

Funerals Market Investigation

Approach to profitability and financial analysis

24 July 2019

This is one of a series of consultative working papers which will be published during the course of the investigation. This paper should be read alongside the issues statement and the other working papers which accompany it. These papers do not form the inquiry group's provisional findings. The group is carrying forward its information-gathering and analysis work and will proceed to prepare its provisional findings, which are currently scheduled for publication in March, taking into consideration responses to the consultation on the issues statement and the working papers. Parties wishing to comment on this paper should send their comments to funerals@cma.gov.uk by 7 August 2019.

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Introduction and purpose of this paper

1. On 28 March 2019 the Competition and Markets Authority (CMA), in exercise of its powers under sections 131 and 133 of the Enterprise Act 2002 (the Act), made a reference for a market investigation into the supply of (a) services by funeral directors at the point of need; and (b) the supply of crematoria services.
2. Shortly after the reference, on 8 April 2019, we published an Issues Statement, which based on the evidence reviewed to date set out:
 - (a) Our initial hypotheses concerning which features of the supply of services by funeral directors at the point of need (referred to as “funeral director services” in the rest of this working paper) and crematoria services are adversely affecting competition;¹ and
 - (b) a number of key areas on which we proposed to focus our evidence gathering efforts² to test our hypotheses.
3. In the Issues Statement we explained that the profitability of both large and small funeral directors and of local authority and private crematoria would be one of a number of key areas of focus.³
4. The purpose of this paper is to set out the CMA’s proposed approach to financial and profitability analysis of funeral director services and crematoria services, which will inform our assessment of profitability.
5. We have sent detailed financial information requests to:
 - (a) The three largest providers of funeral director services;⁴
 - (b) the four largest providers of crematoria services;⁵ and
 - (c) a representative sample of smaller firms within both the funeral director services and crematoria services markets.
6. We are currently reviewing these responses. This document sets out the CMA’s initial thoughts on a proposed methodology for our analysis and has been produced prior to a complete review of the information provided in response to the aforementioned information requests. The methodology may therefore be updated and/or amended based on the data and information

¹ Issues Statement, paragraph 5.

² Issues Statement, paragraph 8.

³ Issues Statement, paragraphs 8g and 8j.

⁴ Dignity Plc, Co-operative Group Limited and Funeral Partners Limited.

⁵ Dignity Plc, Westerleigh Group Limited, Memoria Limited and London Cremation Company PLC.

received. It should not, therefore, be assumed that we will always adopt the approach proposed in this document.

7. Nevertheless, we welcome views on the proposed methodology set out in this paper. Specifically, we are seeking input on:
 - (a) The proposed approach to profitability analysis of the largest providers of funeral director services and crematoria services, including:
 - (i) our approach to identifying relevant operating activities;
 - (ii) our approach to asset valuation and depreciation;
 - (iii) our approach to estimating the weighted average cost of capital (WACC);
 - (iv) our approach to analysing inefficiencies in the provision of funeral director services; and
 - (v) our plan to undertake asset utilisation sensitivities, when analysing the profitability of crematoria services.
 - (b) The proposed approach to profitability analysis of the smaller providers of funeral director services and crematoria services markets, including:
 - (i) our approach to sampling; and
 - (ii) our approach to estimating profitability for the smaller providers.
8. We welcome views and comments on this paper by 9 August 2019.

Role of profitability and financial analysis

9. The information obtained from our profitability analysis will be used across two main areas:
 - (a) *Diagnosis*: as part of our assessment of market outcomes which can help us determine whether there are any adverse effects on competition (AECs); and
 - (b) *Detriment*: as part of our assessment of the degree and nature of any detrimental effect on consumers so far as it has resulted from, or may be expected to result from, any AECs.
10. The rest of this section explains each of these two areas in more detail.

11. As set out in the Issues Statement, as part of our approach of identifying the universe of possible remedies, we included pricing/charging remedies.⁶ Such remedies would seek to limit the ability for funeral directors and/or crematoria operators to set prices significantly above the costs of providing their services.⁷ The financial information obtained through our profitability analysis may also be used to inform our assessment of price control remedies, should they be necessary. Through its contribution to our understanding of the reference markets and the extent of any consumer detriment, our financial analysis will help frame our consideration of remedies more broadly. However, this paper is addressing our diagnosis of profitability and consumer detriment only and does not seek to consider remedies.

Diagnosis

12. When reaching a view concerning the functioning of a market, we consider the outcomes of the competitive process in that market, including: prices and profitability; product quality and range; and levels of innovation.⁸
13. The aim of profitability analysis is to understand competitive conditions within a market, by examining the outcomes of that market in terms of the financial performance of the participating firms. The Market Investigation Guidelines (the Guidelines)⁹ state that:

‘Firms in a competitive market would generally earn no more than a ‘normal’ rate of profit – the minimum level of profits required to keep the factors of production in their current use in the long run, i.e. the rate of return on capital employed for a particular business activity would be equal to the opportunity cost of capital for that activity.’¹⁰
14. The purpose of conducting profitability analysis, therefore, is to understand whether the levels of profitability (and therefore prices) achieved by the firms in the reference markets are consistent with the levels we might expect in a competitive market. If excess profits (i.e. profits above the levels that we would expect in a competitive market) have been sustained over a sufficiently long period of time,¹¹ this could indicate limitations in the competitive process.

⁶ Issues Statement paragraphs 123 to 129.

⁷ Issues Statement, paragraph 12(a).

⁸ Market Investigation Guidelines (CC3 Revised), paragraph 103.

⁹ Market Investigation Guidelines (CC3 Revised).

¹⁰ Market Investigation Guidelines, (CC3 Revised), paragraph 116.

¹¹ See paragraphs 27 to 31 for a discussion of the relevant time period.

15. On the other hand, our Guidelines highlight that a finding of low profitability does not necessarily signify that competition is working well, since low profitability may be concealing ineffective competition. For example, incumbent firms, despite being protected from new entry, may not earn high profits because they are inefficient and operate with higher costs than would be sustainable with stronger competition in the market.¹²
16. We may also be interested in:
 - (a) Potential insights from our profitability analysis into the extent to which price differentials between providers reflect differences in quality.¹³ This is because we might expect higher quality to be associated with a higher cost base and therefore a higher price but not necessarily higher profitability.
 - (b) The trend in profits over the period of review as an indicator of improvements or deteriorations in the competitive environment. For example, where profitability has increased over a number of years, this may indicate a worsening of the competitive situation or weakening of competitive pressures in the reference markets.¹⁴
17. Any results from our profitability assessment will be interpreted in the wider context of our market investigation. In reaching a view about the functioning of the reference markets and identifying any market features that may have an adverse effect on competition, profitability will be only one of the outcomes of the competitive process we shall be taking into account.

Detriment

18. Profitability analysis can also be used as an indicator of the degree and nature of consumer detriment arising from any AECs.¹⁵ Should we find profits to be above the 'normal level' (as defined at paragraph 13), we plan to use these excess profits to inform our understanding of the extent of consumer detriment.
19. This paper does not comment further on our empirical approach to estimating detriment using the profitability analysis, as the assumptions and judgments used in the analyses for quantifying detriment will be the same as those used in the diagnosis phase.

¹² Market Investigation Guidelines, (CC3 Revised), paragraph 125.

¹³ Issues Statement, paragraph 8(g).

¹⁴ Market Investigation Guidelines, (CC3 Revised), paragraph 124.

¹⁵ Market Investigation Guidelines, (CC3 Revised), paragraph 104.

Scope of our analysis

20. In this section we set out the scope of our profitability assessment and the relationship with our terms of reference, highlighting which business activities we consider to be relevant, which firms we intend to analyse and the time over which we propose to assess profitability.

Funeral director services definition

21. For the purpose of this investigation ‘services by funeral directors at the point of need’ (referred to as ‘funeral director services’ in this working paper), means:¹⁶

- (a) Services provided by a funeral director in connection with the arrangements for a funeral, including, but without limitation:
- (i) guidance and support to the family and/or persons arranging the funeral;
 - (ii) collection, storage and care of the deceased;
 - (iii) organisation and services carried out on the day of the funeral;
 - (iv) the supply of goods and services to facilitate the arrangements, including, for example, the coffin, hearse and limousine(s);
 - (v) intermediary services between the customer and third parties, such as the crematorium or burial site, a doctor or medical practitioner, a minister or celebrant;
 - (vi) discretionary services that are provided by the funeral director directly or as an intermediary between the customer and third parties, such as memorials, death notices, venue hire and catering, flowers, Order of Service etc; and
 - (vii) the provision of services by funeral directors in connection with the redemption of a pre-paid funeral plan.
- (b) but excluding:
- (i) the provision of pre-paid funeral plans.

¹⁶ Issues Statement, paragraph 26.

22. The scope includes all services provided by funeral directors at the time of bereavement (regardless of whether such services are paid for at that time or have been paid for in advance, including as part of a pre-paid funeral plan).
23. The provision of pre-paid funeral plans, including financial services activities associated with the provision of pre-paid funeral plans (i.e. investment of funds from pre-paid plan sales and subsequent gains and losses, following actuarial valuations) and suppliers of pre-paid funeral plans are excluded from the terms of reference.

