CMA Funerals Market Investigation

Funeral Partners Limited's non-confidential response to the CMA's Working Papers published 20-21 February 2020

Executive Summary

1.1 Funeral Partners Limited (FPL) welcomes the chance to engage with the CMA on the Working Papers and current thinking, ahead of the CMA's Provisional Decision Report (PDR).

1.2 In this response, we provide our views on these Papers, and the analyses, market features and proposed remedies discussed in them. Notwithstanding the constraints being faced by the industry at this time, and in line with the conversation which FPL had with the CMA on 30th March 2020, we remain happy to engage with the CMA as it further develops its analysis going forward.

1.3 While the CMA has not made any preliminary findings or conclusions at this point, we understand that it is investigating – among other things – whether there could be one or more Adverse Effects on Competition (AECs) in relation to provider profitability and pricing practices. Our view remains that there is no such AEC – or any AEC – in the market for funeral director services.

1.4 In our experience, the market is competitive, with providers competing on quality as well as price to deliver good outcomes for consumers, who are overall very satisfied with the services in the market, as the CMA's own analysis shows.[1]

1.5 **We do not consider that the analysis presented in these latest papers provides evidence to support an AEC finding**. In the rest of our response, we provide more detailed thoughts on these issues.

1.6 As we have articulated in the past, the CMA has not properly considered in its analysis the differentiated nature of the market. The distinguishing feature of competition in this market is quality, and quality varies greatly across the country and even within given local areas. Quality in this market means providing an impeccable service, whether on a very simple funeral or a highly complex affair. The main asset for a provider is therefore the reputation it builds on the quality and reliability of its service. This also results in providers facing different levels of costs, as well as having to make significant investments. The CMA has not

[1] CMA, Consumer survey results, paragraphs 79-80. 57% of respondents mentioned their expectation of service had been met, and an additional 32% indicated expectations were met and exceeded. Eight in ten of respondents had recommended (or would recommend) the funeral director they had used to someone else.

attempted to understand, qualify and measure quality across providers, nor account for it in its analysis. We remark on this as needed in the various parts of our response.

1.7 We consider that the CMA's analysis has been unduly focused on "large" providers. This approach, which the CMA might have applied usefully in other, more concentrated markets which it has investigated in the recent past, does not lend itself to the very fragmented funeral director services market. The CMA analysis needs to take into consideration the "independent" sector more, and account for the local nature of competition more clearly. We remark on this as needed in the various parts of our response.

1.8 The CMA's **profitability analysis** greatly overestimates FPL's return on capital employed, by not accounting properly for the investments made by FPL in maintaining a high-quality offering. FPL imagines similar critiques would apply to the CMA's analysis of some other providers. The effect is that the CMA analysis incorrectly identifies sustained supra-competitive profits in the market. We present our detailed views on the CMA's profitability analysis in Part A of this response, and invite the CMA to revise its estimates ahead of its PDR.

1.9 On **pricing (levels, trends and dispersion)**, the analysis produced to date suffers from a series of methodological flaws. Consequently, FPL considers that a more robust analysis might not confirm the current set of findings. Nevertheless, were these findings to be confirmed, we remain of the view that these, in and of themselves, do not form a suitable evidentiary base for a finding of low competition on pricing in the market for funeral director services. We present our views on the CMA's pricing analysis in Part B of our response.

1.10 Given these significant flaws in the CMA's analysis, **we are strongly of the view that there is no case for intrusive remedies in this market**. We are opposed to remedies that would constrain providers' ability (or distort their incentives) to compete on quality and price in order to provide the best service to consumers. As well as not being justified by the evidence, remedies such as a price cap would have significant unintended consequences in the market. These remedies would also be highly costly to implement and monitor. Without prejudicing our view that no form of a price cap remedy would be effective and proportionate, we wish to particularly emphasise how damaging a price cap remedy would be if it were implemented before a level playing field is introduced in quality standards, in particular in relation to "back-of-house" quality. We present our views on the CMA's proposed price regulation and local authority tendering remedies in Part C of our response.

Part A: FPL comments on the CMA profitability analysis

2 Introduction

2.1 The CMA has published a number of working papers in relation to profitability analysis, whereby the CMA seeks to compare funeral providers' return on capital employed (ROCE) with an industry-wide weighted average cost of capital (WACC). The CMA finds that ROCE exceeds WACC, and therefore that there is evidence of excessive profits in the market for funeral director services. The key piece of analysis on which the CMA's finding turns is its estimation of brand value.

2.2 In this section we explain that the CMA has taken an overly simplistic approach to estimating the brand value of FPL. In particular, it has failed to recognise that valuing brand names can lead to a wide range of results, depending on the assumptions or methodology used. If reliance is to be placed on the results of a profitability analysis in order to inform any findings of consumer detriment and remedies, then the results must be robust and stand up to scrutiny, and in our view the CMA's profitability evidence falls well short of this standard. The CMA has also failed to take into account the unique characteristics of the market for funeral director services in taking the same approach to intangible assets as for other market investigations.

2.3 The rest of this part of our response proceeds as follows:

- Section 3 provides an overview of the CMA's profitability findings and its approach.
- Section 4 sets out our views on the areas of weakness in the CMA's approach to the brand valuation analysis and understanding of the business.
- Sections 5 sets out our remaining concerns around other elements of the profitability analysis.

3 Overview of the CMA's findings

3.1 The CMA estimates the capital employed of FPL to be between £[✂] in 2014 and £[✂] in 2018. The £[✂] is composed of:

- fixed assets of £[✂];

- intangible assets, which after adjustments to remove goodwill and value brands, is valued at just £[✂]; and
- working capital (the remainder).

3.2 Across the 178 FPL branches analysed, this gives rise to an average capital employed of approximately £[✂] per branch in 2018. This has resulted in an estimated ROCE in 2018 of [✂]% (ranging from [✂]% to [✂]% over the period considered) for FPL. This, combined with similar analysis for other providers, leads the CMA to provisionally conclude that there is evidence of excess profitability.

