Response of

to

the CC's profitability analysis

6 April 2013
[✂]

1. Executive summary

Introduction

1.1 This response sets out BMI's initial views on the Competition Commission's (the "CC") calculation of the return on capital employed ("ROCE") of BMI's Core Hospital Business (referred to as "Acute ex-NUK" business by the CC). The remainder of the BMI Group, comprising Care Fertility and Transform is referred to as the "Excluded Businesses".

1.2 We consider that the CC has made errors in its calculation of the EBIT and capital employed figures that it uses to determine ROCE. As a result, the CC's calculation of ROCE materially overstates the profitability of the Core Hospital Business. We provide a summary of each of these errors below and provide an updated version of the "*Confidential BMI profitability model*" prepared by the CC (the "CC Model") to allow the CC to review the adjustments that we have made and the calculations set out in this report.[1]

The CC's calculation of EBIT

1.3 The CC has used the financial information provided to it by BMI to calculate its EBIT. In doing so, however, the CC makes a number of arithmetical and conceptual errors. In summary, the CC incorrectly:

- calculates and allocates central costs;
- excludes some rent paid to third parties;
- assumes that expenditure on intangible assets was included in the calculation of EBITDA;
- calculates equipment depreciation;
- states the level of intangible asset amortisation in each year;
- includes profits from investments in associates, when they should be excluded; and
- excludes warehouse costs.

1.4 The table below sets out our initial calculation of EBIT and the difference between our calculation and the CC's. At this stage, given the limited time available and the significance of the errors identified below, this calculation does not constitute a final view as we may subsequently identify other costs that the CC has incorrectly stated or further errors that may affect the calculation of EBIT.

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[1] This updated model is attached as Exhibit 1 to this response.

Table 1-1: The effect of BMI's initial adjustments to the CC's calculation of EBIT

£000	FY2007	FY2008	FY2009	FY2010	FY2011
CC's calculation of EBIT	[✂]	[✂]	[✂]	[✂]	[✂]
BMI's calculation of EBIT	[✂]	[✂]	[✂]	[✂]	[✂]
Difference	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

1.5 The CC's MEA approach seeks to consider the costs of a new entrant.[2] Therefore, the CC should have considered whether BMI's operating costs in the relevant period provide a reasonable reflection of the operating costs that a new entrant would incur, including significant start-up costs. We consider that BMI's operating costs in the relevant period are not a reasonable reflection of the costs that a new entrant would incur. Consequently, BMI's costs in FY 2007 to FY 2011 are unlikely to provide a reasonable estimate of an entrant's long run average costs and further downwards adjustment to EBIT would be required under the CC's MEA approach. However, we have not sought to address this in detail in this response.

The CC's calculation of capital employed

1.6 We also consider that the CC has materially understated the value of the capital employed in the Core Hospital Business. This is due to the CC making both arithmetic and conceptual errors in its assessment. We have made some initial, conservative adjustments to the asset values the CC has used in its calculation of capital employed, however, we have not been able to quantify precisely all asset values at this point. In summary, the CC:

- makes an error in its calculation of average net working capital;
- very significantly undervalues BMI's land and buildings;
- undervalues intangible assets; and
- takes an extreme position when it excludes all purchased goodwill.

[2] The CC has adopted an MEA approach to the valuation of assets. We consider that an MEA approach requires a consideration of both the value of assets and the level of operating costs. Hence, the CC's approach is incomplete, because it has not considered an MEA level of operating costs. We discuss the CC's MEA approach in more detail in Section 3 below.

1.7 The table below sets out the effect of our initial adjustments to the CC's calculation of the capital employed. We note that our adjustment is conservative[3] and does not include an allowance for goodwill, or for intangibles apart from those permitted by the CC.

Table 1-2: The effect of BMI's conservative initial adjustments to the CC's calculation of capital employed, excluding goodwill and intangibles

£000	FY2007	FY2008	FY2009	FY2010	FY2011
CC's calculation of capital employed	[✂]	[✂]	[✂]	[✂]	[✂]
BMI's calculation of capital employed	[✂]	[✂]	[✂]	[✂]	[✂]
Difference	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

1.8 The table below sets out the effect of our conservative initial adjustments to the CC's calculation of the capital employed, but with the addition of 25% of the net book value of purchased goodwill.

Table 1-3: The effect of BMI's conservative initial adjustments to the CC's calculation of capital employed, including 25% of BMI's purchased goodwill

£000	FY2007	FY2008	FY2009	FY2010	FY2011
CC's calculation of capital employed	[✂]	[✂]	[✂]	[✂]	[✂]
BMI's calculation of capital employed	[✂]	[✂]	[✂]	[✂]	[✂]
Difference	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

The CC's calculation of ROCE

1.9 The table below sets the impact of the initial conservative adjustments we have made to EBIT and capital employed to the CC's calculation of ROCE.

[3] This calculation is conservative because we have only adjusted the top 22 (i.e. approximately 50%) of BMI's freehold hospitals in our estimate of land and building value based on recent comparable market transactions. See Section 3 below.

Table 1-4: The effect of BMI's conservative initial adjustments to the CC's calculation of ROCE

£000	FY2007	FY2008	FY2009	FY2010	FY2011
CC's calculation of ROCE	[✂]	[✂]	[✂]	[✂]	[✂]
BMI's calculation of ROCE (excluding goodwill)	[✂]	[✂]	[✂]	[✂]	[✂]
BMI's calculation of ROCE (including 25% of goodwill)	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: Table 1-1, Table 1-2 and Table 1-3 above.

1.10 Our analysis indicates that the CC has overstated the Core Hospital Business' EBIT and understated its capital employed. As a result, the CC has very significantly overstated ROCE for the relevant time period. After correcting EBIT for errors and making conservative adjustments and corrections to capital employed, our calculation of ROCE is less than [✂] of the CC's calculation, even excluding all purchased goodwill. A conservative analysis therefore clearly demonstrates that BMI's profitability is very significantly lower than the CC's calculation in its Profitability Working Paper.[4] Indeed a conservative calculation clearly indicates that BMI does not make excessive profits.

[4] Private healthcare market Investigation, CC, dated 1 March 2013 (the "Profitability Working Paper").

2. The CC's calculation of EBIT

Introduction

2.1 In this section, we consider the CC's calculation of EBIT for BMI's Core Hospital Business. We have found that the CC makes a number of errors. These errors include the miscalculation or misallocation of certain costs, the incorrect exclusion of certain costs and the incorrect inclusion of certain profits.

2.2 This section is organised as follows. First, we summarise the CC's calculation of EBIT. We then adjust the CC's EBIT calculation to correct for errors. We then restate the CC's calculation of BMI's EBIT.

The CC's calculation of EBIT

2.3 The CC has calculated EBIT figure using financial information provided to the CC by BMI.[5] Below, we summarise how the CC has performed its EBIT calculation.

2.4 The financial information provided to the CC by BMI in Annex 4 of the response to the CC's Financial Questionnaire ("Annex 4") is prepared on a hospital-by-hospital basis. The revenues and costs for each hospital, the Excluded Businesses and central functions are provided separately, so it is possible to calculate the EBIT figure for the Core Hospital Business with relative ease. However, care needs to be taken to ensure that all other relevant costs, such as the correct level of central administrative costs, are included in the CC's calculation of EBIT.

