123</u>	
<i>Expenditure</i>																					
Ship operating†	[
Shore terminal†																					
Booking and consignment																					
Overheads																					
Passenger catering]
	<u>14,064</u>	<u>14,313</u>	<u>16,249</u>	<u>17,617</u>	<u>21,224</u>	<u>2,905</u>	<u>2,426</u>	<u>2,869</u>	<u>2,858</u>	<u>3,247</u>	<u>7,290</u>	<u>7,869</u>	<u>9,020</u>	<u>10,123</u>	<u>12,338</u>	<u>3,869</u>	<u>4,018</u>	<u>4,360</u>	<u>4,636</u>	<u>5,639</u>	
Profit before depreciation and interest	6,369	8,173	9,346	11,216	9,903	187	742	483	862	716	4,281	5,253	6,346	7,272	6,703	1,901	2,178	2,517	3,082	2,484	
Depreciation	<u>2,291</u>	<u>2,812</u>	<u>2,871</u>	<u>2,895</u>	<u>2,995</u>	<u>675</u>	<u>999</u>	<u>998</u>	<u>964</u>	<u>695</u>	<u>998</u>	<u>1,195</u>	<u>1,255</u>	<u>1,276</u>	<u>1,466</u>	<u>618</u>	<u>618</u>	<u>618</u>	<u>655</u>	<u>834</u>	
Profit before interest	<u>4,078</u>	<u>5,361</u>	<u>6,475</u>	<u>8,321</u>	<u>6,908</u>	<u>-488</u>	<u>-257</u>	<u>-515</u>	<u>-102</u>	<u>21</u>	<u>3,283</u>	<u>4,058</u>	<u>5,091</u>	<u>5,996</u>	<u>5,237</u>	<u>1,283</u>	<u>1,560</u>	<u>1,899</u>	<u>2,427</u>	<u>1,650</u>	
As percentages of total revenue																					per cent
<i>Revenue</i>																					
Foot passengers	[
Cars/motorists																					
Coaches/passengers																					
Freight																					
Other revenue																					
Passenger catering]
	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>Expenditure</i>																					
Ship operating†	[
Shore terminal†																					
Booking and consignment																					
Overheads																					
Passenger catering]
	<u>69</u>	<u>64</u>	<u>64</u>	<u>61</u>	<u>68</u>	<u>94</u>	<u>77</u>	<u>85</u>	<u>77</u>	<u>82</u>	<u>63</u>	<u>60</u>	<u>59</u>	<u>58</u>	<u>65</u>	<u>67</u>	<u>65</u>	<u>63</u>	<u>60</u>	<u>69</u>	
Profit before depreciation and interest	31	36	36	39	32	6	23	15	23	18	37	40	41	42	35	33	35	37	40	31	
Depreciation	<u>11</u>	<u>12</u>	<u>11</u>	<u>10</u>	<u>10</u>	<u>22</u>	<u>31</u>	<u>30</u>	<u>26</u>	<u>18</u>	<u>9</u>	<u>9</u>	<u>8</u>	<u>7</u>	<u>8</u>	<u>11</u>	<u>10</u>	<u>9</u>	<u>9</u>	<u>10</u>	
Profit before interest	<u>20</u>	<u>24</u>	<u>25</u>	<u>29</u>	<u>22</u>	<u>-16</u>	<u>-8</u>	<u>-15</u>	<u>-3</u>	<u>0</u>	<u>28</u>	<u>31</u>	<u>33</u>	<u>35</u>	<u>27</u>	<u>22</u>	<u>25</u>	<u>28</u>	<u>31</u>	<u>21</u>	

Source: MMC using Sea Containers data.

*[Details omitted. See note on page iv.]

†Excluding depreciation.

4.6. Sea Containers estimated that the net replacement cost of the capital employed by Wightlink and its predecessors in cross-Solent ferry operations at the year ends 1986 to 1990 and the returns on capital employed (ROCEs) in that business for those years, calculated on a net replacement cost basis, were as set out in Table 4.4. In arriving at these estimates, Sea Containers relied on information from professional sources in valuing certain of its assets, but told us that it did not obtain formal valuation reports. Particulars of the capital employed at 31 December 1990, showing its allocation between the different services at that date and indicating the source of the asset valuations, are given in Appendix 4.2.