3.3 To estimate an intangible asset value for FPL, the CMA has set aside the valuation in FPL's balance sheet and has instead used an estimate based on marketing costs. Using submissions from Co-op and FPL, it has determined that £8,000 of marketing incurred over the course of three years after opening a branch is a reasonable proxy for the value of the brand. No other costs, such as highly experienced staff, have been included (although the CMA does recognise that this contributes to building the brand name of a funeral director)[2]. The CMA recognises that ongoing costs are incurred to maintain a brand, but these have not been included in the estimate on the basis that these are expensed to profit and loss, rather than capitalised.

3.4 Based on the above approach, the CMA has estimated an intangible asset base for FPL of £[✂] to £[✂] over the period considered. In our view, the CMA has substantially underestimated FPL's asset base, particularly in relation to the value of brand names and reputation, which in turn leads to significant over-estimates of the ROCE of this business.

4 Comments on the CMA's approach

4.1 We welcome the CMA's recognition of the need to include a valuation of funeral director brands within the estimate of capital employed. However, in our view the approach that the CMA has taken is inappropriate, and fails to recognise the particular market dynamics of the funerals sector. In the rest of this section we explain our concerns with the CMA's approach, which means that the CMA cannot be confident in its excessive profitability conclusion.

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[2] CMA (2020), 'Funerals directors: Profitability Analysis', footnote 12.

The CMA's analysis is inconsistent with key characteristics of the funerals sector

4.2 As recognised by the CMA, funeral directors are local businesses and as per the results of the CMA's consumer survey, "*reputation and recommendations are very important factors influencing consumer choice*".[3] Given the importance of reputation, the CMA has also highlighted that customer satisfaction (and, to various extents, community engagement) are closely monitored by funeral directors.[4] These factors – receiving recommendations and building a local reputation – are borne out of establishing a strong brand.

4.3 A strong brand is fostered over a long period of time and built up as a result of providing a consistently high quality of service, and thus helping to drive local recommendations, upon which funeral directors such as ourselves are reliant. Furthermore, a funeral director will only have one chance per customer to deliver a high quality service.

4.4 Funeral directors typically trade on the basis of a family name, i.e. the key personnel behind the business who deliver the necessary skill and experience to establish the brand. As funeral directors, we are a 'people-based' business. Indeed, we do not discard existing brand names upon acquisition of a funeral director as there is a recognition that a large part of the value of the business is the brand association, for customers who are only infrequently in the market and value the reassurance of a brand with an established reputation. Funeral businesses often trade with a brand for generations, an extreme example being FPL's E Sargeant business, which has traded in Slough since 1712. This is also recognised by Dignity as it recognises the value of "*funeral directors with established, trusted local reputations*".[5]

4.5 National brands are also important, and we as FPL make significant investments to ensure that across our portfolio of branches, our quality is at the top end in this differentiated market. This includes both in relation to observed quality attributes, but also back of house quality.

4.6 Against this backdrop, the extremely low value attributed to brand in the CMA's profitability analysis is striking, and in our view clearly incorrect. There is an inherent inconsistency in the CMA's analysis: on the one hand the CMA recognises that a strong reputation and personal recommendations are essential for driving business,[6] yet it also places practically no value on the brand names

[3] CMA (2020), 'Updated overview of key research and analysis', paras 8 and 38(c).
[4] CMA (2020), 'Updated overview of key research and analysis', para 38(c).
[5] CMA (2020), 'Funerals directors: Profitability Analysis', para 77.
[6] CMA (2020), 'Updated overview of key research and analysis', paras 8 and 38(c).

that underpin the different funeral directors, some of which have been in business in their local communities for over 300 years in some cases.

4.7 The CMA implies that a reputable business requires only marketing investment of £8,000 per branch over the course of three years and that a funeral business of equal size and market position of FPL could be created by a new entrant by simply purchasing or leasing premises and vehicles, adding employees, and investing a small amount in marketing, and start to compete on an equal footing.

4.8 This is entirely unrealistic, and demonstrates a lack of understanding behind the commercial realities of running a funerals business. In reality, much more is needed and over a longer period of time in order to establish a reputable business, for example, time and resources are invested in: high levels of internal training, a high quality fleet, premises, legislative compliance and establishing a community presence. As set out in paragraph 4.3, funerals are one-off events and customers will want to seek out high quality and reputable businesses, and FPL's investment in its operations is a reflection of the need to meet the high standards required. Much like any other major life event, consumers have a higher willingness to pay for a business with an established reputation for quality.

4.9 The CMA's figures can be juxtaposed against the amount FPL has paid for acquisitions. By way of example, across 2017 and 2018, FPL paid an average of £✄ per branch across their acquisitions. The amount paid for each acquisition is a reflection of the value in which FPL places on each of businesses – namely the brands – it purchases. While the acquisition price paid is not a perfect proxy for these purposes, the contrast between what the CMA believes is a sufficient investment for starting and establishing and business, and the market value of an established business, is stark.

There are a range of estimates for the valuation of FPL's brands

4.10 As set out in paragraph 3.3, the CMA has used marketing costs to estimate brand value, i.e. it has opted for a cost-based approach to estimate brand values. There are, however, alternative approaches such as:

- A market-based approach – this makes use of comparable transactions to benchmark the value of assets. This approach would be difficult for the funerals sector given the lack of benchmarks.
- An income-based approach – this captures the expected future economic benefits accruing to the owner of the brand in the valuation. This approach has been taken in valuing the assets in the balance sheet of FPL.

4.11 As part of the change to the FRS 102 accounting standards, an adjustment was made to the balance sheet of FPL in 2016 to separately disclose brands as an intangible asset and, in doing so, a valuation assessment exercise was carried out. FPL's brand names were valued at £56.6 million in the 2016 audited accounts as a result. Following this approach, as at the year ended 2018, the brand/trade name assets of FPL would be valued at £[✂] or c.£ [✂] per branch.[7] [8]

4.12 Using this estimate of FPL's brand value would result in a capital employed value of £[✂] and a revised EBIT of £[✂] in 2018.[9] These adjustments would result in a ROCE of [✂]%.

4.13 Whilst we recognise that an estimate following the statutory accounts may not fully capture the economic asset base, it does highlight the significant differences that can arise as a result of differences in valuation method. The CMA has estimated a brand value of just £[✂], whilst following a different method yields a result of £[✂]. Similarly, the CMA's estimate of brand value can be contrasted with the amount of money that FPL has paid for businesses that we have acquired, as set out in paragraph 4.99.

