

Anticipated acquisition by Celesio AG of Healthcare Services group plc

The OFT's decision on reference under section 33 given on 29 March 2005. Full text of decision published 11 April 2005.

Please note that square brackets indicate exact figures replaced by range at parties' request, or details excised at the request of the parties, for reasons of commercial confidentiality.

PARTIES

1. **Celesio AG (Celesio)** is a German company active in pharmaceutical wholesaling and retailing throughout Europe. In the UK, Celesio operates through its subsidiary Admenta Plc (Admenta), which has two principal business divisions: pharmaceutical wholesaling and retail pharmacy. For the purposes of this transaction the key subsidiaries of Admenta are: **Farillon Ltd (Farillon)** which provides contract logistics services to pharmaceutical manufacturers and **AAH Hospital Service (AAH)** which is a full line wholesaler.
2. **Healthcare Services Group Plc (HSG)** provides contract logistics services, including distribution, warehousing and sales order processing, to the healthcare industry, but is not active in pharmaceutical wholesaling or retail. HSG's UK turnover for the year ended 31 December 2003 was £37.04 million.

TRANSACTION

3. The parties entered into a sale and purchase agreement for Celesio to acquire the entire issued share capital of HSG on 15 December 2004 and intend to complete the transaction as soon as possible, following a decision from the Office. The transaction was notified to the OFT on 22 December 2004. The administrative deadline for a decision was 25 February, which it has not been possible to meet.

JURISDICTION

4. As a result of this transaction Celesio and HSG will cease to be distinct. The parties overlap in the supply of contract logistics services to the healthcare industry. Within contract logistics for the healthcare industry, the parties overlap in the provision of 'cold-chain' logistics, i.e. the storage and transportation of healthcare products requiring a controlled low temperature environment, where they will have a combined share of supply of approximately [35–45] per cent. Therefore, the share of supply test in section 23(2) of the Enterprise Act 2002 (the Act) is 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.

RELEVANT MARKET

Product scope

5. The parties have submitted, on the basis of earlier European Commission decisions, that the relevant product scope is that for the provision of contract logistics services.¹ The Commission noted in these cases that, although providers of contract logistics services tend to specialise in a particular industry sector, they are generally able to serve all types of customers without distinguishing according to the types of goods transported. The Commission considered that ownership of specialised assets was not necessary to provide contract logistics services. The parties submitted that the same analysis should apply in this case and that, whilst there are certain industry-specific demands on healthcare logistics providers, these are not sufficient to justify considering healthcare logistics as a sector which is distinct from contract logistics services generally.
6. On the supply side, technically it is not difficult for an existing logistics provider to enter the healthcare logistics sector. The evidence provided to the OFT suggests that customers, in the main pharmaceutical manufacturers, however, do look for expertise in healthcare logistics, a proven track record and scale of operation. Also of importance are security of operation, level of IT competence and service levels. These barriers are not insurmountable: many generalist logistics providers have already built up good reputations outside healthcare logistics. There are a number of general logistics providers switching into the healthcare logistics market. Competitors, who provided evidence to the OFT, do consider that such companies act as a competitive constraint in the healthcare logistics sector.

¹ Decisions include IV/M.1895 *Ocean Group/Excel* and COMP/M.3942 *Excel/Tibbet & Britten*.

7. Customers were split as to whether generalist contract logistics services providers are demand side substitutes for healthcare logistics providers. Evidence from previous bidding rounds for healthcare logistics contracts suggests that generalist contract logistics services providers were also considered and in some cases short listed for healthcare logistics contracts. Customers that would not consider generalist contract logistics services providers as demand side substitutes point to the regulated environment and the sector expertise required for healthcare logistics. It appears that the choice of whether to use a generalist or a specialist healthcare logistics provider may depend on the type of product that the customer intends to distribute.
8. Taking all of these points into consideration, the OFT considers that while the scope of the frame of reference is not as wide as to include all generalist contract logistics services providers it is wider than the purely specialist healthcare logistics providers. The OFT therefore includes those generalist providers involved in healthcare logistics within the frame of reference.
9. During our enquiries, third parties raised concerns about two particular aspects of healthcare logistics provision, which are discussed below.
10. **Pre-wholesaling** involves the warehousing of bulk orders of healthcare products (predominantly pharmaceuticals) and their onward transportation to end customers, e.g. wholesalers and hospitals. Depending on the requirement of the customer pre-wholesaling services may include product storage, order taking, invoicing and distribution (usually to wholesalers, hospitals and home-delivery pharmacies) which are all undertaken on behalf of the manufacturing customer.
11. Pre-wholesaling covers both ambient, i.e. not temperature critical, and cold-chain distribution. The parties and third party competitors have submitted that entry barriers are low and that any provider of healthcare logistics services can easily provide pre-wholesaling services. Due to the ease of supply side substitution between healthcare logistics and pre-wholesaling, pre-wholesaling is not considered as a distinct sector.
12. **Cold-chain healthcare logistics** involves the storage and transport of healthcare products that require a controlled low-temperature environment. There is no scope for demand-side substitution because if the medical product must be kept chilled, cold storage is needed. The parties submit that the provision of cold chain facilities does not constitute a distinct sector. On the supply side, the parties claim that logistics providers can easily provide cold-chain services at little extra cost. However, third party evidence does not support this view (see more generally the discussion of entry at paragraphs 28-35 below).

