7 Conclusions

The monopoly situation

7.1. Under the reference dated 17 April 1991, made under sections 47(1), 49(1) and 50(1) of the Fair Trading Act 1973 (the Act) and as varied on 23 October 1991 (see Appendix 1.1), we are required to investigate and report on whether a monopoly situation exists in relation to the supply of ferry services between the Isle of Wight (the Island) and the mainland of England; and if so by virtue of which provisions of sections 6 to 8 of the Act that monopoly situation is to be taken to exist. If such a monopoly situation was found to exist, we would then be required to consider in favour of what person or persons the situation existed.

7.2. Section 7 of the Act is concerned with the supply of services. A monopoly situation under section 7(1)*(a)* can be found to exist in relation to the supply of services of any description in the United Kingdom (or a part of the United Kingdom) when at least one-quarter of the supply is by (or to) one and the same person. Alternatively, a monopoly situation under section 7(1)*(b)* can be found to exist when at least one-quarter of such supply is by (or to) members of one and the same group of interconnected bodies corporate.

7.3. The background to considering this question is as follows. As noted in Table 2.3, Wightlink Ltd (Wightlink), a wholly-owned subsidiary of Sea Containers Ltd (Sea Containers), accounted in 1990 for 71 per cent of the number of passengers, 85 per cent of the number of cars, 94 per cent of the number of coaches and 80 per cent of the number of freight vehicles carried on ferry services between the Island and the mainland of England. Wightlink itself, however, is almost entirely financed by borrowings from the Sea Containers group; its parent company, Sea Containers, is also involved in the control of Wightlink, with substantial headquarters costs allocated to Wightlink; and the Vice President (Ferries) of Sea Containers is the Chairman of Wightlink and one other member of the Board of Wightlink is on the Board of Sea Containers.

7.4. Against this background, it was open to us to find the existence of a monopoly situation either under section 7(1)*(a)* of the Act, by reason of the supply of the relevant services by Wightlink or, in view of the relationship of Sea Containers both as parent company and by reason of practical involvement with Wightlink, under section 7(1)*(b)* (as indeed we provisionally concluded). As summarised in paragraph 6.3, Sea Containers did not agree that it should itself be regarded as a supplier of services for the purpose of section 7(1)*(b)*, or that a monopoly situation under either provision existed in its favour.

7.5. We considered the arguments put forward by Sea Containers and the appropriateness of the alternative approaches under section 7(1)*(a)* and *(b)* respectively. As a result, we believe that the preferable conclusion in the present case is that a monopoly situation exists by virtue of section 7(1)*(a)* of the Act in the relation to the supply of reference services, and we so conclude. We further conclude, in view of the factors set out in paragraph 7.3, that this monopoly situation exists in favour of both Wightlink and Sea Containers.

7.6. In accordance with our terms of reference, we have therefore to consider:

(a) whether any steps (by way of uncompetitive practices or otherwise) are being taken by Wightlink or Sea Containers for the purpose of exploiting or maintaining that monopoly situation, and, if so, by what uncompetitive practices or in what other way;

(b) whether any action or omission on the part of Wightlink or Sea Containers is attributable to the existence of that monopoly situation, and, if so, what action or omission and in what way it is so attributable; and

(c) whether any facts found in pursuance of our investigation operate, or may be expected to operate, against the public interest.

The supply of cross-Solent ferry services

7.7. The cross-Solent ferry services provide almost the sole means of transport for passengers, cars, coaches and commercial vehicles to and from the Isle of Wight. There are no scheduled air services to the Island and, apart from the ferry services, there is only a limited number of bulk cargo shipping services and irregular excursion services for passengers. The ferry services therefore represent an essential part of the infrastructure of the Island, and the economy of the Island is highly dependent on the cost and quality of the services provided by a small number of private sector companies operating without any element of public subsidy.

7.8. Four companies currently operate cross-Solent ferry services:

(a) Wightlink, a subsidiary of Sea Containers, operates car ferry services between Fishbourne and Portsmouth and between Yarmouth and Lymington, and a passenger-only catamaran service between Ryde Pier and Portsmouth. These services were previously operated by Sealink (UK) Ltd, a subsidiary of the British Railways Board until its sale to Sea Containers in 1984, and were among the first of the public sector undertakings to be sold to the private sector. In 1990 the bulk of Sealink's operations were sold by Sea Containers to Stena AB of Sweden. However, Sea Containers retained ownership of the cross-Solent ferry services and associated harbour, ferry and inclusive holidays businesses now operated by Wightlink. As shown in Table 4.2, the restructuring of Wightlink has resulted in a company almost entirely financed by borrowings, mainly from the Sea Containers group, and with a high level of interest payments to that group.

(b) Red Funnel (whose full name is the Southampton Isle of Wight and South of England Royal Mail Steam Packet Public Limited Company) has since 1989 been a wholly-owned subsidiary of Associated British Ports Holdings PLC (ABPH). Red Funnel operates a car ferry service between East Cowes and Southampton (which until May 1991 also set down passengers at West Cowes), a passenger-only catamaran service between West Cowes and Southampton, and (from August 1991) a hydrofoil service between West Cowes and Portsmouth.

(c) Hovertravel Ltd (Hovertravel) operates a passenger-only hovercraft service between Ryde Esplanade and Southsea.

(d) Cowes Express Ltd (Cowes Express) operates passenger-only services with surface effect vessels between West Cowes and Southampton. These services were first operated for a brief period in 1990 and restarted in July 1991.

7.9. The numbers of passengers, cars, coaches and commercial vehicles carried in 1990 are summarised in Table 7.1, and the revenue from the services in Table 7.2.

TABLE 7.1 **Traffic carried on cross-Solent ferry services and market shares, 1990**

	Traffic carried ('000)				*Market share by volume (%)*			
	Passengers	*Cars*	*Coaches*	*Commercial vehicles*	*Passengers*	*Cars*	*Coaches*	*Commercial vehicles*
Wightlink	5,328.4	891.8	15.9	146.4	71.2	84.9	93.5	80.4
Red Funnel	1,522.5	158.8	1.1	35.6	20.3	15.1	6.5	19.6
Hovertravel	632.9	-	-	-	8.5	-	-	-
Total	7,483.8	1,050.6	17.0	182.0	100.0	100.0	100.0	100.0

Source: See Table 2.1.

