PREISKEL & CO

**London Cremation Company**

**Summary of response to CMA's Market Investigation Working Papers**

**Published 30 January 2020 and 20 February 2020**

## 1. INTRODUCTION & OVERVIEW

The LCC sets out below its comments on the CMA's Working papers of 30 January 2020 and 20 February 2020 (the "Working Papers"). We provide below a brief overview of the LCC and CMA positions and findings before reviewing a number of key issues of detail arising from the Working Papers that we believe require additional work and refinement by the CMA. We have also provided our observations on the CMA's proposed remedies and suggest some alternatives that we believe would be more workable, practical, proportionate and justified, together with our conclusions. Our detailed observations and comments are set out in more detail in our individual responses to each CMA working paper (attached).

The cremation services segment is a distinct, standalone subset of the wider funeral services segment. It has a separate provider base to the funeral director ("FD") segment and has entirely different economic and operational drivers. Other than Dignity, there is no overlap between FD service providers and cremation service providers. It is therefore important that the CMA assesses any actual problems that arise from the cremations sector on their own merit.

In our comments below, we therefore focus on the CMA's findings and proposals relating to the cremation services segment.

As set out below, LCC considers:

- It is essential that any remedies proposed should be in response to actual issues within the cremation sector that are identified and properly evidenced in the CMA's work
- Part of the issue is the "bundling" of cremation fees into the overall cost of a funeral by FDs and the resulting loss of transparency to the consumer. Whatever remedies are ultimately implemented, we recommend that cremation fees should at the very least be a separately disclosed disbursement in any funeral bill. Additionally, to enhance competition between crematoria, we would welcome greater visibility of cremation fees generally and would welcome consumers being more aware of their ability to deal with crematoria directly
- We have a number of concerns that the methodology currently adopted is inappropriate for the majority for crematoria providers and will lead to both inaccurate conclusions and to undesirable market consequences. The CMA needs to expand its understanding of the crematoria sector by analysing crematoria on a much more granular and individual basis

## 2. OUTLINE OF PAPER

- Overview of LCC's Position
- Overview of CMA's Position & Key Findings to Date
- Key Issues LCC considers require further consideration by the CMA
- The Impact of Geography
- Extent and nature of remedies that are reasonably required based on actual CMA findings

- Conclusions and Proposals for a way forward: Appropriate & Proportionate Remedies for the Cremation Services Sector

## 3. OVERVIEW OF LCC'S POSITION

With a view to remedies it may be helpful for the CMA to start from the perspective of the incentives of different players in the industry and how remedies will operate with those in mind.[1]The LCC is majority (but not wholly) owned by a charity, and operates six crematoria in the private sector part of the cremation services segment. It is significantly smaller than the largest crematoria operators. The LCC is a small business [✂].

(We note in passing that it is therefore incongruous that the CMA describes LCC as a "large crematoria operator". It is indicative of the highly fragmented and typically very small company provider base in the crematoria segment that LCC can be regarded in any way as "large": it has only six crematoria. The cremation services segment comprises predominantly a large number of small companies.)

We are pleased to note the CMA has established that LCC has not earned excessive profits. The LCC does not disagree with this conclusion, but we do nevertheless have major concerns over the CMA's methodology and its reasonable applicability to small crematoria operators (who comprise the majority of crematoria operators). The LCC believes this methodology to be flawed in certain important respects, leading to inappropriate and incorrect conclusions being drawn regarding the cremation segment.

The CMA has reviewed and analysed the profitability of only 4 out of 24 private crematorium operators. This is a very small sample and ignores 83% (by number) of private sector operators. Notably, only 2 of the 4 private providers reviewed (or c8% of all private providers by number) have actually been assessed as having potentially generated excessive returns on capital (although we acknowledge that these 2 combined operate 75 crematoria, c25% of all UK crematoria). The two other cremation services providers reviewed are not considered to be generating excessive returns, and the CMA has developed no insight into the performance of the other 20 private providers.

Indeed, the CMA's own analysis to date has confirmed that the conduct of the 2 largest private crematoria operators is not typical of even the two other private providers reviewed, far less the 20 that have not been reviewed. The CMA's analysis to date has therefore, at best, identified the existence of a localised problem affecting only two private cremation providers.

Consequently, the perceived need for remedies in the cremation sector that has been established by the CMA to date is restricted only to those two providers based on the evidence we have seen. A nation scheme of regulation and price control is therefore excessive and has not been shown to necessary by the evidence.

Alongside the private crematoria providers, the remaining 183 crematoria (65%) are of course operated by local authorities ("LAs"). These have public sector objectives and incentives. They record data and report numbers that vary widely and are, we suspect, of variable reliability and comparability for the CMA's purposes. None is however tasked with profit maximisation or with making excessive returns, which would of course be detrimental to their own residents.

When CMA analysis suggests that excessive profits are being generated by the public sector, this alone should ring a loud warning bell as to the reliability of the methodology being used. The LCC

[1] CMA3, Guidance on Market Investigations and remedies.

considers the CMA's conclusions regarding likely excessive profitability of LA crematoria to be neither robust nor correct.

Whilst we question the reliability of the CMA's current findings with regard to LA crematoria operator profitability, we nevertheless presume that the question of the potential imposition of pricing controls on LA crematoria in the current economic and public sector funding environment (particularly post COVID) is not a matter for consideration of the CMA.

The FD segment is diverse and fragmented. Most are independent businesses. They provide valued[2] advice and project management services for the bereaved. The CMA is proposing price regulation for all 2,032 FDs. Only Dignity spans both FD and crematoria segments.

