PREISKEL & CO

London Cremation Company

Submission in response to CMA's Market Investigation Working Paper

on Crematoria Profitability Analysis published 20 February 2020

1. Executive Summary

1.1 This submission is made by the London Cremation Company ("LCC") in response to the CMA's working paper on Crematoria Profitability Analysis (the "Working Paper").

1.2 The submission is intended to highlight key areas where the CMA's analysis raises concerns for the LCC. In particular, we highlight the issues raised below in relation to:

- the grouping of "large crematoria",
- sampling,
- the methodology of land value calculations,
- buildings' value and depreciation assumptions,
- and the use of ROCE analysis in these circumstances to assess excessive profitability.

1.3 Cost minus depreciation is not the only recognised accounting basis for building valuation and does not work reasonably for older crematoria. FRS 102 however permits specialised assets that are rarely sold except as part of a continuing business to be (re)valued with regard to their income generating capabilities. We can see how with relation to the specialised nature of crematoria land and buildings that the CMA could legitimately take the approach of valuating the land and buildings on the basis of their revenue generating capabilities with regard to the actual revenues being generated from the use of those assets. This would require the CMA to revisit the calculations and would, we expect lead to more accurate assessments of profitability.

1.4 Whether or not they have chosen to do so, private crematoria operators are free (under GAAP and FRS 102) to revalue their crematoria buildings on this basis where justified by their remaining useful economic lives. They are not forced to write their buildings down to zero where this does not accord with economic reality. The CMA's approach, as well as not being evidence based in the assumed lifespan adopted, is hence the most aggressive and penal (and indeed unrealistic) approach to estimating the value of such buildings and leads directly to ROCE being overstated materially, particularly at older crematoria.

1.5 This aspect of the CMA's current methodology favours operators of new crematoria (typically the two largest private providers that are suspected of making excessive profits). Operators of new crematoria will be permitted to earn higher profits than older operators solely as a consequence of this assumed and entirely notional depreciation adjustment.

1.6 If any price cap is set on the basis of this building valuation methodology as it stands, it will hinder older operators from earning fair returns needed both to pay for upkeep and maintenance to compete effectively. It will also adversely affect their financial ability to invest in new technologies and will potentially irretrievably damage their ability to afford to replace their crematorium if and when it reaches that stage.

1.7 There can be no substitute for the individual assessment of the useful remaining lives of all crematoria buildings to inform whatever depreciation policy the CMA ultimately decides to adopt. In the absence of such a detailed assessment, we would however respectfully submit that it is unsustainable and simply unfair to apply a single and entirely hypothetical depreciation policy equally to 300 different sites nationally without any consideration being taken of the reality of individual circumstances.

2. Initial Points to Note

2.1 The CMA Working paper builds on the previous paper "*Approach to profitability and financial analysis of 24 July 2019*." The CMA's basic premise is that in a competitive market firms would generally earn no more than a 'normal' rate of profit. The approach is summarised below.

2.2 The CMA guidelines define a 'normal' level of profit as:

> '*the minimum level of profits required to keep the factors of production in their current use in the long run, i.e. the rate of return on capital employed for a particular business activity would be equal to the opportunity cost of capital for that activity*.'[1]

2.3 The opportunity cost of capital is the weighted average return on capital, which investors expect for providing capital to firms undertaking the in-scope activities. This can be thought of as a market-based return on investment, to compensate investors for providing money to the firms in the market. It represents the opportunity cost of capital in similar employment and is thus distinct from the bank rate of interest.

2.4 The reason for benchmarking return on capital with the opportunity cost of capital is that, in theory, in a competitive market, if firms persistently earned in excess of the return required to compensate investors for the risks taken, the CMA would expect entry and/or expansion. This entry/expansion would serve to compete away profits in excess of the cost of capital up until the point where firms cover their total costs, including a market-based cost of capital and no more. Where firms persistently earn in excess of a normal return, this therefore signals that there may be limitations in the competitive process.

2.5 It is also possible for inefficient entry to occur if excess profitability is wrongly identified on an unsound basis and an inappropriate cap applied. For example, if notional depreciation is unrealistic, then excess profits may be identified where there are none; incumbents would face low sub-actual cost of capital returns. Incentives to expand and/or enter the market will be distorted and current consumer benefits could be lost.

[1] See paragraph 13 of "Approach to Profitability and financial analysis" dated 24 July 2019 https://assets.publishing.service.gov.uk/media/5d382b7f40f0b604db9e7ce4/Funerals_market_investigation_working_paper.pdf

Existing players may be forced to seek alternative sources of profit and vertical integration may be incentivised.

3. Incorrect grouping of "large crematoria"

3.1 The CMA has grouped together Dignity, Westerleigh, Memoria, the LCC, and a random (and we note, not representative) sample of 22 local authority crematoria.

3.2 The CMA has taken the "four largest [private] providers of crematoria services in the UK." Taking all four together as comparable for the purpose of analysis is clearly incorrect; Dignity and Westerleigh are an order of magnitude larger than all other players in the market and are simultaneously responsible for high prices and assessed excessive profits which have not been identified in the rest of the private cremation segment.

3.3 It appears these four have not been selected on the basis of their competitive similarity, their funding model, their proximity by geographical location, or their similarity in terms of incentives or activity. They have been chosen on the basis they are simply "Large Crematoria" and top the list of crematoria. They are not similar in terms of the volumes of cremations carried out or overall size. Despite the nomenclature chosen by the CMA, the LCC however cannot be reasonably regarded as a "large business" under any rational criteria. We remind you that the LCC has [✂]

3.4 The CMA notes that these firms have a combined share of supply of 26%. This is calculated on a national basis. All the firms concerned do not however compete in the same places nationally. Referring to them as supplying to a national geographic market is therefore incorrect.

3.5 The rationale for the choice appears to be that these four firms are bigger than some others. They represent a set of suppliers in the UK but the competitive significance of the grouping is doubtful.

3.6 Even if the point on the differences between these four private operators were overlooked, the evidence of profitability does not show a problem with two of these four providers. The CMA has estimated the excess profitability per funeral by the two largest private cremation providers (under the CMA's sensitivity 2 analysis) to be £150-200 per funeral and £100-150 per funeral respectively, whilst the two next largest private providers were not generating excess profits or indeed covering their WACC.[2]

3.7 On the basis of the CMA's analysis to date, the proposal is nevertheless for an industry-wide regulator and price capping of cremation fees. This would presumably have the aim of reducing cremation funeral bills by a maximum of perhaps £100-200 at the limited number of crematoria operated by these two private providers (in order to eliminate these perceived excess profits). To put this saving in context, the current average total cremation funeral bill is c£4-6,000 depending on discretionary items chosen by the bereaved so this is only a marginal improvement for consumers. When set against the cost-benefit of the intrusive nature of the proposed regulation, the likely consumer benefits that will be generated on a forward-looking basis appear to be highly

[2] Please see the LCC's submission on the Working Paper on the Cost of Capital.

questionable particularly given the additional risks and potential for unintended consequences including price rises by other crematoria.

3.8 As noted below, there are locations (notably London) in which there is horizontal competition between crematoria which could be lost to vertical integration into the largest players.

3.9 Additionally, it has proven useful in the current COVID19 crisis to have several suppliers, ensuring capacity to meet a public health emergency. We note the recent change to s. 58 of the Enterprise Act 2002 which has added a further public interest consideration to merger control being "the need to maintain in the United Kingdom the capability to combat and to mitigate the effects of public health emergencies." There is no doubt that funeral services are an essential service and that the capacity required to meet emergency demand is vital to combat and mitigate the effect of public health emergencies. We would respectfully submit that the CMA has to be very careful indeed therefore to avoid unintentional supply side consequences from a price control or other regulatory regime that could have the effect of potentially reducing capacity.

3.10 As demonstrated in the analysis below, London crematoria typically conduct 20% fewer cremations per site than their counterparts outside the capital. This implies spare capacity that has been helpful during the recent crisis which has driven volumes to 65% above their usual level over recent months.