TABLE 7.2 **Revenue from cross-Solent ferry services, 1990**

	Revenue	
	£m	*%*
Wightlink	31.1	77
Red Funnel	7.9	19
Hovertravel*	1.6	4
Total	40.6	100

Source: See Table 4.18.

*Figures are for year ending March 1991.

7.10. A route map of the reference services is reproduced in Figure 2.1. The Wightlink services are at the eastern and western ends of the Island and the Red Funnel service to the centre of the Island, but with a longer crossing from Southampton. The Wightlink and Hovertravel passenger-only services compete more directly from Ryde to Portsmouth and Southsea respectively; and the Red Funnel and Cowes Express services compete directly between West Cowes and Southampton.

7.11. Each route tends to cater for different types of traffic or to serve a different part of the Island, and is more suitable to particular points of origin or destination on the mainland. The services between Fishbourne or Ryde on the Island, and Portsmouth or Southsea on the mainland, for example, are more convenient for passengers travelling to and from the eastern part of the Island, particularly for foot passengers using the bus and train services between Ryde, Sandown and Shanklin, and to and from Portsmouth and London. The Cowes-Southampton services are more convenient for travel to and from the central and northern part of the Island and to and from other mainland destinations via Southampton. The Yarmouth-Lymington service tends to be more convenient for travel to and from the western end of the Island (Yarmouth and Freshwater) and western areas of mainland England. Foot passengers, in particular, would find it inconvenient to travel across the Island to use an alternative ferry service (as illustrated in Table 2.4). This is confirmed by figures we have seen on the points of origin and destination of foot passengers. Car drivers and their passengers, coaches and commercial vehicles may have less difficulty in using alternative routes.

7.12. As shown in Table 2.2, the volume of traffic carried by the cross-Solent ferry services has grown significantly since 1983/84: by almost 2 per cent per annum for passengers, by about 4 per cent per annum for cars, by 6 per cent per annum for coaches and by 5 per cent per annum for commercial vehicles. The structure of passenger demand has changed gradually over time with a decline in the number of foot passengers carried, and an increase in the number of passengers accompanying vehicles.

7.13. Demand is characterised by a heavy peak in the tourist seasons, particularly at weekends in July and August, but also on bank holidays and at Easter and Christmas. Capacity is determined by the need to meet peak demand. Some sailings during the peak period are fully loaded, and there is insufficient capacity at certain times of greatest demand. Averaged over the year as a whole, however, capacity utilisation is relatively low. As shown in Table 4.18, in 1990 about 60 per cent of vehicle capacity on the Yarmouth-Lymington car ferry was utilised, but only 54 per cent and 46 per cent on the Cowes-Southampton and Fishbourne-Portsmouth services respectively. About 45 per cent of passenger capacity was utilised on the

Red Funnel hydrofoil and on the Hovertravel hovercraft services, but only about 27 per cent on Wightlink's catamaran service.

7.14. Sea Containers has invested about £20 million in Wightlink since 1984 to meet the growth of demand. Two new vessels have been introduced on the Fishbourne-Portsmouth route in the last five years (the other two vessels currently in operation having been introduced in 1983), resulting in a significant increase in frequency and capacity. There has been an increase in the number of services operated between Ryde Pier and Portsmouth, following the introduction of catamarans in 1986. Wightlink also intends to introduce new, larger vessels on the Yarmouth-Lymington service, but the implementation of its plans has been delayed by local environmental objections in Lymington. Wightlink has in addition invested in improved shore facilities, and its current plans include a new terminal building at Lymington.

7.15. Red Funnel has acknowledged the need to invest in new car ferries on the East Cowes-Southampton service and has examined the specifications for possible replacement vessels. The vessels currently in service are between 17 and 25 years old and of relatively limited capacity, and will not comply with revised safety standards to be introduced over the next few years. On the passenger-only West Cowes-Southampton service, Red Funnel has recently introduced two new catamarans to replace the hydrofoils, the hydrofoils being retained as back-up or re-employed on the new service to Portsmouth. Red Funnel has also invested in shore facilities, including a new ticket office at West Cowes, and plans improvements to its facilities at Southampton. The vessels recently introduced by Cowes Express on the West Cowes-Southampton route are all modern, and two of them have a significantly larger capacity than the Red Funnel catamarans. Hovertravel has also introduced two larger craft in the last two years, and has invested in terminal facilities, particularly at Ryde.

The public interest

7.16. During the course of our inquiry, we received views from ferry operators, other companies and representative bodies such as the local authorities on the Island, as well as about 500 letters from individuals or groups on the Island, the great majority of which complained about the level of fares.

The effectiveness of competition

7.17. One complaint made to us was that there was little or no competition between the ferry operators. Some complainants argued that each individual route was itself a monopoly on which the operators were free to charge what they wished. Others went so far as to claim that the operators colluded on fares, pointing to the close similarity in certain of the fares charged and virtually simultaneous fare increases.

7.18. Wightlink argued that there was effective competition on both price and non-price factors, and that it had only been able to achieve its market share by superior efficiency and as a result of large-scale investment. It also pointed to the recent strengthening of competition, with Cowes Express entering the market, and to more effective competition from Red Funnel since its acquisition by ABPH.

7.19. We mentioned in paragraph 7.11 that the choice of a particular route would largely depend on the point of origin and destination of the ferry user. Competition between individual routes is a matter of degree. Many foot passengers-in particular daily commuters to Portsmouth or Southampton-would be seriously inconvenienced by using a less direct route, although there may be a minority of foot passengers (those, for example-as shown in Table 2.4-travelling between Newport and London) with a more realistic opportunity to choose between routes. In the case of foot passengers, therefore, the different routes might, to a significant extent, be regarded as separate markets. This view is supported by the higher fares which Red Funnel is able to charge on its passenger-only service between West Cowes and Southampton, compared with the level of fares on the Wightlink and Hovertravel services between Ryde and Portsmouth or Southsea. Red Funnel standard return fares, for example, have been some 20 to 30 per cent higher than those of Wightlink and Hovertravel over the last five years.