4.14 It is clear that there is wide range of possibilities for the valuation of funeral brands as any valuation is heavily assumption driven. Against this backdrop, the CMA has not even provided a sensitivity analysis, which would test the robustness of its results to different methodological assumptions. This is standard practice, and clearly lacking in this case.

4.15 More fundamentally, however, the wide variation in estimates of ROCE depending on the different valuation methods used points to significant uncertainty to any finding of excessive profitability. In these circumstances, where the intangibles of a business are of significant importance, but cannot be measured with confidence, then this also casts doubt on following a ROCE based approach to assessing profitability. For example, there have been examples in

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[7] CMA (2020), 'Feb 2020 WP_Funeral Partners,xlsx', Cell T101.
[8] Note that from 2018 onwards, due to a relaxation of accounting disclosure requirements, it was no longer necessary to disclose brands as a separate item in the statutory accounts, however, this should not detract from the value of it.
[9] To remove the marketing adjustment to EBIT and accounting for amortisation of the brands. The amortisation has been calculated over a 20 year useful economic life. We recognise, however, that an argument could be made that this should be amortised over a longer period.

the past where a ROCE approach has been abandoned over the lack of confidence in the ability to estimate the intangible asset base reliably.[10]

4.16 A high degree of certainty over the robustness of the findings is required if the CMA is to place significant weight on a finding of excessive profitability, even more so in using it as a basis for justifying what we consider would be highly intrusive remedies.

The CMA should not use the same approach as was used in the energy investigation

4.17 The CMA has followed a similar approach to valuing brand in the funerals market as it did in its energy market investigation, where it sought to value energy companies' customer relationships. In particular, in the energy market investigation, the CMA also pursued a cost-based approach to valuing energy companies' customer lists.

4.18 However, there are fundamental differences between the retail energy and funeral director services markets.[11] The CMA considered the energy market to be one with homogenous products, where competition was focussed on price, and where quality and service were found to be of secondary importance.[12] As set out above, the funeral director services market is clearly very different. Whilst energy is a commodity and the actual energy supplied by one provider is indistinguishable to customers from that supplied by another, the provision of funerals is a professional service with high levels of differentiation. As the aspect of the service which are the most valued by the customers – quality – is intangible, competition is focussed on maintaining quality and thereby long term brand and reputation. If quality were to slip in the energy market, this can be rectified within the ongoing service provision for a particular customer within a relatively quick timeframe, however, as noted above, this is not possible for funerals.

4.19 Given these appreciable differences between the funerals and energy markets, we are surprised that the CMA has adopted such a similar approach. This has led to the unrealistically low valuation of FPL's brand names and reputational value. This significantly underestimates the capital employed of the business, leading to erroneous conclusions about the profitability of the business. The estimation of funeral brand values requires greater nuance, and consideration of

[10] Recent examples include the PSR's Market Review on card acquiring services and the CMA's Market Investigation on the investment consultants market.
[11] CMA (2016), 'Appendix 9.10: Analysis of retail supply profitability – ROCE', paras 65 to 78.
[12] CMA (2016), 'Energy market investigation: Final report', paras 8.4 to 8.30.

the particular market dynamics, rather than simply applying similar techniques that have been applied in previous investigations into very different markets.

4.20 Overall, in our view, a cost-based approach is not likely to give reliable estimates of brand value in the funeral director services market.

Even if a cost-based approach is pursued, the CMA has incorrectly excluded staff costs

4.21 As set out in paragraph 3.3, to estimate the value of brands, the CMA has simply taken marketing costs estimated at £8,000 per branch as a proxy. Whilst the CMA recognises that there are certain costs beyond marketing which give rise to brand value, such as consistently providing a good quality service via well-trained and well-paid staff, these have not been included on the basis that these are not 'additional' to the running of the business.[13]

4.22 We concur that some level of staff training and salaries are essential costs to running a business. However, some nuance should be applied here: costs are incurred to provide the *essentials* of a service, and extra costs are incurred beyond this to provide a *high quality* service needed to build a brand. Again, a contrast can be made between this market and the energy market, where the CMA nevertheless has taken the same approach. Staff costs and the value of a trained workforce were discounted in the energy market investigation on the same basis of being normal operational costs. In the context of energy, this could be plausible; basic training and activities allows the businesses to 'get the job done' and there is less reliance on high levels of customer service to drive business (for example, the 'Big Six' energy firms often receive poor customer satisfaction ratings). This however, is not the case for funeral directors as discussed in paragraphs 4.2 and 4.3 above.

4.23 In addition, whilst the direct customer experience in the energy supply market is 'anonymous', and therefore harder to make observable quality judgements on particular members of staff, the same cannot be said for funerals. The funerals process largely depends on the observable actions of staff and so the quality of funerals can be attributable to the skills and experience of particular individuals.

4.24 The importance of high-quality staff is reflected in FPL's pay structure, with three career 'stages' for key frontline roles which are aligned with levels of experience and increases in pay. FPL also primarily uses permanent staff to carry out its services, rather than a casual workforce to ensure a consistently high-quality

[13] CMA (2020), 'Funerals directors: Profitability Analysis', footnote 12.

service, provided by trained staff. This is part of FPL's strategy to be positioned at the higher end of the market in quality terms.

4.25 Therefore, notwithstanding our broader concerns with the CMA's analysis, there are strong arguments that the value of a highly skilled workforce should be included in a cost-based assessment of brand value.

4.26 We would urge the CMA to rethink its approach to valuation and we would of course be willing to engage further should the CMA wish to obtain more information to refine its approach. In the current climate, we would refer the CMA to our comments in Paragraph 1.2 of this paper in this regard.

5 Other issues

Robustness of the CMA's sample base

5.1 Notwithstanding the flaws associated with the calculation methodologies themselves, the analysis that the CMA has carried out in relation to profitability is limited to the extent that it unduly focusses on the 13 'larger players' in the market. Whilst the CMA notes that 42% of the market has been analysed in terms of the 13 firms,[14] the sample size for the EBITDARS analysis for the remaining 58% of the market is a mere 32 smaller funeral directors.