4. Market coverage and selection

Observations in other submissions

4.1 Westerleigh has put it to the CMA that "the CMA [...] proposes a light-touch 'small sample' approach meaning that information on profitability of only 30% of the market would be collected".[3] Westerleigh also highlighted that the CMA's Guidelines for Market Investigations state that "Profitability analysis is relevant "where profitability of firms representing a substantial part of the market has exceeded the cost of capital over a sustained period".[4]

4.2 We would agree with Westerleigh's observation. The CMA's work to date has not proven this in relation to a substantial part of the market but only for two providers.

4.3 In relation to LA providers, the CMA again has not attempted to analyse this over any sustained period of time. As Memoria has observed, the proposed sample size "appears very small, comprising just 22 smaller crematoria which is around 10% of the population of smaller providers".[5]

4.4 Dignity has observed that "the proposed market coverage focuses disproportionately on private operators, whereas local authority operators comprise 70% of crematoria in the UK."[6]

4.5 Dignity and Memoria's responses raise the question of whether the fact gathering that underpins the methodology adopted by the CMA could provide sufficient detail to

[3] Paragraph 12, *Working Paper*
[4] Paragraph 13, *Working Paper*
[5] Paragraph 10, *Working Paper*
[6] Paragraph 9, *Working Paper*

properly assess and understand smaller crematoria (including local authorities). As set out later, we strongly agree with this point and it represents a significant weakness in the CMA's fact base and evidence to support its position and analysis to date and renders its analysis of smaller crematoria particularly likely to be highly questionable and unreliable.

4.6 Memoria has also stated that the "stratification proposed to establish a representative sample appears overly simplistic, controlling only for ownership [...] region and volumes [...] Memoria would expect local demographics, the mix of burials versus cremation/memorialisation and local competitive structure to also play a role in driving profitability of local authority crematoria".[7]

4.7 The LCC agrees with the above observations and would add that the relevant market in question has to be meaningful in an economic and competition law sense. Taking one non-representative set of suppliers and adding it to another non-representative set of suppliers to calculate a "share of supply", as has been done by the CMA to date, is not the same as calculating a representative share of an appropriately defined relevant product and geographic market.

4.8 The CMA's assessment of the relevant market has so far not involved sufficient fact gathering or assessment with relation to the locations in which the demand and supply are taking place, as is required for market definition under the CMA's guidelines, applicable legislation, guidance, and case precedents.

<u>LCC comments</u>

4.9 Cremation is not a highly concentrated and homogeneous industry such as utilities where a small number of very large suppliers dominate the market and hence where the market can be understood and analysed based on high level national averages and KPIs that broadly apply to all providers.

4.10 The cremation segment has a very wide range of market participants ranging from very large listed companies such as Dignity, through small providers such as LCC, through even smaller independently owned single crematoria operators. There is a very large predominance of publicly owned and operated LA providers with generally single sites.

4.11 The cremation segment consequently requires a much more detailed and granular level of analysis and evidence to be adequately understood. It is not a segment that is suited to high level analysis using averages and inflexible methodology applied to all providers irrespective of their size and actual circumstances.

<u>Sampling issues</u>

4.12 In its current papers, the CMA has achieved the following coverage in its analysis of the cremation segment:

[7] Paragraph 11, *Working Paper*

June 2018 Crematoria providers Reviewed by CMA
(Source of figures: March 2019 CMA Funerals Market Study)

	No of providers	No of crematoria	Reviewed by CMA	
Private providers:				
Dignity	1	46	46	
Westerleigh	1	29	29	
Memoria	1	9	9	
LCC	1	6	6	
Other private providers	20	20	0	
	24	110	90	82%
LA providers		183	14	8%
		293	104	35%

4.13 The above table is based on the June 2018 data (para 2.37-2.39 of the Funerals Market Study, 28 March 2019). The CMA's latest analysis states at paragraph 22 of the Working Paper that it still covers only 118 out of now approximately 300 crematoria in the UK. This is just under 40%, even if the CMA incorrectly refers to it as being "just under half"[8] of all crematoria.

4.14 The CMA review of private providers has been extremely limited in scope:

- Whilst CMA coverage of private crematoria appears high, it has in practice only attempted to analyse 4 providers out of 24 (17%).

- Of the four reviewed, two can legitimately be considered "large" providers whilst LCC and Memoria are both very significantly smaller (and also less profitable).

- There are a remaining 20 private providers that have not been reviewed at all. They are to the best of the LCC's knowledge single site operators, smaller still than even LCC. The CMA analysis to date provides no understanding at all of this element of the private provider base that nevertheless accounts for c 7% of crematoria capacity.

- The collective base of small private crematoria operators (i.e. these 20 plus Memoria and LCC) collectively represent c12% of total supply in the crematoria market. Whilst lower than represented by the two larger providers, this is nevertheless a significant element of the market.

- The CMA has not attempted to confirm or evidence that its analysis of the four selected private crematoria operators provides a legitimate and representative basis from which conclusions can be validly drawn regarding the remaining 20. We do not believe it is.

- It is not possible to make any assessment of either the behaviour or likely profitability of that base of smaller providers, or indeed of the potential impact of regulation on them, by extrapolating the results of existing analysis based on significantly larger providers only. LCC is a fraction of the size of the two largest crematoria operators, and these smaller crematoria operators are perhaps 80%

[8] Paragraph 22, *Working Paper*

smaller still. The private crematoria providers are simply not sufficiently homogeneous to allow such generalised inferences to be drawn.

- An alternative but entirely legitimate interpretation of the results of the CMA's analysis to date would be that it has identified potential evidence of excess profitability at only the two largest private sector providers whilst the next tier of (much) smaller crematoria operators are not covering their cost of capital.

- The risk of unintended damage to the majority of smaller private sector providers from the introduction of a national price control and regulatory regime is therefore considerable. [✂]

4.15 Whilst private providers represent c 35% of the crematoria market, the remaining c 65% is represented by c 180 or so Local Authority providers.

4.16 The CMA states: "With regards to the fragmented portion of the sector (around 70% of cremations by volume), the CMA considers that a random sample of 22 crematoria, which comprises approximately 11 % of volumes from this part of the sector, is "likely to provide information that is statistically representative of that part of the sector as a whole."[9] The CMA has not explained or justified why this selected sample can be reasonably regarded as representative.

4.17 The CMA has to date developed some degree of understanding of 14 of these providers (c 8% of all LA providers in total). We acknowledge its desire to extend this coverage to 22 (c 12%) if it can resolve data quality issues in the information provided. However, from a statistical perspective alone, it is not evident that a sample size of either 14 or 22 out of c180 can necessarily be regarded as a statistically significant and representative sample from which legitimate general conclusions can be drawn.

4.18 We note that the CMA selected a random sample of LA providers (para 141, Crematoria Profitability). However, it does not follow that a random sample is either adequate or representative. Unfortunately, in this instance it is neither.

4.19 It appears that one driver of this heavily restricted LA sample size might be the analytical burden required in order to properly analyse LA providers who, after all, still represent the majority of the crematoria provider market. However, it cannot be appropriate for extensive conclusions to be drawn on the likely behaviour and profitability of 180 LA providers based on a sample size of just 14 (or indeed 22).

4.20 The CMA has not attempted to confirm that this sample of LA providers is in any way fairly representative of the LA portion of the market. We do not believe it is.

4.21 We analysed the Pharos 2019 report that sets out January 2019 pricing at all UK crematoria for a basic cremation to better understand the LA crematoria selected:

[9] Paragraph 22, *Working Paper*

LAs surveyed by CMA - Fees
2019 Fees per Pharos Report

	Year of opening (Source: Cremation Society website)	Age (Years)	Jan '19 basic Cremation Fee	% above/(below) UK average
Wellingborough (Nene Vally)	2016	4	£1,070.00	34%
Sheffield (City Road)	1905	115	£840.00	5%
Bracknell Forest / easthampste	1972	48	£845.00	6%
Dudley / Gomal Wood)	1960	60	£894.00	12%
Slough	1963	57	£770.00	-3%
Hartlepool (Stranton)	1954	66	£735.00	-8%
Wakefield (Pontefract)	1961	59	£896.00	12%
Carlisle	1956	64	£820.00	3%
Covetry (Canley garden)	1943	77	£828.50	4%
Luton (Value)	1960	60	£760.00	-5%
Sunderland	1951	69	£865.00	8%
Chesterfield	1959	61	£750.00	-6%
Yeovil	1971	49	£750.00	-6%
Cheshire (Crewe)	1958	62	£690.00	-13%
Average fee for above listed crematoria (source: Pharos)			£822.39	
Average cremation fee 2019 (all crematoria)			£797.64	
Average age of above listed crematoria (years)		61		
For LA prices ABOVE national average, excess is on average				11%
For LA prices BELOW national average, discount is on average				-7%

4.22 Of the 14 LA crematoria that currently form the bedrock of the CMA's analysis of the public sector, 8 had January 2019 prices that were above average. On average, these 8 were 11% higher than the national average price calculated by Pharos, with the largest price premium being 34%.