7.20. There is, however, direct competition within each of the two passenger-only routes, between Wightlink and Hovertravel on services between Ryde and Portsmouth or Southsea, and between Red Funnel and Cowes Express on services between West Cowes and Southampton. Whereas there are relatively small differences between Wightlink and Hovertravel fares, the re-entry of Cowes Express to the latter route in 1991 has brought with it a significant degree of price competition. Cowes Express fares are significantly below the Red Funnel catamaran fares, although somewhat above the passenger fares on the slower Red Funnel car ferry services from East Cowes. It was also suggested to us that Red Funnel's improvement of its services had been stimulated by Cowes Express' entry to the market, although Red Funnel denied this. There is no evidence, however, that competition from Cowes Express has affected either passenger or vehicle fares on the other routes.

7.21. As mentioned in paragraph 7.11, it would seem easier for vehicle traffic to switch between routes. The absence of marked differences in fares (see, for example, Table 2.14) is consistent with a sufficient degree of competition, or potential competition, between the services to prevent Red Funnel charging car ferry rates significantly above those of Wightlink, or indeed to earn satisfactory profits on the East Cowes-Southampton service (as discussed in paragraph 7.57). There are, moreover, some differences in fare structure and promotional fares between Wightlink and Red Funnel.

7.22. We find it difficult, however, to regard competition to Wightlink for vehicle traffic as being as effective as Wightlink claims. The Red Funnel crossing from Southampton takes significantly longer than the Wightlink crossings, almost double the crossing time of the Yarmouth-Lymington service for over twice the length of crossing. Furthermore, the ferries operated by Red Funnel are of significantly lower capacity than the Wightlink ferries on the Fishbourne-Portsmouth route, although somewhat larger than those currently used on the Yarmouth-Lymington route. As shown in Table 4.18, as a result of these factors the Red Funnel car ferry service has significantly higher operating costs per unit of capacity than those of Wightlink, a weak position from which to compete effectively with Wightlink. Red Funnel had also not actively competed for coach traffic, although it has now changed this policy.[1]

7.23. As noted in paragraph 7.18, Red Funnel's competitive performance has improved since its acquisition by ABPH. The frequency and operating hours of its car ferry services have also increased (see Appendix 2.1) and it has taken a more positive approach to marketing. These service improvements have been reflected in an increased share of car traffic (16.7 per cent of cars carried from April to September 1991, compared with 16.1 per cent over the same period in 1990, for example), but without seriously threatening Wightlink's dominant position in the market. The ability of Red Funnel to compete in the longer term is heavily dependent on its investment in new ferries. The company is also considering development of additional port facilities elsewhere on Southampton Water, to allow a shorter crossing time.

7.24. On balance, therefore, we do not believe it is accurate to say that there is no competition between the cross-Solent ferry operators. In our view, however, competition to the main operator, Wightlink, cannot at present be characterised as strong, or sufficiently effective in itself to ensure that Wightlink is unable to abuse its monopoly position. A principal matter which we have therefore to consider is whether any aspect of Wightlink's performance operates or may be expected to operate against the public interest.

The level of fares

7.25. The main source of complaint to us was the level of fares, particularly for the short distances travelled, and relative to the incomes available to Islanders or, in the context of holiday traffic, total holiday costs. Many of the letters received said that the level of fares limited the ability of residents, particularly pensioners, or their relatives to visit each other or imposed considerable financial burdens when journeys had to be made, for example for visits to specialist hospital facilities on the mainland. There was also a concern that ferry fares reduced the number of tourists visiting the Island and increased business costs.

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[1] Due to their height coaches (and freight vehicles) can only be accommodated when the mezzanine deck is not in use, which reduces the capacity of the Red Funnel vessels by up to 40 per cent.

7.26. Wightlink argued that fares were determined taking into account cost factors, market conditions and competition and had not contributed to unreasonable levels of profit either generally, or on particular routes. Wightlink also pointed to the steady increase in vehicle traffic carried, in line with road transport generally in the United Kingdom.

7.27. The current level of fares and the trend in fares over time are shown in Chapter 2. The average revenues for Wightlink, for example, in 1990 are shown in Table 2.13, namely £2.10 per foot passenger, £18.40 per car with accompanying passengers, £102.44 per coach with accompanying passengers, and £33.40 per commercial vehicle. These average revenues reflect the effect of traffic mix and of discounted fares, such as multi-journey tickets.

7.28. Standard single passenger fares between the Island and the mainland range from £3.10 on the Yarmouth-Lymington service to £5.30 on the Red Funnel catamaran service; day returns vary from £4.30 on the Yarmouth-Lymington service to £8 on the Red Funnel catamaran service. As shown in Table 2.14, return rates for a car of 4 to 5.5 metres with two adults and two passengers are as much as £68.40 for Red Funnel on July and August weekends, and £59.40 for Wightlink in its `summer' period (Easter to September). They are somewhat less in winter (£55.40 and £53.40 respectively), with all-in day returns as low as £21 for Red Funnel and £27 for Wightlink in off-peak months. Wightlink, however, has also offered cheaper promotional fares: a half-term special of £10 day return for a car and up to four passengers, and a £20 one-month return for a car and up to four passengers for friends and relatives of Islanders. Both Red Funnel and Wightlink offer modest concessions to Island residents; Red Funnel for passengers and vehicles, Wightlink for vehicles only.

7.29. Underlying many of the complaints received is the belief held by many of the complainants that the cross-Solent services are among the most expensive ferry crossings in the world for the distance travelled. A large number of comparisons were quoted to us, and the figures shown in Appendix 2.4, based on a number of other routes in the United Kingdom, confirm that the cross-Solent services (notably the Lymington-Yarmouth crossing as a whole, and fares for cars in off-peak periods on all routes) are indeed among the most expensive in the United Kingdom.