TABLE 4.4 **Wightlink and its predecessors: ROCEs on a net replacement basis**

	<i>Total</i>	<i>Portsmouth- Ryde</i>	<i>Portsmouth- Fishbourne</i>	<i>Lymington- Yarmouth</i>
<i>1986</i>				
Capital employed (£'000)	61,421	18,625	29,885	12,911
Profit before interest (£'000)	4,078	-488	3,283	1,283
Return on capital (%)	6.6	-2.6	11.0	9.9
<i>1987</i>				
Capital employed (£'000)	58,799	17,633	28,834	12,332
Profit before interest (£'000)	5,361	-257	4,058	1,560
Return on capital (%)	9.1	-1.5	14.1	12.7
<i>1988</i>				
Capital employed (£'000)	56,217	16,652	27,787	11,778
Profit before interest (£'000)	6,475	-515	5,091	1,899
Return on capital (%)	11.5	-3.1	18.3	16.1
<i>1989</i>				
Capital employed (£'000)	53,748	15,739	26,775	11,234
Profit before interest (£'000)	8,321	-102	5,996	2,427
Return on capital (%)	15.5	-0.6	22.4	21.6
<i>1990</i>				
Capital employed (£'000)	58,977	15,068	33,468	10,441
Profit before interest (£'000)	6,908	21	5,237	1,650
Return on capital (%)	11.7	0.1	15.6	15.8

Source: Sea Containers.

Notes:

1. Capital employed has been calculated at net replacement values at the year end.
2. Profits before interest are calculated after charging depreciation on replacement values.

4.7. We would normally regard the returns on capital shown in Table 4.4, which are calculated by reference to the estimated depreciated replacement cost of the assets involved, as being useful in a monopoly inquiry of this type in supplementing evidence of profitability based on historical costs. A number of special considerations arise in this case, however, which have caused us to consider carefully whether we should accept them without question. We discuss these in the following paragraphs.

Historical costs

4.8. In order to ascertain the profitability of Wightlink and its predecessors in relation to their original investment in the assets employed, we asked Sea Containers to provide us with the information necessary to calculate the ROCEs on a historical cost basis. Sea Containers told us that this was not possible. It explained that the assets of the Solent ferry routes had formed part of Sealink's total ferry assets, including assets used centrally for the benefit of all routes. The values at which those total ferry assets had been carried in Sealink's books were in part the values existing at the time Sea Containers had purchased Sealink from BRB and in part the cost of subsequent purchases, subject to some asset revaluation. Sea Containers did not know how the book values of the assets taken over from BRB should be related to each of the routes operated by Sealink at the time and thus had no means of identifying the original cost of the assets used in the Solent ferries business. It submitted, moreover, that these figures were irrelevant to our inquiry and that the profitability of the Solent ferry routes should be

measured by reference to the depreciated replacement cost of the assets involved, details of which it had already provided to us (see paragraph 4.6).

4.9. As a result of Sea Containers' declared inability to provide us with historical cost figures we have not been able to ascertain the profitability of Wightlink and its predecessors over the five-year period in relation to their original investment in the assets employed in the business. Neither have we been able to compare Sea Containers' estimates of the replacement values of the assets with their historical costs and reconcile the two sets of figures. While we note Sea Containers' reasons for not providing these historical cost figures, we are not convinced that it could not have made a reasonably close estimate of the amounts involved. The assets taken over from BRB are likely to have been fairly heavily depreciated by 1990, while those which were acquired more recently, since the business passed into Sea Containers' ownership, would have been subject to a shorter period of depreciation.

Replacement costs

4.10. This was the second matter that concerned us. The replacement cost valuations made by Sea Containers were not supported by independent formal valuation reports. We have, however, seen copies of the correspondence giving the advice on the basis of which these estimates were made. Although we note that the advice on ship valuations came from a company that is itself a Sea Containers subsidiary, the values attributed to the vessels do not appear to us to be unduly high. We find it less easy, mainly because of the specialised nature of the assets involved, to form a view on the values attributed to the shore installations. The advice here, although provided by an independent firm of chartered surveyors, was to some extent qualified in that they said it was based partly on the analysis of projects where data were available to them, and partly on the original costs to the company supplemented by indexation. The surveyors added that they had not calculated quantities and applied detailed pricing and that the estimates were thus designed only for valuation purposes. When we put this matter to Sea Containers, it told us that, while the valuation was not prepared specifically for our inquiry, it was a recent valuation prepared on an arm's length basis by professionals whose findings were acceptable to its bankers for security purposes, and also to its insurers. The qualifications in the surveyors' letter were, in Sea Containers' view, no more than standard practice in these matters.

Fixed assets and capital employed

4.11. The third question concerns the difference between the cost figure of £41.3 million for tangible fixed assets included in Wightlink's 1990 draft balance sheet (this, less depreciation of £1.1 million, gives the net book value of £40.2 million shown in Table 4.2) and Sea Containers' estimates of the gross and net replacement costs of those assets at some £90 million and £56 million respectively (see Appendix 4.2). Sea Containers told us that of the price of £90 million paid for the Solent ferries business, some £50 million was attributable to goodwill and that the balance of around £40 million was for the tangible assets transferred at fair market prices. It also told us that while the latter figure did not correspond to their depreciated replacement cost, it represented a fair market price for those assets. At a later stage in our inquiry, when we questioned Sea Containers on the difference between the amount of £40 million and its estimate of the depreciated replacement cost at some £56 million, it told us that the £40 million was an arbitrary allocation of the purchase price, made without the benefit of the work it had subsequently carried out on replacement costs, and that it intended to make appropriate amendments when Wightlink's accounts for 1990 were finalised. As will be seen from Tables 4.1 and 4.2, these amendments were in fact made. While we accept this explanation of the difference between the two amounts, it is apparent that the ROCE for 1990 would have been higher if it had been calculated by reference to the £41.3 million originally attributed to fixed assets instead of on the estimates of £90 million gross and £56 million net replacement cost. There are two reasons for this: the capital base would have been lower and profits would have been higher, as depreciation would have been based on £41.3 million instead of £90 million. We set out in Table 4.5 our estimate of what Wightlink's 1990 return on capital would have been if the figure of £41.3 million had been used.