Crematoria services definition

24. For the purpose of this investigation 'crematoria services' means:¹⁷
 - (a) The services provided by a crematorium in connection with the cremation of the deceased, including the provision of a chapel or specific place for attended cremations, the committal and the associated sales of additional products and services, such as memorials, audio-visual support and hospitality.

Identifying the relevant firms providing funeral director services

25. Our market-wide profitability assessment for funeral director services will focus on two groups of firms:
 - (a) The three largest providers of funeral director services in the UK, namely Dignity Plc (Dignity), Co-operative Group Limited (Co-op) and Funeral Partners Limited (Funeral Partners).¹⁸ In the UK, these firms have an estimated combined market share of approximately 29%, based on number of deaths.¹⁹
 - (b) A representative sample of branches in the remaining 71% of the market, which is composed of smaller providers.²⁰

Identifying the relevant firms providing crematoria services

26. Our market-wide profitability assessment for crematoria services will focus on two groups of firms:

¹⁷ Issues Statement, paragraph 26.

¹⁸ Final Report from Phase 1, paragraph 2.26.

¹⁹ Final Report from Phase 1, paragraph 2.31 16%+11%+2%=29%.

²⁰ Sometimes referred to as 'the Independents'. Regional Co-operatives and direct cremation arrangers e.g. Pure Cremation Limited are included in the population from which Selected Branches are sampled.

- (a) The four largest providers of crematoria services in the UK, namely Dignity, Westerleigh Group Limited (Westerleigh), Memoria Limited (Memoria) and London Cremation Company PLC (LCC). In the UK, these firms have an estimated combined market share of approximately 31%,²¹ based on number of crematoria.
- (b) A representative sample of crematoria in the remaining 69% of the market, which is predominantly composed of local authority operated crematoria.²²

Time period under consideration

27. We aim to examine trends in profitability over a time period that is sufficiently long to provide a representative picture of profitability that is not unduly distorted by unusual macroeconomic conditions or one-off events. Our Guidelines recognise that the appropriate time period may vary depending on the specific market.²³
28. In our view, the profitability of the provision of funeral director services and crematoria services is unlikely to be materially influenced by unusual macroeconomic conditions, given that demand (in the form of the number of deaths) is largely independent of economic forces.
29. Having discussed the availability of data with the largest providers of funeral director services and crematoria services, and considered the nature of demand in the sector, we propose to collect data over a five-year historical period from 2014 to 2018, for both funeral director services and crematoria services (referred to as the “Relevant Period” in the rest of this working paper).
30. Where our profitability analysis is used to estimate detriment and therefore the proportionality of remedies, we propose to consider whether historical (or backward-looking) profitability is a good estimate of prospective (or forward-looking) profitability. We are therefore also collecting forecast information. The largest providers of funeral director services and crematoria services told us that as part of the ordinary course of business they forecast detailed²⁴

²¹ In June 2018, there were 293 Crematoria in the UK. Dignity owns 46 = 16% (46/293); Westerleigh owns 29 = 10% (29/293); Memoria owns 9 = 3% (9/293) and LCC owns 6 = 2% (6/293). 16%+10%+3%+2% = 31%. See Final Report from Phase 1, paragraphs 2.37, 2.38 and 2.39.

²² 110 crematoria are operated by private companies – our largest providers collectively operate 90 of these (46+29+9+6). Of the remaining 203, 183 are operated by local authorities (90%), with the remaining individually owned by private operators. See Final Report from Phase 1, paragraphs 2.37, 2.38 and 2.39.

²³ Market investigation Guidelines (CC3 Revised), paragraph 121.

²⁴ We understand that longer term forecasts are prepared at a higher level. We will consider these as part of our review of internal documents. See paragraphs 83(c), 130(c), 160 and 161 of this paper.

information for one financial year ahead. We are therefore collecting forecast data for 2019,²⁵ giving us a total time period of 2014 to 2019.

31. We shall consider whether, and at what point, updated numbers reflecting 2019 actuals and forecasts for 2020 will be useful for our assessment.

Proposed approach to profitability analysis

Overarching conceptual approach

Return on capital employed versus cost of capital

32. The analysis of profitability as a means of understanding competitive conditions in a market is based on the premise that in a competitive market firms would generally earn no more than a 'normal' rate of profit.²⁶ Our Guidelines define a 'normal' level of profit as:

'the minimum level of profits required to keep the factors of production in their current use in the long run, i.e. the rate of return on capital employed for a particular business activity would be equal to the opportunity cost of capital for that activity.'

33. The opportunity cost of capital is the weighted average return on capital,²⁷ which investors expect for providing capital to firms undertaking the in-scope activities. This can be thought of as a market-based return on investment, to compensate investors for providing money to the firms in the market.
34. The rationale for benchmarking return on capital with the opportunity cost of capital is that in a competitive market, if firms persistently earned in excess of the return required to compensate investors for the risks taken, we would expect entry and/or expansion. This entry/expansion would serve to compete away profits²⁸ in excess of the cost of capital up until the point where firms cover their total costs, including a market-based cost of capital and no more. Where firms persistently earn in excess of a normal return, this therefore signals that there may be limitations in the competitive process.
35. Our Guidelines, therefore, primarily refer to the rate of return on capital as a means of measuring profitability. Return on capital can be based on cash

²⁵ For those firms with a December year end, the 2019 forecasts will have the benefit of approximately 5 months of actuals, in the data we receive in response to the information requests.

²⁶ Market investigation Guidelines, (CC3 Revised), paragraph 116.

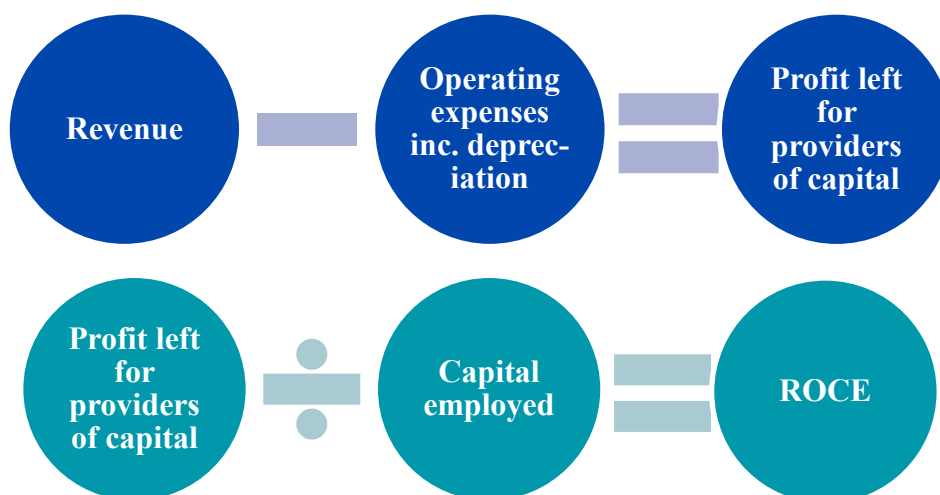
²⁷ Specifically, the mean ex ante expected return on capital of debt and equity holders, weighted by gearing.

²⁸ The time period over which this process may take place may differ between different sectors due to the time taken for entry and/or expansion of capacity.

flows (truncated internal rate of return (TIRR)) or profits (return on capital employed (ROCE)). Ordinarily, where data permits, we use ROCE, as this can be computed annually and thus provides greater insights into trends over time and the drivers of profits above the 'normal' level.

36. Figure 1 below illustrates how ROCE is calculated.

Figure 1: The components of ROCE



Source: CMA analysis. Note, profit left for providers of capital can be distributed or reinvested in the business.

37. The ROCE is then benchmarked against the weighted average cost of capital (WACC), over the Relevant Period. The WACC is the return on investment that providers of capital – both debt and equity – expect, given the risks associated with the relevant activity.²⁹
38. In practice, we might expect the profitability of some firms to exceed a 'normal' level from time to time.³⁰ However, a situation where the ROCE of firms representing a substantial part of the market has exceeded the WACC over a sustained period could be an indication of limitations in the competitive process.³¹
39. However, we note the following considerations when applying the ROCE versus WACC framework:
- (a) ROCE percentages can sometimes be distorted, for example where firms choose to lease a material portion of their assets, and these

²⁹ WACC is therefore expected return on equity and expected return on debt, weighted by gearing – the relative proportions of debt and equity.

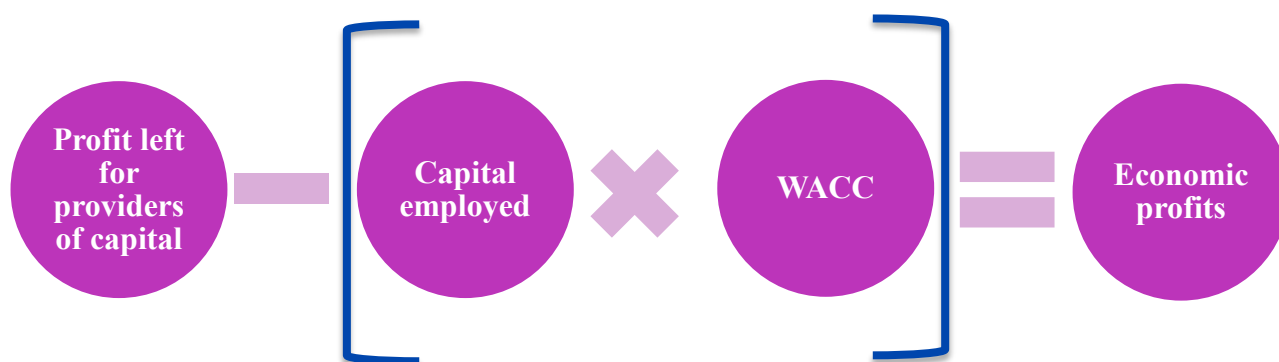
³⁰ Market investigation Guidelines (CC3 Revised), paragraph 117.