2.5 The CC's calculation is based on the unadjusted earnings before interest, taxation, depreciation, amortisation and rent ("EBITDAR") for the Core Hospital Business taken from Annex 4.[6] From the unadjusted EBITDAR figure, the CC deducts rental costs associated with the Core Hospital Business and adds in profits from associates to arrive at unadjusted earnings before interest, taxation, depreciation and amortisation ("EBITDA"). The CC then adjusts this EBITDA figure to include an allocation of central costs to generate an adjusted EBITDA figure. The CC then deducts depreciation and amortisation expenses (which it has adjusted from the financial information provided by BMI) to arrive at the earnings before interest and taxation ("EBIT") figure used in the ROCE calculation.

2.6 The table below reproduces the CC's calculation of the Core Hospital Business' EBIT used in its ROCE calculations for FY 2007 to FY 2011.

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5 This financial data forms the basis of BMI's audited financial statements.

6 In Annex 4 and the CC's Model, the figures used for the Core Hospital Business are referred to as "Acute ex NUK". See Annex 4 worksheet "Profit & Loss". This has been transposed to the worksheet "Consol. P&L" in the CC Model.

Table 2-1: The CC's calculation of the Core Hospital Business's EBIT

	FY2007	FY2008	FY2009	FY2010	FY2011
Core Hospital Business's revenue	[✂]	[✂]	[✂]	[✂]	[✂]
Cost of sales (excluding depreciation/amortisation	[✂]	[✂]	[✂]	[✂]	[✂]
"Acute ex-NUK", or unadjusted EBITDA	[✂]	[✂]	[✂]	[✂]	[✂]
Central costs adjustments	[✂]	[✂]	[✂]	[✂]	[✂]
Rent added back	[✂]	[✂]	[✂]	[✂]	[✂]
Expenditure on intangible assets	[✂]	[✂]	[✂]	[✂]	[✂]
Adjusted EBITDA	[✂]	[✂]	[✂]	[✂]	[✂]
Adjusted depreciation	[✂]	[✂]	[✂]	[✂]	[✂]
Adjusted EBIT	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model; Annex 4.

2.7 The CC has assessed the profitability of the Core Hospital Business, which excludes income and expenditure related to Transform, Care and other "non-core" operations. In making adjustments to derive EBIT, the CC has made a number of errors.

2.8 At a high level, we note that the CC's approach effectively assumes that the Excluded Businesses are loss making at an EBITDAR level, as shown in the table below. On the contrary, BMI considers that the Excluded Businesses are in fact profitable.[7] On this basis, we consider that there must be errors in the CC's approach.

Table 2-2: Comparison of the implied EBITDAR of the Excluded Business and the Core Hospital Business

£000	Total	Core Hospital Business	Excluded Businesses
Revenue	[✂]	[✂]	[✂]
EBITDAR	[✂]	[✂]	[✂]

[7] See for example [✂]

Source: the CC Model.

2.9 We consider the CC's assessment of EBIT on a line-by-line basis below, before considering briefly the time period over which the CC has performed its investigation. However, we have not considered this latter point in detail, which may prove to be significant.

Central costs

2.10 The CC's unadjusted EBITDA figure for the Core Hospital Business does not contain central costs. Central costs have to be deducted to derive EBIT. The CC has taken the "Acute ex-NUK" unadjusted EBITDA figure and deducted an amount for central costs. These central costs relate predominantly to the labour costs of staff in BMI's head office. During the relevant period, these staff were required for the operation of the Core Hospital Business; they had no role in the Excluded Businesses, which operated on a standalone basis.

2.11 We agree that central costs need to be deducted from the EBITDA figure to calculate EBIT. However, we disagree with the amount of central costs that the CC has allocated to the Core Hospital Business.

2.12 The CC makes two adjustments to total central costs that it deducts from EBITDA, which are respectively incorrect and inappropriate. First, the CC incorrectly calculates total central costs for the whole BMI Group (i.e. the Core Hospital Business and the Excluded Businesses) by deducting central rental costs from the central costs figures provided by BMI. Second, it inappropriately - given the fact that all these costs are incurred by the Core Hospital Business - allocates this adjusted central costs figure between the Core Hospital Business and the Excluded Business in proportion to revenues. We consider each of these points in further detail below.

First error, incorrect deduction of rental costs from central costs

2.13 The CC calculates total central costs for BMI Group by removing central rental costs from the central costs figures provided by BMI. In FY 2011, for example, the CC takes the total central costs of £[✂] contained in the worksheet "Unit EBITDAR" in the CC Model and deducts £[✂] of central rent costs as included in the worksheet "Unit rent" in the CC Model. The CC calculates a total "Adjusted Central Cost" of £[✂] for BMI Group in FY 2011.[8]

[8] [✂]

2.14 It is unclear why the CC deducts rent from central overheads, because the central costs figure used by the CC is from an EBITDAR calculation that excludes rent.[9] Therefore, rental costs should not have been removed from central costs because the central costs figures used by the CC do not actually include rental costs for the central corporate function (i.e. these costs are not included in EBITDAR).

2.15 We also consider that rent represents a real cost to BMI, reflecting the cost of BMI's headquarters.[10] It is a cost paid to a third party. The CC accepts that rents paid to third parties should be allowed.[11] Hence, this cost should be added to central overheads.[12]

2.16 The correct calculation is as follows. In 2011, total central costs should be £[✂] plus £[✂] (i.e. £[✂]). The CC's calculation of £[✂] less £[✂] (i.e. £[✂]) is wrong. In conclusion, the CC has wrongly excluded rental costs from its calculation of central costs.

2.17 We note that there has been some fluctuation in the central rental charge between FY 2007 and FY 2011. These fluctuations can be explained as follows:

- in FY 2007 a credit of c.£ [✂] in relation to an office move was received and recorded in the rent account;
- in FY 2008 the rent payable to the NHS on certain sites was booked through head office rather than in the site P&L (therefore increasing the central rental cost, but lowering it at individual hospital sites); and

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9 EBITDAR stands for earnings before interest, taxation, depreciation, amortisation and rent. Annex 4, worksheets "EBITDAR" and "Rent", row 122. The rental figure deducted by the CC from EBITDAR is that provided in row 94 ("Acute ex-NUK") of worksheet "Unit rent" and the central rental costs are below this line and not included in the rental figures used by the CC.

10 [✂]

11 Profitability Analysis of Private Hospitals planned Methodlogy", CC, dated 7 November 2012 (the "Profitability Methodology"), paragraphs 67 and 68.

12 Even if the CC were to resist the inclusion of rental charges – which would be inconsistent, it has inappropriately deducted rental charges from a figure that excludes rental charges.

- In FY 2011 part of the rent charge relating to the 3rd party leases for [✂] was recorded in the head office P&L rather than in the site P&L (again, increasing the central rental cost, but lowering it at site level for these two hospitals).

2.18 Stripping these adjustments out would lead to a relatively flat rental charge per year for central costs, as would be expected. All of these costs and credits relate to the Core Hospital Business and therefore should be included in the Core Hospital Business cost base. The reason for the variation in the rental figures is purely due to management's presentation of these costs in central costs, rather than on a hospital by hospital basis.