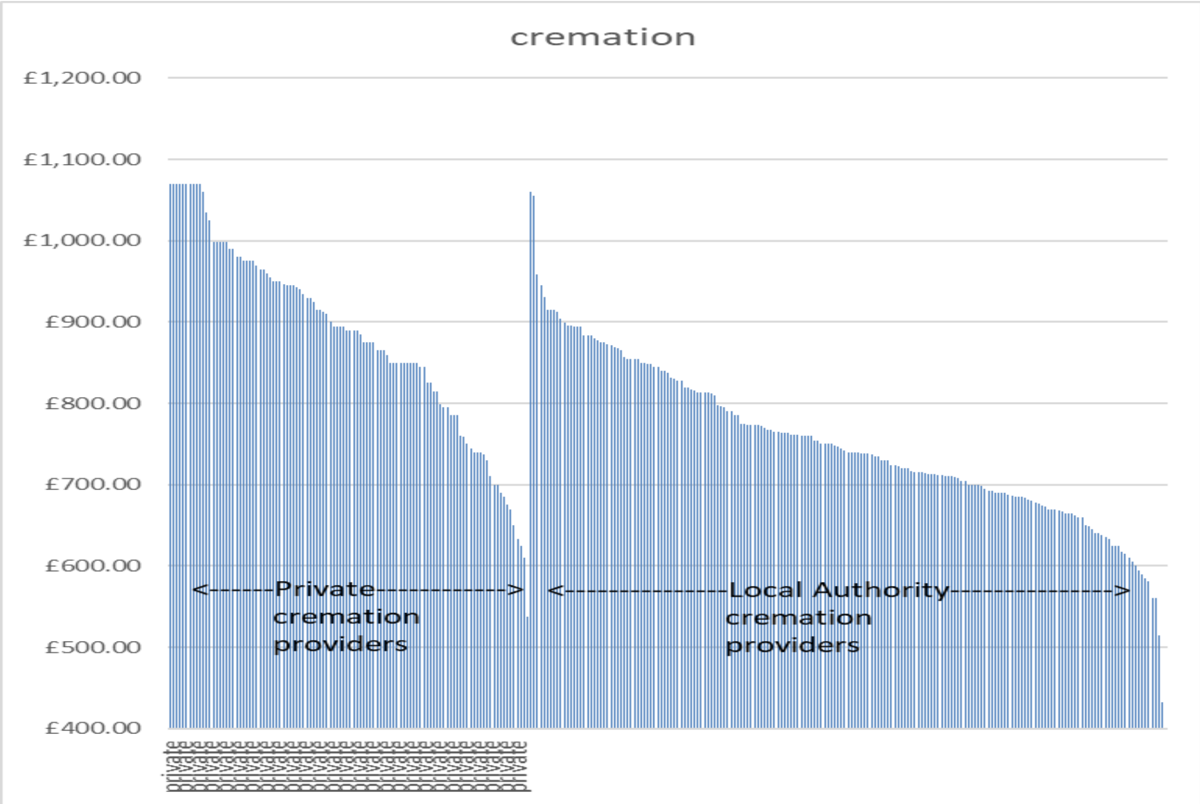
4.23 Of the remaining 6 that priced below the national average, the average discount was however only 7%, with the largest discount being 13%.

4.24 This sample of LA providers reviewed by the CMA to date is consequently unrepresentative, being significantly skewed towards higher charging LAs.

4.25 The CMA has noted and observed that certain areas are more competitive, prices vary by location, costs vary by location, and it is likely that returns on capital will also vary by location and type of supplier. The fact the CMA notes "that our sample of local authority crematoria has broad geographical coverage as well as a mix of larger and smaller urban areas, and rural locations" is a cause for concern as those differences are clearly being subjected to a methodology that does not seek to understand them, but to average them, making them unrepresentative of the particular features of the local markets and operators in question.

4.26 Generally, we note that the overall data set is cut for ownership and type of operator (private and LA), but not by geographic market. The sampling issues are therefore compounded by the fact that competitive conditions, and profitability, differ very significantly between locations. To analyse c 104 crematoria (90 from the "large" private providers and 14 LAs) out of a total of 300 might be appropriate if the total geographic market is UK wide. However, the geographic market has yet to be properly established but the CMA appears to recognise already that the markets for crematoria are much more local. In the context of the contemplated industry-wide price cap this approach to highly limited sampling clearly needs to be reconsidered. At the very least, the CMA need to attempt to analyse return on capital by geography and local competitive dynamics. We expect that return on capital is likely to be higher for less competitive regions and lower for more competitive regions. However, the CMA analysis to date has not even attempted to understand whether the root cause of higher ROCE (whether or not at "excessive" or "acceptable" levels) is driven by a lack of effective local competition or just by higher pricing.

4.27 Again, using the Pharos pricing data, we have attempted to analyse whether any potential "over-charging" of consumers is predominantly centred on either private operators or on LA operators which might legitimise the CMA's limited public sector sample size. Charting the January 2019 prices for a basic cremation makes clear that there is a very broad range of prices charged by both categories of provider. The chart below illustrates that both private and public providers have similar pricing highs and lows, and both have a broadly similar price dispersion pattern:



4.28 It is therefore clear that higher prices to consumers are not the sole preserve of private crematoria providers, though it is undeniable that private providers generally have a higher proportion of locations where they charge higher prices (for instance c 30% of private providers have basic fees of £950 or higher, as against only 3% of LA providers).

4.29 We would note in passing that the private crematoria operators with the highest prices above are very largely limited to the two very largest private providers. We have provided further detail on this in our response to Remedy Options for Crematoria, set out below again for ease of reference.

4.30 The table below provides the pricing and ownership information for all crematoria charging £950 or more based on Pharos 2019 pricing information:

- 26 of the top 37 are owned by Dignity / CMG (=also Dignity)

- 6 are owned by Westerleigh but only appear from position 27 onwards (£975)
- 2 are owned by LAs
- 2 are owned by independent operators
- 1 is owned by Memoria

Position	Owner	Price
1	Dignity	1070
2	Dignity	1070
3	Dignity	1070
4	Dignity	1070
5	Park Grove Crematorium Ltd	1070
6	Dignity	1070
7	Dignity	1070
8	Dignity	1070
9	Dignity	1070
10	Dignity	1070
11	Dignity	1060
12	Dignity	1060
13	Dignity	1055
14	Dignity	1035
15	Dignity	1025
16	Dignity	999
17	Dignity	999
18	Dignity	999
19	Dignity	999
20	Dignity	999
21	Memoria	990
22	Dignity	990
23	Dignity	980
24	Austin's Funeral Directors	980
25	Local Authority	975
26	Dignity	975
27	**Westerleigh**	**975**
28	**Westerleigh**	**975**
29	**Westerleigh**	**970**
30	Dignity	965
31	**Westerleigh**	**965**
32	Dignity	960
33	LA	959
34	**Westerleigh**	**955**
35	**Westerleigh**	**950**
36	Dignity	950
37	Dignity	950

4.31 This price dispersion pattern shown in the above chart at paragraph 4.27 could however be potentially due to crematoria age or quality / heritage with newer facilities perhaps charging a legitimate price premium for newer and/or better premises. This has not been analysed or assessed by the CMA, which appears to disregard any potential relationship between the "newness" of crematoria facilities and they pricing they can (or should) legitimately charge.