³¹ Market investigation Guidelines (CC3 Revised), paragraph 118.

leases are classified as operating leases for the purposes of financial reporting or where investment in intangibles³² is expensed, rather than capitalised;

- (b) ROCE percentages can sometimes be distorted by the choice of accounting depreciation method; and
 - (c) the scale of any excess profits, and therefore detriment, is not immediately clear from a percentage gap between ROCE and WACC.
40. The issues set out at paragraph 39, can to some extent³³ be alleviated by calculating economic profits in absolute terms. We therefore propose to calculate economic profits as well as ROCE. Economic profits are the profits left over, after the providers of capital have been paid a market-based return on their investment, which is equal to the capital employed multiplied by the WACC.

Figure 2: Economic profits



Source: CMA analysis. Note, profit left for providers of capital can be distributed or reinvested in the business.

41. Given that economic profits are revenues less total operating costs including a market-based cost of capital, they can be calculated using the same input data and analysis as ROCE versus WACC.
42. We recognise that economic profitability analysis, based on an ROCE versus WACC framework, requires a number of assumptions to be made. The results from economic profitability analysis can be sensitive to ranges around these assumptions, particularly with regards to asset valuations.³⁴ We

³² Assuming the expense is capital in nature, rather than simply an ongoing cost of running the business – see intangible recognition criteria at paragraph 67 of this working paper.

³³ A complete solution to distorted ROCEs also requires annuity depreciation as set out in paragraph 119.

³⁴ The importance of this issue often depends on the capital intensity of the business and the nature of the assets required to provide the in-scope activities. See for example, paragraph 23 of Appendix 9.9 'Approach to

therefore propose to supplement our ROCE analysis with additional analysis, such as margin benchmarking, as a sense check on our findings. More details of this 'additional analysis', are set out at paragraphs 155 to 157.

Scope of relevant operating revenues, costs, assets and liabilities

43. We determine the ROCE using operating profits and net operating capital employed and then compare it to the relevant pre-tax WACC. The general principle is that all revenues, costs, assets and liabilities necessarily arising from the operation of the business to supply the in-scope activities should be included.
44. In practice this means that the following items should be excluded:
 - (a) Financing costs both of a profit and loss and balance sheet nature, e.g. interest and sources of finance regardless of whether they are short- or long-term.
 - (b) Taxation on income and any associated corporation tax or deferred tax.

Economic versus accounting profitability

45. When estimating ROCE, our approach is to start with accounting profits and the balance sheets for the operating units of the firms that undertook the relevant activities, and then to make adjustments to arrive at an economically meaningful measure of profitability.
46. Deriving an economically meaningful measure of profitability from accounting data, in practice, usually requires adjustments to the following areas:
 - (a) *Value of capital employed in the business:* As set out in Figures 1 and 2 above, an assessment of economic profitability requires an estimate of the capital employed in the business. Capital employed is measured by valuing the assets needed to provide the in-scope activities.³⁵ When undertaking profitability analysis, the assets should, in theory, be valued according to the current opportunity cost of owning the asset or the value to the business (VTB).³⁶ This ordinarily requires an adjustment to one or more balance sheet values, as explained in paragraphs 47 to 48 below and the Annex.

profitability and financial analysis' of the CMA's Energy Market Investigation Final Report, for a discussion of the appropriate approach to profitability for energy generation as compared to retail.

³⁵ More specifically, the net operating assets.

³⁶ In practice this is only necessary where the impact of including assets at book value, rather than VTB has a material impact on the outturn results and conclusions.

(b) *Common cost and asset allocations*: where a firm undertakes other business activities, in addition to those which we are reviewing in the market investigation.

Our approach to asset valuation

47. The assets included in the capital employed input to profitability analysis, should reflect their current VTB.³⁷ The theory behind valuing assets at the VTB is set out in the Annex.
48. A valuation based on replacement cost or modern equivalent asset value (MEA) value is the most common outcome of a VTB assessment. This approach is consistent with our Guidelines, which state that the CMA considers MEA values to be the economically meaningful measure for the purpose of measuring profitability in most cases.³⁸

Allocating common costs and assets

49. We are interested in the profitability of the business activities which are in scope,³⁹ which in this case is the provision of funeral director services and crematoria services. We propose to analyse the profitability of these two different services separately.^{40,41} This is because pure play firms compete in the market i.e. there are stand-alone providers of crematoria services and/or funeral director services in the market.
50. Where the business activity being investigated is only one part of the firms' activities - for example for Dignity that provides both funeral director services and crematoria services - the financial information needs to be prepared as if these activities had been undertaken by the firm on a stand-alone basis. This will require allocation of common costs and assets, which as far as possible, should be done on a cost-causal basis.

Approach to the largest firms providing funeral director services

51. As set out at paragraph 25 above, we propose to undertake profitability analysis of the three largest providers of funeral director services; Dignity, Co-op and Funeral Partners.

³⁷ Also referred to as the deprival value, or value to the owner principle.

³⁸ Market Investigation Guidelines (CC3 Revised), Annex A, paragraph 14.

³⁹ Market Investigation Guidelines, (CC3 Revised), paragraph 114.

⁴⁰ This is particularly relevant for Dignity – as it provides both funeral director services and crematoria services.

⁴¹ In line with the approach taken on previous inquiries, such as the Energy Market Investigation, where retail and generation profitability were considered separately, on a stand-alone basis. See for example, paragraph 26 of Appendix 9.9 of the Final Report of the Energy Market Investigation, dated 24 June 2016.

52. This section sets out our proposed approach to assessing the profitability of the provision of funeral director services by these three firms. The rest of this section proceeds as follows:
- (a) First, we explain our approach to ensuring financial information is aligned to the in-scope activities, including our approach to any necessary cost and asset allocations;
 - (b) second, we set out our approach to asset valuation;
 - (c) third, we set out our approach to WACC;
 - (d) fourth, we set out our approach to assessing potential inefficiencies; and
 - (e) fifth, we set out our approach to considering forward-looking profitability.

Carving out costs and assets for the in-scope activities

53. All three of the largest firms provide services in addition to the provision of funeral director services at the point of need, defined at paragraph 21.
54. As set out at paragraph 50, we aim to calculate ROCE for a stand-alone provider supplying only the in-scope activities.
55. Our information requests have asked the relevant firms to carve out those activities which are in scope and provide financial information for the provision of funeral director services on a stand-alone basis. We have asked firms to explain their methodology for doing so.
56. We expect the following adjustments to be required for firms to do this:
- (a) *Allocation of common costs e.g. head office costs.* The idea being that sufficient costs are allocated to the provision of funeral director services such that a stand-alone firm could operate with the level of central costs included.
 - (b) *Allocation of common assets e.g. IT systems.* The idea being that sufficient assets are allocated to the provision of funeral director services such that that a stand-alone firm could operate with the assets included.
 - (c) *Any assets, liabilities, revenues and costs which are out of scope are excluded.* For example, assets and liabilities associated with investment activities from pre-paid plan sales.

57. We expect parties to approach adjustments 'a' and 'b' using the principles of cost causality and will be reviewing the adjustments made by parties through this lens. Where we do not consider that costs have been allocated on a cost-causal basis, we may make adjustments to the parties' approach to better represent the stand-alone costs of providing the in-scope funeral director services.
58. We expect that the material adjustment with regards to our analysis of funeral director services will be carving out the upfront sale of pre-paid plans and the subsequent investment activities. We expect this to be relatively straightforward on the Balance Sheet side, as any investments and liabilities held with respect to pre-paid plan sales appear to be reported separately (Co-op and Funeral Partners)⁴² or held off-balance sheet (Dignity).⁴³
59. Exclusion of revenues and costs associated with the *upfront sale* of pre-paid plans, and inclusion of revenues and costs associated with the *redemption* of pre-paid plans, is likely to be more complex.
60. Ideally, parties will include revenues for redemption of pre-paid plans and the costs incurred in arranging the funerals – in line with the scope defined at paragraph 21. Similarly, any upfront costs incurred to sell the plan, or revenue recognised at the point of sale, should be excluded.
61. Where this is not practical for the parties, due to the accounting standard applied in the relevant period,⁴⁴ we plan on assessing the materiality of upfront revenues and costs included in the financial information provided and the impact this has on outturn ROCE. If any revenues and costs recognised when a plan is sold do not materially impact our results, we propose to simply be mindful of the impact these revenues and costs might have, when interpreting our results. On the other hand, if any revenues and costs recognised when a plan is sold have a material impact on our results, we propose to work with the parties to make reasonable adjustments to remove the upfront revenues and costs.
62. In addition, we provisionally consider that the expected returns from investing the cash received from the sale of pre-paid plans is likely to be an important driver of the economics and pricing of pre-paid plans. Therefore, whilst the

⁴² Page 116 of Co-op's 2018 Annual Report states that funeral plan assets and liabilities are recorded on the Balance Sheet. Funeral Partners informed us in a data meeting that net investments in pre-paid plans was reported separately.