TABLE 4.5 Recalculation of Wightlink's 1990 profitability

	<i>£ million</i>			
	<i>Total</i>	<i>Portsmouth- Ryde</i>	<i>Portsmouth- Fishbourne</i>	<i>Lymington- Yarmouth</i>
Profit before depreciation	9.9	0.7	6.7	2.5
Revised depreciation	<u>-1.4</u>	<u>-0.3</u>	<u>-0.7</u>	<u>-0.4</u>
Adjusted profit before interest	<u>8.5</u>	<u>0.4</u>	<u>6.0</u>	<u>2.1</u>
Tangible capital employed	41.6	10.6	23.6	7.4
ROCE (%)	20.4	3.8	25.4	28.4

Source: MMC.

Notes:

1. Profit before depreciation has been taken from Table 4.3.
2. Revised depreciation has been calculated by taking the proportion of Sea Containers' depreciation figure in Table 4.3 that £41.3 million (fixed assets at cost) bears to £90 million.
3. Tangible capital employed has been allocated between routes pro rata to the allocation of the £59 capital employed as shown in Table 4.4.

Allocation of group central overheads

4.12. The fourth consideration is the amount of central overheads allocated by the Sea Containers group to its cross-Solent ferry operations. This allocation increased from £1.2 million in 1986 to £2.5 million in 1990. Profits before interest for 1990 as shown in Table 4.4 were £6.9 million and profits before central group overheads would therefore have been £9.4 million. Sea Containers told us that these overheads were actual costs included in its audited accounts, which had been allocated to the Isle of Wight routes on the basis of turnover. While we have seen Sea Containers' group accounts, we have not investigated these and can therefore form no view on the appropriateness, or otherwise, of the way in which these allocations have been made, or as to the amounts involved.

4.13. After giving careful consideration to all of the foregoing matters, we did not find that they provided sufficiently compelling reasons for us to reject the profitability figures reported to us by Sea Containers and set out in Table 4.4. We have therefore accepted Sea Containers' figures for the purposes of our inquiry.

4.14. It will be apparent, however, from the foregoing that it has not been easy to establish a satisfactory basis for measuring the ROCEs of Wightlink and its predecessors. We have therefore given consideration to certain alternative proposals put forward by Sea Containers to the effect that the profitability of the reference business should be measured by reference to its profits, before depreciation and interest, expressed as a percentage of either the gross replacement values of the assets in use in that business (£84.4 million, being the £89.9 million shown in Appendix 4.2, less £8.5 million relating to the *MV Southsea* which was not in use, plus some £3 million subsequently invested as working capital) or the acquisition price of £90 million, also plus the £3 million working capital. Sea Containers analysed the latter figure over the three routes and, using these data, we have calculated that the returns on these bases would be as shown in Table 4.6.

TABLE 4.6 Wightlink: alternative estimates of 1990 profitability

	<i>Total</i>	<i>Portsmouth- Ryde</i>	<i>Portsmouth- Fishbourne</i>	<i>Lymington- Yarmouth</i>
<i>Asset values (£'000):</i>				
Gross replacement cost	84,409	19,534	41,351	23,524
Acquisition price and working capital	93,030	12,044	62,883	18,103
Profit before depreciation and interest	9,903	716	6,703	2,484
<i>Return on assets (%):</i>				
On gross replacement cost	11.7	3.7	16.2	10.6
On acquisition price and working capital	10.6	5.9	10.7	13.7

Source: MMC using Sea Containers data.

4.15. We do not, however, regard either of these methods as preferable to the Commission's normal method of assessing profitability on the basis of the ROCE, arrived at by comparing profit, after charging depreciation but before charging interest, with the capital in use in a business. In particular, we are not persuaded that profitability should be measured by reference to a base figure that includes goodwill. Goodwill does not represent expenditure incurred on the assets of the business from which the consumer derives a benefit. In our view, moreover, to include it in the capital base introduces an element of circularity into the calculation. We agree with Sea Containers that the value of a business, and the price it will fetch, is normally based on a multiple of its earnings and that this applies regardless of how that amount is divided between tangible assets and goodwill for accounting purposes. That value will, however, normally increase in line with the earnings of the business so that the higher the expected profit, the higher will be the capital base if it includes goodwill, and the apparent return on capital will therefore remain constant. Sea Containers did not accept that any element of circularity was involved in this method.

