Studland Parish Council

Objection to proposed increase in certain toll charges by the Bournemouth – Swanage Motor Road and Ferry Company (February 2020)

April 15th[h] 2020

Contents

Summary

- The report by the Inspector into the 2018 toll increase application (Report DPI/G1250/18/10) proposed that the Secretary of State refuse to make a Tolls Revision order because he found that:
  - There was no confidence that the then proposed increases would be utilised to procure a new ferry, or that the ferry replacement reserve (FRR) would be safeguarded
  - The then proposed toll increases would lead to annual revenues greater than those needed for the Ferry Company to meet its statutory requirements

- Our contention is that the February 2020 application by the Ferry Company does not answer these issues:
  - The application by the Ferry Company shows no method for safeguarding funds for purchasing a new ferry: indeed, there are no guarantees shown to stop the Fairacres Group using cash generated by the Ferry Company to fund the other activities of the Fairacres Group, rather than creating a properly funded replacement reserve fund.

  - The underlying profitability of the Ferry Company over recent years remains very high, with profits before tax of 50%, and dividends payable to Directors of 25% of revenues: exceptionally high levels by any standard, and far greater than needed to meet its statutory requirements

  - The proposed method for toll increases – increases linked to RPI over a 12 year period up to a specified amount – remove all scrutiny over the Ferry Company's finances and operations: there is no guarantee that come 2032 the funds will be available; or that the Ferry Company will simply state that another date further in the future will need to be set because the funds had not been generated: e.g. because the Fairacres Group had transferred funds identified for the FRR to finance its other operations.

- Analysis of the Ferry Company and Fairacres Group finances show:

  - Tolls are already sufficiently high to enable the Ferry Company to meet its statutory requirements.

  - A more dedicated and secure method is needed for safeguarding the FRR: such as creating an escrow account or trust fund.

  - The assets of the Ferry Company should be revalued as they are currently set at an artificial, misleading and excessive amount (this is important in determining the actual return on net asset value), understating the returns quoted by the Ferry Company.

  - RPI is an incorrect measure to use – as the Government is about to modify it and will be utilising CPIH, which consistently reports a lower level of inflation to RPI.

    - In addition, as is the practice in most regulated businesses, funding of the new proposed ferry should primarily come from third party funding, so that it is the future users – rather than the current – who will be paying. The Fairacres Group needs to re-examine its capital structure to enable this. It has plenty of time in which to do so over the next 10 to 12 years. This further indicates no need to raise fares at this stage.

- We therefore object to the toll increase application and argue that current toll levels are – as stated in the 2018 Inspectors report – more than adequate to enable the Ferry Company to meet its statutory requirements to operate the ferry and meet its running costs, plus allocate sufficient funds to a dedicated FRR.

We therefore call on the Secretary of State to reject the application from the Ferry Company, and to refuse to make a Tolls Revision order

Supporting comments and analyses

1. 12-year projection of toll increase levels and company finances:

Our objections to the 12-year period are that:

- It removes scrutiny of the Ferry Company's plans and finances for 12 years: we would be unable to see if the Ferry Company was creating a proper reserve fund for a new ferry, or simply using the cash generated for this purpose to fund other parts of the Fairacres Group business, as has happened throughout the past following previous toll increase applications

- Come 2032 the Ferry Company may say they do not have the finances available for a new ferry, and simply give yet another date for its replacement: e.g. 2040. Remember that the depreciation period of the ferry was originally set at 23 years and is now set at 40 years. What confidence is there that the Ferry Company will not continue its past policies?

- A 12-year projection is a meaningless spread sheet exercise where most assumptions are likely to change materially over the time frame. A five-year set of projections with Best, Worst and Most Likely outcomes and a clear and rational set of assumptions behind each would be much more meaningful in terms of determining what might be a realistic and sustainable set of future financial operating results

- ***Proposal:*** reject the 12 year period of review; instead request a shorter period, no longer than 5 year**s**

2. Ferry Reserve Fund (FRR):

- The Ferry Replacement Reserve (FRR) stood at £2.496m in 2008. Since then the Ferry Company has justified various toll increases to fund the increase in the reserve. What has happened to the revenues generated by the higher fares? We know that the Ferry Company has utilised the increases to fund exceptionally high levels of profitability, exceptionally high levels of dividends, and to subsidise other parts of the overall Fairacres Group. The Ferry Company should now fund the FRR with all the promised contributions to the FRR, backdated, going back at least 12 years to 2008.