7.30. It is understandable that such comparisons are a source of concern to many Island residents. We believe, however, that the comparisons are of very limited value. Routes differ, both in their operational characteristics-for example, water conditions, the safety requirements, the size and draught of vessel and the frequency of the crossings-and in the extent to which they are subsidised; some of the Scottish and overseas routes quoted to us as comparators are heavily subsidised. There is also some relationship between length of crossing and cost per mile, shorter crossings tending to have a higher cost per mile, as a greater proportion of vessel time is spent loading and unloading and the incidence of `turnround' costs is higher in relation to total costs.

7.31. In our view, the level of fares must be considered in relation to the cost of providing services and to the profitability of these services. Table 7.3 summarises the revenue, fares and profitability of the individual services and shows that higher fares are no guide to profitability. Of the car ferry services, the standard peak return fare per kilometre for Wightlink's Yarmouth-Lymington service is 83 per cent higher than for its Fishbourne-Portsmouth route. Profitability, however, is lower, 30.6 per cent of revenue before depreciation on Yarmouth-Lymington, compared with 35.2 per cent on Fishbourne-Portsmouth (20.3 per cent and 27.5 per cent respectively after depreciation). This reflects the higher cost of operating smaller vessels, despite higher load factors. Of the passenger-only services, fares per kilometre are higher on the Wightlink and Hovertravel services, although profitability in 1990 was below that of Red Funnel. We discuss the profitability of the services further in paragraphs 7.47 to 7.60.

TABLE 7.3 **Comparison of cross-Solent revenues, profits and fares**

	Car ferry services			Passenger-only services		
	Wightlink		*Red Funnel*	*Wightlink*	*Hovertravel*	*Red Funnel*
	Fishbourne-Portsmouth	*Yarmouth-Lymington*	*East Cowes-Southampton*	*Ryde-Portsmouth*	*Ryde-Southsea*	*West Cowes-Southampton*
Total revenue (£'000)	19,041	8,123	5,613	3,963	1,618	2,258
Profit before depreciation (£'000)	6,703	2,484	105	716	488	684
-as % of revenue	35.2	30.6	1.9	18.1	30.2	30.3
Profit after depreciation (£'000)	5,237	1,650	(415)	21	270	476
-as % of revenue	27.5	20.3	(7.4)	0.5	16.7	21.1
		Per PCU			*Per passenger*	
Revenue per passenger/PCU (£)	16.4	18.2	17.8	2.29	2.48	3.44
Distance (km)	11	6	19	8	7	19
Revenue per passenger/PCU per km (£)	1.49	3.03	0.94	0.29	0.35	0.18
		Per car (of up to 4 metres)			*Per adult passenger*	
Standard peak return fare 1991, £ per km	1.44	2.63	0.92	0.49	0.51	0.25
		PCU			*Passengers*	
Capacity	142	52	71	401	95	67
Load factor (%)	46	60	54	27	46	45

Source: See Table 4.18 and Appendix 2.4.

Note: Depreciation is on a replacement cost basis in the case of Wightlink and Red Funnel, and on a historical cost basis in the case of Hovertravel-this is discussed further in paragraph 4.29. See also notes to Table 4.18.

7.32. We also considered the trend in fares over time. As shown in Chapter 2, a number of Wightlink's standard fares-particularly for passengers-have increased by slightly more than the Retail Price Index (RPI); but (as shown in Table 2.13) average revenues per car, per coach and per commercial vehicle have generally increased by about the same as, or slightly less than, the RPI. Average revenue per foot passenger has increased above the RPI, partly reflecting not only fare changes but also a redistribution between British Rail and Wightlink of income from consolidated fares through to mainland destinations. As shown in Table 7.3, however, the Ryde-Portsmouth service (which accounts for the majority of foot passengers carried by Wightlink) barely broke even in 1990.

7.33. Neither the level nor the increase in fares over time has been such as to prevent an increase in the use of the cross-Solent services. We recognise, however, that much use is non-discretionary, given the essential nature of much travel to and from the Island and the lack of any alternative. We note also the response to special promotional offers when properly publicised. For these reasons, we cannot accept the increase in use alone as justifying the current fares levels, which must also be considered in relation to the cost and profitability of the services. The burden the fares represent to Islanders is partly alleviated by the small concessions available to Island residents, and the various special offers intended to attract traffic in off-peak times. It would not be realistic to expect that burden to be further reduced by the operators of the services unless the current level of profitability was excessive. Amongst the specific concerns raised with us, for example, was the hardship caused by the cost of regular visits to the mainland for specialist hospital treatments. We were told that under National Health Service regulations, people on low income, in receipt of income support or family credit, could at present reclaim the expenses of travelling to see a hospital consultant or visit a disablement service centre, as could a travelling companion where, on medical grounds, it was essential that they be accompanied (see paragraph 5.13). For other Island residents, however, there is currently no relief for these costs through any Government agency.

The structure of fares

7.34. We received complaints about the structure of tariffs on the cross-Solent ferry services, in particular about the smaller differential between peak and off-peak tariffs than is the case (it was said) in cross-Channel ferry services. Wightlink argued that cross-Solent services could not be compared with cross-Channel services in this respect, being less dependent on tourism and having a more constant all-year-round demand. It also argued that a more peaked fare structure would be complex and difficult to administer, given the frequency and number of sailings. On the other hand, both Wightlink and Red Funnel acknowledged that more should be done to shift traffic away from the peak days of the year.

7.35. We have noted in paragraph 7.13 the low capacity utilisation prevailing for prolonged periods of the year despite the excess demand for peak sailings, most notably on Saturdays, in the summer period. We have also noted the relatively limited differential in standard fare rates. Wightlink generally differentiates only between summer and winter periods (the summer fares being applied from Easter to the end of September) although Red Funnel also has a higher rate at weekends in July and August. Wightlink and Red Funnel have, however, recently both agreed to a more flexible structure of fares for HavenWarner, the main operator of holiday centres on the Island, by the division of the main summer season into two parts. Cross-Channel operators, by contrast, operate a number of price bands, which distinguish standard fares by time of day, as well as day of week and time of the year. Similarly, whereas the differential in both Wightlink and Red Funnel standard fares (for car and passengers) is generally about 10 to 20 per cent (see Table 2.14), cross-Channel off-peak fares and fares on routes to Ireland can be less than one-half of peak fares (see Appendix 2.4).