4.16. We also gave consideration to another ratio sometimes used in our inquiries, namely the return on turnover, and drew Sea Containers' attention to the percentage profits before interest shown in Table 4.3. Over the last five years these ranged between 28 and 35 per cent on the Portsmouth- Fishbourne route and between 21 and 31 per cent on the Lymington-Yarmouth route. The Portsmouth-Ryde route, however, made losses in the years 1986 to 1989 and just broke even in 1990, so that the return on turnover on the three routes taken together ranged between 20 and 29 per cent. Sea Containers told us that it did not consider return on turnover to be a suitable measure to apply to a capital-intensive business such as ferries, where capital-carrying costs were high in relation to both operating costs and turnover.

Red Funnel

4.17. Red Funnel prepares its accounts to 31 December each year. In 1990 it made a profit before tax of £2.7 million on a turnover of £12.7 million, with capital employed at the year end of £11.4 million. Its profit and loss accounts for the last five years are summarised in Table 4.7. It should be noted, however, that the figures in Table 4.7 for the years 1986, 1987 and 1988 are obtained from the consolidated profit and loss accounts of Red Funnel and its subsidiaries, whereas for 1989 and 1990 Red Funnel, as a subsidiary of ABPH, did not prepare consolidated accounts. The figures in Table 4.7 for those years therefore relate to the Red Funnel parent company only.

TABLE 4.7 Red Funnel: profit and loss accounts

	<i>Red Funnel group</i>			<i>Red Funnel parent</i>	
	1986	1987	1988	1989	1990
Turnover	10.9	11.8	14.2	11.6	12.7
Cost of sales	-7.9	-8.9	-11.0	-8.7	-9.5
Administrative expenses	-1.0	-1.0	-1.1	-0.8	-1.3
Other operating income	<u>0.3</u>	<u>-</u>	<u>0.5</u>	<u>0.3</u>	<u>-</u>
Operating profit	2.3	1.9	2.6	2.4	1.9
Investment income less interest payable	<u>0.3</u>	<u>0.5</u>	<u>0.2</u>	<u>0.6</u>	<u>0.8</u>
	2.6	2.4	2.8	3.0	2.7
Taxation	-0.7	-0.8	-1.1	-1.1	-1.0
Extraordinary items	<u>-</u>	<u>-</u>	<u>-</u>	<u>-1.2</u>	<u>-1.</u>
Profit available for dividends	1.9	1.6	1.7	0.7	0.6

Source: Red Funnel.

4.18. Summaries of Red Funnel's last five balance sheets are given in Table 4.8. For the reasons stated in paragraph 4.17, for the years 1986 to 1988 these are summaries of the consolidated Red Funnel group balance sheets, whereas for 1989 and 1990 they are summaries of the Red Funnel parent company balance sheets.

TABLE 4.8 Red Funnel: balance sheets

	<i>£ million</i>				
	<i>Red Funnel group</i>			<i>Red Funnel parent</i>	
	1986	1987	1988	1989	1990
Fixed assets					
Tangible	7.1	8.6	7.9	7.3	9.4
Investment	<u>-</u>	<u>-</u>	<u>-</u>	<u>3.3</u>	<u>3.5</u>
	<u>7.1</u>	<u>8.6</u>	<u>7.9</u>	<u>10.6</u>	<u>12.9</u>
Other net assets (excluding cash and borrowings)	<u>0.8</u>	<u>-0.1</u>	<u>-0.8</u>	<u>-0.2</u>	<u>-1.5</u>
Capital employed	7.9	8.5	7.1	10.4	11.4
Cash (including current asset investments) less borrowings	2.5	3.2	4.8	1.1	1.1
Provisions and deferred liabilities	<u>-2.8</u>	<u>-2.7</u>	<u>-2.1</u>	<u>-1.5</u>	<u>-2.9</u>
Capital and reserves	7.6	9.0	9.8	10.0	9.6

Source: Red Funnel.

4.19. Table 4.9 sets out the results of Red Funnel's cross-Solent car ferry and hydrofoil operations as reported to us by Red Funnel. It first shows these results on a historical cost basis. These figures, Red Funnel told us, were extracted from its management accounts, which had been reconciled with the audited consolidated accounts of the Red Funnel group for the years 1986 to 1988 and with the audited accounts of the Red Funnel group parent company (which have themselves been incorporated in the audited consolidated accounts of ABPH) for 1989 and 1990. Red Funnel also gave us additional information concerning the historical cost data in this table, as reproduced in Appendix 4.3. Next, the table shows the amounts of current cost depreciation that Red Funnel has estimated to be chargeable (see paragraphs 4.22 and 4.23) and the profit before interest calculated on that basis. Finally, we have expressed the results as percentages of revenue in each case.