The CMA has raised questions regarding the impact of crematoria service pricing as a possible driver of price inflation in the FD segment. Some crematoria prices have indeed gone up over the last decade but most providers such as the LCC have not followed the price leaders. In any event, crematoria fees represent only a small element of the total funeral cost (typically less than 20%). The CMA's analysis to date has therefore confirmed that crematoria pricing has not been a major driver of any increase in pricing within the FD sector.

FDs are crucial in providing the public with information on crematoria fees and practices, but this is an unreliable symbiotic relationship. It can however be improved (remedied) by the introduction of direct bookings and contracting with the crematorium of choice by the public and by greater transparency of the elements of total funeral costs (including cremation fees) by FDs.

## 4 OVERVIEW OF THE CMA'S POSITION & KEY FINDINGS TO DATE

Key evidence is found in the following[3]:

- Submissions of those being investigated.
- Responses to CMA requests for information.
- Ipsos Mori poll between 26 July and 22 September 2019, where 279 people answered questions focused on the provision of funeral director services and 376 answered questions focused on the provision of crematoria services.
- Consumer research gathered in the Market Study: Research Works[4] in depth interviews with 20 paired and 80 other people. October 2018. Research commissioned by Funeral Directors ("FDs").
- Sunlife database of prices.
- Internal documents from suppliers.

The above list is surprisingly brief, and indicates that the CMA's factual basis for assessing the existence of adverse economic consequence within the cremation sector is limited.

Consumers are generally very satisfied with the crematoria service provided. 66% had their expectations <u>met in full</u>, a further 29% said their <u>expectations had been exceeded</u>, and <u>only 1% were dissatisfied</u> (emphasis added). Consequently most (70%) consumers would be happy to recommend that crematorium to someone else.[5]

These high levels of satisfaction amongst consumers do not suggest any consumer pressure or perceived need for a nationwide remedy in the cremation services segment. Any ill-judged intervention by the CMA in the cremation services segment therefore risks damaging what

---

[2] The Ipsos Mori survey found that 80% of customers are happy with the services.
[3] See CMA Updated overview of key research and analysis 20 February 2020.

consumers already value highly. Should the CMA ultimately conclude that some level of intervention is necessary in the cremation segment, it must be careful to develop highly targeted solutions that address only the specific market issues that are clearly evidenced in its detailed analysis.

The CMA has identified consistent price increases of 6% year on year by only two private players in the cremation sector. This suggests that, in the cremation sector at least, any issue that exists is concentrated only on those two providers. Our own analysis suggests that almost all "high-priced" crematoria are operated by those two private providers. To the extent that there might be any AEC from crematoria pricing, it is concentrated in a limited number of sites operated predominantly by two operators and is not an industry-wide problem in the cremation sector.

In 47% of cases there is apparently only one crematorium in a locality. However, for the majority of consumers wishing to use cremation, (53%) there is choice between competing crematoria.[6]

Consumer choices regarding crematoria are made under challenging circumstances – it is a cathartic process - but the CMA nevertheless accepts that rational decisions are being made. The LCC's experience is that families typically nominate a family member who is organised and rational to act on their behalf.

The basis for the CMA's concerns appears to be the Research Works'[7] report. That report states that a 'large group' (over 60 of just 100 interviewees on this question) felt under time pressure and emotional distress. However, this is very different from being irrational. It is true that a majority thought it would be inappropriate to negotiate on cost,[8] but giving a 'a good send-off' was their paramount motivation.

However, it was also found that 82% of the bereaved[9] nevertheless make reasonable decisions about the location of the funeral. This clearly indicates that the bereaved are making rational decisions when arranging a funeral despite emotional distress at the time. Price sensitivity may be limited because inherited money provides the bereaved with the deceased's funds - which, rationally, are then spent on the deceased's wishes for the funeral, which probably includes the choice of crematoria or burial ground. Whilst we agree that the bereaved are distressed, they are nevertheless rational and the CMA's concern that people are vulnerable and hence open to abuse from predatory crematoria pricing may be overstated and does not appear to be borne out by the actual evidence.

When planning a funeral involving cremation, consumers (or the deceased) typically choose their desired crematoria first. This is evident from the Ipsos Mori poll. It might have been expected that consumers would choose FDs first but that is clearly not the case. This nevertheless appears to be a rational decision, that takes into account the deceased's home location, express wishes and practical needs of family and friends. For many locations in the UK there is little choice between alternative crematoria providers, but there is a choice in many locations and, where it exists, prices are typically lower though by less than might be expected (reflecting the high fixed cost nature of the cremation sector). The FDs organise the funeral service and project manage the performance of that service to the Consumers' specification, having influence over consumers' decisions and choices.

[6] 1.47. Research Works
[7] 4.3.6, p. 34.
[8] 4.4.18 Research Works p 53.
[9] See Ipsos Mori market research.

Not shopping around is regarded by the CMA to be a cause for comment and unusual consumer behaviour.[10] However, what consumers value is much broader than can easily be measured by the CMA. Choices are being made based on a variety of highly qualitative factors, which include venue, quality of facilities, heritage to the family, etc. These factors are impossible to measure, quantify or evaluate, but are of immense importance to consumers.

Knowing this, suppliers such as the LCC are keen to avoid losing custom and monitor their competitors closely to ensure that their facilities, the quality of their service and their prices remain competitive. Crematoria constantly ask FDs what can be done to improve their own quality of service to avoid losing custom. And above all, FDs are extremely rational and profit-maximising agents for the bereaved who can have a considerable impact on utilisation levels of crematoria capacity.

