
Anticipated acquisition by Lloyds Pharmacy Limited of Independent Pharmacy Care Centres plc

The OFT's decision on reference under section 33 given on 8 June 2007. Full text of decision published 22 June 2007.

PARTIES

1. **Admenta Holdings Limited** is the immediate holding company of **Lloyds Pharmacy Limited** (Lloyds), and a subsidiary of the German company Celesio AG. The pharmaceutical wholesaler AAH is also a subsidiary of Celesio AG. Lloyds' UK turnover for the year ending 31 December 2006 was approximately £1.5 billion.
2. **Independent Pharmacy Care Centres plc** (IPCC) comprises 34 retail pharmacies and one drug store, which, unlike a pharmacy, does not have an NHS prescription contract. Its retail pharmacies trade under various names and are principally concentrated in Greater Manchester, Lincolnshire, Cheshire, Derbyshire and the West Midlands. IPCC's turnover for the year ending 31 March 2006 was approximately £19 million.

TRANSACTION

3. The Merger Notice was received on 25 April 2007. The extended 30 working day statutory deadline therefore expires on 8 June 2007.

JURISDICTION

4. As a result of this transaction Lloyds and IPCC will cease to be distinct. The parties submit that the share of supply test is met in respect of the supply of pharmacy services within five individual Primary Care Trusts (PCTs) in which the parties' joint shares range between 25 and 34.3 per cent.¹
5. The parties submit that the five PCTs can be considered in aggregate as a suitable proxy for a 'substantial part of the UK'. There are approximately 150 PCT areas in England in which each PCT is ultimately responsible for the delivery of primary care to the population in its geographic area. Information from the parties confirms that the population

¹ These are: (1) Sandwell, (2) South Birmingham, (3) Heywood, Middleton & Rochdale, (4) North East Lincolnshire and (5) North Lincolnshire.

of the five PCTs accounts for 2 per cent of the UK population and 2.5 per cent of the population in England respectively. The total area covered by the PCTs accounts for about 1 per cent of England's total area. Within each of the PCTs, health services are offered to the population by between 35 and 75 GP surgeries respectively; in four out of the five PCTs there is also a hospital.

6. The OFT has no reason to insist upon a principle of geographic contiguity in respect of the five PCT areas in question for purposes of the share of supply test. It agrees with the Competition Commission (CC) which, in the context of *Archant/INM*² discussed the interpretation of what constitutes a 'part' of the UK for the purposes of Section 23 (3) of the Enterprise Act (the Act), concluding that '... in the context of the Act, no useful purpose would be served by restricting the meaning of 'part' to an undivided geographical area'³. Accordingly, the OFT considers that the five PCTs areas, in aggregate, qualify as a substantial part of the UK within the meaning of Section 23 (3) of the Act.
7. The share of supply test in section 23 of the Enterprise Act 2002 is therefore met. The OFT therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

MARKET DEFINITION

Product market

8. The parties overlap in relation to retail pharmacies, which provide a range of professional and retail services. In particular, these include the retail supply of ethicals, pharmacy only (P) medicines and general sales list (GSL) medicines.⁴ In addition, the parties also stock non-pharmaceutical products such as toiletries, baby food and health food, which are also sold through various other channels, especially supermarkets. No competition concerns arise in the retail supply of these non-pharmaceutical products and they are therefore not considered any further.
9. Ethicals are prescription only medicines. In the vast majority of cases, there is no demand side substitution either within ethicals or between prescription and non-prescription medicines. On the supply-side, a pharmacy contract with a PCT is required for a pharmacist to dispense

² Competition Commission, *Archant Limited and the London newspapers of Independent News and Media Limited: A report on the acquisition by Archant Limited of the London newspapers of Independent News and Media Limited*, Appendix C, 22.09.2004.

³ *Ibid.*, Appendix C, at paragraph 27.

⁴ Monopolies and Mergers Commission, *UniChem PLC/Lloyds Chemists plc and GEHE AG/Lloyds Chemists plc*, A report on the proposed merger, July 1996, Cm 3344, Anticipated acquisition by Boots plc of Alliance UniChem plc, OFT decision of 6 February 2006.