4.32 Our analysis suggests that private crematoria are on average 33 years old and have a median age of only 19 years, whilst LA crematoria on average are 61 years old with a median age of 60 years so this could be a possible explanation for different pricing patterns between the two constituent parts of the cremation provider sector.

4.33 We note that the CMA analysis has not considered crematoria age and quality (in terms of consumer experience) as relevant to pricing when this is clearly a significant factor in the eyes of the consumer.

4.34 We acknowledge the CMA's attempts to measure "quality" to date. However, in the consumer experience, quality is much more subjective and we believe it encompasses aspects such as surroundings, grandeur, "newness" or alternatively "heritage", quality of fit-out and maintenance etc. Whilst this may not be easily measurable or quantifiable, this is nevertheless a very significant element of the service that is valued by the consumer, and that the consumer is willing to pay a premium for. These are not homogeneous characteristics across all 300 crematoria. We submit that this would be an appropriate area for further analysis by the CMA.

4.35 At the current time, we are unable to see any legitimate justification for CMA analysis on the LA cremation services provider base being so heavily restricted in terms of sample size, depth of analysis or the provision of evidence to confirm (or otherwise) the legitimacy of any national conclusions being drawn from the limited analysis performed.

4.36 In the final phases of its analysis and reporting, the CMA must provide robust evidence to support any decision. It is in our view critically important for evidence to be properly gathered and to be properly representative in order that the CMA can draw legitimate conclusions on the entire (and highly diverse) provider base in the cremation sector. This is not currently possible from the restricted sample sizes the CMA has taken to date.

4.37 However, in summary and as regards the evidence based on a small sample of crematoria providers (both private and public) that the CMA has to date analysed and formed some level of understanding of, we have very significant concerns that it is far from representative. There is consequently a very material risk of inaccurate and unreasonable conclusions being drawn based on a shallow factual base. We do not believe that the current limited and selective samples (of both private and LA crematoria) represent a reasonable, fair or reliable foundation for the introduction of a sector regulator and price caps into the cremation sector.

5. <u>ROCE Analysis</u>

<u>General principles</u>

5.1 A ROCE approach is relevant to certain situations. In particular, it would be relevant to utility regulation where capital is and has been raised on public markets and entry is likely. But, where the opportunity for entry is restricted to certain locations, where planning consent is a prerequisite, and in circumstances where there has already been considerable entry limiting the opportunity for further market development, the generic modelling exercise has to be revisited and adjusted to focus on location and local market evidence.

5.2 As you are aware, the CMA has attempted to estimate capital employed by cremation services providers by estimating the MEAV of their assets of which the most significant ones are obviously land and buildings

Land

General Points

5.3 For meaningful and accurate ROCE analysis, land must be valued on the basis of the opportunity cost of similar land. As with other capital employed, a like-for-like in-scope capital analysis is required. In this case, that means a plot of land on which a crematorium could also be operated.

5.4 Where assets (whether intangible or tangible) are difficult to separate from the general running of the business, then the exercise of separating the assets out is theoretical and may be fruitless: the case warned about in CC3 p.89 paragraph 15.

5.5 This is highly likely in the case of crematoria with their specialised use can be valued in line with their revenue generating properties in line with FRS guidance.

Specific observations of the CMA's current approach to estimating land values

5.6 We have previously raised concerns about the approach toward assessing land values and profitability in LCC's submission dated 17 December 2019. Crematoria land values vary considerably with location, with rural land values being generally less than urban locations. This is a particularly significant issue for the LCC as 2 of its crematoria are located in the heart of London where land values are among the highest in the country and a further 3 properties are in the greater London area.

5.7 The LCC understands the difficulties the CMA is experiencing in valuing land. However, it appears unreasonable to seek to justify national pricing controls on the basis of an assumed land valuation structure under which 300 distinct plots of land all across the UK can be "valued" based solely on whether they are "in London" or "not in London".

5.8 If the CMA considers that a simple "two option" valuation matrix is sufficiently accurate to arrive at reasonable and fair estimates of land values at more than 300 separate sites all across the UK, then it requires to evidence that this approach is reasonable. We would be surprised if any professional land valuation surveyor considers an approach that values any site anywhere in the UK based solely on whether it is in London or outside of London to be reasonable.

5.9 This is extremely important. The CMA believes it is identifying instances of excessive profitability and over-charging in the cremation sector and is proposing highly intrusive regulation across the sector and the setting of price controls or caps. However, this entire analysis is fundamentally founded on nothing more than a highly simplistic and assumption driven "estimate" of the land value at more than 300 separate and distinct sites nationally. This is not a solid analytical or evidence base on which to justify the need for wholesale regulation of the cremation sector, far less on which to set a price cap. The scope for material error is simply far too high.

5.10 Furthermore, we remind the CMA that cremation is a highly fragmented sector with a vast majority of crematoria operators (whether private or public) operating a single or, at most, a handful of sites. The current high-level approach to land value estimation will create winners and losers across the whole cremation sector, and the majority of operators will not have the benefit of having a sizeable portfolio of sites that might "average" the impact on them of this approach.

5.11 For a player such as Dignity or other multi-site operators, the approach taken by the CMA will be favourable. For a single site operator, the outcome is binary and could be severe.

5.12 We note that the CMA received no bids to tender for the provision of expert land and property valuation support. The absence of tenders cannot be interpreted as providing justification for not conducting the exercise. The fact that the tender took place does however signify that the CMA recognises the importance of the exercise for the purpose of a properly evidenced and well-founded analysis. To not now conduct the exercise would be irrational. Moreover, we believe that evidence can be obtained from commercial surveyors rather than seeking expert evidence on the point.

5.13 Turning to the specific "detailed" approach that has been adopted by the CMA in arriving at its estimates of land value on which to base its analysis to date, the problems arising from the lack of proper evidence become apparent:

- The **Base Case** is inaccurate and is not fairly reflective of the underlying facts. No London sites can be acquired for £90,000 per acre and it is not legitimate to extrapolate the results of a small sample of ten transactions (none in London) to 300 distinct sites all across the UK. All analysis based on the Base Case is thus flawed and unreasonable.

- **Sensitivity One** (which values London sites at £1.75-2.0m per acre) is more logical than the base case but nevertheless remains an extremely broad-brush approach; too broad-brush to be fair or reasonable. The value of a 10-acre plot of land in the heart of Golders Green or of Marylebone (two of our locations) is likely to be very materially different to the value of (say) a brownfield plot of land on the outskirts of a less salubrious part of Greater London. Whilst Sensitivity 1 is clearly a step in the right direction towards making the CMA's analysis less overtly unfair and unreasonable, it is still entirely assumption led and is too broad brush to be fair to all operators.

- **Sensitivity Two** (valuing all sites outside London at £100-300k per acre) is obviously at attempt to be more realistic. However, once again we have serious concerns that the use of such a simplified and generalised assumption is entirely inappropriate for the assessment of appropriate returns and cost bases in several hundred distinct local markets around the UK.

5.14 These broad-brush and assumption driven estimates might perhaps have some value in forming some tentative views on possible industry issues at a macro-economic level. However, at best they can be interpreted as providing indicators of areas where the CMA needs to do further work to establish a proper evidence base and understanding.

5.15 They are however not sufficient or reasonable bases on which to attempt to arrive at detailed and specific estimates of excess profitability by provider and indeed by individual site.

5.16 We have noted other issues in the assessment that the CMA has attempted to make. Not having the relevant information, the use of proxies is attempted,[10] for example assessment is made with reference to residential land values which may not be relevant. However, where a current location for a crematorium is in a residential or largely residential area, an equivalent asset needs to be identified, while a purely residential site might not be appropriate perhaps a relevant proxy would be an assessment of local brownfield sites.