FDs are felt by consumers to provide a 'distress service' which helps consumers to negotiate a difficult and emotional situation. Their role is highly valued and trusted.[11] Indeed, consumers often connect to a 'family undertaker'. So, FDs make a difference to the choice of crematoria selected in an important number of cases, imposing a risk of lost sales in the event of FD switching.

FDs are knowledgeable and tender for cremation services. There is evidence of Memoria rescinding a price increase in response to Funeral Director pressure.[12] Although FDs generally say that they do not negotiate individually on price,[13] this could also reflect a competitive tendering market in some localities. This should be investigated further; especially the Memoria example.

It is important to focus on the fact that the shares of the three largest FD players have not varied considerably over the past six years. Also, the average revenue per funeral excluding disbursements (ARF) of the three largest FDs grew rapidly between 2013 and 2016, but slowed down in the following two years.[14]

[✂]

LCC considers that competition between crematoria is informed predominantly by quality factors. We however draw the CMA's attention to the following which appear to arise as a consequence of competition on quality and on price:

- On average, fees at crematoria with alternatives tend to be lower than fees at crematoria without alternatives.[15] Fees at private crematoria are lower on average when good quality rivals are closer. There is also one third out of area use in the case of private facilities.[16] In at least one case, *half* the business came from out of area.[17] The catchment areas for crematoria are therefore not as tightly limited as the CMA suggests.
- Crematoria benchmark each other's pricing and compete with other facilities.[18]

[10] The LCC provides a submission from the Rev. DR. P Jupp, a Director of the LCC which includes reference to the funeral service providing a valuable benefit to the bereaved in starting the process of assuaging grief, and submits that a valuable function of the performance of a funeral as part of the grieving process should not be overlooked or impacted by the CMA's proposals for a standardized regulated service package. Moreover- funerals in general should be seen as a competitive market providing a valuable benefit. The full value of a funeral has not been fully appreciated by the CMA- and is detailed in the Rev. Dr Jupp's submission, but while there is a competitive market there may also be a legitimate problem with relation to the profitability of two players that needs to be addressed.
[11] 1.4. 18 Research Works
[12] Crematoria: Overview, para. 39.
[13] Id.
[14] See CMA Updated overview of key research and analysis 20 February 2020.
[15] Crematoria Outcomes Working Paper and Overview p 23.
[16] Survey, para 55.
[17] Survey, para 68.
[18] See e.g. Market Study, 5.43

- Profitability measured in EBITDA margins slightly decreases with proximity of rivals. Those with more rivals charge on average lower fees and conduct fewer cremations (and thus are likely to face higher average costs and lower levels of efficiency). This has a material bearing on the lower margins observed at these crematoria.[19] There are relatively few crematoria with more than one rival.
- Of the four largest crematoria operators analysed, only two appear to have earned profits in excess of their assessed cost of capital over the period from 2014 to 2018. The vast majority of other private sector providers should not be subject to intrusive and unnecessary regulatory remedies as a consequence of the excess profitability of those two players. Indeed, to impose such wide-reaching regulation on all other private providers without good reason or justification would be disproportionate and excessive.
- Some Local Authority crematoria appear to have earned excess returns on capital. However, LCC considers there are difficulties in the sample size and methodology adopted that raise questions about this assessment being representative, robust and fair.
- The planning process requires that quality factors are taken into account as part of the proof of need requirement. This perhaps slows entry but it does occur, and when it does volumes at nearby locations are affected, due to the competition.

## 5 KEY ISSUES LCC BELIEVES REQUIRE FURTHER CONSIDERATION BY THE CMA:

a) ***Measurement of excessive profitability***

The CMA's use of ROCE has underlying evidence issues and its application to crematoria requires very significant further adjustment to be reasonable, particularly when applied to industry providers (whether FDs or crematoria) beyond only the very largest private providers.[20]

Use of a ROCE-based methodology is not theoretically wrong, but its application needs careful adjustment and robust underlying evidence if it is to be applied to a sector which is capital intensive, has very long-life assets, is extremely localised, and is largely populated by what are very small businesses.

The CMA's theoretical starting point is to use a Modern Equivalent Asset (MEA) reference point or replacement costs where possible. This is reasonable in principle – but is difficult to apply in practice where the assets are valuable over very long time periods and may even appreciate in value because of their architectural, heritage value and accumulated connection and importance to families. Assessing "modern" equivalent assets is thus a very difficult issue and we do not consider the CMA has got this right yet.

*b) Estimated land values*

The CMA's approach to **land values** is questionable and does not provide a sufficiently robust or fair basis on which to base the potential introduction of nationwide regulation in the cremation segment under any of the options presented. We acknowledge that the CMA has attempted to make its initial base case scenarios less wrong by applying two sensitivities; however, we do not believe the CMA has yet gone far enough in this area.

The base case is very obviously just wrong. It is not credible or reasonable to extrapolate the results of a sample of only ten land transactions (none in London) to 300 sites nationwide and

[19] Crematoria Outcomes Working Paper and Overview p23.
[20] Please see our submission on the specific working paper for more details.

expect the output to be representative of the diversity of land and the valuation of land which would be suitable for the entirety of the UK.

Sensitivity One, which proposes a valuation adjustment for land in London, still remains too broad brush. Major conurbation areas and prime development land in London, for instance in Golders Green or Finchley (the location of St Marylebone crematorium), are likely to command considerably different valuations to (for instance) brownfield sites on the outskirts of Greater London. We consider Sensitivity One to remain a vast over-simplification and, as a result, highly unfair and unrealistic.