5.2 Based on the CMA's assertion that there are 2,302 funeral businesses in the UK ("*of which over 70% are small businesses operating with/from one branch*"),[15] 32 firms equates to analysing 0.01% of the remaining market (2,289 providers). This is a tiny percentage from which no sound conclusions can be drawn about the sector as a whole.

5.3 In relation to the data that the CMA did obtain from 0.01% of the rest of the market, we note that the CMA itself has significant concerns about the reliability of the data received:

- "*Throughout this investigation we have come across many challenges in obtaining information from smaller funeral directors*."[16]
- "*We found one key issue with regards to profit and loss information, being that funeral directors were not able to provide revenue figures that split out funeral*

[14] CMA (2020), 'Funerals directors: Profitability Analysis', para 29.
[15] Ibid, para 30(a).
[16] CMA (2020), 'Funerals directors: Profitability Analysis', Appendix A, para.7.

director services from disbursements. Any estimates of percentage split based on total revenue figures were their best guess."[17]

- "*We still have some concerns around data quality […]. We consider, however, that this is unavoidable given the nature of some of these businesses. It is clear from the answers we received that, some of the smaller funeral directors were unable to provide meaningful financial information, despite the relatively simple nature of the updated request we sent to them*."[18]

5.4 In light of the above issues, the CMA has had to use their judgement as to which datasets were viewed to be reliable and unreliable and therefore used to support their conclusions. This again, highlights the heavy reliance on assumptions in the CMA's analysis.

Treatment of leased assets

5.5 The CMA has noted the change in IFRS 16 reporting requirements such that leased assets will be recognised on the balance sheet for accounting periods from 1 January 2019 onwards. Whilst FPL has not adopted IFRS, if adjustments are made for the companies which do use IFRS, then these adjustments should be made consistently across the board.

Cost of Capital

5.6 We note two issues with the CMA's cost of capital analysis: the first relating to the estimate of total market return ('TMR') and the second relating to the cost of debt.

5.7 As regards the TMR, the CMA relies heavily on its findings from the Northern Ireland Electricity ('NIE') decision, and proposes the same range of 5% to 6.5%. However, the TMR estimate from the NIE decision was based in real RPI terms, whereas real estimates in this case are treated on a CPI basis. This results in an equivalent TMR that is almost 1% lower than the estimate included in the NIE decision. Therefore, the TMR estimate from the NIE decision should be adjusted in this case to reflect the difference in inflation treatment.

5.8 As per our previous submission, a higher WACC has been calculated relative to FPL's own estimates due to the higher cost of debt. Whilst we recognise that this has not been included by the CMA in its estimate, we maintain that this is an important factor and debt calculations should be included in the CMA's analysis.

[17] Ibid, Appendix A, para 13.
[18] Ibid, Appendix A, para 20.

Part B: FPL notes on the CMA pricing findings

6 Introduction

6.1 FPL have reviewed the pricing papers produced by the CMA[19] to the extent possible. FPL nevertheless has some concerns that the CMA's factual conclusions – in relation to the level of pricing dispersion and trends over time – may not be accurate. Here we focus on concerns we have on the suitability of this analysis to provide a basis for an AEC finding.

6.2 The rest of this part proceeds as follows:

- Section 7 provides an overview of the CMA's core pricing analysis, and some high level comments on its robustness.
- Section 8 sets out FPL's view on the overall implications of the CMA's analysis. The CMA has not set out what overall conclusions it draws from the pricing analysis it has done, and how this analysis may feed into potential AEC findings. This section sets out FPL's view that, on the basis of the analysis conducted by the CMA, there are no clear conclusions that can be drawn that indicate a lack of competition.

7 Overview of CMA findings

7.1 At a high level, the CMA's findings can be summarised as:

- Price trends:
    - Prices have increased above inflation for a period of time, though this has stalled / decreased in the last few years.
    - Some differences are observed across providers in these overall trends, with prices averaged across local areas. In particular, the two large providers appear more expensive (and might have grown more) than independents.
- Price differentials:

[19] We refer here to the papers "Funeral directors pricing levels and trends", "Funeral directors price dispersion analysis", published on the CMA's website on 21 and 20 February respectively. We also cover materials contained in the paper "Company level price and market share analysis", sent by the CMA to FPL.

  - o Within local areas, there are price differentials present for similar packages of funerals (simple, standard), and in particular Dignity might be more expensive than other providers.

- Price changes, market shares and competitor response:
  - o There is no observed link between changes in prices and the level of market shares.
  - o Price decreases by one firm are only matched by other firms after a significant lag.

7.2 We note here a short list of high-level limitations to these analyses:

- The analysis has covered only a sample of independents, which make up the bulk of the market. The CMA cannot therefore conclude it has obtained a fair representation of the market as a whole.
- Part of the analysis is focused on Average Revenue per Funeral (ARF) and Average Total Revenue (ATR). These are not the same as price, as they will be affected by product mix, consumer preference and, in the case of ATR, disbursements. It may not be appropriate to think these measures would provide insight into how prices charged by providers have evolved over time, or differ within and across locations (or across providers).
- The CMA's analyses, in general, have not been nuanced enough to capture the complexities of competition and demand at the local level, for example by not accounting for specific differences in cost or demand for the same local area.

8 FPL's concerns with the CMA's analysis and findings

8.1 We are concerned that due to a number of methodological weaknesses in the CMA's analysis, the factual conclusions set out in the previous section may not in practice be confirmed through a more robust analysis.

8.2 This notwithstanding, even if the CMA's factual conclusions can be maintained, we do not consider that these findings could be used, together or in isolation, as an evidentiary base for an AEC finding in relation to pricing or profitability.

8.3 We discuss this in the rest of this section, beginning with our comments on the CMA's analysis of price trends over time, then setting out comments on the CMA's analysis of price dispersion.

Findings on trends in funeral director prices

8.4 The CMA has identified evidence of real price rises over its sample period, for both larger and smaller providers (with some differences in these trends across providers or groups of providers). We caution against the use of such findings to identify an AEC.

The CMA has not demonstrated that prices have increased above funeral cost inflation

8.5 The CMA states that prices in the funerals sector have increased above RPI inflation[20]. However, the CMA has not compared the computed price increases in the funeral sector to specific cost or input inflation for the sector.