TABLE 4.9 Red Funnel: results of cross-Solent car ferry and hydrofoil operations

	<i>Total</i>					<i>Car ferries</i>					<i>Hydrofoils</i>					<i>£'000</i>
	1986	1987	1988	1989	1990	1986	1987	1988	1989	1990	1986	1987	1988	1989	1990	
Revenue	<u>5,900</u>	<u>6,173</u>	<u>6,610</u>	<u>7,543</u>	<u>7,871</u>	<u>4,637</u>	<u>4,744</u>	<u>4,933</u>	<u>5,541</u>	<u>5,613</u>	<u>1,263</u>	<u>1,429</u>	<u>1,677</u>	<u>2,002</u>	<u>2,258</u>	
Expenditure:																
Direct operating costs	[
Terminal costs:																
Southampton																
East Cowes																
West Cowes																
Southampton booking and commercial																
Cowes management																
Advertising and publicity																
Overheads																
]
	<u>4,622</u>	<u>5,174</u>	<u>5,555</u>	<u>6,259</u>	<u>7,082</u>	<u>3,821</u>	<u>4,205</u>	<u>4,346</u>	<u>4,807</u>	<u>5,508</u>	<u>801</u>	<u>969</u>	<u>1,209</u>	<u>1,452</u>	<u>1,574</u>	
Profit before depreciation and interest	1,278	999	1,055	1,284	789	816	539	587	734	105	462	460	468	550	684	
Historical cost depreciation	<u>273</u>	<u>277</u>	<u>275</u>	<u>304</u>	<u>207</u>	<u>174</u>	<u>184</u>	<u>186</u>	<u>219</u>	<u>122</u>	<u>99</u>	<u>93</u>	<u>89</u>	<u>85</u>	<u>85</u>	
Historical cost profit before interest	<u>1,005</u>	<u>722</u>	<u>780</u>	<u>980</u>	<u>582</u>	<u>642</u>	<u>355</u>	<u>401</u>	<u>515</u>	<u>-17</u>	<u>363</u>	<u>367</u>	<u>379</u>	<u>465</u>	<u>599</u>	
Current cost depreciation*	1,009	947	912	900	728	641	662	672	700	520	368	285	240	200	208	
Current cost profit before interest	269	52	143	384	61	175	-123	-85	34	-415	94	175	228	350	476	
As percentages of revenue																<i>per cent</i>
Revenue	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	
Expenditure:																
Direct operating costs	[
Terminal costs:																
Southampton																
East Cowes																
West Cowes																
Southampton booking and commercial																
Cowes management																
Advertising and publicity																
Overheads																
]
	<u>78</u>	<u>84</u>	<u>84</u>	<u>83</u>	<u>90</u>	<u>82</u>	<u>89</u>	<u>88</u>	<u>87</u>	<u>98</u>	<u>63</u>	<u>68</u>	<u>72</u>	<u>73</u>	<u>70</u>	
Profit before depreciation and interest	22	16	16	17	10	18	11	12	13	2	37	32	28	27	30	
Historical cost depreciation	<u>5</u>	<u>4</u>	<u>4</u>	<u>4</u>	<u>3</u>	<u>4</u>	<u>4</u>	<u>4</u>	<u>4</u>	<u>2</u>	<u>8</u>	<u>6</u>	<u>5</u>	<u>4</u>	<u>4</u>	
Historical cost profit before interest	<u>17</u>	<u>12</u>	<u>12</u>	<u>13</u>	<u>7</u>	<u>14</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>-</u>	<u>29</u>	<u>26</u>	<u>23</u>	<u>23</u>	<u>26</u>	
Current cost depreciation*	17	15	14	12	9	14	14	14	12	9	29	20	14	10	9	
Current cost profit before interest	5	1	2	5	1	4	-3	-2	1	-7	8	12	14	17	21	

Source: MMC using Red Funnel data.

*See paragraphs 4.22 and 4.23.

4.20. Red Funnel also provided us with the data on the historical cost capital employed in its cross-Solent ferries and hydrofoil operations which we summarise in Table 4.10. These data have also been reconciled with Red Funnel's consolidated audited accounts for 1986 to 1988 and with the Red Funnel group parent company's audited accounts for 1989 and 1990.

TABLE 4.10 Red Funnel: historical cost capital employed on cross-Solent ferries and hydrofoil operations

	£'000				
	1986	1987	1988	1989	1990
Fixed assets:					
Vessels	1,679	1,451	1,182	942	763
Other	<u>829</u>	<u>1,385</u>	<u>1,444</u>	<u>1,888</u>	<u>2,203</u>
	2,508	2,836	2,626	2,830	2,966
Stocks	14	19	16	19	25
Debtors	508	611	545	430	542
Creditors	-706	-738	-790	-811	-1,595
Provisions	<u>-203</u>	<u>-283</u>	<u>-185</u>	<u>-174</u>	<u>-63</u>
Capital employed	2,121	2,445	2,212	2,294	1,875

Source: Red Funnel.

