ANNEX 6

PROFITABILITY

1. INTRODUCTION

1.1 Ramsay welcomes the CC's overall finding from its profitability analysis that it has not been earning excessive profits during the period under investigation. This supports the more general conclusion that Ramsay does not have market power either at the local level or in national negotiations with insurers, which further highlights the major inconsistency of the CC's local market analysis.[1]

1.2 However, Ramsay remains concerned with some of the CC's comments in the PFs. In particular, the CC states that "*Ramsay has earned returns in excess of the cost of capital in the last three years of the period*",[2] and that "*Ramsay has demonstrated a significant increase in profitability over the period, moving from a position of making profits that were less than the cost of capital to generating returns in excess of that level*".[3] The CC seems to be inferring from these statements that the last 3 years may in some way show that Ramsay is earning excessive returns, albeit that there is insufficient evidence to support a conclusion of excessive profits over the period as a whole.

1.3 Ramsay considers that any such allegations would be entirely unfounded. Whilst the CC has [✄] [CONFIDENTIAL] its ROCE calculations for Ramsay compared with those reported in the working paper (e.g. from an average of [✄] [CONFIDENTIAL] per cent over the 5-year period to [✄] [CONFIDENTIAL] per cent; equivalent to [✄] [CONFIDENTIAL]), Ramsay is concerned that the CC's profitability analysis continues to contain some manifest errors and omissions, which result in Ramsay's profitability being significantly overstated, particularly over the last 3 years of the period considered. These errors and omissions include, *inter alia*, the following:

1) Intangible assets are excluded

1.4 Ramsay notes that the CC has still not assigned any value to Ramsay for the intangible assets in its business, other than for the IT systems that were already included in Ramsay's asset base. This is an implausible position to take. On any objective basis the healthcare sector is a professional services and knowledge-based industry, and intangible assets must account for a proportion of the total asset base if a realistic economic valuation is to be attempted. Ramsay submitted a detailed response to the CC on intangible assets on 11 January 2013, and a further submission in response to the Annotated Issues Statement which described the various classes of intangible assets in its business.[4]

1.5 The CC seeks to justify the exclusion of these intangible assets on the basis that "*many of the other categories of intangibles proposed by the relevant firms did not represent expenditure that was additional to that necessarily incurred in running their businesses, or separable from the business*".[5] This reasoning is illogical and entirely circular.

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1 The CC has concluded from its profitability analysis that "*BMI, HCA and Spire have, during the period under review, been earning returns substantially and persistently in excess of the cost of capital*". The CC goes to explain that "*[t]his evidence is consistent with HCA, BMI and Spire, having market power and with our finding of barriers to entry*". Paragraph 43 of the PFs.

2 Paragraph 43 of the PFs.

3 Paragraph 6.275 of the PFs.

4 These include: (a) the established operating processes and procedures; (b) human capital in the form of an experienced and well trained workforce; (c) relationships with GPs, consultants, insurers, the NHS and ultimately patients; (d) leadership; brand and reputation; and (f) IT systems etc.

5 Paragraph 6.264 of the PFs.

1.6 All investments, whether in relation to tangible assets or intangible assets, arise to a greater or lesser degree in connection with the general running of the business. Investments in operating processes and procedures, for example, are not undertaken just for the sake of ensuring the current running of the business, but they represent an investment in knowledge and know-how that seeks to improve service and standards in order to drive the business forward, differentiate it from its competitors, and generate future returns. The fundamental value of these processes and procedures would be clearly shown by the potential severe detrimental impact on Ramsay's business if it were being deprived of these assets.

1.7 Similarly, Ramsay invests in human capital (i.e. developing an experienced and well trained workforce) and in creating relationships with GPs, consultants, insurers, the NHS etc. Whilst some of this expenditure is clearly relevant to Ramsay's current operations, it is also highly relevant to the future success of the business (e.g. in terms of generating future returns). Again, the CC has failed to differentiate between investment in an asset that is required for the general running of the business, and the value of processes, procedures and experience within a workforce in a knowledge based business that has the effect of generating future returns for the business (such as in human capital or in developing relationships with key stakeholders).