Likewise, whilst an improvement on the other two options, Sensitivity Two nevertheless also remains far too generalised to be fairly and reasonably applicable to 300 individual sites around the UK. No surveyor would value all sites nationally on the basis of a matrix with only three available options, and it is unrealistic and unsustainable for the CMA to do so either. A reasonable basis requires more detailed work on a site by site basis. National property surveyors are however likely to hold such data and it should be readily accessible.[21] The absence of any surveyors willing to respond to the CMA's invitation to tender should not be interpreted as justification to simply apply an over-simplified and assumption led basis of valuation, particularly when the results are to be used to justify the introduction of a nationwide and highly intrusive and costly regulatory system and more so when the results of the CMA's consumer research do not point to any consumer pressures for such a system.

Unfortunately, we see no fair or reasonable alternative to the CMA looking at crematoria sites on an individual and detailed basis. It is unreasonable to introduce national price and profit controls across an entire industry based on extrapolated assumptions that are founded on a disproportionately small piece of data. If the CMA wishes to conclude that a national regulatory and price control mechanism is required covering 300 individual locations, then it appears unreasonable to do so based on a highly simplified and assumption driven assessment.

c) *Estimated Building values*

The CMA's approach to estimating **building values** - taking insurance cost and then deducting notional depreciation - does not provide a reasonable proxy for the current fair value of the building in question either.

The "insurance replacement value" methodology is a sensible and pragmatic starting point for "cost". However, the LCC strongly disagrees with the CMA's subsequent application of "notional depreciation". This is a major structural flaw in the CMA's methodology and leads to the CMA's analysis significantly and systematically undervaluing all older crematoria buildings and assets across the entire sector.

We consider this particular flaw to be one of the main reasons for the CMA's analysis suggesting that a majority of LA operators are generating excessive profits. We believe that is an erroneous conclusion.

The average age of crematoria outside London is approaching 60 years. In London it is 75 years. The blanket use of an assumed 100-year life for all crematoria in the UK is not based on any evidence and does not reflect the fact that crematoria operate for long periods of time, far beyond conventional businesses and civil authorities' activities.

This approach therefore means that the CMA analysis is based on valuing crematoria buildings on average at only 25%-40% of their current replacement cost. It is therefore no surprise that this

[21] As referenced in the LCC bank loan documentation.

methodology suggests some crematoria operators with older sites are apparently generating high returns. This apparent result is however the predictable outcome of systematic undervaluing the capital employed in older crematoria buildings and cannot be reasonably interpreted as indicating widespread excessive profitability.

The issue is on the capital account side of the calculation. The CMA values capital employed based on replacement cost less notional depreciation. The model then applies the proposed WACC to this to get to "acceptable profit" and compare it to actual profit (albeit adjusted for their notional depreciation).

The LCC's Golders Green Crematorium is >100 years old and so a good example. The CMA model values the capital employed on the building at nil. So, the LCC's "permitted profit" at an 8% WACC does not increase to reflect the building value as it has been (in this calculation) fully depreciated already. This would mean that the LCC would get to make less profits that someone with a brand new but otherwise identical building.

This also appears to be behind the LA results. Outside London the land value element is negligible so the principal asset / capital employed is the building itself. For all older crematoria, the model depreciates this down. On average across the sector, the approach depreciates building values / capital employed in buildings down to only 25-40% of their replacement value and then determines acceptable profit based on this lower figure.

Actual crematoria lifespans and useful economic lives (based on Cremation Society data) confirm that 96% of all UK crematoria that have ever been opened still remain in operation today. Just 3.7% of all crematoria opened since the first in 1885 (Woking crematorium; still open) have required replacement in the intervening 140-year period. The actual data does not support the CMA's assumed 100-year lifespan on which its notional depreciation adjustment is based.

Indeed, of the 11 crematoria opened prior to 1920 (100 years ago), 8 remain in operation today.[22] Two of these coincidentally are owned by LCC and both have very long future lives still remaining.

The "notional depreciation" aspect of the CMA's methodology effectively (and wrongly) treats all of these heritage buildings as being of nil economic value today. This is contrary to the facts and hence is unreasonable. We would be delighted for the CMA to visit (e.g.) our Golders Green

[22] From Cremation Society Data and explained further in LCC's Crematoria Profitability Working Paper response. The Cremation Society website shows all 308 crematoria open today by year of opening, with the first one being the LCC's Woking facility in 1885.

It also lists (but does not include in the 308 total) 12 crematoria that have been replaced by new ones in the same location over that 135-year period, and just 1 crematoria that closed and was not replaced.

The replacements were:
- Hull (opened 1901, replaced 1961)
- Darlington (opened 1901, replaced 1961)
- City of London Manor Park (opened 1904, replaced 1973)
- Southampton (opened 1932, replaced 1973)
- Cheltenham (opened 1938, replaced 2019)
- Aberdeen (opened 1938, replaced 1975)
- Walsall (opened 1955, replaced 1984)
- Bedford (opened 1955, replaced 1995)
- Hereford & Worcester (opened 1957, replaced 2009)
- Nuneaton (opened 1957, replaced 1995)
- West Bromwich (opened 1961, replaced 2010)
- Chester (opened 1965, replaced 2013)

The permanent closure without replacement was Bristol (Arnos Vale): opened 1928, closure date not listed.

This tells us that 96% of all UK crematoria that have ever been opened remain in operation today. Only 3.7% of any crematoria that have ever been opened (12/(308+12+1)) have required replacement in that 135 year period.

crematorium and to see for itself the quality of the buildings today that its methodology treats as being of nil value.

Significant adjustments are needed to the CMA's estimation of building values (and hence capital employed) to make them more realistic. This will make a material difference to the estimated valuation of older crematoria buildings, and hence to the CMA's estimates of the acceptable normal profitability of older crematoria (which represent the majority in operation).