NHS⁵ prescriptions. There is no price competition between pharmacies on ethicals since the price of the prescription is set by the NHS. Pharmacies are remunerated by the NHS and reimbursed (less a 'clawback'⁶) for the costs of the drugs dispensed.

10. P medicines do not require a prescription but can only be dispensed by a pharmacist. Following the ending of resale price maintenance (RPM) on over-the-counter (OTC) medicines (that is, P and GSL medicines) in 2001, pharmacists can now set their own retail prices for P medicines, and limited pricing competition therefore occurs.
11. GSL medicines do not need to be sold in pharmacies and can therefore be found in supermarkets, convenience stores, petrol stations, etc. Around 40 per cent of P medicines have a GSL alternative (for example, in the form of a smaller pack size), implying the possibility of some pricing constraint on P medicines from GSL alternatives.
12. The parties both also provide other pharmacy services, such as certain screening services and consultation services, for example on medicine use review. Pharmacies may also offer direct to home prescription delivery and repeat prescription services.
13. For purposes of market definition, nothing is gained in this case by considering separate relevant markets for the individual supply of products and/or services supplied at retail level by pharmacies. Although the constraints in relation to price and non-price parameters of competition may differ depending on the product or service in question (and in particular, whether that parameter is regulated), these issues are best dealt with in the competitive assessment. The relevant product market, consistent with previous decisional practice, is therefore the overall provision of retail pharmacy services.

Geographic market

14. OFT analysis in previous cases relating to retail pharmacies has used a one mile radius as the basic proxy for the scope of relevant local geographic markets. The OFT report on the control of entry regulations⁷ (the OFT report) found that 78 per cent of consumers travel less than one mile to get to a pharmacy, and 96 per cent travel less than three miles. This approach has been supplemented on occasion by consideration of narrower and larger areas (for example where there are significant geographic

⁵ Note that since all the local overlaps discussed below arise in England, this assessment only refers to the NHS in England.

⁶ The 'clawback' is based on an assumed level of discount that pharmacies may get from wholesalers.

⁷ The control of entry regulations and retail pharmacy services in the UK – A report of an OFT market investigation (January 2003).

features affecting local access, or the closest competing pharmacy is more than 1 mile away).

15. Third party respondents have suggested a range of distances for the geographic scope relevant to retail pharmacies. Distances of 1 to 1.5 miles were mentioned most frequently.
16. The OFT has not received any convincing evidence to warrant deviation from using a one mile radius as the principal basis and starting point for assessment of retail pharmacy competition, while acknowledging that identifiable local factors may warrant some scope for flexibility, including flexing of the 1-mile radius, which is, after all, measured as the crow flies, and not an isodistance on foot or by road. Due to the relatively small number of overlaps in this particular case, the OFT was able to consider each local area on an individual basis based on specially-prepared maps and other relevant evidence.

Supply of pharmacy services to the NHS

17. In addition to providing services to customers, pharmacies have contractual relationships with the NHS. This includes negotiating the national pharmacy contract with the Department of Health, which specifies the core services to be undertaken by the pharmacies and remuneration levels, and negotiating enhanced service level initiatives with individual Primary Care Trusts.
18. The candidate markets for national and local (PCT-wide) supply of pharmacy services to the NHS is therefore also briefly considered below.

HORIZONTAL ISSUES

National shares

19. Lloyds currently operates 1,574 pharmacies throughout the UK. On a national basis the parties' combined share of pharmacies (by number) and the merger-related increment are estimated by the parties as 13.1 per cent and 0.3 per cent respectively. Given the relatively small scale of this acquisition, national competition issues are not considered to arise.

Regional (PCT-level) increments

20. The parties identified a number of PCTs where their combined share of pharmacies would exceed 25 per cent as a result of the merger. The largest combined share is in North East Lincolnshire, at 34 per cent, with an increment of 6 per cent (the increment arising from the acquisition of just two IPCC pharmacies).

21. The scale of this merger is not considered to be sufficient to raise concerns in relation to the negotiation and provision of services to PCTs. In Boots/Alliance UniChem the OFT did not believe that any competition problems would arise, even in those areas where the parties jointly accounted for in excess of 50 per cent share of pharmacy numbers in certain PCTs. The minimum number of pharmacies needed to support a typical new PCT initiative was found to be low, and PCTs' negotiating position was considered to be strengthened by their ability to grant new pharmacy application licences. We have not received any evidence in this case to warrant a different view.