7.36. We recognise that there may be difficulties in introducing a more complex fare structure given the large number of sailings and high frequency of services, particularly at peak times. In practice, drivers arriving early are often carried on the next departure if space is available. This process could be complicated by the charging of different fares for different crossings, and lead to increased congestion of the already limited parking facilities. The reservation system, rather than a greater range of peak prices, is at present used to ration available capacity. It is not clear to us that it would necessarily be in the public interest to have significantly higher prices at peak periods to ration demand. Similarly it is by no means clear-cut that a general lowering of off-peak fares would increase demand sufficiently to ensure that the viability of some off-peak services would not be put at risk by such a move, although there may well be scope for a particular off-peak service to carry a promotional rate on a regular basis. Special offers are already used from time to time to generate additional demand in off-peak periods.

7.37. Although, therefore, some aspects of the pricing structure might be improved-there may, for example, be more scope for lower fares on the less convenient and less popular sailings, or special offers for group travel-we do not think that the present fare structure significantly distorts demand.

Freight rates

7.38. We received complaints both about the overall level of freight rates charged by the ferry operators and about the process for agreeing freight rates.

7.39. As with passengers and car fares, the need to use ferry services is an unavoidable burden on freight carriers and on Island businesses which wish to bring goods to or from the Island. In this respect, Isle of Wight businesses do not enjoy the subsidy available to some remote island communities. However, they have the advantage that the Island is served from two ports-Portsmouth and Southampton-of significant economic importance and with easy access to other industrial centres. This contrasts with more remote island communities which are distant from comparable mainland markets.

7.40. From the figures in Chapter 2, there is no evidence that freight bears a disproportionate share of the costs of the ferry services. The proportion of revenue accounted for by freight is far lower than its share of the traffic carried, perhaps as a result of the more even spread of freight demand through the year.

7.41. Freight rates are based primarily on negotiations with individual freight operators, with discounts of up to 75 per cent off published prices for some of the larger carriers. It is quite usual for larger purchasers to get better terms, but the extent of the discounts would seem unusually large in the present case. It would be better for smaller freight operators if there were a more transparent system of setting freight rates, and a closer relationship between charges to individual operators and costs. However, we received no firm evidence to suggest that small freight operators are seriously disadvantaged by the present system.

Quality of service

7.42. A further source of complaint related to the levels and quality of service, mainly:

(a) the shortage of capacity at peak times;

(b) the formerly limited operating hours of the Red Funnel services;

(c) the withdrawal by Red Funnel of the car ferry stop at West Cowes which required the residents of West Cowes either to pay a higher fare to use the hydrofoil service or travel via East Cowes; and

(d) the limited operating hours of the Lymington-Yarmouth service, and of the Ryde-Portsmouth service on Saturdays.

Other complaints about the quality of service included the susceptibility of hydrofoils and catamarans to bad weather and poor connections with British Rail.

7.43. The companies pointed with some justification to the improvements in service over the last five years. As shown, for example, in Appendix 2.1, the number of Wightlink services has increased significantly between Fishbourne and Portsmouth, and between Ryde and Portsmouth, as have the number of Red Funnel ferry and, more particularly, the passenger-only services between Cowes and Southampton. There has also been a recent extension in the operating hours of the Red Funnel services, with the introduction of evening services, up to 2310, on several days of the week. Wightlink took some pride in its claim to be the only public transport operator in the United Kingdom to run on all days of the year, including Christmas Day.

7.44. Wightlink acknowledged that there was a shortage of capacity at peak times. On a peak Saturday in August, for example, all services after 1315 between Yarmouth and Lymington were full, as were all sailings between 0830 and 1900 on services between Fishbourne and Portsmouth. As discussed above, however, it has invested in new capacity on the Fishbourne-Portsmouth service, and is intending to purchase new ships for the Yarmouth-Lymington service; further investment solely to meet the exceptional peak demand on peak days may be neither feasible nor viable.

7.45. There are, on the other hand, various aspects of the service offered which could be improved. The timing of the last passenger-only Saturday service between Ryde and Portsmouth-2135 from Portsmouth in summer, 2035 in winter, compared with 2345 on other days of the week-is clearly likely to inconvenience Islanders who may wish to spend the evening on the mainland, or foot passengers travelling to the east of the Island from further afield. It suggests an inflexibility of working practices or of management approach that compares unfavourably with Red Funnel or Cowes Express. It would, however, be difficult to regard this one aspect of service as sufficient to constitute a factor that operates against the public interest, given the later operation of the 2300 and 0100 car ferry services from Portsmouth to Fishbourne, albeit these are inconvenient for foot passengers without the use of private transport. On some of the other complaints made, Wightlink told us that it had experimented with later services on the Yarmouth-Lymington route, but there had been little demand. We also find it difficult to argue that withdrawal of the West Cowes stop on the Red Funnel car ferry service was on balance detrimental, given the improved frequency and viability of the service to East Cowes which this allowed.

7.46. Similarly, the introduction of new vessels-particularly by Wightlink on its Portsmouth routes, and by Red Funnel on its passenger-only services-has improved the quality of service. It would seem in the nature of ferry services that problems of poor punctuality and cancellation will arise in bad weather, with some types of vessel and berthing facility more vulnerable to such difficulties than others. Problems of interconnecting with rail services may also be unavoidable from time to time, although there may be scope for improved passenger information. All the operators, in our view, appear committed to providing a good service. The figures we have seen for punctuality and reliability would not suggest that overall performance can be regarded as unsatisfactory in these respects.

Profitability

7.47. As we discussed above, the complaint that fares on the cross-Solent services may be too high should in our view be considered mainly by reference to the costs and profitability of the services. Wightlink, the only current operator which is materially profitable, argued that its profits had been earned in conditions of effective competition, and that it had achieved increases in profits by increasing volume and efficiency as a result of investment in the services; investment which it described as driven by the perceived need to improve value for money of the services offered and sustain its competitive position in the market.