Unfortunately, any analysis of ROCE based on a flawed notional depreciation methodology that does not reflect actual remaining useful asset lives will systematically over-estimate and exaggerate the incidence of any economic profits within the cremation sector. It will also potentially underestimate returns from more recent crematoria investments.

Given the importance of crematoria buildings to multiple generations of consumers, and their accumulated family connections over many generations, the CMA's approach to notional depreciation systematically undervalues older crematoria buildings and represents an incorrect basis for assessing ROCE for revenue generating assets (buildings) at older crematoria.

The CMA's overall "building valuation estimation" methodology therefore strongly favours operators of new crematoria in terms of their permitted level of acceptable profitability over operators of older crematoria.

If this methodology is used as the basis of a remedy for all crematoria operators, it will distort outcomes and incentives. It will allow operators of newer crematoria to earn higher profits than older crematoria. We highlight that the operators of most "new" crematoria in the segment tend to be the two largest private providers that the CMA analysis to date suggests are already generating excessive profits and charging the highest prices to consumers. This methodology risks actively favouring those just two providers going forward.

Cost minus depreciation is of course not the only recognised accounting basis for building valuation. FRS102 permits specialised assets that are rarely sold except as part of a continuing business to be valued with regard to their income generating capabilities.[23] However, we see no other option given the manifest unfairness that results from the existing proposed methodology when applied to operators of older crematoria.[24]

The current methodology emphasises that the CMA's approach to the estimation of buildings value in the crematoria segment is, unfair and unreasonable compared to normal accounting standards.[25]

The law requires the CMA to take into account relevant evidence to establish excessive pricing. LCC submits new evidence of local value being affected by local competition from its independent surveyors' reports contained in its bank loan documentation[26].

*d) WACC*

[23] S17.15: An entity shall measure all items of property…after initial recognition using the cost model (historic cost less any accumulated depreciation and less any accumulated impairment losses) **OR using the revaluation model.** (see S17.15B-D) which allows an item of property to be included in the accounts at a revalued amount which estimates the fair value of the asset at the date of revaluation. This is usually determined based on market-based evidence by professionally qualified valuers. **However (s17.15D), "if there is no market based evidence of fair value because of the specialised nature of the item of property….and the item is rarely sold except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach".**

[24] See FRS 102 accounting standard, and revised crematoria profitability paper.

[25] See FRS 102 accounting standard, and revised crematoria profitability paper.

[26] Please see attached loan documentation provided by the LCC.

LCC also has serious reservations over identical methods of valuation and identical levels of WACC being applied to all cremation service (and indeed FDs) providers irrespective of their very different circumstances.

In simple terms, the CMA has adopted a single benchmark for cost of capital that is based on public markets, large businesses and a small selection of "comparable companies" that are anything but comparable to LCC or the vast majority of crematoria operators that are also small businesses. The resulting WACC estimate is not reasonably applicable to small companies (including LCC) and cannot reasonably be used as the basis for estimating the level of appropriate profitability return for small crematoria operators whether privately or publicly owned.

As a small business that is unlisted, LCC would be unable to raise external funding for any new project at the WACC used by the CMA in its analysis, and neither would any other small business in the cremation sector (which is the majority of providers). It is unreasonable and unrealistic for the CMA to assume otherwise. We believe that this will be confirmed by any experienced corporate finance adviser with experience of raising equity and debt funding for small businesses with revenues of only £1-7m.

Bluntly, the WACC of a large, listed company with extensive and diversified operations covering very many local sites is significantly lower than the WACC of an operator with only one or a small handful of sites. This is self-evident on reflection. From an investor's perspective, a large business with many sites can easily withstand a problem at one site. However, a small business with a single site does not have that inherent diversification of risk and so a problem at its single site can easily become an existential risk. The smaller the business, the greater the risk and hence the greater the return required by an investor.

It is consequently widely recognised amongst corporate finance practitioners that smaller businesses require to offer a risk premium to investors, and their cost of money is consequently higher, often significantly, than for bigger businesses.

Perversely, the unintended consequence of the CMA's approach is therefore again to actively favour the two largest crematoria operators (i.e. those believed to be generating excess returns already) over all other crematoria operators. A regulatory or price control regime based on this methodology will consequently lead in the medium term to greater industry concentration rather than less.

*e) LA Operators Reviewed*

Our observations above regarding building value estimation and the impact of crematoria age on assessed capital employed and hence ROCE apply equally to LA providers, and this needs to be reconsidered by the CMA. However, there are other potential issues in even the current limited analysis carried out by the CMA.

The sample of 14 LA providers appears randomised and, whilst an extremely small sample, was intended to be fairly representative of all 180 LA crematoria operators. However, it unfortunately is not fairly representative when viewed in the context of the Pharos 2019 pricing report.

Of the 14 LA crematoria currently reviewed, 8 had January 2019 prices that were above the UK average. On average, these 8 were 11% higher than the national average price, with the largest price premium being 34%.

Of the remaining 6 that priced below the national average, the average discount was only 7%, with the largest discount being 13%.

It therefore appears that this sample is in fact unrepresentative, being significantly skewed towards higher charging LAs.

Furthermore, it is not clear that the CMA has carried out the detailed work required to confirm that the financial information provided by these LA crematoria is genuinely fully comparable to the information provided by private crematoria operators.