Second error, an inappropriate allocation of central costs

2.19 The CC accepts that central overheads need to be included in its calculation of the Core Hospital Business' EBIT. The CC apportions central costs between the Core Hospital Business and the Excluded Business in proportion to respective revenues. This equates to approximately [✂]% of central costs (after the incorrect rental deduction discussed above) being allocated to the Core Hospital Business. This figure is then deducted in the CC's adjusted EBITDA calculation. In 2011, the CC calculates a central cost of £[✂] for the Core Hospital Business and reduces EBITDA by this amount.[13]

2.20 The CC has not provided its rationale for allocating central costs in proportion to revenue. The key fact to appreciate is that the Excluded Business is completely separate from the Core Hospital Business. In particular, the Excluded Businesses have their own central costs, which are not included in the central cost figures used by the CC. The entities that comprise the Excluded Business have their own management teams and support structures. They do not receive any support or services from the BMI central support structure, with the exception of some non-executive director representation (which constitutes a tiny fraction of central costs). Indeed, this situation is plainly illustrated by the fact that Care Fertility has now been sold and Transform has been de-consolidated and there has not been a material change to the quantum or activities being undertaken by BMI centrally. Put differently, central costs are incurred to provide centralized services to BMI hospitals and so are all unavoidable costs of the Core Hospital Business.

2.21 The consequence for the analysis of this factual position is that no central costs should be allocated to the Excluded Business and instead the full 100% of BMI's central costs should be properly allowed for in the CC's ROCE calculation for the Core Hospital Business.

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[13] £[✂]

Conclusion on central costs

2.22 The table below sets out our restatement of central costs and the adjustment required to correct the CC's calculation of EBIT used in its ROCE calculation.

Table 2-3: BMI adjustment to the CC's calculation of central costs

£000	FY2007	FY2008	FY2009	FY2010	FY2011
The CC's calculation of central costs	[✂]	[✂]	[✂]	[✂]	[✂]
BMI calculation of central costs	[✂]	[✂]	[✂]	[✂]	[✂]
Adjustment to EBIT required	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

Rent added back

2.23 The CC has excluded rental payments made by the Core Hospital Business for the lease of the [✂] and the [✂] (numbers [✂][14] The CC has not explained why it has excluded these rental payments.

2.24 The CC's methodology allows for rental costs made to third parties because the value of the assets is not included in capital employed for the purposes of the ROCE calculation.[15] The rental payments for both of these sites are made to third parties. The rental payments relate to the leased part of each site and not the freehold element.

2.25 Put simply, the CC has capitalised the asset value of the freehold sites in its calculation of capital employed and has not capitalised the rental values relating to the leased sites. It is incorrect to exclude these payments from both EBIT and capital employed.

[14] As indicated in the worksheet "Freehold & leasehold" of the CC Model, these sites are leased from [✂] and [✂] respectively.

[15] CC Profitability Methodology, paragraphs 67 and 68. Paragraph 49 of the Profitability Working Paper also states that the cost to the business of rented buildings is reflected in the rent expense. Excluding these costs would therefore mean the cost to the business was not reflected in the rental expense.

2.26 The table below sets out our restatement of rent for the leased parts of [✂] and [✂] Hospitals and the adjustment required to correct the CC's calculation of EBIT.

Table 2-4: BMI adjustment to the rent for [✂] Hospitals

£000	FY2007	FY2008	FY2009	FY2010	FY2011
Rent added back in the CC's EBIT calculation	[✂]	[✂]	[✂]	[✂]	[✂]
Rent added back in BMI's EBIT calculation	[✂]	[✂]	[✂]	[✂]	[✂]
Adjustment to EBIT required	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

Expenditure on intangible assets

2.27 The CC has allowed the net book value (measured as historical cost less accumulated amortisation) of internally developed IT software and bid costs as intangible assets in the calculation of capital employed. The CC has also allowed the amortisation expense of these assets to be included in the calculation of EBIT. The CC's treatment of these costs is correct from an accounting perspective and ensures consistency between the numerator and denominator in the ROCE calculation.

2.28 However, the CC then makes an additional adjustment to its calculation of adjusted EBITDA that is incorrect. The CC has identified the cost capitalised for these allowed intangibles in each year and then increased EBITDA by this amount. The CC does not explain why it makes this adjustment.

2.29 From an accounting perspective, the CC's treatment of these capitalised costs is wrong. This is because only the amortisation cost relating to intangible assets should be included in operating expenses. The costs of these intangible assets were never included as a cost in the Income Statement (as they were capitalised) and therefore it is inappropriate for these costs to be added back to income, thereby increasing EBIT.

2.30 In summary, the CC incorrectly reduced costs in the Income Statement, which increases adjusted EBITDA. The table below sets out our restatement of annual expenditure on intangible assets to include and the adjustment required to correct the CC's calculation of EBIT used in its ROCE calculation.

Table 2-5: BMI adjustment to the CC's intangible asset "expenditure"

£000	FY2007	FY2008	FY2009	FY2010	FY2011

The intangible asset adjustment included in the CC's EBIT calculation	[✂]	[✂]	[✂]	[✂]	[✂]
The intangible asset adjustment included in BMI's EBIT calculation	[✂]	[✂]	[✂]	[✂]	[✂]
Adjustment to EBIT required	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

Adjusted depreciation

2.31 The CC has only allowed depreciation for equipment in its calculation of EBIT. The CC says it has not allowed any depreciation on buildings in its calculation of EBIT because it calculates capital employed using the undepreciated reinstatement value of the assets as a proxy for the MEA of the assets.[16] Implicitly, the CC assumes that the building will be maintained, such that the building will not depreciate over time. In considering the implications of the CC's approach to measuring asset valuations, it is important to keep firmly in mind that the very fact that the asset value is not depreciating requires the expenditure of resources to ensure that is the case. In short, the CC does not appear to have included sufficient maintenance expenditure in its assessment of allowable costs.[17]

2.32 We first discuss the issue relating to maintenance costs, before explaining that the CC has also understated the actual depreciation expense relating to the equipment used by the Core Hospital Business. We furthermore go on to explain that the CC has understated leasehold improvements depreciation, which it considers an allowable cost, as some data was previously not available to the CC. This data is now provided in Exhibit 1.[18]

16 Profitability Working Paper paragraphs 12, and 44 to 47.

17 Specifically, the amounts that BMI capitalises for facilities capital expenditure and refurbishments each year are not included as an expense in the calculation of EBIT. If these amounts are not capitalised, then the expense must run through the Income Statement.

18 [✂]

The costs associated with maintaining building value

2.33 The CC has determined the value of buildings on an MEA basis. The CC argues that a depreciated MEA value would be inappropriate to use in the calculation of capital employed.[19] This is because the buildings employed can remain in use for longer than their estimated economic lives in the financial statements. The CC argues that if capital employed includes undepreciated values, then it would be inappropriate to include depreciation in EBIT.

2.34 However, the CC fails to consider the maintenance costs required to maintain a building at this value over time. There is a significant maintenance cost involved in keeping hospitals at their current value. As such, an entrant would, have to incur maintenance costs to keep the buildings at their undepreciated value every year.

2.35 To see why, consider the following simple example. Suppose that at September 2010 a hospital has an undepreciated replacement value of £30million. The hospital will suffer some real physical depreciation during the year from wear and tear or indeed from events that happen. Suppose for example that our £30million hospital roof springs a leak and so must be repaired. For simplicity suppose that BMI spends £1million on capital maintenance so that at the end of the financial year September 2011, the hospital is again valued at £30million. The asset value in each period will be the undepreciated £30million, but ensuring that is the case has actually required expenditure in this example of £1million.