Analytical framework for assessment of local overlaps

Fascia as an appropriate concentration screen

22. As a starting point for the assessment in *Boots/Alliance UniChem*, a 'fascia' count approach was adopted, consistent with previous practice. It assesses the change brought by a merger within the framework of the reduction in the number of competing independently-owned pharmacies, or fascia. The OFT's rationale for using the fascia test as an initial concentration test to provide a framework for more detailed effects analysis was two-fold. First, a fascia test takes account of the fact that stores under common ownership may be standardised in terms of competitive parameters, such as prices and service levels. Second, it provides a short hand measure for the economic presumption that a common owner will internalise competition between its retail outlets so as to profit-maximise. However, the OFT also recognises that in some circumstances fascia analysis is capable of under-reporting potential problem areas where the parties are particularly close competitors, since a fascia approach treats all (included) competitors as being of equal competitive discipline upon each other.
23. On the basis of a one mile radius, there are 17 locations where the parties' pharmacies overlap, that is both are present within one mile of one another. No areas were so-called 2 to 1 areas, but several local overlaps create 3 to 2 or 4 to 3 areas, and are dealt with below. For these purposes, the radii have been centred on the retail outlets of both the target and the acquirer. No additional competition concerns were raised by re-centering on the outlet(s) of the acquirer.

Parameters of local competition between retail pharmacies

24. Various elements of the NHS pharmacy contract act to limit the parameters of competition between retail pharmacies, including at the local level. For example, the NHS contract is restrictive in terms of its imposition of minimum service standards and required opening times. There is no price competition between retail pharmacies in the supply of prescription

medicines. The parties estimate that prescription medicines typically account for 80 per cent of a dispensing pharmacy's business.

25. The OFT report found that despite the removal of resale price maintenance (RPM) on P and GSL medicines, competition between pharmacies was still muted. It found no statistically significant relationship between price and local concentration. It did, however, identify some correlation between local concentration and certain quality-related aspect such as opening times and the availability of certain facilities and services.
26. Previous relevant cases have established that there is some scope for competitive interaction between pharmacies. For example, the Boots/Alliance UniChem investigation established from internal documents that new entry will usually prompt some competitive response. Competitive interaction between retail pharmacies may include price competition on P medicines and non-price competition across a range of service and quality parameters. Hence, even though location may be the main factor determining customers' choice of pharmacy, the evidence does not suggest that no reduction in pharmacy fascia could bring about a meaningful reduction in competition.
27. Third party responses in this case supported the view that retail pharmacies monitor competitor activity and compete, to some extent, across a range of factors. Factors identified by third parties included: price; product range; promotions; range of services; opening hours; quality of advice; pharmacy appearance and layout. Some third parties identified location and convenience as an overriding factor in competition between pharmacies, particularly with respect to proximity to GP surgeries. This suggests that where merging parties have outlets in close proximity to each other, they may represent particularly significant mutual competitive constraints pre-merger.

Closeness of competition between the merging parties' business models

28. As discussed above, a reduction in the number of pharmacy fascias present in a local area implies a reduction in the number of independently-competing retail propositions available for consumers to choose between. However, in *Boots/Alliance UniChem*, the merging parties had a different business focus. Boots was mainly viewed as a general health and beauty retailer, typically located on the high street, and competing on the basis of a large range, price offers and own-brand labels, with the majority of its revenue from non-pharmaceutical products; UniChem, on the other hand, positioned itself as a local or community pharmacy competing more on the basis of location and across service parameters. Accordingly, the merging parties in Boots/Alliance UniChem were -- geography aside -- less close competitors than a merger between two community pharmacy operators is likely to be. As a result, as a starting point the merging parties can in

principle be viewed as reasonably close competitors in terms of their general market position in relation to the supply of (community) pharmacy services at local level when in sufficiently close geographic proximity to one another. This has then informed the OFT's judgment when it has turned to the specific issue of location and proximity of the parties to one another, and to rivals, to identify the closeness of competition between the parties in the relevant local area. In one particular 3 to 2 area, discussed below, this has made it appropriate to apply a more cautious view than that applied in *Boots/Alliance UniChem*, where the OFT's concerns were in principle restricted to areas where a 3 to 2 area closely resembled a 2 to 1 area – in other words, where the merging parties were in relatively close geographic proximity, while the third party was significantly further away, albeit within the 1-mile radius adopted for purposes of geographic market definition.