5.17 Evidence, such as the following from Memoria is preferred:

> *"Memoria told us that 'small (~5 acre) sites are no longer sufficient to meet client expectations in relation to parking, gardens, interment sites, etc. Memoria now seeks sites [%]. This view is consistent with the evidence from recent transactions, in which the average site size was just under 9 acres"*[11]

5.18 The above evidence is contradicted by evidence from the LCC which is not even referenced in the CMA's Working Paper.[12]

5.19 The CMA appears to have chosen 10 acres as the maximum approved size for a crematorium plot. Why this was chosen rather than any plot size based on the evidence is unclear. We also question whether it is legitimate for the CMA to retrospectively seek to determine and limit what area of land should have been appropriate for a crematoria, to effectively limit this going forward for any future crematoria, and indeed to build a price control regime that is based on an artificial limit for plot size rather than actual land used. Presumably the builders of 300 separate crematoria over the last 120 years had some rational logic for the amount of land they chose to use. We do not understand why the CMA believes it appropriate to retrospectively second guess this and to limit the permitted profitability of individual crematoria.

5.20 In summary as regards the CMA's approach of the estimation of land value, it is based on assumed plot sizes and assumed land values with no solid evidential base, and is sweeping in the generalisations that it makes.

5.21 If the CMA wishes to reliably and reasonably assess the ROCE earned by sector providers and then introduce national pricing controls which will have potentially serious effects on cremation providers (the majority of which are single site operators), it appears unreasonable and inequitable to do so on anything other than an evidence base that actually properly assesses the actual land values at the actual sites in operation.

Buildings

[10] Paragraphs 67-68, *Working Paper*
[11] Paragraph 72, *Working Paper*
[12] See, for example, Stephen Wright's comments in relation to the Sainsbury's local model, at page 5 of the transcript of LCC Hearing 19 July 2019.

5.22 The CMA may have inadvertently misunderstood the heritage value of certain buildings and their importance and value to consumers. Utilities such as telephone exchanges or waterworks have a utilitarian purpose that overrides their architectural value or heritage, and a utilitarian model can be applied in such sectors. However, that is not the case with crematoria where their resonance, history and heritage value make them more important to the community and hence of greater value to customers.

5.23 Indeed, the CMA's own consumer research identified the physical environment of crematoria as being an important attribute for consumers who would often select between crematoria on this basis.

5.24 Crematoria are not just utilitarian places where bodies can be "disposed of"; they are the setting where the bereaved say goodbye to their loved ones, honour their memory, grieve, and often return regularly to remember them.

5.25 We refer to the Revd. Dr. Jupp's letter *The Importance of Funerals in Society* for further discussion of the spiritual aspects of funerals and remind the CMA of its duties as a government body to take into account impacts on protected characteristics.

5.26 As the Revd. Dr. Jupp notes, the spiritual value of a funeral resides in giving and in non-monetary qualitative aspects. This implies that the short-term consumer welfare measured in price, and mourners' spirituality, are far from identical. Indeed, an overly utilitarian funeral could actively undermine spiritual aspects of the funeral.

5.27 It will be appreciated that religious faith is protected as a characteristic *despite* the cost of protection: by definition, all equality legislation carries costs, and privileges protected characteristics above them in the requirement to give them "due regard" (s.149 Equalities Act 2010). The need for the CMA's analysis and any proposed remedies to allow for sufficient flexibility in funeral and cremation service offerings in order to meet the needs of ethnic, cultural, religious and/or other groupings is of immense importance.

5.28 The CMA has attempted to "value" crematoria buildings as follows:

> "*For each crematorium owned by each party, we revalued the building based on the replacement cost estimate included in the parties' insurance policy and applied depreciation.*
>
> *At this stage, we have applied straight line depreciation to the building from the point at which the crematorium was first constructed using a useful economic life of 100 years. Where the building was over 100 years old, we recorded a value of £nil. In our set of 118 crematoria, there are 8 fully depreciated buildings*."[13]

5.29 The use of insurance replacement value as a proxy for "cost" is pragmatic as a starting point for the CMA's purposes. [14] Furthermore, the CMA's approach in then applying "notional depreciation" on the above basis across the board is fundamentally incorrect flawed and is leading to incorrect conclusions being drawn.

[13] Paragraphs 81-82, *Working Paper*
[14] See the LCC's document: Bank of Scotland, Valuation of St Marylebone Crematorium, 30 March 2015, submitted with this paper (revealing valuation at lower than replacement cost for the purpose of a loan (p.4)).

5.30 It is a peculiarity of the crematoria industry that its properties frequently continue in use for exceptionally long periods of time. The Cremation Society website contains a list of all UK crematoria together with their date of opening. The first one listed (Woking in 1885) happens to be owned by LCC and is still in use. In fact, given the importance that consumers place on their family's connection with their chosen crematorium, this is to be expected and is a positive factor in helping the bereaved deal with their loss.

5.31 Based on the Cremation Society data, the average age (in years) of crematoria in the UK is as follows:

	All locations	London	Non London
Average	51	76	45
Median	59	75	55

5.32 This highlights that the typical crematoria in the UK is almost 60 years old already. It is interesting to note that the "typical" crematorium in London is approaching 75 years old.

5.33 Outside of London and other high land value areas, the building is by far the most expensive physical asset for most crematoria operators. The CMA's approach to building depreciation is therefore a key determinant of its estimates of capital employed and returns for the majority of the cremation sector.

5.34 It appears unreasonable and unsustainable for the CMA to effectively value such property assets at effectively 40p in the £ of current replacement cost for a typical crematorium (or only 25p in the £ for a typical London crematorium) with no consideration being taken of their actual condition and remaining useful life. This aspect of the CMA's methodology is a key determinant of its estimates of acceptable profitability for all crematoria outside of London. Indeed, we suspect that this assumed accounting treatment is the single most significant driver of the CMA's estimates of ROCE returns for all non-London crematoria.

5.35 Unfortunately, we do not consider that a generalised assumption by the CMA that all crematoria buildings cease to have any remaining useful life and hence no value beyond 100 years is reasonable or sustainable. Some will have shorter lives due to either design or condition factors, whilst others (e.g. Golders Green) have the realistic potential and heritage to continue for another hundred years. No industry should have price and profitability controls introduced based on generalised assumptions that have neither been researched or evidenced thoroughly.

5.36 The CMA's consumer research identified that many consumers select a crematorium based on prior experience, family connection and/or similar subjective factors. This "emotional connection" between consumers and a crematorium cannot be measured, but is a very important element for the bereaved in handling the grieving process. The "shared history" between a crematorium and its customers forms part of the heritage value of the facility and is highly valued by consumers.

5.37 Cost minus depreciation is of course not the sole recognised accounting basis for building valuation. FRS 102 permits specialised assets that are rarely sold except as part of a continuing business to be (re)valued with regard to their income generating capabilities. We are surprised that the CMA has not considered this approach which more closely accords with the economic reality of crematoria lifespans.

5.38 Whether or not they have chosen to do so, private crematoria operators are free (under GAAP and FRS 102) to revalue their crematoria buildings on this basis where justified by their remaining useful economic lives. They are not forced to write their buildings down to zero where this does not accord with economic reality.

5.39 The CMA's approach, as well as not being evidence based in the assumed lifespan adopted, is hence the most aggressive and penal (and indeed unrealistic) approach to estimating the value of such buildings and leads directly to ROCE being overstated materially, particularly at older crematoria.

5.40 In other words, if there were a new build next to an older crematorium such as Golders Green the new build operator would be allowed to make perhaps £650,000 more in profit each year solely because they had a new crematorium. This appears irrational and unfair.

5.41 There can be no substitute for the individual assessment of the useful remaining lives of all crematoria buildings to inform whatever depreciation policy the CMA ultimately decides to adopt. In the absence of such a detailed assessment, we would however respectfully submit that it is unsustainable and simply unfair to apply a single and entirely hypothetical depreciation policy equally to 300 different sites nationally without any consideration being taken of the reality of individual circumstances.

5.42 This aspect of the CMA's current methodology actually works against the legitimate and fair interests of all older crematoria and actively favours operators of new ones (typically the two largest private providers). Operators of new crematoria will be permitted to earn higher profits than operators of older ones solely as a consequence of this assumed and entirely notional depreciation adjustment.

5.43 If any price cap is set on the basis of this building valuation methodology as it stands, this will hinder operators of older units from earnings the returns they need both to keep their older units running, operational and maintained to a high standard in order to compete effectively. It will also adversely affect their financial ability to invest in new technologies, and will potentially irretrievably damage their ability to afford to replace their crematorium if and when it reaches that stage. It is not clear to us why the acceptable profitability of a crematorium should in any way be determined or influenced by the age of its buildings, far less to the extent that we believe this simplifying assumption is directly pre-determining the output from the CMA's profitability analysis.