2.36 Such costs include roof replacements, window replacements, resurfacing access roads and car parks, etc. A large proportion of these maintenance costs would typically be capitalised in the accounts and so would not appear as a cost in the income statement. However, given the CC's position on the asset values, maintenance costs will have to be deducted in the calculation of EBIT to ensure consistency between the numerator and denominator in the EBIT calculation. Continuing our example above, we clearly cannot simply ignore the real £1million in capital maintenance costs required to keep the hospital at its undepreciated value. Of course, in practice some large items of capital maintenance expenditure may occur infrequently – the roof may not end up being replaced every year – but nonetheless such expenditures on maintaining the assets are most certainly required and do constitute a very significant cost of operating a hospital business.

[19] Profitability Working Paper, paragraph 47.

2.37 Over the period FY 2007 to FY 2011, BMI incurred hospital maintenance costs for freehold buildings of approximately £[✂] that were capitalised.[20] Following the logic of the analysis described above, we have therefore included the amounts for each year in our calculation of EBIT.

The CC has understated the depreciation expense of the equipment used in the Core Hospital Business

2.38 We consider that the CC has incorrectly calculated depreciation. The unadjusted depreciation figures used by the CC are taken from Annex 4 and contain a mixture of building and equipment depreciation.[21] As only equipment depreciation is allowed in the CC's calculation of EBIT, the unadjusted depreciation figure must be adjusted to remove building depreciation. The CC removes building depreciation by deducting approximately £[✂] per year. The CC has not explained how it has calculated this reduction or provided the rationale for this reduction. This adjustment has been hard-coded in the CC's model and therefore it is not possible to identify the source or basis of the adjustment.

2.39 We consider that a more appropriate calculation of equipment depreciation is to use the figures included in the depreciation schedule of the CC model (which the CC has not used).[22] The schedule in the CC Model splits out depreciation by asset class. This means that equipment depreciation can be calculated accurately and separately from building depreciation. We consider that the correct equipment depreciation calculation according to this methodology is to sum rows 17 to 24 and rows 26 and 27 in worksheet "Depreciation".[23]

2.40 The CC states that there is no charge to EBIT for fully depreciated assets.[24] This statement is inconsistent with the MEA principle. The firm still derives value from the assets, i.e. they have a longer economic life. To match revenues to economic cost, the asset values of fully depreciated assets prior to 2007 need to be restated and depreciation of these charged to the Income Statement. We have not yet been able to determine whether this would have a material effect on the calculation of EBIT.

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20 [✂]

21 [✂]

22 The CC Model, worksheet "Depreciation".

23 Row 25 is computer software depreciation that may include amortisation from IT projects included in the allowed intangibles amortisation calculation.

24 Profitability Working Paper, paragraphs 51 to 53.

Leasehold improvements depreciation

2.41 The CC permits the depreciation expense of leasehold improvements in the calculation of EBIT. Unfortunately our review has revealed that the data previously provided to the CC was incomplete and did not include the book value or depreciation expense in each year for the [✂] and [✂] Hospitals or for the shared services centre and head office support centres.

2.42 This data is now provided in Exhibit 1 and this leads to an increase in the depreciation expense to be included in the calculation of EBIT.[25] The table below shows the adjustment to be made to the CC's EBIT calculation.

Table 2-6: BMI adjustment to the CC's calculation of leasehold depreciation

£000	FY2007	FY2008	FY2009	FY2010	FY2011
CC's calculation of leasehold depreciation	[✂]	[✂]	[✂]	[✂]	[✂]
BMI's calculation of leasehold depreciation	[✂]	[✂]	[✂]	[✂]	[✂]
Adjustment to EBIT required	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

Conclusion on the depreciation expense

2.43 The CC's depreciation expense – for the types of depreciation the CC has deemed allowable – is incorrectly calculated, inappropriately increasing EBIT and hence ROCE. The table below sets out our restatement of depreciation and the adjustment required to correct the CC's calculation of EBIT used in its ROCE calculation.

[25] [✂]

Table 2-7: BMI adjustment to the CC's calculation of depreciation

£000	FY2007	FY2008	FY2009	FY2010	FY2011
The CC's calculation of equipment depreciation	[✂]	[✂]	[✂]	[✂]	[✂]
BMI calculation of equipment depreciation	[✂]	[✂]	[✂]	[✂]	[✂]
Capital maintenance of buildings	[✂]	[✂]	[✂]	[✂]	[✂]
Additions to leasehold depreciation	[✂]	[✂]	[✂]	[✂]	[✂]
Adjustment to EBIT required	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

Amortisation of intangibles

2.44 The CC has included the asset value of computer software and bid costs in the calculation of capital employed and correctly includes the amortisation of these intangible assets in its calculation of EBIT. However, the CC's calculation of amortisation contains an arithmetic error that can be explained as follows.

2.45 The CC Model incorrectly links the amortisation figures included in the worksheet "Intangible assets" to the worksheet "Total capital employed", which then feeds to the CC's ROCE calculation.[26] For each year, the CC incorrectly applies the current year amortisation charge to the previous years' EBIT and this means that there is no amortisation charge for FY2011. This has the effect of misstating EBIT for each year.

2.46 The table below sets out our restatement of amortisation and the adjustment required to correct the CC's calculation of EBIT used in its ROCE calculation.

Table 2-8: BMI adjustment to the CC's level of amortisation

£000	FY2007	FY2008	FY2009	FY2010	FY2011
The CC's calculation of amortisation	[✂]	[✂]	[✂]	[✂]	[✂]
BMI calculation of amortisation	[✂]	[✂]	[✂]	[✂]	[✂]
Adjustment to EBIT required	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

[26] The error is in cells C26 to G26 of the worksheet "Total capital employed".

Investment in associates

2.47 In assessing ROCE for the Core Hospital Business, the CC should adopt a consistent treatment for investments in associates. That is, BMI's share of profits and investments in associates could either be included in both calculations or excluded from both EBIT and capital employed and the correct treatment depends in part on the nature of the associates. If the investments are part of the Core Hospital Business, they should be included in both EBIT and capital employed. If the associates are not part of the Core Hospital Business, they should be excluded from both EBIT and capital employed. It is incorrect to include profits, but not asset values and vice versa.

2.48 The associates included in the financial data provided to the CC from BMI are not parts of the Core Hospital Business for the purpose of the CC's investigation. It is therefore appropriate to exclude them from capital employed but it is also important that these profits are not included in the calculation of EBIT.

2.49 The CC has made two errors in including profits from associates in the calculation of EBIT:

- first, these investments are not considered part of the Core Hospital Business and therefore the share of profit should not be included in CC's calculation of EBIT. We note the CC has not included the MEA value of the associates in capital employed; and
- second the unadjusted central costs figures discussed in paragraphs 2.10 to 2.21 above are net of the share of profits in associates, i.e. the costs are already reduced by profits from the share of associates. The correct approach is therefore to deduct these profits and reduce EBITDA, not increase EBITDA.

2.50 The CC has therefore included these profits twice in its calculation of EBIT, by adding the profits back to EBITDA when they were already implicitly included in the central costs figure. The CC should in fact have excluded the share of profits of associates already implicitly included in the central costs figure. We have therefore removed the share of profits from the investment in associates from the calculation of EBIT twice.[27] The table below sets out our restatement of investment in associates to include and the adjustment required to correct the CC's calculation of EBIT used in its ROCE calculation.