- Ferry replacement reserve (FRR): this is a meaningless and arcane accounting concept. Unless there are restrictions in terms of distributions of the shareholders' funds apportioned to the FRR that are incorporated into the Articles of Association of the Company (to the extent they can be), there is nothing to stop these funds being paid to shareholders by a future Board of Directors.

- Escrow account/trust fund : if any form of prefunding of a new ferry is to be considered within the Company through a FRR, or similar, it should be on the basis that an asset should be ringfenced rather than a meaningless proportion of shareholders' funds. The most_effective way of doing this would be to place the designated funds, in cash, in each year into a trust fund. The trustees of the trust fund could be appointed from the local community or a professional trustee company used e.g. Law Debenture. Assets of the fund would be invested through a leading fund manager in Sterling investment grade corporate bonds with a maturity matching the ferry replacement date i.e. 2032.

- ***Proposal*:** mandate that the Ferry Company create an Escrow account, or Trust Fund, under scrutiny, as indicated above, as real protection for the Ferry replacement fund.

3. RPI / CPIH:

We have two objections to the proposal to link increases to the level of RPI:

- If it were appropriate to apply any indexation, CPIH not RPI should be used. RPI is to be downgraded by the UK Statistics Authority following review by the Lords Economic Affairs Committee in January 2019 (see https://www.parliament.uk/business/committees/committees-az/lords-select/economic.) and recommendation to the Chancellor of the Exchequer, which he has accepted. RPI is considered to be an inappropriate measure of inflation. CPIH is usually between 0.7% pa and 0.8% pa below RPI. Regulators such as Ofgem have switched from RPI to CPIH.

- The Ferry Company total operating costs represent only about two thirds of revenues: it is therefore inappropriate to link RPI increases: only half of the increase can be justified to fund increases in operating costs. Therefore, if the RPI or CPIH were 3%, the justifiable increase can only be 2.0%

- ***Proposal*:** reject RPI in favor of CPIH

4. Asset re-evaluation:

- The Ferry Company argues that annual return on net asset value is an important measure of the financial viability of the business as an investment opportunity. However, our view is that the net asset value has been artificially inflated by the company and needs a revaluation.

- Asset valuation: the assets should be valued on a replacement cost, alternative use or third-party sale basis. The value of land, roads and slipways is shown on the 2019 accounts at £11.5 million versus a cost figure of £140,000. At the public inquiry in 2018, a construction engineer opined that the cost of re-building the road to the ferry should be no more that £3 million. It is difficult to see how the balance of the assets can possibly equate to £8.5 million.

- ***Proposal:*** commission appropriate professionals to conduct an independent review of the value of assets of the Ferry Company.

5. Bond yields:

- In para 3.3.2 of their submission the Ferry Company quote Ibbotson and Associates as stating that annual average returns on low risk bonds is 6.1%. The Ferry Company argues that they should have a higher rate of return for running the ferry. However, in today's markets, 6% is an unrealistic expectation, and a figure closer to 4 - 5% is more realistic. Regulators such as Ofgem and Ofwat have opted for a weighted average cost of capital (WACC) as the appropriate measure for calculating allowed revenues for regulated assets.

- ***Proposal*: **utilise WACC as the appropriate measure for calculating allowable revenues

6. Funding of replacement ferry:

- A major question is: who should fund a new ferry? Existing passengers, or the future ones who will benefit from a new ferry?

- Financing a replacement ferry – our understanding is that under its Acts of Parliament, the Company can borrow up to £5 million. This would represent some 40% of the projected cost of a new ferry in 2032, or around 60% of the cost if it was replaced over the next couple of years. This borrowing should be capable of being provided by bank or lease company finance despite Handelsbanken's comments to the contrary if appropriate security arrangements are put in place.