⁴³ Page 104 of Dignity plc's 2018 Annual Report states that the pre-arranged funeral plan trusts are not consolidated during the period as they are not controlled by the Group.

⁴⁴ For example, where the application of IAS 18 (prior to the roll-out of the new IFRS 15 standard) has resulted in recognition of certain revenues (associated with the costs incurred in achieving the sale) at the point of sale, rather than recognising the revenue at the point of redemption of a pre-paid plan.

investing activities are out of scope, for us to assess the profitability of pre-paid plan redemptions, a notional return on the cash received upfront will be included in the profits figure.

Approach to asset valuation

63. For the provision of funeral director services at the point of need, the main tangible assets are buildings (e.g. funeral homes and mortuaries) and the vehicle fleet. We are seeking information from the parties to understand to what extent the net book value on the Balance Sheet is a good approximation for the MEA value of these assets.
64. Where book value is not a good approximation for MEA value, we are seeking information from the parties on MEA value, for example through replacement cost estimates prepared for the purposes of insurance.
65. We propose to address the potential distortive effects on ROCE of firms leasing their assets, such as rented funeral homes, using the approach set out at paragraph 40 above. Where firms lease a significant portion of their assets, we shall consider whether lease capitalisation is necessary to avoid the distortive effect on ROCE.⁴⁵
66. In addition to the tangible assets used to provide at-need funeral director services, we shall consider whether certain intangible assets are required, including brand and reputation assets.
67. When determining whether to include an intangible asset, we propose to apply the following recognition criteria, which have been used on previous CMA inquiries.⁴⁶ An intangible asset must meet all three of the following conditions:
 - (a) It must comprise a cost that has been incurred primarily to obtain earnings in the future;
 - (b) this cost must be additional to those necessarily incurred at the time in running the business; and

⁴⁵ In line with IFRS 16 Leases.

⁴⁶ Based on a report by Oxera commissioned by the OFT in 2003 (Assessing profitability in competition policy analysis, Economics Discussion Paper 6, A report prepared for the OFT by Oxera) which was added to the CMA's Market Investigation Guidelines (CC3 Revised) – see Annex A, paragraph 14.

- (c) it must be identifiable as creating such an asset separate from any that arises from the general running of the business.⁴⁷
68. We plan on working with the parties to assess to what extent the intangible assets they consider necessary to provide funeral director services meet the above criteria. If they do not meet these criteria, then the expenses incurred to generate the intangible 'assets' referred to by the parties are not capital in nature i.e. investors are not deferring receipt of capital or forgoing a return from placing their capital elsewhere. Rather, the costs are simply ongoing costs of running the business, which will be captured in the ongoing costs in the profit and loss account, rather than as an asset in capital employed.
69. Depreciation, where relevant, will follow a straight-line approach in the first instance, unless it becomes apparent that economic or annuity depreciation would yield materially different results.⁴⁸

Approach to WACC

70. As set out at paragraphs 33 and 37 above, our ROCE estimates will be benchmarked against the WACC.
71. WACC is the weighted average cost of capital. More specifically, it is the mean return debt and equity investors expect for providing capital for the in-scope activities, weighted by the gearing.⁴⁹
72. We propose to estimate a market-based WACC, for a notional stand-alone provider of funeral director services at the point of need.
73. We propose to undertake two pieces of work to inform our WACC estimate.
74. Firstly, we propose to estimate our own WACC for a notional stand-alone provider, as follows:
- (a) We propose to estimate the cost of equity using the Capital Asset Pricing Model (CAPM). The CAPM is a one-factor model, with the beta – which measures the way returns on investment in a specific stock varies with returns on the market as whole⁵⁰ – being the only

⁴⁷ Market Investigation Guidelines (CC3 Revised), Annex A, paragraph 14 and Assessing profitability in competition policy analysis, Economics Discussion Paper 6, A report prepared for the OFT by Oxera, July 2003, paragraph 5.24(b).

⁴⁸ This is the case where asset replacement patterns are lumpy and infrequent.

⁴⁹ Gearing is the relative proportion of debt and equity.

⁵⁰ Specifically, the formula for beta is the covariance of the returns on the specific stock with returns on the market index divided by the variance of returns on the market index.

specific factor that needs estimating.⁵¹ We propose to estimate the beta using Dignity, as it is the only listed firm of the three largest firms,⁵² and listed international firms in the same sector.^{53,54} International firms will be identified as those listed in the US, Europe, Canada and Australia,⁵⁵ that provide funeral director services.

- (b) We shall consider whether adjusting the average beta is appropriate, given the systematic risk profile of the in-scope activities compared with the comparator data set. For example, Dignity's beta will reflect the risks faced by a listed provider of funeral director services and crematoria services. To the extent that funeral director services exposes investors to different levels of systematic risk than crematoria services, an adjustment may be required.
- (c) We shall consider if any adjustments are required to the CAPM outputs, owing to the shape of the distribution of expected returns i.e. if expected returns are skewed to the downside or upside.
- (d) The cost of debt will be estimated based on the actual cost of debt of the three largest firms in the market and the market evidence on the cost of debt for investment grade firms over the Relevant Period.
- (e) Gearing will be set based on the gearing of the comparator set of firms, described at paragraph 74(a) above.

75. Secondly, we shall consider the internal WACC estimates used by the largest providers in their internal investment decisions during the Relevant Period.

Assessment of potential inefficiencies

76. As set out at paragraph 15 above, a finding of low profitability would not necessarily signify that competition is working well. Low profitability may be concealing ineffective competition. Reasons for this may include:

'Weak competition as a result of customers not responding effectively to competing offers may sometimes result in an inefficient market structure in which operators have higher costs

⁵¹ Market-wide parameters – being the risk-free rate and equity risk premium, will be estimated using market data and follow regulatory precedent in this area, to the extent that the precedent remains relevant/valid.

⁵² Co-op is owned by its members and other Co-ops. Funeral Partners is owned by a private equity firm.

⁵³ Betas can only be estimated for listed firms.

⁵⁴ With due allowance for differences in gearing levels between the comparators.

⁵⁵ Countries/continents with comparable risk profiles to the UK with listed companies that provide funeral director services.

and set higher prices than would be the case in a competitive market.⁵⁶

Incumbent firms, despite being protected from new entry, are not earning high profits because they are inefficient and operate with higher costs than would be sustainable with stronger competition in the market.⁵⁷

77. Whilst we might expect some variation in efficiency levels in a well-functioning (rather than a perfectly competitive) market, we consider that there is sufficient evidence from the Market Study phase to warrant further exploration of inefficiencies in this phase of the investigation.⁵⁸
78. Inefficiencies can arise where too much is paid for key inputs and/or key inputs are underutilised. Based on our understanding of the cost structure for the provision of funeral director services, property, vehicles and staff costs are the material cost items. It follows that inefficiencies could arise in areas such as the following:
- (a) Investment in vehicles i.e. spending too much on vehicles;
 - (b) investment in buildings i.e. spending too much on funeral homes and mortuaries;
 - (c) the level of staff remuneration i.e. paying too much for staff;
 - (d) utilisation of vehicles e.g. funerals per hearse per week;
 - (e) utilisation of staff e.g. funerals per full time equivalent (FTE) per week; and
 - (f) utilisation of buildings e.g. funerals per funeral home per annum.
79. We propose to undertake descriptive analysis for those areas set out at paragraph 78, across the three largest providers.⁵⁹ Such descriptive analysis could include:
- (a) Variability in actual costs per funeral; and
 - (b) key asset and staff utilisation metrics.

⁵⁶ Market Investigation Guidelines, (CC3 Revised), paragraph 125b.

⁵⁷ Market Investigation Guidelines, (CC3 Revised), paragraph 125c.

⁵⁸ Issues Statement, paragraph 62.

⁵⁹ Data permitting, this analysis may be supplemented with data from the Selected Branches of the smaller providers. See the section on our approach to the fragment portion of the funeral director services market.

80. Where we find large variations in the metrics set out at paragraphs 78 and 79, that may provide evidence that competition is not working well in the provision of funeral director services.
81. There may be certain legitimate reasons for variations in costs and asset utilisation, such as:
- (a) Higher costs coinciding with a higher quality of service, such as more staff time on health and safety activities.⁶⁰
 - (b) Variations in costs due to exogenous factors, such as cost differences based on location.⁶¹
82. We consider that the issues identified at paragraph 81 are mitigated, to some extent, by placing more weight on the evidence we find around utilisation metrics i.e. ratios based on items 'd' to 'f' in paragraph 78, rather than the absolute cost estimates i.e. the amount paid for inputs. This is because utilisation metrics are likely to be largely independent of the amount paid for inputs.

Forward-looking profitability

83. As set out at paragraph 30, where our profitability analysis is used to estimate detriment, and therefore the proportionality of remedies, we shall consider whether profitability in the past is a good estimate of forward-looking profitability. In order to do this, we propose to assess the following:⁶²
- (a) Trends in profitability over time and the drivers of such trends. By way of example if profitability has declined, we propose to explore whether this is due to one-off costs associated with internal projects undertaken by a provider or due to long term increases in the costs of providing funeral director services. We propose to do this by comparing costs year-on-year and identifying the drivers of changes in these costs;
 - (b) the impact any potential mix changes (i.e. changes in the relative proportion of different funeral packages sold) will have on profitability.