5.44 This is a broader point than just affecting LCC. However, looked at from our own perspective, we have three crematoria that would be treated as "fully written off" under the CMA's methodology. All three are maintained to a high standard, are well loved by consumers, and have very many years of heritage behind them as well as useful life in front of them. However, the CMA's assumption-based methodology would reduce LCC's permitted profitability [✂] compared to the level of profitability that would be permitted to a new crematorium situated next door. This is fundamentally inequitable, and would actually damage competition and the long-term sustainability of older sites to continue to operate.

5.45 We would invite the CMA to visit (for instance) our Grade I listed Golders Green site and to see for themselves the heritage, grandeur and condition of the building that their methodology regards as having no remaining useful life and as essentially valueless. It will be immediately apparent that to treat the buildings there as having no value and as representing zero capital employed is simply unreasonable.

6. The "London Crematorium" problem

6.1 Our own analysis has identified a potentially concerning issue for the CMA in the London market which clearly illustrates the unreliable and incorrect conclusions that the CMA's overall methodology is generating.

6.2 We have analysed the latest Pharos data set to look at pricing in the London market (as defined by Pharos) and outside of London. In doing so, we have attempted to look at pricing for the four largest private sector providers versus "everyone else" as best we can, based on publicly available information.

6.3 The results of this analysis can be summarised as follows:

London / Non London average Pricing
Based on Pharos dataset

	Dignity		Westerleigh		Memoria		LCC		All other		Total	
	£	Vol	£	Vol	£	Vol	£	Vol	£	Vol	£	Vol
London												
Lowest	815	499	649	786	0	0	610	712	432	407	432	407
Highest	1,070	1,879	895	3,048	0	0	690	2,343	857	3,606	1,070	3,606
[redacted]												
Non London												
Lowest	633	182	745	43	560	384	740	1,106	364	170	364	43
Highest	1,070	3,027	975	2,770	990	3,000	895	1,750	1,070	3,840	1,070	3,840
[redacted]												

6.4 Points to note from this analysis are:

- Median pricing for a cremation in London is £650 compared to £790 in the rest of the UK. London prices are therefore c18% lower already than in the remainder of the UK.
- London crematoria typically conduct c20% fewer cremations per site than their counterparts outside of the capital.
- This means that competition between London crematoria is absolutely leading to lower prices for the end consumer already. However, this competition is not leading to individual crematoria winning higher volumes. On the contrary, London crematoria are doing fewer cremations AND charging cheaper prices than their regional counterparts.
- This is notwithstanding the higher capital employed in London crematoria, which is c£15m higher under the CMA's methodology as a result of land value costs alone.
- The typical (median) London crematorium generates revenues of only c£825k per annum (£650 x 1,269), whereas the median non-London crematorium generates revenues of £1.25m (£790 x 1,582). Put differently, despite a very considerably higher level of capital employed in London crematoria, the typical

London crematoria generates revenues that are only two thirds those of a non-London site.

6.5 Adopting the CMA's methodology for estimating capital employed and assuming a 10-acre site size, a median crematorium in London would be expected to have capital employed of c£25m (£17.5m of land, £6m of buildings, and say £2m of everything else). The CMA's ROCE analysis would suggest that such a business should be making an 8% ROCE on this capital employed, which equates to "normal" profits of £2m per annum.

6.6 However, far from earning "normal" profits of £2m/year, the median London crematorium only generates REVENUES of perhaps c£0.8m per annum with profits likely to be considerably below this revenue figure.

6.7 Consequently, it appears that London crematoria are generally earning far, far below the CMA's estimates of their cost of capital and have no realistic likelihood of ever covering their cost of capital.

6.8 There are two possible implications of this:

- Either the CMA's current methodology for assessing the level of capital employed in a crematorium is wrong in that, when looking at one local market (in this case London) it suggests the entire provider base in that market is fundamentally unviable. This appears illogical but is what the CMA's methodology suggests.

- Alternatively, if the methodology is indeed accurate and reasonable, then it is clear that the London crematoria market has a very serious issue around the long-term sustainability of crematoria provision. If this is correct, then any regulatory regime that introduces additional cost and/or that attempts to impose price caps will only make the long-term viability of crematoria in London even worse.

6.9 We highlighted earlier our separate analysis that suggests the average age of a crematorium in London today is c75 years. At some point, it is therefore likely that the London crematoria base will require substantial investment to either extend its life or to replace existing capacity.

6.10 However, based on this analysis, it appears that the levels of return being earned by these crematoria are far from covering even the CMA's estimate of their cost of capital (and we have pointed out earlier that we consider the CMA's estimate of WACC to be unrealistically low for all crematoria providers outside of the two or perhaps three largest). It is therefore a matter of considerable concern for future crematoria capacity in London that future crematoria developments and replacements are potentially uneconomic (i.e. would fail to cover their WACC) at current pricing levels.

7. <u>CMA Assessment of Crematoria Profitability</u>

7.1 The CMA's analysis to date of private crematoria operators appears to have identified two providers that are potentially generating excessive profits, and two that are clearly not.

7.2 The CMA has no evidence on which it can reasonably extrapolate these results to draw conclusions regarding the likely profitability and returns of the remainder of the private provider crematoria base. Indeed, based on the analysis of LCC and Memoria returns, the only legitimate assumption available would be that the smaller private providers do not generate sufficient returns to cover their assessed cost of capital.

7.3 The CMA analysis on LA crematoria profitability appears to suggest that a number of LA crematoria are potentially generating excess returns. However, we do not consider this assessment likely to be correct or robust:

- As noted earlier, there are considerable issues around the LA sample used.

- As also noted earlier, the CMA's approach to the "notional depreciation" of buildings underestimates the actual level of capital tied up in buildings. LA crematoria are typically older (and we note that the average age of LA crematoria reviewed was c 60 years as shown in the table earlier in this paper).

- Consequently, the CMA's estimate of the capital employed in these LA crematoria has been reduced very materially by the assumed notional depreciation where the assessed value of buildings net of depreciation will be substantially below the replacement cost of the buildings. Effectively, the CMA's analysis of these crematoria will estimate their building value at only 40% of their current replacement cost. This has the effect of unreasonably depressing the assessed capital employed and hence exaggerating their assessed ROCE.

- It is worth illustrating this point further for clarity and to emphasise the impact this has on the CMA's estimates of excess profitability at these LA crematoria.

- If an LA has a crematorium building that would cost say £6m to erect but which was erected 60 years ago (the sample average), then he CMA's notional depreciation adjustment will have reduced that LA's notional capital employed by £3.6m. That in turn will have reduced the CMA's estimate of acceptable "normal profitability" (at 8%) for that site by £290k per annum. For a small crematorium business with revenues of perhaps c £1m, this scale of swing in what is regarded as its "normal" profitability is very material and has the potential to be misleading in any ROCE analysis.

- The CMA has not attempted to confirm whether (or not) these LA crematoria are indeed approaching the end of their useful lives as the methodology assumes, or whether they potentially have extremely long lives remaining ahead. If the latter is the case (which appears likely given our observations on crematoria lives earlier) then the CMA's estimates of capital employed at these sites will be unreasonably low and will materially overstate the assessed ROCE.

- It is not clear that the CMA has carried out the detailed work necessary to confirm that the financial information provided by these LA operators is either fully comparable between them, or fully comparable with private crematoria operators. LAs are not required to ensure that all crematoria costs are allocated against their crematoria operations with the same degree of rigour and accuracy that a standalone private operator applies. For instance, grounds and property maintenance services may be provided by other council departments, and may or may not be internally recharged on whatever basis the council deems appropriate so internal LA transfer pricing arrangements need to be reviewed to ensure any recharges are complete and at full market price. Similarly, many LA crematoria management and monitoring costs (e.g. some element of the LA CEO's salary, some element of central finance team costs etc) are unlikely to be properly or fully allocated and recharged against the crematoria operations. Again, it is not clear whether LAs will levy business rates on their own in-house operations. Insurance costs may well be borne centrally or may benefit from being part of a council-wide policy that provides savings. And how rigorous are LAs about ensuring that all costs are correctly calculated on an accruals basis? And what cost allocation or sharing measures exist between LA crematoria and LA cemeteries, and are these being reasonably and fairly applied?