[27] First by reversing the CC's addition of these profits and second by removing them from the central costs figure, which is net of profits from the share of associates.

Table 2-9: BMI adjustment to the CC's level of investment in associates

£000	FY2007	FY2008	FY2009	FY2010	FY2011
The CC's calculation of investment of associates	[✂]	[✂]	[✂]	[✂]	[✂]
BMI calculation of investment in associates	[✂]	[✂]	[✂]	[✂]	[✂]
Adjustment to EBIT required	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

Warehouse costs

2.51 The CC has not considered the costs of operating a warehouse in calculation of EBIT. This warehouse is integral to the operations of the Core Hospital Business. It provides drugs and other medical consumable supplies to the hospitals and exists to make BMI's purchasing and logistics more efficient therefore, the costs associated with having a warehouse facility should be incorporated into the calculation of EBIT.

2.52 The warehouse is required to store large amounts of consumable supplies and prosthetics and to a lesser extent drugs for use in BMI's hospitals. These supplies are distributed to BMI's hospitals when required.[28] To operate efficiently an entrant would require warehouse facilities for the storage of materials and would either have to purchase a warehouse, or lease one and would incur the operating costs associated with the operation of such a facility. The CC has not included any warehouse costs in its calculation of the Core Hospital Business's EBIT.

2.53 We set out at Exhibit 1, the cost data related to BMI's warehouse facilities.[29] The direct unavoidable costs associated with running the warehouse and the adjustment to EBIT required are shown in the table below.

[28] [✂]

[29] [✂]

Table 2-10: BMI calculation of warehouse costs

£000	FY2007	FY2008	FY2009	FY2010	FY2011
The CC's calculation of warehouse costs	[✂]	[✂]	[✂]	[✂]	[✂]
BMI calculation of warehouse costs	[✂]	[✂]	[✂]	[✂]	[✂]
Adjustment to EBIT required	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: Exhibit 1.

The time period analysed by the CC

2.54 For the purposes of its investigation, the CC has selected the relevant time-period as the five financial years between 1 January 2007 and 30 June 2012.[30] The CC notes that there may be issues associated with selecting a timeframe that is significantly shorter than the lifespan of the assets employed in the private healthcare industry and that an assessment of profitability is usually conducted over a period longer than five years.[31] However, the CC contends that as there were a number of changes in ownership in the industry between 2006 and 2008, there may not be adequate financial data prior to 2006. Consequently, it decided that a five-year period should be sufficient for its investigation.

2.55 In addition, the CC states that it must:[32]

> *"balance the potential benefits of examining a longer time period with the practical difficulties of doing so. These difficulties include both the issue of interpreting the results of such analysis against a background of significant changes in the market structure over time, and the challenge of obtaining (comparable) data over the longer period."*

30 Profitability Methodology, paragraphs 26 to 30. As BMI has a year-end of 30 September, the relevant period for BMI is 30 September 2007 to 30 September 2011. We refer to the year ending 30 September 20XY as "FY 20XY" in this report.

31 Profitability Methodology, paragraph 27.

32 Profitability Working Paper, paragraph 26.

2.56 In this response, we do not consider the CC's choice of time-period in detail. However, we note that a firm should be able to earn a normal return on its investment over a suitably long period. Therefore, care must be taken when looking at profits over a short period because higher profits in the period may still be consistent with earning a normal return over the life of the investment. Taken together, the firm may only earn a normal profit across both periods. The CC acknowledges this and notes that:[33]

> *"it may be necessary to consider a number of such factors, including past innovation, efficiency and the economic cycle, when interpreting the results of our profitability analysis on each of the Relevant Firms."*

2.57 Currently the CC makes no adjustment for these factors and does not appear to have considered them at this stage – or indeed consulted on the reasons why it has decided not to.

2.58 Finally, we note that the CC's MEA approach, which seeks to consider the costs that would be incurred by a new efficient entrant, requires that the CC should also have considered whether BMI's operating costs in FY 2007 to FY 2011 provided a reasonable reflection of the operating costs of a new entrant. An entrant is likely to incur a range of start-up costs and, consequently, BMI's costs in FY 2007 and FY 2011 do not provide a reasonable estimate of a new entrant's long run average costs. Hence, the CC understates operating costs.[34]

Conclusions on EBIT

2.59 The table below sets out a summary of the adjustments that we consider should properly be made to the CC's calculation of EBIT in the CC Model. At this stage, given the limited time available and the significance of the errors identified below, this calculation does not constitute a final view as we may subsequently identify other costs that the CC has incorrectly stated or further errors that may affect the calculation of EBIT.

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[33] Profitability Working Paper, paragraph 25.

[34] The CC has adopted an MEA approach to the valuation of assets. However, such an approach requires a consideration of both the value of assets, and the level of operating costs. The CC's approach is incomplete, because it has not considered operating costs. We discuss the CC's MEA approach in more detail in Section 3 below.

Table 2-11: BMI calculation of EBIT

£000	FY2007	FY2008	FY2009	FY2010	FY2011
CC's calculation of EBIT	[✂]	[✂]	[✂]	[✂]	[✂]
Central costs adjustment	[✂]	[✂]	[✂]	[✂]	[✂]
Rent added back adjustment	[✂]	[✂]	[✂]	[✂]	[✂]
Intangible assets expenditure adjustment	[✂]	[✂]	[✂]	[✂]	[✂]
Depreciation adjustments	[✂]	[✂]	[✂]	[✂]	[✂]
Amortisation adjustments	[✂]	[✂]	[✂]	[✂]	[✂]
Share of profits in associate's adjustments	[✂]	[✂]	[✂]	[✂]	[✂]
Warehouse costs	[✂]	[✂]	[✂]	[✂]	[✂]
BMI calculation of EBIT	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

3. The CC's calculation of capital employed

Introduction

3.1 In this section, we consider the CC's calculation of the Core Hospital Business' capital employed. Specifically, we consider:

- the CC's calculation of the capital employed for the Core Hospital Business;
- the MEA approach adopted by the CC;
- the CC's approach to valuing land;
- the CC's approach to valuing buildings;
- the CC's approach to valuing equipment;
- the CC's approach to valuing lease building improvements;
- the CC's approach to valuing intangibles; and
- the CC's calculation of working capital.

The CC's calculation of capital employed

3.2 The table below sets out the CC's calculation of the capital employed in the Core Hospital Business.

Table 3-1: The CC's calculation of capital employed

£000	FY2007	FY2008	FY2009	FY2010	FY2011
Leasehold buildings improvements	[✂]	[✂]	[✂]	[✂]	[✂]
Equipment	[✂]	[✂]	[✂]	[✂]	[✂]
Intangible assets	[✂]	[✂]	[✂]	[✂]	[✂]
Buildings	[✂]	[✂]	[✂]	[✂]	[✂]
Land	[✂]	[✂]	[✂]	[✂]	[✂]
Average net working capital	[✂]	[✂]	[✂]	[✂]	[✂]
Capital employed	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

The MEA approach taken by the CC

3.3 The CC has valued assets using an MEA approach. We agree that an MEA approach is the correct approach to adopt for an ROCE assessment. However, adjusting MEA values involves an element of subjectivity and therefore there is some uncertainty in performing these calculations. We consider best practice is to make any adjustment with regard to a range of appropriate and informative benchmarks. We also consider that where there is significant uncertainty, or where adjustments to MEA values yield questionable results, that more emphasis should be placed upon values that are known with certainty (i.e. net book values).