- Given that the borrowing limit in the Acts of Parliament were set many years ago, there should be no inherent reason why the Acts of Parliament could not be amended to allow for a higher borrowing limit – they have been amended twice in the past and there is plenty of time to do so before the proposed replacement date as well as justification i.e. the increased cost of ferry replacement due to inflation.

- In its proposals for a toll increase the Company has said '*The Ferry Company owners have committed voluntarily to ensuring the Ferry Company is loaned the required funds when required and to acquire and bring into operation a suitable, newly built replacement vessel for the current ferry, Bramble Bush Bay, by the time it reaches the end of its useful life'*. It is thus unclear why any pre-funding is required now or immediately before the new ferry is ordered.

- If the current capital or borrowing structure of the Fairacres Group does not support third party financing of a new ferry for some reason, then it should be reconfigured to make sure that it does – again there is plenty of time to do this in advance of the proposed ferry replacement date. There is no reason why users should pay for an inefficient capital structure or provide cross subsidies for other businesses within the Fairacres Group. The equity required for a new ferry should be provided by the equity holders, who should be rewarded appropriately when they have invested the capital but not before.

- If the current Directors are unwilling to commit the necessary funds for a new ferry, then new investors should be given that opportunity, if necessary, under new management and ownership. The Ferry Company is highly profitable and would be very attractive to investors.

- ***Proposal*: **the primary source of funding the new ferry should be borne by future users, and not the existing users, and should come from borrowing (as with other regulated companies).

7. **Dividends and Profitability:**

Appendices 4.1 and 4.2 of the Ferry Company submission show:

- Profitability after tax to be exceptionally high: an average of 19.1% over the 12-year period to 2032 if no toll increases are applied, and 36.9% over the 12 year period to 2032 if toll increases are applied

- Dividends also to be exceptionally high, equivalent to one-quarter of all revenues: they will be an average of 26.8% of turnover over the 12-year period to 2032 if no toll increases are applied, and 23.6% over the 12-year period to 2032 if toll increases are applied

- We believe the forecast levels of dividends as a percentage of total net assets to be understated: they are shown to be 5.5% p.a. with no toll increase, and 4.9% p.a. if there is a toll increase. However, we believe that a revaluation of net assets would show them to be grossly overstated: the assets should be valued on a replacement cost, alternative use or third-party sale basis. The value of land, roads and slipways is shown on the 2019 accounts at £11.5 million versus a cost figure of £140,000. At the public inquiry in 2018, a construction engineer opined that the cost of re-building the road to the ferry should be no more that £3 million. It is difficult to see how the balance of the assets can possibly equate to £8.5 million. If assets were to be more correctly revaluated to a lower level, then dividends as a per centage of net assets will appear much higher.

- ***Proposal*****:** the profitability of the Ferry Company shows there is no need for an increase in tolls for it to meet its statutory objectives.

8. **Environmental concerns: Diesel versus Electric**

- The Ferry Company does not make it clear whether a replacement ferry would be electric, electric diesel, or diesel. One of its papers (CF Bramble Bush Bay: Planned Maintenance and Replacement Costing) dated 28th March 2019, discusses some of the pros and cons of the various options.

- The issue is: given the Government's objectives of reducing the volumes of CO2 gases and going carbon neutral, plus Dorset Council's declaration of a Climate Emergency, any option for a replacement ferry that includes any aspect of diesel cannot be conceivable. It would be a very strange situation if drivers, compelled by the Government to move to non-petrol / diesel vehicles, had to board a diesel driven ferry.

- We call on the Ferry Company to make a clear and unambiguous statement that a replacement ferry would have no petrol or diesel component, and that its emissions would be in line with Government and Dorset Council targets.

- ***Proposal*****:** the Ferry Company must commit to the new, replacement ferry having zero / very low emissions, most likely to be gained by being electric and not diesel or petrol

9. Sandbanks Ferry Ticket Card (SFTC) / Passes

- There is a significant difference in types of users of the ferry: on one hand, there are residents of Studland and the wider Isle of Purbeck (and businesses based there) for whom the ferry is an *essential* means of transport to reach Poole, Bournemouth and beyond, for work, for shops, for hospitals, etc; and then there are tourists / day trippers, for whom use of the ferry is *discretionary*.