8.6 The identified price trends might, at least in part, be explained by cost inflation specific to the funeral sector. Indeed, representations have been made to the CMA by FPL in the past in relation to the increased costs associated with the provision of funeral director services.

8.7 On top of this, certain providers (including FPL) have invested significant amounts into their business over the years to improve both "back-of-house" and "front-of-house" quality.[21]

8.8 We have submitted detailed evidence of some of these investments. FPL would point the CMA to the example of the Daren Persson branches, provided as part of the CMA's "event study". This is one of the more recently acquired branches mentioned above, where FPL investment totalled £[✀] across the two locations. This included fitting out one of the two branches (in North Shields), and updating the signage on both the North Shields and the Wallsend branches – these improve "front-of-house" quality. Additionally, a new fridge was fitted into North Shields – improving "back-of-house" quality, bringing in line with our consistently high national standards, and thereby contributing to minimising the risk of issues which may negatively impact our clients' perception of our services, including risks around poor "back-of-house" standards.

8.9 Additionally, the identified differential between the price increases observed by the CMA and RPI inflation is not large. Therefore, even if industry-specific cost inflation is higher than general inflation by some relatively modest amount, this

[20] CMA "Funeral directors pricing levels and trends", paragraph 43 and footnote 20.
[21] Front-of-house quality investment may extend to, but is not limited to, the refurbishment of the funeral home, the provision of new vehicles and the introduction of new IT and telephone systems, all of which can be seen and appreciated by consumers. Back-of-house quality investment may extend to, but is not limited to, provision of new or updated mortuary equipment including refrigeration, trolleys and coffin biers.

might close the gap the CMA has currently identified between inflation and price increases. By not comparing prices to specific costs for the funeral sector, the CMA can have no confidence that it has genuinely identified real price rises.

8.10 Overall, by not including cost inflation as a potential factor in overall price inflation, the CMA fails to appreciate the need for certain investments in some of the funeral homes which FPL acquires (as explained above), in order to bring these homes up to the very high quality standards which we have set ourselves as a business.

The CMA has provided no explanation of how any increase in prices is linked to competitive conditions

8.11 The CMA has not attempted to infer what competitive dynamics might explain the increase in price trends it states it has identified, nor whether these point to any lack of competition in the market. Without this analysis, it is not clear how this evidence can be relied on in order to identify an AEC.

8.12 We are aware of no evidence of any softening of competitive conditions in recent years that would explain a trend of increasing prices, and the CMA has not identified any either.

8.13 Indeed, the CMA's narrative suggests that prices have risen while, in reality, prices increased only for the first part of the CMA's sample period (2013-2016) and have been increasing at below inflation, constant or declining in the later part of the period. Tables 11, 12, 13 and 14 in the *Funeral directors pricing levels and trends* paper show that trend. Just as one example, for FPL, Average Revenue per Funeral ("ARF") for a standard funeral have only increased at a [✂]% CAGR over the period 2016-2018, compared to a yearly inflation of around 3%.

8.14 The CMA's working paper provides no consideration of what might have driven this shift in pricing trends, or the implications for its conclusions on competition.

8.15 As explained in previous submissions, from FPL's point of view, the market feels to have become more competitive in recent years. An analysis of list prices for FPL identified that, in recent years, FPL has started to introduce price decreases as well as price increases for its business, in areas where that is deemed necessary. In the 2018 price review, around a quarter of branches saw a price decrease. In the most recent year, prices for funeral packages have not increased.

8.16 In addition, FPL has also introduced some "tactical" pricing, as previously submitted to the CMA. This policy, which saw the introduction of aggressive price cuts, was introduced with consideration of local competitive dynamics. A significant number of branches (57) were included in this tactical pricing exercise, which was undertaken in order to improve the branches' market shares. In three Funeral Homes in the South West (in Torquay and Paignton), "Basic" funeral prices were significantly reduced by more than [✂]%. This resulted in an improvement of the market share position for those branches of between [✂]% and [✂]% over the course of the year to October 2019. FPL considers that the mere introduction of such a policy speaks to the competitive pressure it faces. The success of the policy, on the other hand, shows that demand is responsive to price changes and that providers benefit from offering a competitive alternative in the market.

8.17 This confirms what the CMA itself has acknowledged, that the largest funeral directors take rivals' prices and actions into account when setting their own prices, as well when making marketing and price trial decisions.

Findings on pricing differentials

8.18 The CMA analysis identifies price differentials within a local area, as well as differences in average prices of providers (averaging across locations for those providers in several cases). For example, the CMA has identified a "premium" of Dignity's prices over those of Co-op. The CMA finds that Dignity and Co-op have higher price increases on average than independents and others, and that areas where Dignity is present might have higher prices than areas where it is not present.

8.19 The CMA has not linked this to a particular concern at this stage. However, we are aware that, as part of its wider investigation, the CMA is exploring issues around lack of price competition, and exploring whether larger suppliers are able to command higher prices in the market.

8.20 In our view, the analysis produced to date does not provide an evidentiary base to support these arguments. What the analysis shows instead is that consumers care about quality, and are willing to reward funeral directors that provide the greatest quality in any given local area.

8.21 In a differentiated market, some degree of price dispersion is to be expected, due to cost and quality differentials across providers. As a result, a finding of price differentials, whether across providers within a local area or on average at the provider level, is not in itself evidence of a lack of competition.

8.22 As explained by FPL in the past, the funeral director services market is differentiated, with providers offering varying levels of quality, and positioning themselves differently on the market.

8.23 Indeed, the CMA analysis shows evidence that consumers look for quality and trustworthiness when organising a funeral:

- In fact, the three most common reasons for recommending a funeral director, as captured in the CMA's own consumer survey were: (i) level of customer care they provide (32%); (ii) confidence (15%); (iii) level of quality they provide (10%).[22]
- Surveyed consumers also indicated that the aspect that drove their choice most was the level of customer care they could expect (mentioned by 32 out of 68 respondents), the level of quality (mentioned by 16 respondents), confidence (mentioned by 14 respondents), as well as capability to cater to personal or faith specific requirements (mentioned by 14 respondents). Price and value for money were mentioned by only 7 respondents.[23] It is therefore clear that consumers make their decisions based on quality first, and price as a secondary concern.