1.8 It is also of note that the CC's position in relation to intangible assets in this case is completely at odds with previous market investigations (e.g. local bus services, statutory audit, home credit), all of which included different categories of intangible assets. This further highlights the fundamental inconsistency in the CC's approach in this case: it is plainly implausible that a professional services and knowledge-based industry such as private healthcare can have a lower level of intangible assets than in the case of local bus services, yet this is precisely what the CC's analysis entails.

1.9 It is noteworthy that the CC seems to acknowledge that there are intangible assets in the business of a PH operator (i.e. the CC states that "*an operational business incurs some additional costs during the start-up phase - over and above the cost of replacing the tangible and current assets*"[6]). However, the CC has failed to quantify or take material consideration of these costs. The CC goes on to acknowledge that this means that its estimates of ROCE will be overstated, although it then makes the unsupported assertion that ROCE will only be "slightly" overstated. In the absence of seeking to quantify the magnitude of these costs the CC has erred in its assessment.

2) Fully depreciated assets

1.10 As set out in Ramsay's response to the Annotated Issues Statement, [✂] [CONFIDENTIAL]. These assets are currently providing a contribution to earnings and have an economic value. However, they have [✂] [CONFIDENTIAL] in Ramsay's accounts, are ignored by the CC and therefore result in ROCE being overstated.

1.11 The CC's explanation as to why it has failed to make any adjustment to its profitability analysis to take account of [✂] [CONFIDENTIAL] fully depreciated assets is obviously incorrect. The CC seems to suggest that just because the asset lives used in the accounts for depreciating certain assets do not match their actual economic lives, that this must mean that the asset lives used in the accounts are systematically wrong across <u>all</u> assets.[7] This is simply not the case.

1.12 [✂] [CONFIDENTIAL]. In relation to most other assets, however, Ramsay explained in response to the Financial Questionnaire that the assumed asset lives used for depreciation

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6 Paragraph 6.264 of the PFs.

7 The CC states in paragraph 120 of the PFs that "*in order to rectify this in a consistent manner, it would be necessary to adjust the timeframe over which all assets are depreciated to reflect their actual useful economic life, restating both the capital value and depreciation charged in each period*."

purposes in the accounts was a reasonable approximation for the actual economic lives of those assets. Accordingly, the adjustment for fully depreciated assets should be made in relation to those specific assets that are fully depreciated in the accounts, but not to all assets as suggested by the CC.

1.13 It is noteworthy that the CC seems to accept that "*the lack of quantification of start-up costs and <u>fully depreciated assets</u> in our analysis could result in the material misstatement of the level of returns being earned by the relevant firms. We concluded that if these could be quantified, it is likely that they would <u>reduce</u> our ROCE estimates*".[8] [Emphasis added] Accordingly, by failing to make such an adjustment, the CC has again accepted that its ROCE calculations are overstated.

1.14 The CC's position is unsupportable because as set out in Ramsay's response to the Annotated Issues Statement, Ramsay had re-worked the CC's ROCE calculations to take effect of those assets that were fully depreciated in the accounts but still in use, which gives an indication of the magnitude to which Ramsay's ROCE numbers are overstated. This one adjustment has the effect of:

(a) [✂] [CONFIDENTIAL] Ramsay's average ROCE over the five year period by [✂] [CONFIDENTIAL] percentage points (i.e. which would [✂] [CONFIDENTIAL] Ramsay's average ROCE from [✂] [CONFIDENTIAL] per cent, based on the figures in the PFs); and

(b) [✂] [CONFIDENTIAL] Ramsay's ROCE in [✂] [CONFIDENTIAL] by [✂] [CONFIDENTIAL] percentage points ([✂] [CONFIDENTIAL]) but [✂] [CONFIDENTIAL] Ramsay's ROCE in [✂] [CONFIDENTIAL] by [✂] [CONFIDENTIAL] percentage points respectively [✂] [CONFIDENTIAL].

1.15 Accordingly, by failing to make an adjustment for the assets that are fully depreciated in Ramsay's accounts but are still in use, not only is Ramsay's overall average ROCE overstated, but it also means that Ramsay's ROCE in the last three years of the reference period is materially overstated.