- We welcome the extension of the book ticket scheme which enables local residents and businesses to buy numbers of books of tickets at discounts. However rather than extending this scheme, at current prices, to only April 2021, we argue that it is necessary that current discounts and prices are extended to the end of the current toll increase application process: i.e. to 2032. This is because the use of the ferry is essential: it is not a "nice to have". The only alternative to the ferry for Studland residents is the long drive round Poole Harbour via Wareham, which is more costly, more time consuming, and more environmentally unfriendly.

  An example of an alternative to an extension of the book ticket scheme is provided by the Dartford – Thurrock toll. This enables local residents unlimited journeys for £20 a year. The details of the scheme are available on the internet: see Dartford Crossing local residents' scheme. Discounts are available for locals who are resident and pay council taxes to either Dartford Borough Council or Thurrock Council. The discounts are for one vehicle only; evidence must be provided: e.g. documents of ownership (V5C), vehicle details, a current Council tax bill that matches the address of the application, recent utility bills.

  Proposal: to extend the current book scheme at today's prices to 2032; or to introduce a scheme similar to the Dartford Crossing residents' discount scheme.

Appendix 1: Discounts for local residents: the Dartford Crossing

Use of the ferry is essential for local residents in Studland – for access to work, hospitals, shops, etc. in Bournemouth and Poole: it is not a “nice to have”. An option to extending the current book bulk buying scheme to 2032 is provided by the Dartford Crossing (see https://www.gov.uk/pay-dartford-crossing-charge/charges).

Local residents in Dartford and Thurrock can either:

- Pay £20 a year to use the Dartford Crossing as many times as they like
- Pay £10 for 50 crossings, plus 20p for each additional crossing

This is instead of the normal fare of £2.50 a time for each crossing.

To obtain these discounts, local residents must set up a standard or commercial account showing:

- Their personal details, or company details
- Details of each vehicle being registered
- A debit or credit card

Discounts are given for only one vehicle; applications are online and require

- Vehicle details
- A current Council Tax bill that matches the address of the application
- Proof of residence in Dartford or Thurrock e.g. gas or electricity or water bills that are less than 3 months old, bank or credit card statements that are less than 3 months old, income support book, rent document, or driving licence
- Proof your vehicle is registered in Dartford or Thurrock e.g. copy of V5C vehicle registration
- Debit or credit card

Appendix 2: **How does the financial circumstances of the Fairacres Group Ltd impact on the Ferry company?**

We have assessed the financial situation of the Ferry company and its relationship with the owner - the Fairacres Group Ltd (FG). It is felt that the ferry company is being prejudiced by the other business activities of the owner. In order to undertake this analysis, we have summarised the trading results of both undertakings for the years from 2008 – 2019. We have gone back to 2008 as at that time the Directors of FG decided to diversify and consider other business opportunities in addition to the ferry and its property interests.

We have obtained information as follows:

- Companies House for the accounts of Fairacres Group Ltd
- Ferry accounts are not in the public domain so the headline net profit before tax (NPBT) has come from the FG Directors Report.
- Dividends paid by the Ferry company since 2012 have come from information submitted to the Public Inquiry in 2018**.**
- Have estimated 2008 – 2011 dividends highlighted in yellow on the attached document.
- Have assumed that Corporation Tax paid by Ferry company at 32% - being average rate paid by the Group over the years.
- Have assumed that Ferry company did not pay a dividend for 2019 as per recent public comments.

The history of the Ferry dates back to 1923 when the company was incorporated by Act of Parliament. It is well documented, and it is not proposed to reproduce it here. The current vessel went into operation in Jan 1994 and was taken out of service bi – annually for maintenance – described as a refurbishment year. This had a significant effect on the financial results of the Ferry as the accounts suffer a loss of revenue for the period out of service, as well as the costs of repairs. This is highlighted in the summary (see table) of the trading of FG over the years.