3.4 We are concerned that the CC's approach leads to a significant reduction in asset values compared to actual investment costs. In particular, the CC has estimated land and building costs at approximately [✂]% of the net book value of these buildings in BMI's financial statements.[35] This is a very significant gap.

3.5 In fact, the difference between the reinstatement value used by the CC and historical cost implies that a new entrant would be able to enter the market at [✂]% of the capital cost of BMI. Further, it suggests that BMI is sitting on a very large amount of excess capital that would be available for distribution to shareholders on restructuring of the business. This would be the case for example if the modern equivalent hospital could be built on a smaller plot of land and the existing site could be sold to property developers. The CC's analysis therefore raises a large number of questions about the apparent rationality of BMI's corporate choices under the CC's asset valuations. For instance, why would BMI purchase hospitals when they could construct them for [✂]% of the cost? Why would BMI, which has been owned by sophisticated professional investors since at least 2006, not have released this excess capital? Why would the efforts to study strategic business planning and refinancing not have identified an opportunity of such magnitude? Such questions would need to be convincingly answered for the CC's approach to be a credible one. A far more likely implication is that the CC's approach to asset values is simply wrong.

[35] The book value of land and buildings in BMI's financial statements is approximately £[✂]; however, the CC has valued these assets at approximately £[✂]. Including the goodwill on these purchases would increase the value to £[✂], which means that the CC's has reduced total book value by approximately [✂]%.

3.6 The CC should of course be concerned about the consequences of getting its analysis wrong. Investors should clearly be allowed the potential to earn a return on investments commensurate with the levels of investment actually made. Not allowing the investor returns on the actual level of investment risks significantly distorting future investment decisions and also of course entails or implies confiscation of returns on invested capital. Such actions should clearly not be taken lightly by any responsible regulatory authority and so the CC is clearly under a very significant obligation to stand back and reflect on the inherent plausibility of its analysis.

3.7 The CC's concern is that private hospital providers may be earning excessive profits. However, by assessing EBIT against an artificially low asset base, the CC's findings in fact become self-fulfilling. It is a false conclusion.

3.8 One way to at least start to help avoid such outcomes is for the CC to, for example, consider the reasonableness of its findings by performing scenario analysis on its assessment. For example, by using the capital employed figure per BMI's financial statements as an upper limit.

3.9 In the table below, we show the impact on ROCE using our adjusted EBIT figure and the capital employed for the entire BMI business, but excluding goodwill and tax as per the CC's methodology. BMI's financial systems account for goodwill and many tangible fixed assets centrally rather than on a hospital basis. Therefore, we have not been able to calculate precisely the capital employed for the Core Hospital Business. However, by excluding all purchased goodwill, this figure will understate capital employed, rather than overstate it.

Table 3-2: The calculation of ROCE using the book values of capital employed

£000	FY2011
Capital employed (financial statements, excluding goodwill)	[✂]
Capital employed (financial statements, including goodwill)	[✂]
Capital employed (CC)	[✂]
CC capital employed as % of capital employed in the financial statements (excluding goodwill)	[✂]
CC's ROCE	[✂]
ROCE with the CC's EBIT and book value of capital employed (excluding goodwill)	[✂]
ROCE with BMI adjusted EBIT per Section 2 and book value of capital employed (excluding goodwill)	[✂]
ROCE with BMI adjusted EBIT per Section 2 and book value of capital employed (including goodwill)	[✂]

Sources: Annex 4, the CC Model, BMI financial statements for FY 2011, BMI analysis.

3.10 We note that the CC's estimation of the capital employed is approximately [✂]% of the book value in FY 2011. Using the book value of the capital employed (excluding goodwill and tax effects) leads to significantly lower ROCE results of around [✂]%, when our adjusted EBIT figure is used. Combining this with goodwill and our corrected EBIT figure, as set out in Section 2 above, leads to ROCE that is approximately [✂]%

3.11 Even if an adjustment to the asset value included in the CC's calculation of capital employed of the order of [✂]% were merited (which it is not), it still leaves open what should be done with this reduction in asset values. The Core Hospital Business needs to recover this fall in asset value.

Land

3.12 BMI has gone to very significant effort and incurred considerable expense to demonstrate to the CC that the approach and outcome of the land valuation work is profoundly wrong. We do not repeat those submissions but refer you to our response of 26 February 2013 and the chain of correspondence between the Inquiry Manager and our solicitors on this matter.

3.13 The importance of land valuation and the extent of the failures identified have compelled BMI to express these views in strong terms. We have done so because it is clearly extremely important at this stage that the CC does not react defensively but instead takes a step back and properly considers the right way forward in light of these fundamental criticisms.

3.14 Once it has done so, we are confident that the CC, acting as an evidence led authority, will see that it cannot possibly proceed on the basis of the DTZ Report (even amended). Instead, the CC needs to either have regard to the actual evidence of land and building value reported by the hospital providers and/or run the whole valuation process again. The DTZ Report does not (and cannot) reflect the published Profitability Methodology and reach land values that are "*proxied by their current market value as estimated by a third party expert*".[36] The current DTZ Report (or any amended report) prepared on a DRC basis pays regard to neither "current market value" or indeed "value" at all – as DTZ themselves make clear.

3.15 The effect of the approach chosen by the CC to date has been to significantly depress capital employed and thereby inappropriately increase the CC's estimate of ROCE.

Buildings

3.16 The CC has valued the Core Hospital Business's buildings using the insurance reinstatement value as a proxy for the MEA value. By using solely the reinstatement value of the building, the CC is neglecting to include the capital value of a number of assets that relate to the hospital site. These include for example costs related to:

- any land decontamination required;
- renewal of foundations;
- access roads and car parks and so forth;
- provision of utilities to the site;
- interest and other financing costs of reinstatement; and
- developer's profit.

3.17 These costs would be incurred if the building were to be built entirely, rather than rebuilt on an existing site. These costs can be significant and may have a material impact on the level of capital employed and hence ROCE.

[36] CC's Profitability Methodology, paragraph 72

3.18 The CC acknowledges that a number of costs are not included in the reinstatement value but the CC does not attempt to quantify these.[37] The CC currently simply states without detailed analysis that it considers that reinstatement values were the most reliable estimate of the cost of a building and that the parties did not offer an alternative approach. Given the likely materiality of these costs, we consider that if the CC were to use reinstatement values the CC would clearly need to attempt to estimate each category of such costs or deliberately decide that they could not be estimated and then bring them into the analysis at a later stage qualitatively. The CC's approach will bias ROCE upwards.

3.19 The CC does not appear to have considered actual evidence of costs incurred to assess MEA values.[38] We consider that these actual costs provide a significantly better proxy than the theoretical approach that the CC has applied and at the very least provide a sense check to the chosen reinstatement value. In the table below, we provide details relating to a number of recently built hospitals. This information was provided to the Members during the hearing.