8.24 These findings match FPL's experience in the market – funeral director services are highly differentiated. Providers compete to supply a high quality service, and a funeral provider's brand strength is a function of its reputation for supplying high quality services. The more established providers who have built a reputation through several years of quality provision of funerals, as well as strong investment in staff and facilities, can position themselves at a premium compared to lower quality providers.

8.25 However, this is not a sign of any lack of competition or of undue market power. Reputation (and thereby the brand strength) has to be maintained and this reputation for quality is at risk of being easily lost. This is true both locally (as a badly performed funeral can generate negative word of mouth) and at a national level.

8.26 Accordingly, FPL has invested significantly in "front-of-house" quality and "back-of-house quality" since 2017 in its branches, with capex spend in the last three years amounting to £[✄], around [✄]% of the EBITDA in the same period.

8.27 Providers that offer higher quality or inspire greater confidence might therefore be expected to be priced at higher levels. Indeed, while FPL's acquisitions have been of businesses with sound reputation for quality, FPL has nevertheless often

[22] CMA, Consumer Survey Results, Table 20.
[23] CMA, Consumer Survey Results, Table 6.

made significant investments upon acquisition in order to bring standards up to the highest quality level it strives for. Accordingly, FPL has increased its prices mostly in its acquisition branches, as a reflection of these investments. FPL has provided numerous examples of investment in quality in order to differentiate from other providers and examples include, but are not limited to, general investment in people, premises and fleet, along with specific initiatives such as improvements in "in hours" enquiry handling, enhancements in "out of hours" service provision, defining 'funeral etiquette' and establishing common 'funeral standards' across our funeral homes.

8.28 The converse of this is that, for a national brand, a lapse in quality in one area risks jeopardising the whole national brand. For this reason, branded providers have particular incentives to invest in order to maintain standards, and a lower incentive to pursue a lower cost, lower quality strategy. As a result, customers develop confidence in the brand and reputation, and this might in turn allow some larger providers (but also certain highly reputed independents) to be positioned at higher price points. This process cannot in any way be described as not arising from demand and competitor pressure – it is indeed evidence of customers choosing higher quality and security.

8.29 In spite of analysing the sector for nearly two years, the CMA has not defined quality in any meaningful way to allow for any effective comparison of providers on price dispersion grounds. For example, no Working Paper exists on "front of house" quality, despite quality being an overarching concern for consumers, as per the CMA's own research. Consequently, we believe that the CMA is unable to draw any sound conclusions about price dispersion in the market.

8.30 Finally, as mentioned above, it is not only the national providers with strong brands that are subject to reputational damage. Competition is local, and there are many independents with very strong local reputation – as per CMA's finding that 71 percent of areas have an independent as the most expensive provider.[24] This is, again, a function of competition to maintain a reputation for quality.

Part C: FPL position on Price regulation and Local Authority remedies

9 Introduction

9.1 FPL presents in this part of the response its views on the proposed remedies, without prejudice to its position in relation to any AEC in the market.

[24] CMA, "Funeral Directors – price dispersion analysis" WP, paragraph 33.

9.2 FPL considers that the price control and local authority tendering remedies proposed in the CMA's working papers are not only inappropriate for improving competitive conditions in the funeral director services markets but are, additionally, disproportionate, ineffective and extremely difficult to design, implement and monitor. We struggle to see how the implementation of these measures could be seen as being in the interests of consumers in this market.

9.3 We outline our reasoning below for each of these two remedy proposals. Where possible, without prejudice to its overall position on the AEC, FPL has provided suggestions to the CMA of what an alternative, less disruptive remedy could look like.

10 Proposals for regulating the price of funeral director services at need

Our understanding of the CMA's remedy proposal
The CMA is evaluating the introduction of measures to regulate the price charged by funeral directors for either a basic package or a "benchmark" package of services. Such a remedy is likely to:

- apply to all providers of funeral director services in the UK;
- apply a maximum price to a defined benchmark package of funeral products and services;
- exclude disbursement costs, albeit with an obligation to pass these costs onto customers without a mark-up/profit margin added;
- would be set by reference to available pricing data for comparable products and services provided across the UK;
- would be accompanied by a recommendation to government to set up a relevant sector regulator to assume responsibility for price control regulation.

Effectiveness of a price control remedy

10.1 We consider that a price control remedy would in all likelihood not be "effective" at increasing the degree of competition in the funeral director services market.

10.2 Price regulation will **reduce the scope for competition**:

- A price cap does not allow providers to compete on price, unless a lot of headroom is left for them to do so.
- A price cap similarly does not provide a reward for providing high quality in the form of higher prices, and therefore hinders competition in quality.
- Price caps can also reduce consumers' incentives to shop around. The CMA states that it has found little shopping around currently. Price regulation does not address the root of this issue that the CMA claims to have identified and will, instead, stifle any shopping around that does occur. Indeed, 17% of customers

shop around according to the CMA's own evidence, a not insignificant proportion, and price regulation puts this at risk. Our own evidence, presented above, shows that demand can respond significantly to changes in pricing. Softening this incentive for consumers by removing price differentials would be detrimental for these marginal consumers, as well as for the wider set of consumers. FPL notes that the CMA considered this potential detrimental effect when contemplating (and ultimately ruling out) the introduction of a market-wide cap in the context of the retail energy market investigation. The cap was then introduced by Government, and in its impact assessment Ofgem noted that their chosen price cap level would lead to an expected 30% reduction in customer switching rates.[25]

- A benchmark package and price restrictions would further likely impact funeral providers' ability and incentive to innovate, as there are fewer dimensions on which providers can innovate and reduced scope to generate return on the innovative efforts. This would come at the detriment of current innovations such as direct cremation, unbundling and online offerings.