In the years up to 2008 FG had traded on a cautious basis and built up a substantial cash balance of £11M. The Directors Report of that year highlighted difficult trading exacerbated by substantial slipway repairs being commissioned. The Directors stated that they would seek other investment opportunities. The financial results for 2009 showed the Ferry making a loss of £1.9M primarily because of repairs and improvements to the slipways. During the 2010-year FG mortgaged their investment properties and obtained an £8M loan. This was quite unusual in that it was an interest only loan with no visible provision for capital repayments. In the 2011 financial year a subsidiary of FG acquired The Bedford Lodge Hotel for £13M. In the following years FG extended and refurbished this hotel at a cost of £6M. At the end of the 2018 financial year a further hotel was acquired for £4M.

Regrettably the hotel division of FG (Review Hotels Ltd) has not been profitable - as at the end of the 2019 financial year it had accumulated losses of £867K in the 8 years of operation. **The Directors state that they plan to refurbish and extend the new site in the near future.**

The consequence of this £23M diversification into the hotel business is that FG has borrowings of £12.6M at 31st March 2019 and incurred interest costs of £304K. In the 2019 financial year the Group made a pre-tax loss of £507K.

The analysis of the financial results for the past 12 years show that the Ferry has paid FG dividends of £7M whilst making profits after tax of only £4.8M. This shortfall has been enabled by utilising the Ferry Replacement Reserve together with the depreciation charged on the vessel. These funds have gone to subsidise the other activities.

In addition, the Ferry pays FG management charges which have steadily increased. In 2018 these were £158K.

In analysing the financial results, it shows clearly that the activities **excluding** the Ferry have moved from a profit to a loss with the transitional year being 2014 when a loss of **£358K** was incurred. This increases to **£512K** in 2019.

The financial pressure must also be behind the changes in the ferry repair programme. Up until 2017 there was a **bi – annual refurbishment**. The Directors Report for 2017 states that Ferry turnover was maintained at £3.05M as a result of not taking the Ferry out of the water for a full refit. Consequently, costs were also contained, and profitability maintained.

The 2018 Directors Report of FG refers to repairs being carried out to the Ferry at a reduced level. Profitability was maintained.

The 2019 Directors Report states that repair work on the ferry was extensive and involved the ferry being out of the water for an extended period as part of the **four-yearly cycle** of refit works. Profit before tax was only £5K compared to £1,483M. To summarise the ferry was out of the water in November 2014 and then November 2018. Four years between major re-fits to improve profitability.

There has been changing views on the ferry's expected life span. Starting in 1996 at 23 years (expiring 2017) and ending up in 2019 at 40 years (expiring in 2034). The ferry vessel has been periodically revalued along the way to increase the value of the company.

Conclusions

- The revenues from the ferry company have been used to support the other business activities of FG.
- FG have failed to make provision for the replacement of the ferry vessel putting the payment of dividends to themselves as the priority.
- In 2008 FG had £11M available but chose to incur significant borrowings as preparation for diversification. They then expended £23M on non - profitable hotel operations. This sum would have purchased several ferries.
- The pursuit of profit from the ferry caused the planning of repairs to be revised. This must have contributed to the unreliability of the vessel and caused great distress and financial loss to the residents and commercial undertakings in the Purbecks during 2019 when the ferry service was suspended for nearly 6 months.
- The Directors of FG admitted at the 2018 Public Inquiry that they placed the payment of dividends to themselves ahead of making provision for a new ferry. The Inspector stated that this was not tenable and was critical of this process.
- The constant revaluation of assets is used to justify ever higher dividends. This is a flawed and circular process. The assets are also overstated as it includes the value of the right to the income arising from operating the ferry.
- The Ferry Company has stated that they can borrow £5M to assist ferry replacement. However, it states that it could take many years to earn the balance. As the ferry is profitable

when operating normally, we do not understand this comment. If the ferry is purchased outright there will be significant repayments of Corporation Tax which will assist the funding.

Appendix 3 : Fairacres Group and Ferry Company financials 2008 - 19 : see attached excel document