4.21. Red Funnel's returns on its year-end historical cost capital employed in its cross-Solent ferries and hydrofoil operations are as shown in Table 4.11.

TABLE 4.11 Red Funnel: returns on year-end historical cost capital employed in cross-Solent ferries and hydrofoil operations

	1986	1987	1988	1989	1990
Operating profit (£'000)	1,005	722	780	980	582
Capital employed (£'000)	2,121	2,445	2,212	2,294	1,875
Return on capital (%)	47.4	29.5	35.3	42.7	31.0

Source: MMC using Red Funnel data.

4.22. Red Funnel submitted that historical costs were an inappropriate basis for the measurement of its ROCEs, having regard to the age of its vessels and the current high costs of replacement. It provided us with the additional information set out in Table 4.12 regarding the estimated net replacement cost of these vessels at the end of the years 1986 to 1990. This was based on a professional valuation in July 1989 indexed by reference to inflation indices for shipbuilding to give equivalent values for the other years. Depreciation was then deducted based on the estimated lives of the vessels, namely 25 years for the *Cowes Castle* and *Norris Castle*, 20 years for the *Netley Castle* and 15 years for the hydrofoils.

TABLE 4.12 Red Funnel: estimated net replacement cost of vessels

	£'000					
	Valuation July 1989	1986	1987	Indexed value 1988	1989	1990
Ferries:						
<i>Cowes Castle</i>	5,000					
<i>Norris Castle</i>	5,000					
<i>Netley Castle</i>	<u>6,000</u>					
	16,000	14,652	15,157	15,368	16,000	16,618
Four hydrofoils	<u>6,000</u>	<u>5,494</u>	<u>5,684</u>	<u>5,763</u>	<u>6,000</u>	<u>6,232</u>
	22,000	20,146	20,841	21,131	22,000	22,850
Accumulated depreciation		<u>14,791</u>	<u>16,247</u>	<u>17,386</u>	<u>19,000</u>	<u>20,462</u>
		5,355	4,594	3,745	3,000	2,388

Source: Red Funnel.

4.23. Using the data in Table 4.12, Red Funnel recalculated its returns on capital as shown in Table 4.13.

TABLE 4.13 Red Funnel: returns on year-end capital employed valuing vessels at net replacement cost

	£'000				
	1986	1987	1988	1989	1990
<i>Profits</i>					
Historical cost profits	1,005	722	780	980	582
Historical cost depreciation of vessels	273	277	275	304	207
Current cost depreciation of vessels	<u>-1,009</u>	<u>-947</u>	<u>-912</u>	<u>-900</u>	<u>-728</u>
Profits after current cost depreciation	<u>269</u>	<u>52</u>	<u>143</u>	<u>384</u>	<u>61</u>
<i>Capital employed</i>					
Historical cost capital employed	2,121	2,445	2,212	2,294	1,875
Book value of vessels	-1,679	-1,451	-1,182	-942	-763
Net replacement cost of vessels	<u>5,355</u>	<u>4,594</u>	<u>3,745</u>	<u>3,000</u>	<u>2,388</u>
Capital employed valuing vessels at net replacement cost	<u>5,797</u>	<u>5,588</u>	<u>4,775</u>	<u>4,352</u>	<u>3,500</u>
Return on year-end capital employed (%)	4.6	0.9	3.0	8.8	1.7

Source: Red Funnel.

4.24. Red Funnel pointed out, however, that competition from Cowes Express, the purchase of two new catamarans in 1991, and the possible purchase of one or two ferries within the next two years would all tend to reduce its profits and its rates of return, whether calculated on a historical or net replacement cost basis. With regard to the possible ferry replacements, it provided us with two studies it had undertaken. The first concerned the replacement of two of its ferries with new vessels costing £10 million each and the second the replacement of one ferry, with a lower specification, at a cost of £8 million. It commented that these studies showed that the cost of new vessels would in any event be higher than the estimated replacement costs in Table 4.12.

Hovertravel

4.25. Hovertravel prepares its accounts to the Saturday nearest to the end of March in each year. In the year to March 1991 it made a profit before tax of £190,000 on a turnover of £2,779,000, with capital employed at the year end of £2,838,000.

4.26. Hovertravel's last five profit and loss accounts are summarised in Table 4.14.

TABLE 4.14 Hovertravel: profit and loss accounts

	£'000				
	Year to end March				
	1987	1988	1989	1990	1991
Turnover (including sales of hovercraft)	1,503	2,281	2,484	3,052	2,779
Gross profit	161	185	225	320	440
Administrative expenses	<u>-123</u>	<u>-131</u>	<u>-141</u>	<u>-159</u>	<u>-193</u>
	38	54	84	161	247
Profit on hovercraft disposals and other operating income	<u>122</u>	<u>334</u>	<u>444</u>	<u>323</u>	<u>2</u>
	160	388	528	484	249
Net interest receivable/(payable)	<u>-3</u>	<u>24</u>	<u>7</u>	<u>22</u>	<u>-59</u>
Profit on ordinary activities before tax	157	412	535	506	190
Taxation	-48	-120	-134	-159	-44
Extraordinary item	-	-245	-	-	-
Dividends	<u>-33</u>	<u>-46</u>	<u>-46</u>	<u>-46</u>	<u>-46</u>
Retained profit	76	1	355	301	100

Source: Hovertravel.