Barriers to entry

29. The control of entry regulations remain the key entry barrier in retail pharmacy. These were amended in 2005 to introduce certain automatic exemptions from the control of entry test applied by PCTs. For example, an exemption applies if the applicant pharmacies are based in large out of town developments or intend to open for more than 100 hours per week.
30. In *Boots/Alliance UniChem* entry possibilities were not considered sufficient to mitigate competition concerns arising from local fascia count reductions. While there is some evidence to suggest that entry may have become slightly easier than in the past, the threat of entry is still not considered to sufficiently constrain the parties post-merger in the local areas discussed below where the relevant reduction in fascia triggers competition concerns.

Assessment of individual 3 to 2 areas

31. There are five local overlap areas where the merger will leave only two remaining fascia. These areas relate to the IPCC pharmacies in the postcode locations listed below. The parties have not actively sought to argue, or supplied area-specific evidence to rebut any concerns that may arise in these 3 to 2 areas.
32. In this case, in three of the five areas considered below, the 3 to 2 areas effectively resemble 2 to 1 areas, because the parties are located in relatively close proximity to one another, while the third party fascia is located at or close to the periphery of the 1-mile radius. If the radius were flexed only slightly inwards, the third fascia would be excluded and the area would be a 2 to 1. Consistent with the approach in *Boots/Alliance UniChem*, therefore, such areas are problematic, and give rise to a duty to refer within the 'may be the case' spectrum of belief between less likely than not and more than fanciful, as established by the Court of Appeal in

the IBA case. The three cases that closely resemble 2 to 1 areas are DN34 5SU (Grimsby), and B45 9HY and B45 9JA (both in Rubery, Birmingham). Given the lesser degree of differentiation in retail proposition between these merging parties and Boots and Alliance UniChem, the concerns in this case are less marginal than were the relevant concerns in the former case.

33. In a fourth case, in the area around SK6 4BT (Stockport), the 3 to 2 area is more marginal than the three mentioned above, in that it does not resemble a 2 to 1 in the sense of the parties' pharmacies located in close proximity with the third party substantially further away. On balance, considering in particular that in this case the parties are both closer retail propositions than in the Boots/Alliance UniChem case, the general evidence on entry, and the absence of area-specific evidence suggesting a lack of material competition between the parties, the OFT believes the concerns posed by this 3 to 2 area sufficient to give rise to a realistic prospect of a substantial lessening of competition.
34. In a fifth area, DN15 8AL (Scunthorpe), both Lloyds-owned pharmacies and an independent competitor are located at the very fringe of the one mile radius centred on the IPCC pharmacy. It is clear that neither Lloyds pharmacy is materially closer geographically to the IPCC pharmacy than a third rival such that the merger poses unilateral effects concerns based on a loss of close competition, because there is no reason to suppose the requisite level of switching between the merging parties. Indeed, if the 1-mile radius is flexed inwards slightly, the overlap would be entirely removed; if the radius was adjusted to just over one mile, there would be a further competing fascia present in the relevant area. In the latter case, the merger would represent a fascia reduction of four to three, which, in the absence of any evidence to the contrary, is not considered to raise any competition concerns (see below). There OFT is therefore satisfied that, in this particular area, the 3 to 2 overlap is essentially nominal and, on an effects analysis, does not give rise to a realistic prospect of a substantial lessening of competition.

Assessment of 4 to 3 fascia areas and lower levels of concentration

35. In Boots/Alliance UniChem the OFT found that while a fascia reduction from four to three or higher in that particular merger case could give rise to a lessening of competition, it could not be expected to be substantial; in other words, it would not weaken rivalry to such an extent that pharmacy customers in such areas would be harmed.
36. As already noted, given that this merger involves two competing community pharmacy operators, rather than Boots and a traditional pharmacy operator, the OFT further considered, on a cautious basis, whether any 4 to 3 area could give nevertheless rise to concerns.