- Such factors would perhaps go a long way to explaining why the CMA considers that a quarter of LA crematoria earn margins that exceed those of even the two most expensive private providers.

- We do not know whether some or all of these issues are potentially relevant and could be distorting the CMA's analysis of LA profitability. However, the point is that none of these issues is unrealistic or impossible, and they need to be carefully checked if the analysis is to be used to justify sweeping regulation and price controls in the crematoria sector.

- If the CMA wishes to assess the ROCE of a LA crematoria, or even to just compare its reported margins against private sector providers, it therefore must first ensure (and evidence) that the information is genuinely complete and fully comparable. Anything less is unreasonable and risks incorrect conclusions being drawn.

- We note that the CMA has excluded the results of 8 (out of 22) LAs that submitted data to the CMA as a result of "potential issues with the data submitted". This reinforces our point that, any analysis of LA crematorium profitability must take extreme care to ensure that all providers prepare their results in consistent ways. We expect that legitimate variances in accounting treatment and cost recognition / allocation between different LAs will be more likely to over-state (and not understate) the perceived profitability of their cremation activities in the CMA's analysis.

- LA crematoria are very small businesses with very low revenues. Their reported profitability is therefore extremely sensitive to small differences or errors. The numbers are small, and it takes very little to distort them materially. This is a real danger of attempting to apply "big company methodology" (in the form of ROCE analysis) to very small businesses.

7.4 Finally, and perhaps most compellingly, it should not be overlooked that the CMA's findings are currently suggesting that a large number of LA crematoria operators are over-charging their own local residents. LAs of course have no profit maximisation objective or incentivisation, so this is a surprising conclusion. We would respectfully suggest that the mere fact the CMA's methodology when applied to LA crematoria suggests that a large proportion of them are profiteering at the expense of their own local residents might be prima facie evidence that the methodology being applied may be misconceived.

8. <u>Inconsistency of approach between crematoria and funeral director profitability analysis</u>

8.1 There are significant differences in approach to the analysis of competition in the FD and crematoria segments. This raises significant concerns, because of the acute need for consistency of analysis between different levels in the vertical supply chain so as to avoid distortions between non-vertically integrated players, and anti-competitive activities by vertically integrated players, including significantly those whose pricing has increased the most.

<u>FDs</u>

8.2 With relation to the situation in the funerals markets it is clear that at the level of Funeral Directors, there is a thriving market composed of a larger number of smaller firms and a small number of bigger players. The majority of branches are accounted for by the smaller firms and 13 firms account for 46% of the branches. In its working paper on the profitability of funeral directors, the CMA claims that revenues and profits have exceeded costs, principally the cost of property, over time. However, there is a recognition in that paper that the CMA has limited evidence of the price and hence cost of funeral director property and has not gathered evidence of the price and cost of property, by location, over time.

8.3 It is also recognised by the CMA that it had difficulty in evaluating reputation, which is an important source of revenue for firms operating in the industry, according to the Ipsos Mori research conducted on behalf of the CMA. That failure to gather evidence of property prices is compounded by the recognition that costs vary by geography and insufficient geographic analysis has been undertaken. A similar issue arises with relation to crematoria and the issue of property values and geographic differences in land value.

8.4 Profitability analysis based on return on capital is only one way in which the CMA assesses the profitability of an industry or part of an industry. This is recognised and applied in this case, as the CMA conducted an EBITDA assessment of profit in the Final Report, and in this phase of the proceedings by using EBITDARS for Funeral Directors because the assessment of land values is problematic.

<u>Crematoria</u>

8.5 As noted earlier, the CMA's approach to "estimating" land values for the purpose of its assessment of crematoria profitability is highly problematic.

8.6 There is thus a risk of an inconsistent approach toward the same issue in the case of crematoria. The capital assets for both include land and buildings; crematoria have plant, whereas funeral directors have vehicles, but this is not a stark or predominant differentiator. In the case of funeral directors, there is difficulty in identifying capital on which to base a ROCE; but this is equally true of historic land valuation for crematoria, as noted above.

8.7 It is very difficult to see the difference such as to merit these very different approaches to modelling permissible returns in the case of funeral directors and crematoria.

8.8 As a matter of reasonable decision-making, the CMA appears to have taken into account the difficulty of the land values issue in its assessment of profitability for FDs, but not crematoria.

Inconsistent cost accounting within the supply chain

8.9 Crucially, differential treatment of funeral directors and crematoria may drive significant vertical inefficiencies, as the differences in approach could be leveraged by vertically integrated operators, effectively Dignity, which will be in a position to undertake internal transfer pricing so as to exploit any differences in approach between the layers.

9. Conclusions

9.1 The imposition of price controls whether on a national or local basis is a highly intrusive remedy

9.2 We do not consider that the CMA's analysis or methodology to date is sufficiently robust or reasonable to make a case for such sweeping controls to be applied to all crematoria operators, or to form a basis for determining the level of any such controls on a rational, reasonable and evidence-based basis.

9.3 The cremation sector is highly fragmented. Whilst it has two large providers, the majority of current providers are small businesses. The CMA has insufficient understanding of this small provider base to understand or assess the potential impact on the 75% of the market it represents of the introduction of price controls aimed at preventing perceived abuse by the two largest providers who represent only 25%.

9.4 The scope for serious and damaging unintended consequences arising from industry-wide controls is therefore extremely high. These could very easily damage the existing provider base and actually create economic incentives towards greater industry concentration and a loss of competition.

9.5 We have considerable reservations over the suggestion that the majority of LA crematoria are in fact over-charging and generating excess profitability from their own local residents and believe this needs considerable further detailed work to make this analysis robust. However, we believe that the CMA's methodology with regard to building valuation and notional depreciation is actually driving this perceived result with a flawed approach that does not reasonably reflect the actual level of capital tied up in older crematoria buildings in particular.

Annex: Additional points to note regarding intangibles

Intangibles

Memoria emphasised the value of its brand name to the business. They told the CMA that "*another key asset is Memoria's brand and local reputation – both of which are critical to Memoria being able to offer (and charge for) a high-quality service" and that "if the CMA proposes to make any kind of comparison between profits and the capital base on which profits are earned, then the value of Goodwill associated with Memoria's brand and reputation must also be taken into account*."[15]

Westerleigh told the CMA that it strongly believes that "*a significant part of what it offers the sector is its high level of quality and service*" and that "*reputation adds significant value to Westerleigh as a business*."[16]

This appears to be consistent with the Ipsos Mori survey showing the value of relationships in generating business for funeral directors. As a service industry this type of intangible is likely to be undervalued if not otherwise recorded as an asset. Being recommended by others is clearly relevant to reputation, which is at the heart of valuation of goodwill and brand. Ipsos Mori findings show:

(a) 35% Previous personal experience: used them before to arrange a funeral;

(b) 26% Recommendation by family member(s)/ friend(s)/ neighbour(s)/work colleague(s);

(c) 20% Local knowledge/ word of mouth; and

(d) 6% Internet search.[17]

It is also clear that customers valued highly the idea of the type of experience they would be getting in the recommendation, with high scores for the type of staff, level of customer care and level of quality.[18]

Furthermore not only does the Ipsos Mori evidence suggest that word of mouth is a highly important source of new business, the experience and care for the bereaved is provided as the critical factor in the feedback from end users on whether they would make a recommendation.[19] The top factors found were all related to the experience that people had:

(a) Confidence (felt they would be a safe pair of hands/could rely on them/could trust them/it would all go smoothly/ satisfied with them on previous occasions etc.) 21%;

(b) Level of customer care I/we knew I/ we could expect 48%; and

(c) Capable of meeting our personalisation/ bespoke requirements 14%.[20]

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[15] Paragraph 87, *Working Paper*
[16] Paragraph 88, *Working Paper*
[17] Tables 49, 50 and 51 of Ipsos Mori Report
[18] Tables 52, 53 and 54 of Ipsos Mori Report
[19] See, for example, responses to question 49 of Ipsos Mori Report
[20] Tables 61, 62 and 63 of Ipsos Mori Report

The CMA appears to be determined not to include as capital employed any purchased goodwill as it is not a standalone asset class.[21] Furthermore, the CMA considers that including goodwill is circular when trying to assess whether profits have been above the level needed to cover costs, including asset costs.