10.3 In addition, the price cap would likely have the **unintended consequence of facilitating poor quality standards**.

- If the CMA were to set a cap at a level that is too low, this might distort incentives to the point that quality offering to consumers deteriorates.
- As price regulation is introduced, it is likely that some higher quality and higher cost providers will face downward price pressure. This will mean that certain providers would need to decrease costs in order to remain profitable at the prevailing price. Whilst some of these cost reductions might be obtained by reducing inefficiencies, it cannot be ruled out that some providers might (potentially) compromise quality (both observed and unobserved).
- Even if market exit were to be limited following the introduction of a cap, higher quality providers may still choose to sacrifice certain elements of observed quality as a consequence of the cap. These aspects may entail scaling back on those high quality elements for upon which Funeral Partners currently differentiates such as availability of our services (e.g. restricting opening hours), provision of our services twenty-four hours a day (e.g. precluding certain services being available out of hours), switching to a more casual workforce or limiting general investment in people, premises and fleet.
- This would be particularly problematic if the cap were to be introduced before a level playing field is introduced for what concerns "back-of-house" (or "unobserved") quality. To do otherwise would mean that providers might adjust to lower prices by undercutting "unobserved" quality. As such, FPL would strongly state that, were the CMA to introduce any cap before introducing "back-

[25] Ofgem, Default Tariff Cap Decision, Appendix 11, paragraph 5.66.

of-house" quality regulation, this would severely risk a deterioration in "back of house" quality in particular.

- Indeed, while our experience tells us that consumers would be swift to react to a deterioration in "observed" quality. In the short run, consumers may not be able to assess providers on the basis of "unobserved" quality, leaving them at risk of adverse outcomes.[26]
- Mandating standards for "back-of-house" will mean that providers will share minimum quality standards, which would have to be followed by providers at any price point. This of course means providers will also face a minimum common cost base, from which a cap would have to be derived (with some headroom). This supports our assertion above that, were a price cap to be introduced, any such introduction could feasibly only take place once the change in the cost base across all providers was fully understood in the marketplace.
- This way, while the cap might reduce the incentive to innovate and differentiate across providers, it will not create warped incentives to undercut "back-of-house" quality.

10.4 Additionally, there is the potential risk of market exit if the cap were to be set incorrectly at a level that does not allow certain providers to compete profitably in the market. While we understand that, in a competitive market, inefficient providers would be driven out, the CMA should recognise that the funeral director services market is characterised by mostly fixed costs and limited margins. Small changes in the level of the cap might drive a large number of providers to exit the market. Furthermore, there is a risk that it is higher quality – and hence higher cost – providers that are driven from the market. This is clearly a very significant potential unintended consequence.

10.5 Even if the cap were to be applied only to specific components of the cost of a funeral, such as on the fees for collection and transport of the deceased, providers still compete on these elements on quality. While the CMA might consider that such components are more "commoditised", they are indeed inextricably linked with care of deceased and the incentive to go above and beyond in terms of 'back of house' quality.

10.6 There are several **challenges that the CMA will encounter in the design of such a remedy.**

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[26] We would contend that consumers might – in the absence of a price cap – get some indication of "unobserved quality" through word of mouth, of course, and, in the short run, through price signalling by providers, where very low prices might indicate a less robust offering.

10.7 How to define a "benchmark" funeral package: The funeral director services market is a highly differentiated market, with providers supplying services at varying levels of quality:

- While the CMA may aim to establish a core set of products or services that would be subject to the cap, the services offered and demanded are not homogenous. Firstly, there is wide horizontal differentiation in the services offered by providers alongside significant variation in customer preferences over funeral services which means that no benchmark package could be fully representative. Secondly, as explained above, even components of services such as "care and transport of the deceased", which at first glance may not appear to be vertically differentiated, can be carried out with differing level of care and attention, and at facilities which vary in their level of quality (and therefore, costs to the provider).
- Additionally, by implementing a cap on a package, the CMA may unwittingly steer consumers into acquiring more products than they actually need, something the CMA itself is concerned about and that the industry is already addressing through increased unbundling of funeral products.
- Given that a benchmark funeral package, as explained, presents some key challenges and unintended consequences, FPL considers that the least damaging option would exclude certain quality differentiating elements such as arranging the funeral and include some restriction on available time and materials. FPL further considers that the benchmark package should include an officiant as an essential feature.

10.8 Defining a relevant price: it is incredibly difficult to arrive at a price cap for "comparable" products and services.

- As the CMA has noted in its work to date, the very fragmented and differentiated nature of the market, as well as the lack of any consolidated data sources, mean that analyses of prices across the funeral director services market are not straightforward.
- Furthermore, this price would need to continue to track a competitive level in the future and therefore be indexed to some measure of inflation. Firstly, this poses an issue in designing the remedy, as the most appropriate cost index is unclear. Secondly, changing customer preferences will render the benchmark obsolete very soon.
- Capping revenues per funeral would be equally impractical, considering that consumers may easily deviate from the CMA's benchmark package or request add-ons, which would render the cap meaningless. Further, customers with preferences for additional services not included in a benchmark package, or a preference for higher quality would likely be harmed. There is a concrete risk

that funeral providers might be forced to respond to an average revenue cap by reducing the quality and extent of their offering, as discussed in paragraph 10.3 above.

- Cost reflectivity to prevent circumvention risk may work better for disbursements but for quality differentiated services or add-ons this would be hard to define and especially to monitor.
- We would also note that the CMA is considering whether prices set by the local authorities after introducing local authority tendering for funerals could be used as a price ceiling benchmark for funeral director services. This does not seem appropriate. First, we do not agree with the introduction of such tendering remedy, as we elaborate below. Secondly, we do not consider that prices that are set in a variety of locations for, presumably, different types of packages with differing levels of quality could then be used to conclude on a wider geographic benchmark price.

10.9 Geographic dimension: Both of the points described above are compounded by the fact that such a cap would have to balance the need to account for local cost and demand conditions against the greater implementation and monitoring costs of more granular price remedies. Our view is that if the CMA decided to pursue a remedy, even in the absence of any evidence of an AEC, that the most reasonable balance would be for a regional level price remedy.

10.10 Timeframe: The CMA has not to date defined whether any price remedy should be in place for only a limited period of time, and whether sunset clauses need to be built into the remedy. The CMA has suggested that a price remedy be introduced quickly, and potentially prior to an independent sector regulator being established, which would increase the likelihood that the benchmark price and packages are not set with due consideration given to quality levels, not least “back of house” quality. FPL considers that shorter timeframes with annual updates to account for inflation would be the least distortionary, though that will of course increase the cost of monitoring and compliance.