⁶⁰ The importance of this caveat will depend on the strength of the evidence we obtain regarding quality differentials across providers.

⁶¹ Asset utilisation may also vary over the year due to higher death rates in the winter. Nevertheless, if the analysis is done annually and benchmarking is done within the sector this should not be an issue. However, we may also consider whether inter-year variation in the death rate is sufficiently great to drive year on year variation in utilisation.

⁶² There will be other areas of research to understand the drivers of any change in profitability such as changes in consumer behaviour and price competition in the market. This paper addresses the assessment of profitability only.

For example, what impact an increase in the proportion of ‘simple funeral’ packages would have on profitability.⁶³ We are working with the largest providers to see if it is possible to estimate profitability by package, which will help us assess the impact any future mix changes may have on overall profitability; and

(c) internal documents around forward-looking profitability.

Approach to the smaller providers in the funeral director services market

84. A set out at paragraph 25, we propose to undertake profitability analysis for a representative sample of the branches in the 71% of the market, which is predominantly composed of smaller providers. In the rest of this section we refer to the selected branches as the “Selected Branches”.
85. This section sets out our proposed approach to assessing the profits made by the Selected Branches when supplying funeral director services. The rest of this section proceeds as follows:
- (a) First, we explain, briefly, the limitations in the available data, which we have identified in planning our assessment of profitability for the fragmented portion of the funeral director services market;
 - (b) second, we set out our approach to sampling and therefore identifying the Selected Branches;
 - (c) third, we set out our approach to assessing profitability for the Selected Branches;
 - (d) fourth, we set out our approach to WACC; and
 - (e) fifth, we set out our approach to assessing potential inefficiencies.

Data challenges in the fragmented portion of the funeral director services market

86. 71% of the funeral director services market is supplied by approximately 5,000 branches,⁶⁴ operated by smaller providers. Analysing the profitability of such a large number of suppliers is a challenge.

⁶³ As set out at paragraph 27 of the Issues Statement, ‘Simple funeral’ means a more limited, lower cost (i.e. lower priced) funeral that may: exclude provision of limousines; have no/limited choice of slot for the funeral director service; have no viewing options and/or include a basic coffin with no/limited opportunity to upgrade.

⁶⁴ Approximately 7,000 branches in the UK, see the Market Study final report, paragraph 2.30. 71%*7,000~5,000 (assuming number of funerals is broadly equivalent across branches).

87. Furthermore, there is limited publicly available information on the profitability of the smaller providers. This is due to the majority of the smaller providers being small enough to meet small company reporting requirements and therefore producing abridged or filleted accounts, in which there is no requirement to produce a profit and loss account.⁶⁵
88. It is not therefore possible to do a comprehensive market-wide analysis using publicly available data.

Approach to sampling

89. Given the limited publicly available data, and the fragmented nature of this portion of the market, we propose to take a sampling approach to obtaining data and undertaking profitability analysis.
90. As there is no complete list of all funeral director branches in the UK, we created a list from a range of data sources.⁶⁶ Combining these together, and removing duplicates, resulted in a list of approximately 7,000 funeral director branches.⁶⁷
91. Having used a range of sources as the basis for this list, we are confident that we have captured a large proportion of the market. The total number of funeral director branches is supported by findings from the Market Study, that in 2017 there were estimated to be just under 7,000 funeral director branches in the UK.⁶⁸
92. In selecting the sampling frame and the variables we used for stratification, we were mindful of:
 - (a) The two options for the sampling frame being either the firm or the branch;
 - (b) the variables that we considered most likely to impact costs, revenues and volumes, and therefore profits; and

⁶⁵ Of the 2,500 firms recorded under the 'Funeral and related services' SIC code on Companies House, just 55 produce a full set of accounts. This figure includes the accounts of the three largest providers and their subsidiaries.

⁶⁶ The sources of data were: trade associations (NAFD, SAIF), pre-paid funeral plan providers (Golden Charter, Avalon), companies' own lists of branches (Dignity, Co-op) and CMA research reviewing smaller websites for branches that were not covered in the trade associations' lists.

⁶⁷ Duplicates are likely to remain in this list due to data quality issues (i.e. errors in postcodes or addresses) and inconsistencies between the data sources (i.e. spelling of branch names or not including a street number). As the number of branches affected is likely to be small relative to total number of branches, the effect on the sampling is expected to be small.

⁶⁸ Market Study Final Report , paragraph 2.30.

- (c) the availability of data on the variables identified in 'b'.
93. We considered that the primary drivers of cost and revenue variation across providers are likely to be:
- (a) *Region*: between the regions of England, and the countries Wales, Scotland and Northern Ireland, there are likely to be variations in the cost of land and labour, and in population and demographics.
 - (b) *Urban/rural classification*: there may be cost differences of serving each of these types of areas such as differing staff salaries, land values and transport costs.
 - (c) *Volumes*: where fixed costs are material, volumes are likely to materially impact costs per funeral and variations in revenue may be driven by differences in volumes.⁶⁹
94. We selected the branch, rather than the firm for the sampling frame. This is because the variables listed above could vary across the branches of a multi-branch firm.
95. For the stratification variables, we selected Ownership,⁷⁰ Region and Urban/Rural classification. This was owing to limited data on volumes across the approximately 5,000 branches owned by smaller providers.
96. We propose to target a sample size of 100 Selected Branches.⁷¹ To achieve 100, we have sampled 110, owing to anticipated difficulties with getting a 100% response rate to our questionnaires. These Selected Branches will receive a financial questionnaire seeking data for our profitability assessment.

Approach to estimating profitability

97. As a matter of principle, we consider that ROCE is the theoretically correct method for analysing profitability, for the reasons set out at paragraph 32 to 35 above. However, the information which we can collect from the Selected Branches is necessarily more limited than the information we can collect from the largest providers. This is due to the smaller providers being

⁶⁹ We also added a variable for ownership structure. This allowed us to remove branches owned by the three largest funeral directors from the list of Selected Branches.

⁷⁰ This allowed us to remove branches owned by the three largest funeral directors from the list of Selected Branches.

⁷¹ We consider this is likely to be a large enough sample to draw robust inferences, while remaining manageable in terms of stakeholder management and analysing responses.

predominantly small (often family-run) businesses, which may not have full time accountants or bookkeepers.

98. We have therefore kept our financial questions concise, whilst still aiming to obtain sufficient data, in order to undertake the analysis.
99. The main implication of this relates to asset valuation. Unlike with the three largest providers, we have not asked the Selected Branches to assess whether net book value is a good approximation for MEA value, nor have we asked them to provide evidence on MEA values. However, we propose the following options for estimating capital employed in the Selected Branches, depending on data availability:
- (a) We are requesting an asset register for the Relevant Period. This should allow us to assess whether property and vehicles have been depreciated in line with their useful economic life or whether these assets may need revaluing. We should then be able to use data within the asset register of the Selected Branch (e.g. initial purchase price), publicly available data⁷² and/or data provided by the three largest providers, to inform any revaluations for the Selected Branches.
 - (b) We may also calculate the ratio of book value to MEA value for the largest funeral providers and apply this ratio to the book values of the Selected Branches and calculate the impact on ROCE. For example, if MEA value:book value for the largest funeral providers is 1.2, we can multiply net operating assets by 1.2 and recalculate ROCE for the Selected Branches. How robust this is as an approach will depend, in part, on how comparable the accounting policies are for asset valuation between the largest providers and the Selected Branches.⁷³
100. Which (if any) of the options set out at paragraph 99 are adopted may depend on the response rate from the Selected Branches.
101. Given the potential for the information from the Selected Branches being insufficient to calculate a robust ROCE, we also plan on analysing the profit margins⁷⁴ of the Selected Branches. The margins earned can then be benchmarked against the following:

⁷² Such as property and vehicle prices.

⁷³ By way of example, if the largest providers record their property at market value whereas the Selected Branches record property at historical cost, the uplift to move from book value to MEA value may be larger for the Selected Branches compared with the largest providers.

⁷⁴ EBIT margins will be used in the first instance. We shall consider whether EBITDA is more appropriate once we have data on the prevalence of different asset financing strategies and depreciation policies.

- (a) The actual margins earned by the three largest providers;⁷⁵ and
 - (b) our calculation of the normal margin which would be required for the three largest providers to pay their debt and equity providers a market-based WACC.⁷⁶
102. Having calculated the profits made by the Selected Branches (on the basis of ROCE, economic profits and/or margin, depending on data availability), we propose to extrapolate our findings across the population.

Approach to estimating WACC

103. In the first instance, we propose to use the WACC estimated for the three largest providers as a benchmark for ROCE.
104. We shall consider whether the smaller providers have a higher cost of capital because of their ownership structure and lack of access to listed debt markets.

Assessment of potential inefficiencies

105. As with the largest providers of funeral director services, we are collecting data on the cost per funeral and asset and staff utilisation across the sampled branches. Where we find large variations in these metrics, this may provide evidence that competition is not working well in the provision of funeral director services.