3) Revaluation of assets

1.16 Whilst the CC has accepted the general principle that the assets recorded in the accounts should be revalued to take account of their Modern Equivalent Asset (**"**MEA**"**) value (i.e. replacement cost), it is noteworthy that the CC has not made such adjustments in relation to the equipment, fittings and fixtures in Ramsay's hospitals. This is inconsistent with its approach to valuing freehold land and buildings, as well as the CC's own market investigation guidelines.

1.17 The CC seems to have dismissed carrying out such an adjustment on the basis that the economic life of the assets is generally short lived (i.e. less than 10 years), which means "*the carrying value of these assets in the accounts of the relevant firms were likely to be a reasonable approximation of their economic value*".[9] However, this logic is flawed. The cost of replacing these assets can generally be expected to have increased over time (e.g. due to inflation and technological advances), which means that the historic book cost may bear little resemblance to the actual replacement cost of those assets. The CC's approach is also inconsistent with that adopted in other market investigations. For example, in the recent market investigation into local bus services in the UK, the CC recognised that buses (within the same category of assets to those in question) needed to be adjusted to the MEA values.[10]

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8 Paragraph 6.280 of the PFs.

9 Paragraph 6.266 of the PFs.

10 Paragraphs 10.17 to 10.23, Local bus services market investigation, Final report.

1.18 Accordingly, the CC's approach of not revaluing the equipment, fittings and fixtures in Ramsay's hospitals is another clear example of adopting an approach that will understate the capital employed in its business. At the very least, the CC should revalue these assets to take account of inflation (e.g. using RPI or CPI).

4) Working capital

1.19 As mentioned in Ramsay's response to the Annotated Issues Statement, Ramsay's ROCE in [✂] [CONFIDENTIAL] is artificially inflated by a transitional change in the way that the NHS is paying for services, which has reduced the amount of working capital held in Ramsay's business (from [✂] [CONFIDENTIAL]).

1.20 However, despite this transitional change being specific to NHS services, which is outside the scope of the investigation, the CC has failed to make any adjustments to its calculations (i.e. the CC states in paragraph 132 that "*we have not conducted a sensitivity on the level of working capital employed by the relevant firms*". As set out in Ramsay's response to the Annotated Issues Statement, if this change is considered in isolation, Ramsay's calculations show that its average ROCE (based on the CC's calculations) is being inflated by [✂] [CONFIDENTIAL] percentage points and by [✂] [CONFIDENTIAL] percentage points in [✂] [CONFIDENTIAL] as a result of this change.[11]

1.21 Accordingly, the CC should be extremely cautious of jumping to conclusions in relation to the increase in Ramsay's ROCE in [✂] [CONFIDENTIAL], when this is likely to largely reflect the temporal change in the way it is being paid by the NHS.

5) NHS revenue

1.22 Ramsay remains concerned that the CC's profitability analysis has fundamentally failed to recognise the role of NHS-funded treatment in the improvement in Ramsay's performance. In particular, it is the increase in NHS-funded treatment that has allowed Ramsay to increase utilisation rates at its facilities, which has improved the efficiency of its fixed assets, and is ultimately what is driving the improvement in Ramsay's performance. The following chart shows that this could not be any clearer.

[11] Assuming that the average working capital balances over the previous four year period applies in [✂] [CONFIDENTIAL].

Chart 1: The evolution of Ramsay's NHS and privately funded (insured and self-pay) admissions (based on 12-month rolling annual volumes)

[✂] [CONFIDENTIAL]

1.23 The CC acknowledges that "*Ramsay has experienced a particularly large increase in the revenues generated from providing services to the NHS*"[12], but rather than concluding that this is what is driving the improvement in Ramsay's performance, the CC only goes so far as to say "*this may be obscuring the returns earned on private patients both over the relevant period and in the longer run*."[13]

1.24 This incomplete analysis gives rise to two fundamental errors.

(a) First, trying to draw parallels between the improvement in Ramsay's performance as a result of conducting more NHS-funded treatment and improving internal efficiency as against, in contrast, the profitability of the private healthcare sector, is a basic error and wholly misleading.

(b) Secondly, the obvious explanation for Ramsay's improved performance is from [✂] [CONFIDENTIAL].

1.25 Ramsay believes that the increase in NHS-funded treatment at its facilities has been [✂] [CONFIDENTIAL].

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12 Paragraph 6.282 of the PFs.

13 Ibid.