It has asserted that, in extremis, if all future profits were capitalised as goodwill, it would not be possible to find supernormal profits under a ROCE versus WACC framework. This is however an extreme case, and not the relevant question, which is *how much* reputation should be included: it is always possible to argue that anything can be capitalised, but if operation requires reputation then it is being consumed on a daily basis, like any other business investment. For example, reputation consumed in year 1 has depreciated out, and is appropriately in-scope, even though in theory it is possible to capitalise the value of that depreciation in advance.

In other words, the extreme claim that reputation can always be capitalised and thus implicitly can never be used is logically irrelevant to the issue at hand; the point being made about goodwill is not a point about future profits It is about the current value of the business based on its current reputation and how that should be taken into account in accordance with the CMA's guidance.

An important point of principle is raised here. The CMA's guidance, when quoted in full, states:

> *"12. Whatever measure of profitability is used, the calculation of profitability for the purposes of competition analysis is often not straightforward because of the need to obtain an appropriate value for capital employed, as described below. In industries with a relatively low level of tangible assets, such as service and knowledge-based industries, the book value of capital employed may bear little relationship to the economic value because of the presence of significant intangibles. In some cases, the replacement cost of assets may be different from historical costs due to the length of time elapsed and changes in asset prices and efficient technologies over time.*
>
> *13. Obtaining a value for capital employed can present difficulties irrespective of the choice of model. For example, the use of a truncated IRR requires the assets to be valued appropriately at the beginning and end of the period selected. Similarly, a return on capital approach, whether return on equity or return on capital employed (ROCE), requires an economically meaningful value for the capital base which may not accord with the value ascribed in the financial records.*
>
> *14. Hence, it may be necessary to make adjustments to accounting data produced in line with UK GAAP. In particular, the following adjustments may be considered:*
>
> - *Under current accounting standards, most assets are held at historical cost and this may differ substantially from the 'replacement cost' or 'Modern Equivalent Asset value',5*
> - *Secondly, the CC may consider the inclusion of certain intangible assets where the following criteria which the CC considers to be the*

[21] Paragraph 91, *Working Paper*

economically meaningful measure for its purposes in most cases. In these circumstances, and where this would be likely to have a material effect on its calculations, the CC will consider whether replacement cost values can be derived reliably.

- *it must comprise a cost that has been incurred primarily to obtain earnings in the future; are met:*

- *this cost must be additional to costs necessarily incurred at the time in running the business; and*

- *it must be identifiable as creating such an asset separate from any arising from the general running of the business."*[22]

Importantly, the guidance continues after the quoted section to say (emphasis added):

- *"In establishing a value for intangible assets meeting the above criteria, the CC will have regard to similar principles as for other types of assets.*

- *Other adjustments may be considered on a case-specific basis.*

15. In situations where capital employed cannot be reliably valued the CC may consider alternative measures, such as the return on sales or other relevant financial ratios. For instance, comparisons with businesses operating in different but similar markets may on occasions be helpful.

16. In assessing levels of profitability the CC will have regard to its view of firms' cost of capital. The CC will generally look to the capital asset pricing model (CAPM) when considering the cost of capital, since this is a widely understood technique with strong theoretical foundations. However, the CC will have regard to alternative models where appropriate."[23]

The CMA's guidance also includes the following footnotes:

"These terms are used interchangeably to mean the current cost of acquiring assets which yield equivalent services to those currently used by the firm, based on the most efficient technology and optimal configuration."[24]

"These criteria were originally set down in the CC report, The supply of banking services by clearing banks to small and medium-sized enterprises (March 2002)."[25]

The reference to selective quotation of the guidance is inappropriate. It is helpful in principle because clear that the CMA has considerable flexibility within the bounds of reasonableness, and the additional references are designed to provide a practical basis on which the capital

[22] CC3 (Revised) Guidelines for market investigations: Their role, procedures, assessment and remedies Annex A, paragraph 12- 14
[23] CC3 (Revised) Guidelines for market investigations: Their role, procedures, assessment and remedies Annex A, paragraph 14- 16
[24] Footnote 5, [24] CC3 (Revised) Guidelines for market investigations: Their role, procedures, assessment and remedies Annex A
[25] Footnote 6, [25] CC3 (Revised) Guidelines for market investigations: Their role, procedures, assessment and remedies Annex A

employed, and the returns made in the industry, can reasonably be calculated. They are not intended to be relied on as a mechanism for excluding material and significant assets from ROCE calculations, or as a basis for allowing the CMA to shoehorn those industries that do not fit into a ROCE analysis. Other measures that may be more appropriate are available to the CMA.

For example, the idea that assets can be segmented and sold on a replacement cost basis is in some cases a perfectly reasonable approach, and certain assets can be. Funeral parlours are not unique and other retail property may be regarded as broadly substitutable or replicable, and reference values found. That can and should be done to establish land values for funeral parlours. A second-hand market may also exist for the product in question and that could readily be referred to as a reference point for valuation in other cases, such as is considered for vehicles. We support the CMA's approach in that regard.

However, here, the value of crematoria land and the benefit to the business of their location and attractiveness in generating business are equally intricately bound up with the business.[26] The CMA's guidance seeks to establish whether replicability is possible and whether there is a reference point that can be taken for the value of an asset such as a sale. As it suggests, if that cannot be done then the approach cannot reasonably be applied as the basis for a price cap, as is stated:

> *"In establishing a value for intangible assets meeting the above criteria, the CC will have regard to similar principles as for other types of asset."*[27]

Crematoria land is difficult to replicate; that does not mean it has no value, it just means that using the ROCE as the basis for calculating a number that will go into an assessment and be used as the basis for a price cap and then as the basis for calculating another number by which the cap is to be applied, is an unreasonable and inappropriate exercise.

The same error is being made twice, because ROCE is the chosen measure and because crematoria land and buildings do not easily fit into the CMA's preferred calculation methodology, the values of those assets are being ignored, with the result that CMA's calculations of LCC's profits are seen to be supra normal.

Recommendations are the main source of all business, and crematoria are chosen by customers before they contact funeral directors. This is evidenced in the Ipsos Mori research. This evidence indicates that land and buildings, the setting of the service, have value to consumers. This should be recognised in the assessment and valuation.

The CMA also needs to recognise the importance of trusted relationships and their value to the service and product offering in this case. The fact that these points are people-related and emotion-related issues does not make them less valuable to customers or the businesses concerned. It is clear that customers value recommendations and the way that the service is handled and managed, they are also vitally important as a key mechanism for the generation of volumes and sales. Accounting for their value needs to be included in the assessment if the true economic value of the business, and whether it is making excessive profits, is to be properly understood.

[26] See LCC Submission dated 17 December 2019
[27] CC3 (Revised) Guidelines for market investigations: Their role, procedures, assessment and remedies Annex A, paragraph 14

Put another way, if these factors are not taken properly into account in the setting of a price cap, the price cap is likely to be disproportionate and undermine the service being provided to grieving people.

Furthermore, the CMA has accepted Dignity's argument in its assessment of funeral director profitability that marketing costs can be used as the basis of trade name or brand asset in the accounts. Taking such an approach risks valuing that which can more easily be measured from that which may be more difficult but is nevertheless equally, if not more, valuable in marketing terms. For example, formal spend on marketing is likely to be worth less than the setting which is critical to the choice of crematoria and the less formal word of mouth which is actually generating sales. All generate sales, but the CMA appears to be willing to only include one (marketing in a database capitalised software) as value of one part of the equation that it has numbers for, ignoring the more important parts because calculation is more of a challenge. This is conceptually inconsistent and unreasonable. Strikingly, it also strongly favours high marketing spend business plans over those based on reputations that have been built up, which again discriminates against long standing providers who may have adopted a low-cost model based on reputation rather than large marketing spend.