Approach to the largest firms providing crematoria services

106. As set out at paragraph 26, we propose to undertake profitability analysis for the four largest providers of crematoria services; Dignity, Westerleigh, Memoria and LCC.
107. This section sets out our proposed approach to assessing the profitability of the provision of crematoria services for these four firms. The rest of this section proceeds as follows:

⁷⁵ Including analysis of how the margins of the smaller and largest providers compare over time.

⁷⁶ Normal EBIT margin = $WACC \times \text{capital employed} / (\text{total operating costs including depreciation} + (WACC \times \text{capital employed}))$. Where WACC is pre-tax. We may use EBITDA (earnings before interest, tax, depreciation and amortisation), if the depreciation policies are materially different between the largest and smaller providers.

- (a) First, we explain our approach to getting financial information aligned to the in-scope activities, including our approach to any necessary cost and asset allocations;
- (b) second, we set out our approach to asset valuation;
- (c) third, we set out our approach to WACC;
- (d) fourth, we set out approach to asset utilisation sensitivities; and
- (e) fifth, we set out our approach to considering forward-looking profitability.

Carving out costs and assets for the in-scope activities

- 108. As set out at paragraph 50, we aim to calculate ROCE for a stand-alone provider supplying only the in-scope activities.
- 109. Of the largest four providers of crematoria services, Dignity has the most diverse portfolio of services, from which only the activities in scope under crematoria services are required to assess the profitability of Dignity's crematoria services business.
- 110. Westerleigh and Memoria both provide some burial services, which are out of scope of the market investigation and therefore need carving out.⁷⁷
- 111. LCC only provides crematoria services, so this section is not relevant for LCC.⁷⁸
- 112. Our approach in the information requests has been to ask the relevant firms to carve out those activities which are in scope and provide financial information for the provision of crematoria services on a stand-alone basis. We have asked firms to explain their methodology for doing so.
- 113. We expect the following adjustments to be required for firms to do this:
 - (a) *Allocation of common costs e.g. head office costs.* The idea being that sufficient costs are allocated to the provision of crematoria services such that a stand-alone firm could operate with the level of central costs included.

⁷⁷ Memoria also sells pre-paid plans. We shall consider whether the assets and income from these pre-paid plan sales are material enough to warrant a separate carving out exercise.

⁷⁸ LCC told us in a data meeting that they have rental income of approximately £20,000 from rental properties. This is likely to be immaterial.

- (b) *Allocation of common assets e.g. IT systems.* The idea being that sufficient assets are allocated to the provision of crematoria services such that a stand-alone firm could operate with the assets included.
- (c) *Any assets, liabilities, revenues and costs which are out of scope are excluded.* For example, land required for the provision of burials.
114. We expect parties to approach adjustments ‘a’ and ‘b’ using the principles of cost causality and will be reviewing the adjustments made by parties through this lens. Where we do not consider that costs have been allocated on a cost-causal basis, or where parties have declined to undertake such an exercise, we may make adjustments to the parties’ financial information to better represent the stand-alone costs of providing the in-scope crematoria services.
115. We expect that the material adjustment with regards to our analysis of crematoria services will be stripping out the land assets associated with the provision of burials, where a site contains both a crematorium and a cemetery. For sites where this applies, we therefore propose to carve out the land value on the basis of the proportion of the land that is used for burials as compared to cremations and any associated memorials.

Approach to asset valuation

116. For the provision of crematoria services, the material assets are the land and crematorium building and the cremator equipment. We are seeking information from the largest providers⁷⁹ to understand to what extent the net book value on the Balance Sheet for these assets is a good approximation for the MEA value.
117. Where book value is not a good approximation for MEA value, we are seeking information from the parties on MEA value. Evidence for MEA value may include, for example, replacement cost estimates prepared for the purposes of insurance and/or the cost of constructing a new crematorium.⁸⁰
118. With regards to the depreciation profile of the crematoria buildings, we propose to depreciate the building from the point at which the crematorium was first constructed. We are working with the largest firms⁸¹ to understand the useful economic lives of crematoria buildings, and therefore the period over which the assets will be depreciated. However, we are open to the

⁷⁹ Those listed at paragraph 26(a).

⁸⁰ With an appropriate deduction for depreciation.

⁸¹ Those listed at paragraph 26(a).

possibility that certain of the crematoria assets may not depreciate if maintained correctly, such as the building shell.

119. Where crematoria assets have a finite useful economic life, we consider that the depreciation profile will need to follow an annuity approach⁸² to ensure the lumpy investment profile does not distort outturn ROCE estimates.
120. We propose to value the land based on its average market value during each year of the Relevant Period and not apply depreciation. This will involve indexing the purchase price from the point of acquisition, using an appropriate land value index.⁸³ The exception to this approach will be where a crematorium has been constructed on land that would not have been granted planning permission for a new crematorium during the Relevant Period. For example, where a crematorium is constructed close to residential property. This is because the replacement cost would not equal the cost of purchasing the land in the residential area where the crematoria is located, as planning would not be granted. Rather, to obtain an equivalent asset (if deprived of its existing land), an operator would have to purchase land that would have been granted planning permission in the Relevant Period. Here, we propose to identify nearby land that would have been likely to receive planning permission and value the area of land on which the crematorium is located, in line with the market value of this suitable land nearby.
121. Any intangible assets which are put to us by firms will be assessed against the criteria set out at paragraph 67 above.

Approach to WACC

122. As with our approach to estimating WACC for the largest funeral director services providers, we propose to calculate a market-based WACC, for a notional stand-alone provider of crematoria services.
123. We propose to undertake two pieces of work to inform our WACC estimate.
124. Firstly, we propose to estimate our own WACC for a notional stand-alone provider, as follows:

⁸² Annuity depreciation works much like a mortgage that has both capital repayment and interest or similarly the actuarial method of accounting for a finance lease. Early in the period a high return on capital element is charged and a smaller depreciation charge. Towards the end of the period, greater depreciation is charged and only a small portion of interest is charged. This ensures a constant total cost of the asset – comprising both the return on capital and depreciation – and smooths out ROCE, which can get distorted with large, lumpy investments.

⁸³ Unless land values have not changed materially during the Relevant Period.

- (a) We propose to estimate the cost of equity using the CAPM, which is explained at paragraph 74(a). We propose to estimate the beta using Dignity, as it is the only listed firm of the four largest firms,⁸⁴ and listed international firms in the same sector.^{85,86} International firms will be identified as those listed in the US, Europe, Canada and Australia,⁸⁷ that provide crematoria services.
- (b) We shall then consider whether adjusting the average beta is appropriate, given the systematic risk profile of the in-scope activities compared with the comparator data set. For example, Dignity's beta will reflect the risks faced by a listed provider of funeral director services and crematoria services. To the extent that crematoria services expose investors to different levels of systematic risk than funeral director services, an adjustment may therefore be required.
- (c) We shall consider if any adjustments are required to the CAPM outputs, owing to the shape of the distribution of expected returns i.e. if expected returns are skewed to the downside or upside.
- (d) The cost of debt will be estimated based on the actual cost of debt of the four largest firms in the market and the market evidence on the cost of debt for investment grade firms over the Relevant Period.
- (e) Gearing will be set based on the gearing of the comparator set of firms, described at paragraph 124(a) above.

125. Secondly, we shall consider the internal WACC estimates used by the largest providers in their internal investment decisions during the Relevant Period.

Asset utilisation sensitivities

- 126. Due to the high fixed costs associated with the provision of crematoria services (primarily the cost of the crematoria building itself), the volume of cremations is likely to be a key driver of profitability.
- 127. There has been significant expansion in the provision of crematoria services during the Relevant Period. A number of the crematoria operated by the four largest providers are therefore still relatively new. To the extent that new crematoria take some time to reach target levels of capacity utilisation, the

⁸⁴ Westerleigh and Memoria are privately owned and LCC is owned by a charity.

⁸⁵ Betas can only be estimated for listed firms.

⁸⁶ With due allowance for differences in gearing levels between the comparators.

⁸⁷ Countries/continents with comparable risk profiles to the UK with listed companies that provide crematoria services.

presence of a large number of new crematoria in a firm's portfolio may serve to reduce profitability. This is because volumes and therefore capacity utilisation may remain low for a period of time, which means that the cost per cremation is higher and, all else equal, the profitability is lower.

128. We therefore propose to undertake sensitivity analysis to test the impact that different levels of capacity utilisation have on profitability. Capacity utilisation estimates for use in this sensitivity will be based on:
- (a) Internal investment appraisal documents from the four largest providers, which are likely to include volume forecasts over time, from the point at which the crematorium becomes operational; and
 - (b) Capacity utilisation data from across the market, including local authorities.
129. Finally, we propose to collect data on staff utilisation, such as cremations per FTE per week, to understand the range of staff utilisation across the largest providers. Where we find large variations in these metrics, this may provide evidence that competition is not working well in the provision of crematoria services (for the reasons outlined at paragraph 15).