Notes:

1. Hovercraft leasing fees in 1986/87 and 1987/88 were charged to profit and loss account as incurred.
2. The extraordinary item in 1987/88 represented levies of £350,000 payable to British Technology Group, less tax.

4.27. Hovertravel's turnover is analysed between its different activities in Table 4.15.

TABLE 4.15 **Hovertravel: analysis of turnover**

	<i>Year to end March</i>					<i>£'000</i>
	1987	1988	1989	1990	1991	
	Passenger and freight services	1,109	1,183	1,316	1,424	1,618
Other	<u>394</u>	<u>1,098</u>	<u>1,168</u>	<u>1,628</u>	<u>1,161</u>	
	1,503	2,281	2,484	3,052	2,779	

Source: Hovertravel.

4.28. A summary of Hovercraft's balance sheets at its last five year ends is given in Table 4.16.

TABLE 4.16 **Hovertravel: summarised balance sheets**

	<i>End March</i>					<i>£'000</i>
	1986	1988	1989	1990	1991	
	Tangible fixed assets	1,017	890	920	1,337	2,347
Other net assets (excluding cash and borrowings)	<u>-119</u>	<u>188</u>	<u>656</u>	<u>1,040</u>	<u>491</u>	
Capital employed	898	1,078	1,576	2,377	2,838	
Net cash/(borrowings)	<u>242</u>	<u>55</u>	<u>-51</u>	<u>-385</u>	<u>-774</u>	
Capital, reserves, provisions and proposed dividend	1,140	1,133	1,525	1,992	2,064	

Source: MMC from Hovertravel data.

4.29. Hovertravel made available to us its management accounts for 1990/91 from which, with its assistance, we were able to calculate its profit before interest and tax on its cross-Solent hovercraft operations for the last two years. These calculations are shown in Table 4.17. These results are on a historical cost basis (unlike the replacement cost results of Wightlink and Red Funnel shown in Tables 4.3 and 4.9) but as Hovertravel's fleet of two hovercraft were acquired in 1989 and 1990 respectively, the use of historical costs in this instance is unlikely materially to affect the results shown. The 1990/91 results as shown in Table 4.17 omit exceptional expenditure of £75,000 on the refurbishment of the Ryde slipway.

TABLE 4.17 **Hovertravel: results of cross-Solent hovercraft operations**

	<i>Year to end March</i>			
	1990		1991	
	<i>£'000</i>	%	<i>£'000</i>	%
Revenue:				
Passengers	1,286	90	1,481	92
Parcels	<u>137</u>	<u>10</u>	<u>137</u>	<u>8</u>
	<u>1,423</u>	<u>100</u>	<u>1,618</u>	<u>100</u>
Expenditure:				
Craft operating costs	561	39	595	37
Terminal costs	397	28	426	27
Administration	50	4	55	3
Advertising	21	1	33	2
Other costs	<u>50</u>	<u>4</u>	<u>21</u>	<u>1</u>
	<u>1,079</u>	<u>76</u>	<u>1,130</u>	<u>70</u>
Profit before depreciation and interest	344	24	488	30
Depreciation	<u>137</u>	<u>9</u>	<u>218</u>	<u>13</u>
Profit before interest	207	15	270	17

Source: MMC using Hovertravel data.

Comparisons of revenues, costs and profits

4.30. Table 4.18 compares the revenues, costs and profits for 1990 (1990/91 in the case of Hovertravel) of the services on Wightlink's, Red Funnel's and Hovertravel's different routes, using the figures submitted by the companies concerned, which are based on replacement costs in the case of Red Funnel and Wightlink and historical costs in the case of Hovertravel. It also shows certain traffic statistics and expresses the monetary figures in unit cost terms: per passenger in the case of the passenger-only vessels, per PCU in the case of the car ferries and per trip in the case of all vessels. (No attempt, however, has been made to establish a PCU equivalent for foot passengers on the car ferries. Neither have the Hovertravel figures per passenger or per trip been adjusted to exclude revenue and expenditure relating to parcels.) Finally, it shows vessel capacities, average passengers carried and load factors.