37. There are two local overlap areas where the merger will leave three remaining fascias. These areas relate to IPCC pharmacies with the postcodes OL12 0SN (Rochdale), and DN16 3LG (Scunthorpe). There were no localised reasons or evidence available to believe that the merger would cause concern by removing close competition between pharmacy fascia. Similarly, no reasons for competition concerns were identified in relation to the remaining local overlap areas where the merger will leave four or more fascias present.

VERTICAL ISSUES

38. AAH, a sister company of Lloyds, is one of the two largest national full line wholesalers. Alliance UniChem is IPCC's current principal full-line wholesale supplier, accounting for 45 per cent of IPCC's purchases. One pharmacy competitor considered that an increase in the number of local pharmacies sourcing supplies from AAH, arising from the merger, would limit the range of products available to consumers.
39. On balance, given the limited number of pharmacies involved in this transaction and the fact that Alliance UniChem is already the major wholesaler to these pharmacies, the OFT considers that the merger does not raise any significant vertical competition concerns.

THIRD PARTY VIEWS

40. A number of third party retail pharmacy operators expressed concerns about the merger. Some were general comments related to Lloyds strengthening its overall position by adding further stores to its national pharmacy network. Others were focussed on specific local consequences relating to reduced fascia count (and choice), or to Lloyds' post-merger share of local pharmacy numbers. Local concerns were not all restricted to the three to two (or four to three) fascia reduction areas.
41. One PCT expressed concern that an increase in the high number of Lloyds pharmacies in its area would limit choice. Others mentioned experience of Lloyds struggling to maintain a continuous service due to lack of pharmacist availability.

ASSESSMENT

42. The parties overlap in the provision of retail pharmacy services. The share of supply test for the supply of pharmacy services in a substantial part of the UK is met in relation to five PCT areas. In light of the limited scope of this transaction involving only 34 pharmacies, no national, regional or vertical competition concerns are considered to arise.

43. Both parties operate a traditional community pharmacy model, and therefore this case is distinguishable from Boots/Alliance UniChem in this respect. At the local level on the basis of a one mile radius there are five areas where the merger would result in a three to two reduction in the number of competing pharmacies. Due to this relatively small number overlapping areas, the OFT was able to carry out an individual assessment. On evidence available to the OFT, including the persistence of regulation as a barrier to entry, in four of the five 3 to 2 areas the OFT believes there is a realistic prospect of a substantial lessening of competition post-merger.
44. Consequently, the OFT believes that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

UNDERTAKINGS IN LIEU

45. Where the duty to make a reference under section 33(1) of the Act applies, pursuant to section 73(2) of the Act the OFT may, instead of making such a reference, and for the purpose of remedying, mitigating or preventing the substantial lessening of competition concerned or any adverse effect which has or may have resulted from it or may be expected to result from it, accept from such of the parties concerned undertakings as it considers appropriate.
46. The OFT has therefore considered whether there might be undertakings in lieu of reference which would address the competition concerns outlined above. The OFT's *Mergers Substantive Assessment Guidance* states that, 'undertakings in lieu of reference are appropriate only where the competition concerns raised by the merger and the remedies proposed to address them are clear cut, and those remedies are capable of ready implementation.' (para 8.3).
47. Lloyds has offered undertakings with a view to remedying the realistic prospect of a substantial lessening of competition identified as a result of the merger in the reduction of fascia from three to two within the relevant one mile catchment areas for the supply of pharmacy services. In order to solve competition concerns in these areas, Lloyds has offered to divest either one of the acquirer's or a target store in the five local areas discussed above.
48. The OFT believes that the undertaking offered is capable of clearly addressing the competition concerns arising in the local areas identified above, as it would restore pre-merger competition and three fascia to the relevant 3 to 2 areas.
49. Accordingly, on the information currently available, the OFT has decided to exercise its discretion under section 73(2) of the Act to negotiate undertakings in lieu of reference.

DECISION

50. The OFT has therefore decided to refer the anticipated acquisition by Lloyds of IPCC to the Competition Commission pursuant to section 33 of the Act. However the OFT's duty to refer is suspended because the OFT is considering whether to accept undertakings in lieu of reference from Lloyds pursuant to section 73 of the Act.