LA's do not require to ensure that all crematoria costs are allocated against their crematoria activities with the same degree of rigour and accuracy as is required in a standalone private operator. For instance, grounds or property maintenance costs may be provided by other LA departments on whatever pricing basis they choose to adopt internally. Similarly, some management and supervision costs (e.g. part of the LA CEO and finance team's salaries) are unlikely to be allocated down to the crematoria accounts, and it is not clear whether or not LAs will levy business rates on their own in-house operations.

LA crematoria are very small businesses with low revenues, and it does not take many differences in cost allocation or internal charging to lead to incorrect conclusions being drawn regarding the actual profitability of individual LA crematoria. In small businesses with low revenues, minor differences in accounting treatment, accuracy and rigour lead to significant differences in assessed profitability and ROCE.

The CMA's analysis of LA crematoria therefore needs to be taken to the next level of highly detailed analysis to confirm that the accounting information used is entirely comparable and robust both between individual LA crematoria and also against private sector crematoria. Anything less means that the (currently early stage) analysis of LA profitability and returns will be entirely unreliable and potentially misleading.

*f) London crematoria illustrate the anomalies inherent in the CMA's methodology*

To illustrate the illogical outcomes resulting from the CMA's methodology, we highlight that its application suggests that no London crematoria is able to cover its WACC.

Applying the methodology allows the estimated capital employed at a typical London crematorium to be estimated and its "normal" level of acceptable profitability to be estimated.

However, London crematoria typically charge fees around 20% below the national average notwithstanding their very significantly higher level of capital employed and typically conduct fewer cremations than many regional crematoria.

The CMA's methodology as it stands consequently indicates that the long-term sustainability of crematoria provision in London is in jeopardy – which is hardly a robust or necessary basis for the introduction of national pricing controls. This illustrates the risk of potentially severe unintended outcomes from the current methodology.

*g) Measurement Methodology - Conclusion*

Overall, these issues may perhaps not undermine the assessment of excess profitability for the two large private operators of crematoria but the CMAs methodology (particularly with regard to land value, estimated building valuation and WACC) needs to be materially modified if it is to be reasonably and fairly applied to all other crematoria operators, whether publicly or privately owned.

## 6 <u>THE IMPACT OF GEOGRAPHY</u>

The CMA's analysis to date is essentially at a national or macro level. However, crematoria are local businesses and we would suggest that geographical differences and factors must be properly considered during the next phase of its analysis of the crematoria segment.

The CMA has already identified that the conditions of demand and supply, costs and profits all vary by location.

On the demand side it is apparent that bereaved families and their communities have different cultures, traditions, and religious preferences and those vary often substantially by location. A nationwide regulated package of services would ignore such important differences and could easily be culturally insensitive. Definition of the product creates serious specification risks but unintended cultural issues may also arise in such a one size fits all approach.

Similarly, as the nature of demand varies by location, regional caps set with relation to broad political boundaries could also potentially be culturally insensitive and fail to reflect the local reality.

On the supply side, the risk of loss of customers is uppermost in the LCC's mind when setting its local prices and in defining its propositions to end customers and FDs. Quality of service is therefore critically important, particularly in maintaining reputation in a sector where care for the bereaved is an essential part of the service provided. That quality of service carries underlying costs. We train (and monitor) our people in appropriate behaviours and in customer service. Importantly, the cost of employing people varies with the cost of labour, by location, with the cost of living and pay being higher in London than elsewhere in the UK though there are other regional differences too.

Perhaps contrary to the CMA's expectations, the LCC does actively compete by seeking to provide higher quality services than its nearby competitors. We take into account the quality of service and prices charged by competitors and seek to surpass it. These facts are evident in the factual record before the CMA.

The CMA has observed that there is a correlation between competitor proximity and price - but its methodology starts with an assumption that customers shopping around are the sole determinant of the level of competition by location.

In reality, this approach misses the fact that competition is generated by supplier vs supplier loss aversion. It arises from suppliers seeking to outcompete each other by offering higher quality services at lower prices to avoid the loss of marginal volumes. This is a feature of competition in this market even if the customer is not shopping around as much as takes place in other markets.

This "supplier to supplier" competition is in fact an element of the competitive landscape where suppliers monitor each other as the CMA has found. It is a type of competition that should be nurtured and supported by the CMA given its duty to promote competition and to adopt a market-based solution where possible. Promoting competition can, particularly, best be supported through the CMA leaving the London and any other already-competitive markets outside of any national price capping or regulatory regime should that prove the end outcome regardless of our representations in this paper.

Moreover, because land values vary and are essential in calculating normal profitability, calculations of excessive profitability can be (and currently are) materially distorted by major differences in land value between locations.

All land values vary by location because all land is different. It derives value because of the differences between different blocks of land vis a vis others. As a result, and as noted earlier, the CMA's approach that is based on just three bands of proposed average land values that will apply nationally for the purposes of the capital account, cannot reflect the true level of profitability of any supplier. Modern equivalent asset values are inherently difficult to establish as equivalent land is difficult to identify as a reference point. The substitutability of alternatives thus always varies.

This issue is doubly difficult when considering land in London.

Recognising these issues, it would be unreasonable to set a nationwide price cap. By setting a nationwide cap some players will benefit and some will not, with higher or lower levels of profit being allowed by the cap, in a way that is not merited by any business activity or efficiency and which would be inherently disproportionate.

Major players with multiple sites are likely to see some degree of averaging across their estates and so be relatively unaffected, while smaller players with fewer or single locations (the majority of the cremation services segment) will be disproportionately affected whether favourably or unfavourably. Some may be able to put their price up; others may go out of business.

In the absence of detailed analysis, the outcome for individual operators of a nationwide price cap will essentially be down to their luck – whether their actual land value and capital employed happens to be under or over-estimated under the simple, three tier land valuation model proposed.