Forward-looking profitability

130. As set out at paragraph 30, where our profitability analysis is used to estimate detriment and therefore the proportionality of remedies, we shall consider whether profitability in the past is a good estimate of forward-looking profitability. In order to do this, we propose to assess the following:⁸⁸
- (a) Trends in profitability over time and the drivers of such trends;
 - (b) the impact any potential mix changes (i.e. changes in the relative proportion of different cremation packages) will have on profitability. For example, what impact an increase in the proportion of direct cremations would have on profitability. We are working with the four largest providers to see if it is possible to estimate profitability by package, which will inform our understanding of the impact any future mix changes may have on overall profitability; and
 - (c) internal documents around forward-looking profitability.

⁸⁸ There will be other areas of research to understand the drivers of any change in profitability such as changes in consumer behaviour and price competition in the market. This paper addresses the assessment of profitability only.

Approach to the smaller providers in the crematoria services market

131. As set out at paragraph 26, we propose to undertake profitability analysis for a representative sample of the crematoria in the remaining 69% of the market, which is predominantly composed of crematoria operated by local authorities.
132. This section sets out our proposed approach to assessing the profitability of the fragmented portion of the crematoria services market. The rest of this section proceeds as follows:
- (a) First, we explain the extent to which publicly available information is available for the fragmented portion of the crematoria market and what analysis we plan on doing with this information;
 - (b) second, we set out our approach to sampling those crematoria which will be analysed in detail – referred to as the Selected Crematoria;
 - (c) third, we set out our approach to estimating profitability for the Selected Crematoria;
 - (d) fourth, we set out our approach to WACC; and
 - (e) fifth, we note that we propose to undertake asset utilisation sensitivities.

Analysis of publicly available information

133. Local Authorities make up 90%⁸⁹ of the smaller providers in the crematoria services market.⁹⁰ Separate financial statements for the operation of the local authority run crematoria are not publicly available.
134. However, the Chartered Institute of Public Finance and Accountancy (CIPFA) undertakes annual surveys of local authority operations, in order to provide managers of the services with information about how their activities compare with operations in similar organisations.⁹¹ Relevant to our assessment of profitability is the CIPFA survey which requests financial information on crematoria operated by local authorities.

⁸⁹ See paragraph 26 of this Working Paper.

⁹⁰ Smaller providers comprise 69% of the total market for crematoria services. See paragraph 26 of this Working Paper.

⁹¹ <https://www.cipfastats.net/terms.asp>

135. CIPFA sends a questionnaire which includes questions on the financial performance of 194 local authority operated crematoria.⁹² The response rate is just under 40%.⁹³
136. We propose to analyse two years of this data to assess margins across the local authority operated crematoria. The margins earned will then be compared against:
- (a) The actual margins earned by the four largest providers;⁹⁴ and
 - (b) our calculation of the normal margin which would be required for the four largest providers and the Selected Crematoria to pay their debt and equity providers a market-based WACC.⁹⁵
137. In undertaking the above exercise, we recognise that margins are directly linked to capital employed, so higher levels of investment require higher margins. The extent to which we consider the margins of the larger operators and the Selected Crematoria to be suitable benchmarks for the margins of the local authorities in the CIPFA dataset will, therefore, depend on how comparable the level of investment is across the different crematoria.
138. In addition, we propose to analyse how margins vary across the crematoria that responded to the CIPFA questionnaire. Evidence of a large range in the outturn margin may suggest that some local authorities are cross-subsidising other services.

Approach to sampling

139. Given that the CIPFA dataset cannot be used to estimate ROCE and local authorities make up 90% of the fragmented portion of the market,⁹⁶ we propose to follow a sampling approach to assessing the economic profitability of the fragmented portion of the crematoria services market. This will be assessed in conjunction with the CIPFA dataset.
140. We used data from the Institute of Cemetery & Crematorium Management (ICCM) and the Cremation Society of Great Britain to create a complete list

⁹² The CIPFA questionnaire is sent to 194 local authorities. However, we understand that there are only 184 local authorities that operate crematoria. We suspect that the questionnaire is sent in error to 10 local authorities that don't operate crematoria.

⁹³ 73 respondents out of 194 (37.6% response rate).

⁹⁴ We propose to compare net margins for the local authorities to the after-tax margins (EBI) of the private operators, seeing as EBIT for the private providers needs to be higher, in order to meet their corporation tax bill.

⁹⁵ Normal margin = $WACC \times \text{capital employed} / (\text{total operating costs including depreciation} + (WACC \times \text{capital employed}))$.

⁹⁶ In the CIPFA data set, only incremental capital investments are recorded for the previous five years, rather than total replacement cost estimates being requested, which is what we require for our ROCE assessment.

(including both crematoria operated by local authorities and smaller private providers) of crematoria in the UK. We consider these data sources to be the best available for the information we require.

141. In selecting the sampling frame and the variables we used for stratification, we were mindful of:
- (a) The variables that we considered most likely to impact costs and revenues and therefore profits; and
 - (b) the availability of data on the variables identified in 'a'.
142. We considered that the primary drivers of cost and revenue variation across providers were likely to be:
- (a) *Region*: the regions of England and the countries Wales, Scotland and Northern Ireland. To reflect cost variations in land and labour and variations in population and demographics.
 - (b) *Volumes*: this is because fixed costs are material, so volumes are likely to materially impact costs per cremation and variations in revenue may be driven by differences in volumes.⁹⁷
143. For the stratification variables, we selected both of the above variables and ownership structure.⁹⁸
144. We are targeting a sample size of 22 Selected Crematoria.⁹⁹ These Selected Crematoria will receive a financial questionnaire seeking data for our profitability assessment.

Approach to estimating profitability

145. As a matter of principle, we consider that ROCE is the theoretically correct method for analysing profitability, for the reasons set out at paragraph 32 to 35 above. We shall therefore aim to collect sufficient data to undertake a ROCE calculation for the Selected Crematoria.
146. We consider that the profit estimate for the numerator should be relatively straight forward.¹⁰⁰

⁹⁷ We also added a variable for ownership structure. This allowed us to remove crematoria owned by the four largest providers from the list of Selected Crematoria.

⁹⁸ This allowed us to remove crematoria owned by the four largest providers from the list of Selected Crematoria.

⁹⁹ Just over 10% of the population of smaller providers.

¹⁰⁰ Except for any adjustment to depreciation necessarily arising from asset revaluations.

147. The capital employed, as with the largest four crematoria operators, will require detailed analysis and consideration. In principle, we would like to approach the valuation of the crematorium building, land and cremator equipment in the same way as for the four largest operators (set out at paragraphs 116 to 120 above). This is because to understand the profitability of a capital-intensive activity, like the provision of crematoria services, getting a robust estimate of the MEA value for the building and land and therefore the cost of capital faced by the operators, will be key.
148. The questionnaires sent to the Selected Crematoria therefore include questions regarding the date of initial construction, the initial cost of acquiring the land and constructing the building and the useful economic life of the assets.
149. We understand that some crematoria operated by local authorities were constructed over 50 years ago. This poses some data and conceptual challenges.
- (a) First, where the crematorium building was constructed such a long time ago it may be unlikely that data is available on the initial construction costs. Alternatively, where construction costs do exist, they may not represent the MEA value of a crematoria building during the Relevant Period.¹⁰¹ Where this is the case, we may therefore try to construct a MEA value estimate by either:
- (ii) Indexing the initial construction costs using a suitable construction price index; and/or
- (iii) using the replacement cost estimates from private operators that have constructed a crematorium recently.¹⁰²
- (b) Second, where the evidence shows that crematoria assets have a finite useful economic life (see paragraphs 118 and 119), we may find that certain local authorities have crematoria with assets that are 'life-expired'. In other words, the assets are past their optimal useful economic life and should have been replaced. Where this is the case, we propose to include a notional value for capital employed, reflecting the value in use of the crematoria assets (in line with Figure A.1 in the Annex). The relevant local authorities could therefore have a materially

¹⁰¹ Due in large part to inflation but also due to changes in regulations and/or technology since initial construction.

¹⁰² With a suitable depreciation deduction to reflect the age of the crematorium.

lower capital employed estimate and therefore lower capital costs, reflecting the age of the assets.

150. Having calculated the profits made by the Selected Crematoria – both as a ROCE percentage and as an economic profits estimate, we propose to extrapolate our findings across the population.

Approach to estimating WACC

151. In the first instance, we propose to use the WACC applied to the four largest providers as a benchmark for ROCE.
152. We recognise that local authorities do not have actual cashflows associated with a market-based cost of capital. However, local authorities could sell their crematorium or the right to operate the crematorium to a private operator. Local authorities still therefore face an opportunity cost associated with having capital tied up in their crematorium, equivalent to the market-based return on capital of a private operator.

Asset utilisation sensitivities

153. As with the largest providers of crematoria services, we propose to undertake sensitivity analysis to test the impact that different levels of capacity utilisation have on profitability.
154. We are also collecting data on staff utilisation such as cremations per FTE per week to understand the range of staff utilisation across the Selected Crematoria. Where we find large variations in these metrics, this may provide evidence that competition is not working well in the provision of crematoria services (for the reasons outlined at paragraph 15).

Additional analysis for diagnosis

155. Economic profitability analysis requires a number of assumptions to be made, to move from accounting profits to economic profits (see paragraphs 45 and 46). The results from economic profitability analysis can be sensitive to ranges around these assumptions, particularly with regards to asset valuations.
156. In our profitability analysis, we shall be mindful of the sensitivity of our analysis and results to key assumptions and undertake sensitivity analysis where appropriate.