7.48. The profits earned on the Wightlink routes are shown in Table 4.3. Over the three Wightlink routes as a whole, profits (after depreciation on a replacement cost basis but before interest) rose from £4.1 million in 1986 to £8.3 million in 1989, and declined to £6.9 million in 1990. Profit as a proportion of revenue rose from 20 per cent in 1986 to 29 per cent in 1989, declining to 22 per cent in 1990. Sea Containers stated that Wightlink's profits are after deduction of group central costs allocated to the reference services, which increased from £1.2 million in 1986 to £2.5 million in 1990. These costs include, for example, finance and accounting systems; marketing, advertising and public relations; and sales force and reservations (see Appendix 4.1). They are allocated to Wightlink on the basis of turnover. Other costs, including overhead costs, are all directly incurred by Wightlink in providing the reference services.

7.49. On individual services, the Ryde-Portsmouth passenger-only route, where Wightlink is in direct competition with Hovertravel, was unprofitable in each of the four years 1986 to 1989, and broke even in 1990: Wightlink referred to the Ryde-Portsmouth service as a `public service'. The Fishbourne-Portsmouth service has been consistently the most profitable of the three services, with profit as a proportion of revenue of 27 per cent in 1990, whereas profits on the Yarmouth-Lymington service were some 21 per cent in that year. As discussed in paragraph 7.22, those two car ferry services face less effective competition from the longer Red Funnel service between Cowes and Southampton; capacity utilisation is also higher than for the Ryde-Portsmouth passenger-only service.

7.50. For a relatively capital-intensive business such as the cross-Solent ferry services, we would normally pay particular attention to return on capital employed (ROCE) in assessing profitability: the main alternative measure, return on turnover, is less appropriate for a capital-intensive industry which requires a higher operating margin on turnover to generate an adequate return on investment. In so doing, we would as a general rule consider the rate of return on the historical cost of the capital employed in the business-that is, the amount actually invested in the business. In a case such as the present where asset lives are long and historical cost returns are affected by the age of assets and the effect of inflation, it may be useful additionally to consider the ROCE at current replacement cost. Sea Containers told us, however, that it did not know how the historical cost book values of some of its assets, which had been taken over from British Rail, were related to each of the routes operated by Sealink at the time. It thus had no means of identifying the original cost of the assets used in the Solent ferries business.

7.51. Sea Containers instead put forward a figure of some £59 million capital employed, based on its current estimate of the depreciated replacement cost of the assets involved. We accept, as noted above, that the depreciated replacement cost method would in principle be a reasonable basis for assessing profitability. ROCEs on this basis are summarised in Table 4.4; over the three Wightlink routes taken together they increased from 6.6 per cent in 1986 to 15.5 per cent in 1989, but declined to 11.7 per cent in 1990. In 1990, ROCE on the Ryde-Portsmouth service was 0.1 per cent, on Fishbourne-Portsmouth 15.6

per cent, and on Yarmouth-Lymington 15.8 per cent. The asset valuations put forward by Sea Containers were not supported by formal valuation reports but the values attributed to the vessels (which account for about three-quarters of the gross replacement value of assets) did not appear to us to be unduly high, although, mainly because of the specialised nature of the assets involved, we were less able to form a view on the values attributed to the shore installations.

7.52. An alternative suggestion made by Sea Containers as to how profitability should be calculated for the purpose of this inquiry was that it should be based on the consideration of £90 million agreed between Sea Containers and Stena AB for the purchase back by Wightlink of the Solent ferries business when Sealink was sold by Sea Containers to Stena AB in 1990. Sea Containers initially attributed some £40 million out of the amount of £90 million to tangible assets, this being its opinion of their fair value at the time, the balance of around £50 million being attributed to goodwill. Subsequently, Sea Containers raised its estimate of tangible assets to about £59 million, to accord with the estimate it had provided of their depreciated replacement cost, with a corresponding reduction in the value of goodwill. We are not, however, persuaded that it would be correct to base the calculation of the return on capital on the total consideration of £90 million which includes a goodwill element. In our view this must have largely reflected Sea Containers' expectation of profit from the Solent ferries business. Its suggested approach would therefore introduce an element of circularity into the calculation. The consideration payable for a business would tend to increase in line with a purchaser's expectation of profit from its investment. The effect would therefore be that the higher the expected profits, the higher would be the goodwill, and the higher would be the capital base on which the return on capital was calculated if this method were used. The apparent return on capital would therefore remain constant.

7.53. Another measurement of profitability that we considered was to base the calculation of ROCE on the figure of tangible net assets of £41.6 million at 31 December (see Table 4.2), using the fixed asset values that Wightlink itself adopted in its draft 1990 accounts. As we show in Table 4.5, the ROCE on the Wightlink services as a whole on this basis would be nearer to 20 per cent than 12 per cent. Wightlink later told us, however, that the initial allocation of the overall price of £90 million between tangible and intangible assets had been arbitrary, without the benefit of the work done during the course of our inquiry on replacement costs. It now regarded the figure of £59 million as a more accurate assessment of the value of the tangible assets, and it subsequently amended the figure for tangible assets when the Wightlink accounts for 1990 were finalised. On balance, therefore, we are inclined to accept that the lower figure for tangible assets of £41.6 million would not be an appropriate basis for estimating ROCE.

7.54. As regards Sea Containers' calculation of the ROCE using its estimates of depreciated replacement cost, this, at about 12 per cent in 1990, is somewhat above the level which has been adopted in the regulation of low-risk public utilities, and indeed somewhat above those for the economy as a whole. The current cost rate of return for all industrial and commercial companies in the United Kingdom in 1990, for example, was estimated at some 7.8 per cent (but about 10 per cent on average over the previous five years). Arguably, indeed, a lower than average rate of return might be appropriate given that the purchase of ships can be financed by subsidised borrowings at fixed low interest rates. We doubt, however, whether the reference services should be treated as a form of a low-risk public utility. Those services now operated by Wightlink were initially sold, as part of Sealink, to Sea Containers without being subject to regulatory control as a surrogate for competition, and they remain subject to a greater degree of competition than most of the other utilities that have been privatised. Increases in revenue and in profitability have, moreover, been generated mainly by increases in the volume of business, for which Wightlink has invested heavily in additional capacity, rather than by any significant increases in average revenues relative to the RPI (as shown in Table 2.13).