10.11 Target of remedy: The CMA has considered targeting a price control or monitoring standards at a subset of funeral providers. Since the CMA has not yet established a link between any subset of funeral providers and any AEC, there currently isn’t any rationale to support such a targeted measure. In particular, FPL would stress that “larger” funeral providers which operate on a national basis compete on an equal footing with “independents” within each individual local market, so a measure that applies only to the former group would confer an unfair advantage on the latter, even in areas where they may be the larger or most expensive provider. Our view is therefore that any remedy and standards must apply to all providers.

Implementation challenges

10.12 There are several challenges with the implementation and running of such a price cap remedy, which FPL lists below.

- Implementation cost: Certain providers might need to undertake quite disruptive changes in order to provide the package at the mandated price, for example by adjusting their supply chain or employed versus casual workforce mix in order to adjust their cost base. Several providers may not even currently offer products or services that are directly comparable to what is subject to the price cap. For example, this may include, but is not limited to, those operators who transact primarily online or who specialise in newer offerings such as direct cremation.
- Cost of monitoring and enforcement: The cost of monitoring is likely to be high for such a highly fragmented sector, especially if the cap is to be reviewed frequently, or differ across geographic areas.
- Cost of compliance: This is likely to be quite high, and proportionally very high for small providers. As indicated above, this might lead to market exit.

Proportionality

10.13 The CMA's analysis to date in the investigation has neither identified evidence of an AEC nor attempted to produce an estimate of the costs of this remedy, which would be used for a proportionality assessment.

10.14 FPL would note on this point:

- The CMA should not rely on its current profitability findings in order to support an AEC finding and to inform a proportionality assessment. As we have argued in Part A of this response, the findings from that analysis are not robust and should be revisited by the CMA.
- The cost of this remedy should include an assessment of the large distortion of competition it might engender, including a degradation of quality and increased concentration in several local markets where the cap might cause firms to exit, as outlined above in our analysis of unintended consequences.
- FPL would also consider that the great distraction to government (and the CMA) and cost (to the taxpayer) of setting up a new regulator to monitor and update the pricing cap would be likely to outweigh any benefits from the introduction of the cap.

11 Local authority tendering proposal

Our understanding of the CMA's remedy proposal

A number of local authorities ("LAs") across the UK operate arrangements to give local residents access to funeral services at a pre-agreed fixed rate, below the typical local price. Under such schemes, the LA does not itself provide the funeral services. The funeral services are provided to the bereaved by a funeral director, normally on terms, and at a price, agreed with the LA. Therefore, there is a generally a contract for each individual funeral between the bereaved and the funeral director.

The CMA is proposing wider operation of such arrangements, either:

(i) through a recommendation to LA, or to government that they require LAs to tender for these services; or

(ii) through a CMA Order to mandate that LAs tender for these services.

The resulting prices through these tendering process may then be used to supplement the price control remedy.

Effectiveness

11.1 The CMA notes that the rationale for this remedy is that consumers, at the point of need, are weakly engaged in the choice of a funeral provider or specific funeral services due to factors such as emotional distress and time pressure. In the CMA's view, the LA, when tendering for the services, would not suffer from these factors.

Remedy effectiveness in improving consumer choice and outcomes

11.2 Such a remedy would therefore be "effective" if it resulted in the LA selecting a winning funeral director that can suitably cater to the needs of consumers in the LA. FPL does not consider that this is realistically feasible, other than potentially for the most basic types of funerals.

11.3 If an LA option is provided to consumers as standard from an "official" third party such as an LA, this may lead to consumers being less inclined to "shop around" or compare providers in the marketplace. This remedy therefore risks significantly undermining competition in the market.

11.4 The funeral specification chosen by the LA would presumably be fixed for a period following the award of the LA contract, and this package would likely be different from the very many unique choices available to consumers. At best, it may be an ill-fitting product specification to most consumers. At worst, it may mislead consumers into thinking they have a product specification which meets their wishes but in fact is not suited to their needs when they realise the many other available choices upon actually arranging the funeral.

11.5 Certain providers may homogenise over the LA product specification, leading to reduced innovation and a general flattening of overall quality standards in both back-of-house and front-of-house, leading to less consumer choice and therefore consumer detriment. This would be of particular detriment to certain faith groups for which the LA specification may not be likely to cater to certain demands.

11.6 If the LA prices were set too low, providers might not be able to provide their best service to LA consumers (as this might not be profitable), whilst at the same time still providing a quality service for their non-LA customers. This remedy therefore may not be effective in increasing quality for LA customers.

Remedy effectiveness in driving competition

11.7 Additionally, the CMA aims for the remedy to introduce competition “for the market” and potentially create opportunities for providers. We do not consider this as likely to be realised in practice. We elaborate on this further below.

11.8 Certain firms may be unable to cope with the potential volume and thereby not be able to compete for the LA contract.

11.9 The remedy may also result in market exit of firms if take up is significant because firms that are not successful in the tender may not be viable. This would result in increased concentration in local markets in the long run, which in particular would damage competition in subsequent LA tenders. This is likely to especially affect the higher quality end of the market.

11.10 Issues of competition might also arise when the LA provider is associated in marketing with the LA, as that might lead to anti-competitive advantage.

Suitability of LA tendering pricing as a benchmark price for funeral director services

11.11 As discussed in the context of the price regulation remedy, we do not consider that the prices obtained through the tendering process would serve as a suitable reference point for price regulation. These prices would clearly be set with the notion of providing a generic package which would aim to be suitable for a wide range of consumers across the LA, and would therefore not be a suitable comparator for the wider “non-LA” market, where consumers would look to personalise their funerals to a much greater degree.

Proportionality

11.12 The CMA's analysis to date in the investigation has neither identified evidence of an AEC nor attempted to produce an estimate of the costs of this remedy, which would be used for a proportionality assessment. FPL notes that:

- The proportionality of this remedy needs to be linked to the benefit that would be obtained by consumers through its introduction, such as how many consumers would be expected to receive better outcomes through this process.
- The remedy is likely to be very costly to implement for all LAs across the UK. The CMA proportionality assessment needs to include a comparison of the effectiveness of this remedy over and above other less intrusive remedies proposed as part of the package, such as price transparency and quality standard, which may also act to address issues of consumer demand.
- A proportionality assessment would equally need to address the unintended consequences listed above.