4.31. In the case of car ferries, Red Funnel's costs per PCU are considerably higher than Wightlink's on the latter's Portsmouth-Fishbourne and Lymington-Yarmouth services but detailed comparisons may be affected by port charges: Wightlink to a large extent operates its own port and harbour facilities, and is not subject to port charges from other companies in the Sea Containers Group, whereas Red Funnel uses, and is charged for, facilities at Southampton belonging to ABP. Differences in costs and profits are mainly volume-related, with Wightlink's larger-capacity vessels on the Portsmouth-Fishbourne service being able to carry more traffic than Red Funnel's (even though the latter's load factor is slightly higher) despite the fact that costs per trip are about the same. Comparing Red Funnel with Wightlink's Lymington-Yarmouth route shows the effect of Wightlink's lower vessel capacity to be offset by its lower costs per trip than those of Red Funnel. Comparing the passenger-only craft, Hovertravel operates at much the same cost per trip as the Red Funnel hydrofoils while carrying many more passengers. The Wightlink catamarans are not comparable, being of larger capacity: the main problem there seems to be their load factor of only 27 per cent.

TABLE 4.18 Comparison of 1990 revenues, costs and profits

	Wightlink			Red Funnel		Hovertravel
	Portsmouth- Ryde	Portsmouth- Fishbourne	Lymington- Yarmouth	Ferries	Hydrofoil	Hovercraft
<i>Profit and loss (£'000)</i>						
Revenue	<u>3,963</u>	<u>19,041</u>	<u>8,123</u>	<u>5,613</u>	<u>2,258</u>	<u>1,618</u>
Expenditure:						
Ship operating	[
Terminal costs						
Booking etc						
Overheads						
Catering]
	<u>3,247</u>	<u>12,338</u>	<u>5,639</u>	<u>5,508</u>	<u>1,574</u>	<u>1,130</u>
Profit before depreciation	716	6,703	2,484	105	684	488
Depreciation	<u>695</u>	<u>1,466</u>	<u>834</u>	<u>520</u>	<u>208</u>	<u>218</u>
Profit after depreciation	21	5,237	1,650	-415	476	270
<i>Traffic statistics ('000)</i>						
Passengers	1,728.2	-	-	-	655.35	650.47
Cars	-	640.3	279.5	166.7	-	-
Coaches	-	12.6	3.43	1.07	-	-
Freight vehicles	-	110.7	36.32	35.64	-	-
PCU (see note 3)	-	1,158.7	445.4	315.7	-	-
Trips	16.211	17.72	14.25	8.182	21.830	14.888
<i>Per passenger/PCU (£)</i>						
	<i>Passenger</i>	<i>PCU</i>	<i>PCU</i>	<i>PCU</i>	<i>Passenger</i>	<i>Passenger</i>
Revenue	<u>2.29</u>	<u>16.4</u>	<u>18.2</u>	<u>17.8</u>	<u>3.44</u>	<u>2.48</u>
Expenditure:						
Ship operating	[
Terminal costs						
Booking etc						
Overheads						
Catering]
	<u>1.88</u>	<u>10.6</u>	<u>12.6</u>	<u>17.5</u>	<u>2.40</u>	<u>1.73</u>
Profit before depreciation	0.41	5.8	5.6	0.3	1.04	0.75
Depreciation	<u>0.40</u>	<u>1.3</u>	<u>1.9</u>	<u>1.6</u>	<u>0.32</u>	<u>0.33</u>
Profit after depreciation	0.01	4.5	3.7	-1.3	0.72	0.42
<i>Per trip (£)</i>						
Revenue	<u>244.5</u>	<u>1,075</u>	<u>570</u>	<u>686</u>	<u>103.4</u>	<u>108.7</u>
Expenditure:						
Ship operating	[
Terminal costs						
Booking etc						
Overheads						
Catering]
	<u>200.3</u>	<u>697</u>	<u>396</u>	<u>673</u>	<u>72.1</u>	<u>75.9</u>
Profit before depreciation	44.2	378	174	13	31.3	32.8
Depreciation	<u>42.9</u>	<u>83</u>	<u>58</u>	<u>64</u>	<u>9.5</u>	<u>14.7</u>
Profit after depreciation	1.3	295	116	-51	21.8	18.1
<i>Ratios</i>						
Passengers/PCU per trip	106.6	65.4	31.3	38.6	30.0	43.7
Capacity (passengers/ PCU)	401	142	52	71	67	95
Load factor (%)	27	46	60	54	45	46

Source: MMC using companies' data.

Notes:

1. The above figures are for the calendar year 1990 in the case of Wightlink and Red Funnel, and for the year to end March 1991 in the case of Hovertravel.
2. For Wightlink and Red Funnel, depreciation is based on replacement costs. For Hovertravel, it is based on historical costs (but see paragraph 4.29).
3. For the purposes of this table we have adopted Wightlink's practice of treating a coach as equivalent to 6 PCUs and a freight vehicle as equivalent to 4 PCUs. Red Funnel, however, applies lower factors of 3 to cars and 2.5 to freight vehicles, which would produce a load factor of 45 per cent on its ferry service.
4. The Red Funnel figures for cars include caravans and trailers.
5. In Wightlink's view the pattern of travel across the Solent, taking into account peak periods, is such that averaging load factors over the whole year is not a meaningful measure of performance.