Table 3-3: Recent hospital build costs

Hospital	Characteristics	Cost (includes land and commissioning costs)
Circle Bath	4 theatres, 28 IP beds, no ICU or HDU	£30 million
Spire Montefiore	3 theatres, 20 IP beds, no ICU or HDU	£29 million
London Clinic Cancer Centre	Specialist cancer equipment, 35 IP beds	£90 million
HCA Christie Clinic	6 NHS theatres,34 IP beds, no ICU or HDU	£35 million
Circle Reading	5 theatres, 30 IP beds, no ICU or HDU	£58 million
KIMS	5 theatres, 77 IP beds	£90 million
Nuffield Oxford Manor	8 theatres, 71 IP beds, 7 bed ICU	£50 million
Nuffield Leeds	6 theatres, 48 IP beds	£40 million
Average		**£53 million**
Average excluding LCCC		**£47 million**

Source: See sources and weblinks included in Exhibit 1.

[37] Profitability Working Paper, paragraph 45.

[38] Profitability Working Paper, paragraph 45.

3.20 The average number of theatres and beds in BMI owned hospitals is three and 42, respectively. Looking at only the top 50% (i.e. 22) owned hospitals, the average number of beds is 62 and the average number of theatres is four. BMI's hospitals therefore appear comparable, at least in terms of theatre and bed numbers as these new hospital builds. Also, the CC has considered BMI's proposed entry into Edinburgh in 2007 (i.e. five years ago). The contemporaneous documents discussing this opportunity constitute primary evidence for the purposes of the CC's investigation and referred to build out and fit out costs of £[✂] for a 32 bed / 2 theatre new build hospital.[39]

3.21 Even assuming that only the top 22 of the hospitals owned by BMI (i.e. only 50%) are comparable to the example provided above (an excessively conservative assumption for illustration purposes only) would provide an MEA value of approximately £1,034 million for the land and buildings of these 22 hospitals.[40] This demonstrates an obvious and significant problem with the CC's approach. The CC's value of land and buildings of approximately £[✂] in FY 2011 equates to a value of £[✂] per hospital, which is half the value of even the lowest costing comparable and well under half of the build costs identified by BMI five years ago for entry in Edinburgh (on scale of 2 theatres and 32 beds).[41]

3.22 Increasing the capital employed in FY 2011 to the value of land and buildings implied by the assumption above would reduce the ROCE to [✂]% (assuming the CC's calculation of other capital employed items and EBIT is unchanged and excluding the remainder of the hospitals).[42] Adjusting for all the required corrections to EBIT stated in section 2 above would result in ROCE of [✂]%.[43]

3.23 The table below sets out the impact of adjusting the value of land and buildings of only the 50% most valuable hospitals by their reinstatement value to reflect the comparable information available. The remaining freehold hospitals are maintained at their reinstatement value in this calculation.

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39 [✂]

40 £47 million x top 22 = £1,034 million.

41 Note that the figure of £[✂] is a nominal 2007 figure and adjusting for inflation for five years would yield a higher value.

42 [✂]

43 [✂]

Table 3-4: Our conservative adjustment to land and buildings value

£000	FY2007	FY2008	FY2009	FY2010	FY2011
CC's value of land and buildings	[✂]	[✂]	[✂]	[✂]	[✂]
BMI calculation of land and buildings of top 22 hospitals	[✂]	[✂]	[✂]	[✂]	[✂]
Reinstatement value of the remaining 22 hospitals	[✂]	[✂]	[✂]	[✂]	[✂]
Adjustment to capital employed	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

Note: We have used the calculation of 22 hospitals multiplied by £47 million for FY 2011 discussed above and then adjusted this by the construction index used by the CC for each preceding year.

Equipment

3.24 The CC has valued equipment at net book value as set out in BMI's accounts on the basis that the CC understands that "*the large majority of these assets have useful economic lives of ten years or less and are depreciated accordingly, such that their net book value provides a reasonable approximation of their depreciated replacement cost*".[44]

3.25 As explained above, the Core Hospital Business still uses a number of fully depreciated assets. Consideration should be given to assets that have been fully depreciated, but are still in use. If no consideration is given for fully depreciated assets still in use, then the asset value and depreciation rate are misstated and do not reflect long run economic costs. Restating fully depreciated assets will have an impact on ROCE as it decreases EBIT (via depreciation as explained above) and increases capital employed (via increasing the asset value).

3.26 As specified in our response to supplemental questions provided on 9 January 2013 this is a very significant exercise that the company has not carried out. This does not mean that it is appropriate for the CC to ignore the potential effect of this on its analysis. The CC should at the very least cross check the level of depreciated assets found in other private healthcare providers and consider the effect of applying the average rate of this to BMI's profitability.

[44] CC Profitability Methodology, paragraph 79.

Leasehold buildings improvements

3.27 The CC has included the depreciated capital cost (i.e. the net book value) of leasehold building improvements in the capital employed calculation. We agree with the CC's approach. However, as stated in paragraph 2.37 above, previously data for [✂] and [✂] Hospitals or for the shared services centre and head office support centres was not available. We have now updated (as is shown in the table below) the CC's capital employed calculation to account for the additional net book values of leasehold improvements in these hospitals.

Table 3-5: BMI adjustment to the book values of leasehold improvements included in the calculation of capital employed

£000	FY2007	FY2008	FY2009	FY2010	FY2011
The CC's calculation of leasehold net book value	[✂]	[✂]	[✂]	[✂]	[✂]
BMI calculation of leasehold net book value	[✂]	[✂]	[✂]	[✂]	[✂]
Adjustment to capital employed	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

Average net working capital

3.28 The CC considers that it is appropriate to include the average monthly net working capital position in its calculation of the capital employed. We agree that such an inclusion in the calculation of capital employed is appropriate; however, we disagree with the calculation performed by the CC. The error in the calculation is that the CC has calculated the average of the year-end position for each year in the monthly movements in working capital, not the actual level of working capital balances. This error has led to the average working capital position being significantly understated.

3.29 The table below sets out the correct average working capital figures that should be included in the calculation of capital employed.

Table 3-6: BMI adjustment to the value of working capital included in the calculation of capital employed

£000	FY2007	FY2008	FY2009	FY2010	FY2011
The CC's calculation of average working capital	[✂]	[✂]	[✂]	[✂]	[✂]
BMI calculation of average working capital	[✂]	[✂]	[✂]	[✂]	[✂]
Adjustment to capital employed	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

Intangible assets

3.30 The CC has included the net asset value of internally generated computer software and bid costs in its consideration of the capital employed. The CC has explicitly excluded all purchased goodwill. We discuss the CC's approach to each of these in turn.

The CC's guidance on intangible assets to be included in capital employed

3.31 The CC has provided guidelines on the recognition of intangible assets. These are that the potential intangible asset must:[45]

(1) comprise a cost that has been incurred primarily to obtain earnings in the future;

(2) the cost must be additional to the costs necessarily incurred a the time in the running of the business; and

(3) it must be identifiable as creating such an asset separate from an arising from the general running of the business.

[45] Profitability Working Paper, paragraph 59.

3.32 Based on these guidelines, which appear to be derived from accounting standards and IAS 38 (paragraph 8) in particular, the CC rejects most internally generated intangibles. This accounting standard reflects the disclosure of accounting costs in statutory financial statements and not the economic substance of the cost incurred. We do not consider that these criteria are relevant in an ROCE assessment, which is trying to determine whether a firm earns super normal profits above economic cost and the CC has not provided an explanation why these costs should not be included. While we understand the CC will wish to apply its guidance, it need not and indeed should not apply these tests in the same manner as the accounting standard is applied. The accounting standard also acknowledges that there are difficulties associated with identifying internally generated intangible assets and with satisfying the recognition and measurement criteria for the purposes of statutory accounts. This means that the accounting standard take the view that such assets are indistinguishable from the rest of the business or cannot be reliably measured. In addition, there are outright prohibitions against recognising specific types of intangible assets where the recognition criteria can never be satisfied. This means that the allowance for intangibles in statutory accounts is likely to understate the true economic costs involved.