7.55. A ROCE of about 12 per cent in these particular circumstances may be regarded as substantial and toward the upper limit of what may be regarded as reasonable for a company enjoying such a strong market position, but not so high as to be regarded as excessive or to justify regulatory intervention. We also noted, in paragraph 7.51, the higher rates of return of almost 16 per cent on the Yarmouth-Lymington and Fishbourne-Portsmouth car ferry services, whereas the passenger-only service between Ryde and Portsmouth only broke even. To some extent, this variation in profitability reflects the degree of competition on each of the three routes. However, given that the higher profitability of the car ferries has enabled the Ryde-Portsmouth route to be maintained as a public service, on balance we believe it is appropriate to consider mainly the rate of return for the Wightlink services as a whole.

7.56. The profitability of the Red Funnel services is shown in Table 4.9. The Red Funnel operation as a whole has recorded profits (after estimated current cost depreciation, but before interest) of £269,000 in 1986, £52,000 in 1987, £143,000 in 1988, £384,000 in 1989 and £61,000 in 1990. In historical cost terms, profit before interest has ranged between £1,005,000 in 1986 and £582,000 in 1990. Current cost profit as a proportion of revenue has ranged between 5 per cent in 1986 and 1989 and 1 per cent in 1987 and 1990.

7.57. As also shown in Table 4.9, Red Funnel's car ferries have shown a current cost loss before interest in three of the last five years, and a small historical cost loss in 1990. The hydrofoil services, which until summer 1991 faced little competition, have, on the other hand, shown a consistently increasing level of profitability on a current cost basis-from 8 per cent of turnover in 1986 to 21 per cent of turnover in 1990. Red Funnel believes that competition from Cowes Express and the purchase of the new catamarans will reduce profits in 1991 as, over the next few years, would the possible purchase of new ferries.

7.58. Red Funnel's ROCE has been relatively high on a historical cost basis, ranging between some 47 and 30 per cent over the last five years although the trend has been generally downwards. Also, these returns largely reflect the age, and the extent of depreciation, of assets nearing the end of their operating lives. In this case ROCE with vessels valued at net replacement cost represents in our view a more appropriate measure of profitability, particularly given the replacement of the hydrofoils by catamarans on the Cowes-Southampton passenger service and Red Funnel's admitted need to replace the car ferries in the next two years. On this basis, ROCE has ranged between 0.9 per cent in 1987 and 8.8 per cent in 1989, following which it declined to 1.7 per cent in 1990.

7.59. The third operator, Hovertravel, made a profit before tax of only £190,000 in 1990/91 over its activities as a whole, on capital employed of £2,838,000. On its cross-Solent hovercraft service it made profits before interest of £207,000 in 1989/90 and £270,000 in 1990/91, some 15 per cent and 17 per cent respectively as a proportion of turnover. Cowes Express, which operated only for a brief period in 1990 and recommenced services in July 1991, told us that it expected to make a loss for the first two years of its operation.

7.60. There is, therefore, in our view no evidence that Red Funnel or the smaller operators of the reference services are currently making substantial profits.

Barriers to entry

7.61. Several members of the general public and a number of companies raised with us the issue of barriers to entry into cross-Solent ferry services. Concern was expressed not only about the cost of entry, but also about the difficulty of securing access to port facilities, particularly when ports were owned by the established ferry operators, and about the lack of available sites should a new entrant alternatively wish to develop a new port. One cross-Channel operator, for example, told us that the problem of access to suitable ports was a near insuperable barrier for any would-be entrant into the cross-Solent vehicle ferry market. Some parties, indeed, raised access to ports as an issue of more general relevance to competition in ferry services. Our concern is, however, strictly limited to the cross-Solent services.

7.62. Wightlink argued that there are no serious barriers to entry, in respect of either cost or access to port facilities. On port facilities, it argued that the Solent was not unique as regards ferry operators owning ferry terminals, or having preference at them, reflecting the investments commonly made by ferry operators in the provision of linkspans and other essential port facilities.

7.63. As we have already noted, our inquiry coincided with the re-entry into the market of Cowes Express, the only new entrant to the market since the 1960s. The company's initial entry into the market in 1990, and its re-entry earlier this year, suggest that the cost of operating passenger services is not sufficient to deter a determined new entrant: the facilities required to operate a passenger service are relatively limited.

We were quoted estimates of the far more substantial cost of establishing car ferry services-in the order of £20 to £30 million-but understand that Cowes Express is also considering operation of such a service. Aside from an initial capital cost, entry is dependent upon access to existing port facilities, or a site and necessary permissions for development of new port facilities convenient for travellers.

7.64. As discussed in paragraphs 2.79 to 2.92, existing port facilities for the cross-Solent services are generally owned by the existing operators, or used by them under long leases. The port of Southampton is owned and run by Red Funnel's associate company, Associated British Ports (ABP), which is also the statutory harbour authority for the port with certain rights and obligations in connection with its management and the control of navigation. Red Funnel owns the freehold of the terminal and infrastructure at East and West Cowes. Wightlink owns the freehold of the landing stage at Portsmouth Harbour Station, and has a lease and operating agreement with Portsmouth City Council for the Gunwharf car ferry terminal. Wightlink is the statutory harbour authority for Portsmouth Harbour Railway Jetty, for part of Ryde Pier, for the terminal at Fishbourne and for Lymington Pier. It has a long-term commercial operating agreement for the use of the linkspan and marshalling area at Yarmouth, with first call on use of the berthing facilities. We were told that there was little or no spare capacity at peak times at any of the facilities currently used for car ferry services.