The CMA has raised a question about whether London should be excluded from its proposed nationwide price cap and nationwide regulation. The LCC considers that suppliers in London and other competitive locations should certainly not be regulated or subject to a price cap, but that a much deeper assessment of both competition and underlying land values by geographical location generally is unavoidably required prior to the CMA's investigation reaching a conclusion.

## 7 EXTENT AND NATURE OF REMEDIES THAT ARE REASONABLY REQUIRED BASED ON ACTUAL CMA FINDINGS

Subject to the resolution of the methodology issues raised above, the LCC can potentially see a potential case for remedies in relation to the two leading private players in the cremation services segment. Those two providers also happen to be the operators of the majority of the most expensive crematoria nationally.

However, we cannot see any case from the existing evidence for a remedy being necessary in relation to any of the 22 other private crematoria providers.

Similarly, we believe that there are significant question marks over the CMA's current findings with regard to LA crematoria which we believe have been similarly skewed through the application of an inappropriate methodology. We are not persuaded that the CMA's analysis of LA crematoria profitability is sufficiently robust to justify their inclusion in a national price cap scheme.

Effective remedies have to be proportionate and relevant to issues clearly identified – by company, activity, and location. In our view, the CMA's work to date on the cremation services sector has produced robust and reasonable evidence to support assertions of potentially excessive profitability by only two private providers (out of 24).

Indeed, we note that the CMA's estimates of excess profit per funeral by the two largest private cremation providers (only) is c£1-200 per funeral (under the sensitivities). Even if this calculation was entirely accurate and this excess profit was eliminated entirely by a price control regime, this would represent an extremely modest and probably unnoticeable reduction in overall funeral cost. Any potentially excess profits in the cremation sector are simply not a key driver of overall funeral costs.

Furthermore, industry pricing data (Pharos 2019) highlights that the vast majority of crematoria providers generally charge within a clear range, with high prices outside this range being limited to a small number of (usually but not always) private crematoria. These tend to be (usually though not always) newer crematoria. Again, this highlights the problem is not industry wide in the cremation sector but can be clearly attributed to a small number of sites operated by a handful of operators:

We have attempted to evaluate the likely consumer benefit if an industry price cap was set at a level that would eliminate the current estimates of excess profits being earned by the two most expensive private crematoria operators. Our rough analysis suggests that the aggregate consumer benefit might be only c£1-5m nationally, and this would be reduced by the costs imposed on the cremation industry of a national system of regulation which those cremation providers (the majority) who are currently not generating excessive profitability would have no option other than to pass on in the form of higher prices.

We therefore see no case for industry wide regulation in the cremation services sector. The actual problem identified by the CMA appears to be clearly confined solely to two large private operators, and to an identifiable subset of crematoria sites.

A similar pattern would appear to exist in relation to FDs.

The cost benefit of industry wide regulation is consequently unjustified when the CMA can adopt more targeted remedies that more accurately resolve the actual problems identified in its investigation into the cremation sector. Regulating c. 200 individual cremation services providers solely to deal with the perceived misconduct of two and yielding only a modest aggregate benefit to consumers is not reasonable or necessary.

Generalised remedies create a problem where the solution does not properly address the specific problem identified. Here, an industry and nationwide solution is not properly addressing or tailored to the specific issues identified and evidenced by the CMA in terms of increases in pricing and excessive profits at two crematoria operators only. The remedy should be addressed solely to those two entities. A national intervention that impacts all other providers to deal with the misconduct of only those two is unwarranted.

CMA has identified two private players who appear to have made excessive profits. When considering remedies there are material and relevant differences between the two main private suppliers and the vast majority smaller suppliers, whether those smaller providers are privately or publicly owned.

Smaller suppliers represent a significant element that should not be overregulated through a one-size-fits-all approach. Fundamentally, the CMA has no evidence of excessive profits by ANY smaller crematoria and should not impose a blanket remedy in the crematoria segment where the actual problem identified can be dealt with very effectively through a more targeted approach.

When considering how a remedy might operate the CMA is proposing a nationwide regulatory system. We consider that such a system is unnecessary both for the retail market (FDs) and for the component that is represented by crematoria. It is important not to lose sight of the fact that the market for funerals is highly fragmented with highly differentiated offerings being provided through 2,032 FDs. Definition of a new regulated standard product subject to a price cap for all funerals against the proposed 'standard benchmark' creates specification risks and marketing and sales risks we have detailed in our response to the working paper.[27] These include likely price rises. They include the undermining of incentives to personalise offerings and care for individuals and the weakening of the current incentives for the differentiation of products to meet needs that the CMA may not have fully appreciated. The standardised package looks likely to limit current consumer benefits, with variable regional and local impacts. In summary, a national cap and system would be overbroad, disproportionate, and unjustified.

[27] Further identified in our response on Remedy Options for Regulating the Price of Funeral Director Services.

The LCC highlights the fact that CMA guidance indicates that market-based solutions should be preferred, and AECs should be dealt with through remedies which significantly increase competitive pressures in a market.[28] With that in mind, allowing consumers to contract directly for their choice of crematoria would seem appropriate and more impactful, especially if combined with cremation fees being accounted for by FDs as a disbursement and passed through transparently and without any mark-up. Direct contracting would support consumer choice where there are choices available locally.