3.33 Indeed the accounting profession does not say these types of cost are not intangible in nature and nor do the accounts purport to provide economic costs for market investigation purposes. The accounting profession simply says that for statutory disclosure purposes, prudence requires that these costs should not be capitalised. Such a position certainly does not mean that intangibles should be excluded from a proper consideration of economic cost, especially when costs are considered on MEA principles (i.e. the actual cost of entry of a new entrant).

3.34 For the purposes of applying the CC's guidance, the three tests should be applied considering economic costs. Broadly, that (1) there has been a genuine investment made; (2) that the investment is additional to other costs incurred in running the business; and (3) that a genuine asset has been created by incurring those costs. Read in terms of economic costs, there is no inherent difficulty in applying this guidance reasonably while making proper allowances for intangible assets in the CC's profitability analysis. But doing so would not apply the same standards as are used for statutory accounting purposes.

3.35 In terms of the second limb of the test, it seems to us that its key economic purpose is to make sure that costs are not counted twice – once as ordinary costs and a second time as costs that are investments in intangible assets. Similarly, in terms of the third limb of the test, it seems to us that its key economic purpose is again to avoid double counting. We agree that costs should not be counted twice. However, that is not to say that economically efficient investments in intangible assets should not be counted at all in an assessment of long run average costs. We do understand that the CC will reasonably wish to place some limit on what can be designated as an investment in an intangible asset. One potential approach to doing so would be for the CC to disallow intangible assets based on limb 3 of the test if those assets would not have been invested in by a hospital chain in a competitive environment.

3.36 Returning to the facts of this case, the reality is that BMI has spent considerable sums of money over the long-term in order allow it to operate effectively. A hypothetical new entrant would also have to incur such costs. Because of the accounting standard, such economic costs are not currently reflected in BMI's cost base between FY 2007 and FY 2011. Some examples of intangibles that will have incurred significant levels of costs that are not currently recognised include:

- the procedures and processes that BMI use;
- consultant relationships;
- branding and local reputation. In this regard we note that 79% of patients according the CC's own survey know which hospital they wish to attend before they are referred. Brand presence in consumers' minds must be valued at higher than zero;
- investment in NHS data provision;
- internally developed bespoke database IT solutions;
- market leading knowledge from operating the shared services centre;
- BMI's decontamination provision; and
- training procedures and programs.

3.37 One way to consider the capitalisation of intangible assets is that it is a way of spreading high costs in one year across time, i.e. to generate a long run economic cost. When thinking of an MEA value, one needs to consider not only capital costs but also operating expenses. Hence, if there are higher costs at the beginning to get processes correct then these costs need to be incorporated in an assessment of long run average costs. The CC's approach assumes that a new entrant could walk into the newly constructed hospital at zero cost above the cost incurred to build and equip a hospital. This is not correct and represents an important error in the CC's approach that will clearly bias ROCE upwards.

3.38 Third parties have expressed interest in purchasing some of these. This indicates that these intangible assets developed by BMI do have value, even if it is not currently recognised on BMI's balance sheet.

***Purchased* goodwill**

3.39 The CC has also excluded all purchased goodwill on the basis that it considers that this reflects the super normal profits that will be earned on the assets. This introduces circularity into the CC's analysis. The assumption that all goodwill represents capitalised excess profit pre-judges the conclusion and makes an excess profitability finding almost inevitable. The CC's approach assumes that there are super-normal profits (without evidence). On that basis, the CC exclude purchased goodwill and then uses the resulting depressed capital values to create high returns on capital. It then completes the circle by using these calculated high returns as evidence of confirming its assumption that BMI is making excess profits.

3.40 An alternative is that purchased goodwill is not assumed to result from expected excess profits and so some or all of it should be included in the asset base. If purchased goodwill is included to a significant degree, the calculation of ROCE very clearly indicates that BMI does not make excessive profits. In any industry, regardless of the competitive position, there would be at least a proportion of goodwill that does not reflect the purchase of super normal profits. In excluding all purchased goodwill, the CC takes an extreme position unsupported by evidence.

3.41 If an investor pays more for the right to higher revenues, then potentially there may be no benefit to the purchaser because any potential value may be given away to the seller (i.e. the investors NPV is zero and he only earns a normal profit on the investment). Hence, it may be the seller who gains from the transaction who may or may not still be in the market.[46] But if hospitals were merely capital investments that required no intangible investment, why would the firm overpay for the assets? The CC's analysis indicates that it would be cheaper for the business to replace (i.e. replicate) the assets rather than buy them at their recoverable amount. This is not logical.

3.42 The CC does recognise that some element of purchased goodwill may reflect non-separable but nevertheless important assets, but these assets are valued at zero. The fact is that the CC writes asset value down significantly to represent the costs of new entrants, but simultaneously does not include the actual cost of entry – which would include the factors recognised by the CC. When BMI purchases a new hospital, it is buying a collection of processes, knowledge, reputations, relationships and expertise. It also avoids start-up losses associated with low capacity and initial recruiting costs, agreeing contracts with service providers etc. All of these costs give value to the purchase over and above the depreciated replacement cost of assets.

3.43 We note that the including even small amounts of goodwill in capital employed will have a material impact on the calculation of ROCE. For example, even before making any other corrections to EBIT or capital employed, including 10% of the book value of BMI's goodwill (i.e. c. £[✂]) will decrease the CC's calculation of FY 2011 ROCE of [✂]% by almost [✂] percentage points to [✂]% and with our adjusted EBIT to [✂]%.[47]

Conclusions on the capital employed

3.44 The table below sets out a summary of the adjustments that we consider should be made to the CC's calculation of capital employed in the Core Hospital Business in the CC Model. We have not sought to be exhaustive in the limited time available for this response given the wide range of errors we consider that the CC has made. As a result, we consider it likely that the figures below are still likely to understate the level of capital employed in the Core Hospital Business and so provide a conservative benchmark for the CC's analysis of ROCE.

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[46] If there are lots of competing investors, the price would be bid up to where the successful bidder's NPV equals zero.

[47] [✂]

Table 3-7: BMI adjustments to capital employed

£000	FY2007	FY2008	FY2009	FY2010	FY2011
CC's calculation of capital employed	[✂]	[✂]	[✂]	[✂]	[✂]
Correction of average net working capital	[✂]	[✂]	[✂]	[✂]	[✂]
Adjustment to land and buildings value	[✂]	[✂]	[✂]	[✂]	[✂]
Adjustments to leaseholds	[✂]	[✂]	[✂]	[✂]	[✂]
BMI calculation of capital employed	[✂]	[✂]	[✂]	[✂]	[✂]
Capital employed including 10% of goodwill	[✂]	[✂]	[✂]	[✂]	[✂]
Capital employed including 25% of goodwill	[✂]	[✂]	[✂]	[✂]	[✂]

Sources: the CC Model, BMI analysis.

Note: Adjustment to land and buildings value is that calculated in Table 3-4, above. An adjustment is only applied to the top 22 of BMI's hospitals, with the remainder being stated at reinstatement value.