7.65. Our attention was drawn to the existing legislation for ports. Section 33 of the Harbour Docks and Pier Clauses Act of 1847 (which is usually but not always incorporated in local harbour legislation) establishes in the ports where it applies a general right of entry to the port and to the use of its facilities. ABP confirmed that this provision applies to its facilities at Southampton, but Wightlink told us that it did not apply to its facilities at Lymington, Fishbourne or Portsmouth Harbour. Section 31 of the Harbours Act 1964 provides for appeal on written application to the Secretary of State as respects ship, passenger and goods dues charged at statutory harbours; section 27 of the Harbours Act requires certain other charges of statutory harbour authorities to be `reasonable'. Wightlink and ABP confirmed that the 1964 Act applied to the port facilities they operated. In several cases elsewhere in the United Kingdom, use has been made of the right to appeal to the Secretary of State. The question of ownership by ferry operators of ports may indeed be of less relevance than the priority rights given to the existing users of a port facility, particularly at ports with little spare capacity, as evidenced by the difficulty of new entrants gaining access to facilities at ports not owned by ferry operators elsewhere in the United Kingdom. It was even suggested to us that new operators should be able to displace existing operators from their peak berthing facilities if there was little spare capacity for new operators, as is the case with many of the facilities used by the cross-Solent services. It is, however, only open to us to consider alternative means of allocating capacity of the ports used in the supply of the reference services should we find any relevant effects adverse to the public interest.

7.66. At the time of its first entry into the market in 1990, Cowes Express questioned the charges of over £500,000 sought for the use of facilities at Southampton for its passenger-only service. This compares with the current payment by Red Funnel to ABP of £500,000 per annum, of which about £100,000 relates to the Red Funnel foot passenger service. In part, the difference reflects the fact that the level of rents paid by Red Funnel was fixed several years ago, and we were told that ABP would seek a higher level of these charges when the current agreement expires. During the course of our inquiry, agreement was reached between Cowes Express and ABP on the terms for temporary use of Cowes Express' current facilities, and future use of more permanent facilities for operation of passenger services from Southampton. ABP also told us that it was considering proposals put to it by Cowes Express for use of additional facilities at Southampton for operation of a car ferry service. ABP confirmed that it would not be in a position to deny such facilities to Cowes Express, and that terms could be subject to appeal to the Secretary of State. Also during the course of the inquiry, Red Funnel obtained access to facilities at Portsmouth for operation of a new service from Cowes, and Cowes Express entered into negotiation with Wightlink for use of its facilities at Portsmouth for a passenger-only service from Cowes.

7.67. At present, therefore, there are, in our view, insufficient grounds to establish that control of ports has operated as a barrier to entry, or that the existing provisions of ports legislation are insufficient to allow access to ports on reasonable terms. If there were to be difficulties in the future, however, recourse to the remedies afforded by ports legislation may be required, or the possibility may arise of further investigation under competition legislation.

7.68. The number of sites available for development of new port facilities is limited-ABP, for example, controls some 80 per cent of frontage at Southampton-and cost of development would be high. A number of possible locations for new port facilities for cross-Solent ferry services were, however, identified to us by Wightlink and Red Funnel (see paragraph 2.95). Red Funnel is considering development of a new terminal for a shorter crossing to Cowes, and we understand Cowes Express has also examined alternative sites for new facilities on the Island.

7.69. The cost of entry (particularly for car ferry services), access to port facilities, and the availability of sites for new ports are in our view factors which in combination are likely to reduce the prospect of entry into the market. A determined new entrant may overcome such difficulties and, for example by greater flexibility in labour practices within the statutory requirements or by lower overheads, be able to operate more cheaply than the existing operators. Recent entry into the passenger-only ferry market has already improved choice, and brought lower fares on the passenger-only services between Cowes and Southampton, and there is a possibility of new entry into the car ferry market. However, we are doubtful whether the threat of entry into the market is itself sufficient to ensure that a dominant operator such as Wightlink is unable now, or in the future, to abuse its position.

Conclusions

7.70. The concerns of Island residents about the apparently high level of fares are understandable. We face, however, a situation where the smaller companies are making losses or moderate profits, with Wightlink's main competitor operating old and uneconomic ships on its car ferry route. In contrast, Wightlink has a major market share and enjoys a substantial level of profitability, based on efficient operation of modern ships on its principal route. In our view, however, neither its level of profitability nor its level of fares is sufficient in current circumstances to be regarded as against the public interest.

7.71. The level of fares is nevertheless, as we have pointed out, a matter of concern to the public. It is to be hoped that the conditions leading to the substantial profitability of Wightlink will themselves enable competition to thrive. The advent of Cowes Express has already increased the competition to which Red Funnel is subject, but without affecting Wightlink. Red Funnel itself has introduced a service to Portsmouth, but its success will depend on the extent to which Island passengers to Portsmouth will use Cowes rather than the traditional route from Ryde. Cowes Express has also made known its intention to operate from Cowes to Portsmouth. Any move by Red Funnel to operate car ferry services from a port facility closer to the Island than Southampton would no doubt have a greater impact on Wightlink. In our view, the interests of Islanders and other users are best served by such an increase in competition, which may then put pressure on fares levels, rather than artificially-imposed fares reductions which may drive out the competition that exists.

7.72. It is, however, too early to say whether the recent increase in competition will prove sustainable, or develop further. Competition with Wightlink cannot at present be regarded as strong and it remains the dominant provider of the reference services, a position which could be open to abuse. This is a matter of some disquiet as to the future, and there may be a need for further monitoring of Wightlink's fares and overall profitability.

7.73. Other aspects of recent performance have clearly been to the benefit of the users of the services, in particular the increase in the capacity and usage on most of the ferry services over time, the improvements that have been introduced to the services and the availability of cheap promotional fares. The operators will no doubt recognise it as in their own interests to continue to improve their services to meet users' needs and thus to alleviate some of the criticisms summarised in Chapter 5. There would be particular benefits from greater transparency of freight charges. We have not, however, found any current aspects of the services provided to be against the public interest.

7.74. Having considered carefully the matters discussed, particularly in paragraphs 7.70 to 7.73, and in pursuance of our investigation, we have found and conclude that:

(a) no steps are being taken by Wightlink or Sea Containers for the purpose of exploiting or maintaining the monopoly situation;

(b) there is no action or omission on the part of Wightlink or Sea Containers attributable to the existence of that monopoly situation; and

(c) there are no facts which operate or may be expected to operate against the public interest.

B C OWENS *(Chairman)*

L BRITZ

P K R MANN

J D MONTGOMERY

S N BURBRIDGE *(Secretary)*

13 December 1991