As noted earlier, our analysis suggests that the aggregate financial benefit to consumers from a national price cap in the cremation services segment is likely to be relatively modest and arise from only a small number of locations and providers. In this regard, the wider cremation industry context here is important:

- Direct cremation is already impacting the profitability of all crematoria and providing an even cheaper alternative. We recognise that direct cremation itself is out of scope for the CMA but it nevertheless already represents a low cost option for consumers which is growing in popularity.
- Price caps affecting smaller players who comprise c. 75% of the cremation services segment may affect their viability. There is past experience of even relatively small cost increases (e.g. mercury abatement treatment costing only £100k -150k per cremator) threatening the viability of as many as a quarter of crematoria.
- Some locations are already competitive and do not require price caps.

Given the costs and operational burden of a national regulation and price control scheme on the cremation services sector, we would question whether the actual scale of consumer benefit from national price regulation provides sufficient justification for the scale of market intervention being proposed in the cremation sector. Available consumer benefits on this small scale would probably be more than offset by the costs of regulation.

The CMA has suggested a Local Authority Tender Proposal Remedy. There are some aspects of this idea that we are attracted to. However, from a cremation sector perspective, this proposal as currently presented is unfortunately flawed as a result of an irresolvable conflict of interest.

LAs operate the majority of crematoria in the UK. It is inconceivable in practice that any LA will put together a local cremation funeral package at a fixed price that does not direct those cremation volumes to their own crematorium. Consequently, this measure (if controlled by LAs) would effectively reinforce the local monopoly position of those LA crematoria and make it impossible in practice for any new provider to enter that local market.

The proposal would place LAs in a difficult position – if they prefer their own facilities over private sector providers they could be accused of discrimination to support their own business – not meeting consumer needs, for which they could be accused of misusing public funds for private sector benefit and not supporting their own, publicly funded activities.

Finally, the LCC also has considerable concerns as to the compliance costs that a national system of price and quality controls will impose on the cremation services sector. We reiterate that the majority of UK crematoria are very small businesses and have little or no capacity to absorb the costs and burdens of a national system of regulation and control without raising prices to pay for this.

[28] Paragraph 300, CC3

## 8 CONCLUSIONS AND PROPOSALS FOR A WAY FORWARD: APPROPRIATE AND PROPORTIONATE REMEDIES FOR THE CREMATION SERVICES SECTOR

There are structural problems with the CMA's methodology which are leading to questionable (or wrong) conclusions on profitability within the cremation services segment. Adjustments to the methodology are necessary, and we believe these will lead to more accurate assessment of any excess profitability by some providers but also help resolve CMA concerns over LA crematoria providers.

Price caps on two crematoria suppliers appear to be potentially justified and, if adopted only for those players only, would avoid the need to create a nationwide regulated standardised product as the basis for a cap and a complex (and expensive) regulatory system. This is clearly for the CMA to consider further.

The CMA has raised questions about how price caps could be benchmarked. We consider that an appropriate benchmark could be taken, potentially based on the crematoria cost covered under pre-paid funeral plans? Any concern that at-need purchasers are being faced with unfair crematoria prices would be resolved by using such a benchmark since those customers already benefit from the highly rational, considered and non-distress purchase nature of pre-paid plans.

Given the prevailing culture, custom and practice of the industry in monitoring and following each other's prices, controlling the prices of just two suppliers would directly control prices for approximately 70% of the country's private crematoria and would operate as a strong but informal signal to all others. One could see this would be economical and straightforward to monitor and enforce using a monitoring trustee or other independent entity.

Benchmarking is prevalent in the wider funeral industry. [✂] for the cremation industry and funeral services market as a whole. This would avoid the need for deep intervention in the market in way that would be likely to produce distortions and unintended consequences.

We do not believe that the CMA's work to date has established an industry wide problem in the cremation services sector. We also comment that an industry wide solution does not require each and every player to be subject to direct regulation – nor is there a clear need for a very costly, industry-wide regulatory system which would be extremely onerous for the majority of cremations services providers that are small businesses.

The culture of the industry is a fact and one that can be relied on to deliver industry wide benefits.

The LCC believes that price capping all FDs nationally would not achieve increased customer choice nor would it achieve a cap on FD profitability. This is because the funeral director will seek to maintain as much of the consumer's available spend on a funeral as possible. A better way to deliver the benefits and to secure customer choice would be to unbundle the cremation and increase transparency of the components within the funeral package. This would also conceivably allow the customer to book directly with the crematorium if they wish to do so. The cremation would then flow through to the final funeral director bill as a specific and visible disbursement without mark up. It is a lighter touch and potentially more effective remedy.

We provide specific responses to your remedy options paper separately in the following Attachments:

- Submission of 27 February 2020 on the CMA's Working Papers published on January 30 2020, and Appendix 1 to the 27 February submission.

- Submission in response to CMA's Market Investigation Working Paper on FDs: Pricing Levels and Trends published 20 February 2020

- Submission in response to CMA's Market Investigation Working Paper on FDs - Price Dispersion Analysis published 20 February 2020

- Submission in response to CMA's Market Investigation Working Paper on Funeral Director Profitability published 20 February 2020

- Submission in response to CMA's Market Investigation Working Paper on Crematoria Profitability published 20 February 2020

- Submission in response to CMA's Market Investigation Working Paper on Cost of Capital Analysis published 20 February 2020

- Submission in response to CMA's Market Investigation Working Paper on Remedy Options for Regulating the Price of Crematoria Services published 20 February 2020

- Submission in response to CMA's Market Investigation Working Paper on Remedy Options for Regulating the Price of Funeral Director Services at the Point of Need published 20 February 2020

- Submission in response to CMA's Market Investigation Working Paper on Local Authority Tendering Remedy Proposal published 20 February 2020

- Letter from the Revd. Dr. Peter Jupp, *The Importance of Funerals in Society*, 22 June 2020.