157. In addition, we propose to undertake additional analysis to test the results obtained through our economic profitability assessment. The rest of this section sets out the areas of additional analysis, which we propose to conduct.

Review of acquisitions

158. There have been a number of acquisitions of smaller providers of funeral director services and crematoria services in recent years. The firms who have made these acquisitions will ordinarily have performed an investment appraisal calculation, which can provide useful insights into economic profits.

159. We have requested investment appraisal documents from the largest providers of funeral director services and crematoria services. We propose to assess the following across these investment appraisal documents:

(a) *Market value to book value ratios*: This is because high market to book values can signal high levels of economic profits. We note that ideally the relevant ratio would be market value to MEA value.¹⁰³ However, for the purposes of ‘additional analysis’ we consider that market to book ratios from acquisitions are still an informative data point to consider in the round.

(b) *Expected internal rate of return (IRR)*: Investment appraisals ordinarily forecast the expected cash flows, including the cash outflow for acquisition. An IRR is then calculated, which is the discount rate at which the net present value (NPV) of the investment would be zero. Where the IRR is larger than the firm’s internal cost of capital (or hurdle rate) the investment is considered viable. IRRs in investment appraisals which significantly exceed our WACC estimate may therefore be a signal of high profitability.¹⁰⁴

Internal documents

160. We propose to review internal documents on financial performance,¹⁰⁵ prepared for the board and/or management of the largest providers of funeral director services and crematoria services. In particular, we shall be interested

¹⁰³ This is because high market to book values can also arise due to tangible assets being depreciated too quickly and/or off-balance sheet assets such as intangibles i.e. the book value not being in line with MEAV.

¹⁰⁴ Assuming expectations are realised.

¹⁰⁵ We may supplement this analysis with publicly available documents and stock broker reports on the sector, including analyst reports on Dignity plc.

in commentary around the profitability of the businesses in the Relevant Period and the forecast for 2019.¹⁰⁶

161. Whilst we recognise that internal documents are produced for a number of different purposes, we consider that when considered in the round, alongside other evidence, statements by firms on their profitability are relevant and informative to our overall assessment.

Margin benchmarking

162. During the Market Study, we undertook margin benchmarking of the largest providers to international firms in the funerals sector. We recognise that margin benchmarking may have some limitations. In particular, where firms operate in different countries:
- (a) Provide services beyond the services which are in the scope of our investigation;
 - (b) face different risks to the risks faced by firms providing funeral director services and crematoria services in the UK;
 - (c) face different costs to the cost base faced by firms providing funeral director services and crematoria services in the UK; and/or
 - (d) have different reporting requirements and/or accounting policies for material items within the profit and loss account such as disbursements and pre-paid plans.
163. Nevertheless, we consider that in principle margin benchmarking provides context and additional background information on profitability, which when considered in the round is useful evidence.
164. However, we propose to explore the extent to which the items listed at 'a' to 'd' in paragraph 162 above limit the applicability of the international comparators, in this phase of the investigation.

¹⁰⁶ We propose to consider longer forecast periods, where available.

Annex: Theoretical approach to asset valuation

1. The assets included in the capital employed input to profitability analysis, should reflect their current value to the business (VTB).¹⁰⁷ The VTB approach aims to value assets in such a way that the cost base included in our economic profitability analysis allows for:
 - (a) The existing firms in the market to recover the opportunity cost of using the assets to supply the in-scope activities; and
 - (b) a hypothetical entrant to recover the costs of the assets,¹⁰⁸ required to supply the relevant activities.
2. Accounting values for assets may not reflect the VTB. This may be because:
 - (a) For reasons of accounting prudence, an asset is not on the balance sheet;
 - (b) the firm has paid off most of the upfront cost of the asset and is accounting for the asset at depreciated historical cost e.g. vehicles at zero book value;
 - (c) changes in technology over time may mean that asset values in the Relevant Period differ to the balance sheet values; and/or
 - (d) the firm is accounting for the asset at market value, but market-based valuations are not reflective of the cost of the assets, because strategic considerations and/or inflated future income expectations due to ineffective competition (i.e. profits above the 'normal' level), impacted value.
3. The VTB methodology, explained in detail below, ensures that the conditions set out at paragraph 1 are met and that the issues set out at paragraph 2 are overcome.
4. The VTB of an asset can be determined by reference to entry value (replacement cost), exit value (net realisable value) or value in use (discounted present value of the cash flows expected from continuing use and ultimate sale by the present owner). For some assets (for example, investments in actively traded securities), these three alternative measures produce very similar amounts, with only small differences due to transaction

¹⁰⁷ Also referred to as the deprival value, or value to the owner principle.

¹⁰⁸ Where the assets yield equivalent services to those currently used by the existing firm/(s) being analysed.

costs. However, for other assets (for example, fixed assets specific to the business), differences between the alternative measures can be material.

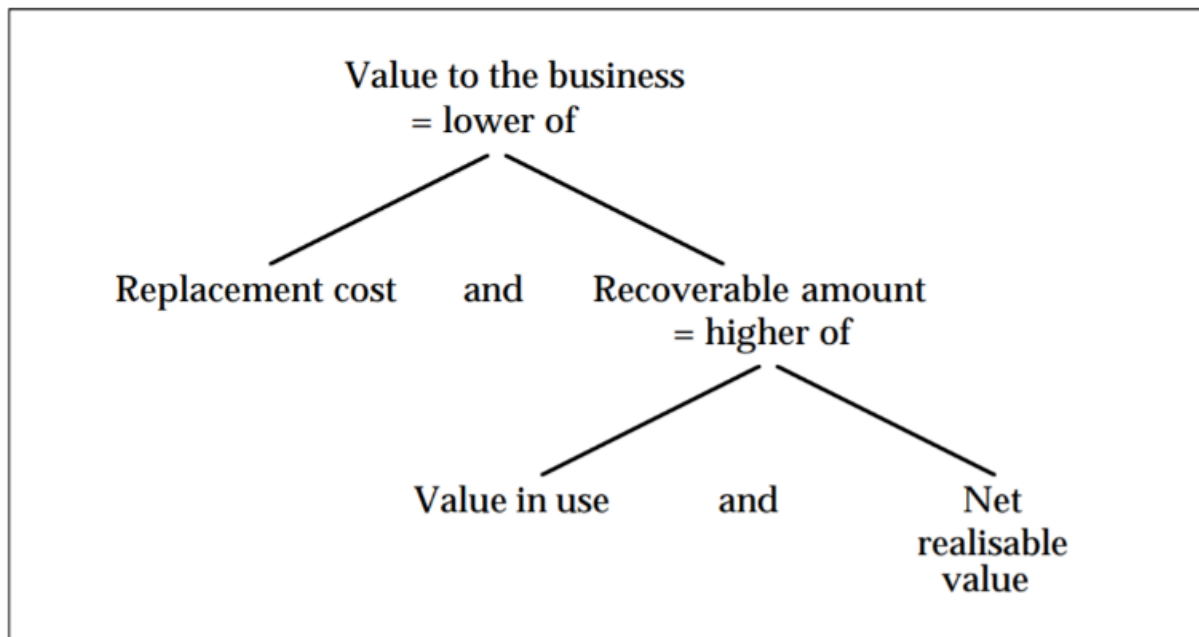
5. In most cases, as the entity will be putting the asset to profitable use within its current operations, the asset's value in its most profitable use (in other words, its recoverable amount) will exceed its replacement cost. In such circumstances, the entity will, if deprived of the asset, replace it, and the current value of the asset will be its current replacement cost.
6. Where an asset is worth replacing, its VTB will be its current replacement cost, or more precisely the replacement cost of a Modern Equivalent Asset (MEA)¹⁰⁹ determined in a fully competitive market and allowing for the asset's *remaining useful life*.¹¹⁰ The MEA value is the cost of replacing an old asset with a new one with the same service capability.
7. A valuation based on replacement cost or MEA value is the most common outcome of a VTB assessment. This approach is consistent with our Guidelines, which state that the CMA considers MEA values to be the economically meaningful measure for the purpose of measuring profitability in most cases.¹¹¹
8. However, in some circumstances the recoverable amount may be lower than the replacement cost. An asset will not be replaced if the cost of replacing it exceeds its recoverable amount. In such circumstances, the asset's current value is determined as follows:
 - (a) When the most profitable use of an asset is to sell it, the asset's recoverable amount will be the amount that can be obtained by selling it, net of selling expenses; in other words, its net realisable value (NRV).
 - (b) When the most profitable use of an asset is to consume it – for example, by continuing to operate it – its recoverable amount will be the net present value of the future cash flows. In other words, its value in use.
9. This can be portrayed diagrammatically as shown in Figure A.1.

¹⁰⁹ The MEA value is the current cost of acquiring assets that yield equivalent services to those currently used by the firm, based on the most efficient technology and optimal configuration.

¹¹⁰ Otherwise known as depreciated replacement cost.

¹¹¹ Market Investigation Guidelines (CC3 Revised), Annex A, paragraph 14

Figure A.1: Establishing which valuation basis for an asset gives its value to the business



Source: UK Accounting Standards Board, Statement of Principles, 1999 paragraph 6.8.

10. Application of these valuation principles consistently across all assets is also called current cost accounting (CCA).