13. Cold-chain healthcare logistics may be regarded as a distinct sector because of the need for cold storage that complies with Medical and Healthcare Products Regulatory Agency (MHRA) guidelines and licence requirements, and suitable transportation methods. As for transportation, the MHRA does not require licences for transportation, even for high risk products. There appear to be two methods of entry: either refrigerated vehicles that can be used to transport cold-chain products and have the advantage of being able to carry high volumes; or the use of smaller cool boxes or containers, which can be obtained cheaply. The parties note that many pharmaceutical manufacturers use separate distributors for cold storage and final delivery.
14. As a result of the lack of demand and supply side substitutability, the OFT has considered cold-chain healthcare logistics as a separate sector for the purpose of this investigation.

Geographic scope

15. The parties submit that the relevant geographic scope should be the UK for any product scope. This has been broadly confirmed by third parties. The European Commission has previously found the geographic scope for contract logistics services to be national.² The OFT has no evidence relating to healthcare logistics in particular to warrant a departure from this view. The Farillon depot is in Romford and HSG's in Bedford. Both companies have a network of depots and distribute nationally, including to Northern Ireland. Many competitors also have networks of depots and will distribute nationally. It is therefore concluded that the geographic scope is the UK.

HORIZONTAL ISSUES

Shares of supply

All healthcare logistics

16. The parties have had difficulty in estimating shares of supply for the healthcare logistics sector as no independent data are available. However, the parties' best estimate puts the total value of the healthcare logistics sector at some £400 million, the bulk of which represents ambient healthcare products, of which they have a combined share of [10-20] per cent. The parties have provided estimated shares for their competitors and conclude that there are four other suppliers with shares of 10 per cent or more, as well as a number of other smaller suppliers. A number of assumptions have been made in order to calculate shares of supply and an appropriate degree of caution should be applied when interpreting the figures. Third parties generally believed that the parties' combined share of supply for all

² Case No. IV/M.1500 *TPG/Technologista*.

healthcare logistics provision was in the 10-20 per cent range, although some felt that this was on the low side.

17. The parties also submitted that a number of pharmaceutical manufacturers handle healthcare logistics services in-house, which may act as a constraint. No data are available to estimate the value of in-house healthcare logistics. One competitor supported this view, although another notes that very few competitors are in-house. Bidding data show that in-house healthcare logistics have been used following a bidding round for healthcare logistics contracts on some occasions. In short, based on the evidence before it, the OFT considers that although some competitive constraint is provided by in-house provision, it is not significant.
18. The healthcare logistics sector comprises both ambient and cold-chain segments. Using the estimated values of the total healthcare logistics sector and the cold-chain segment, some 96 per cent of the value is represented by products requiring ambient logistics services. Third parties have also raised concerns about cold-chain healthcare logistics separately. Third parties have not suggested that competition problems will arise in the broader ambient healthcare logistics sector: customers consider themselves to have buyer power in what is a 'bidding market'.

Cold-chain healthcare logistics

19. It has proved more difficult to estimate shares of supply for the cold-chain sector. Again, a degree of caution should be applied in the interpretation of these figures. However, both the parties and a competitor have estimated the value of the sector at £15m. The parties' combined share in this sector is 35-45 per cent (increment [10-20] per cent). [] of Farillon's revenue is accounted for by a recently won NHS vaccines contract. The parties believe that this distorts their share of supply and is not indicative of future competitive pressures in this bidding market. However, this contract was awarded to Farillon in 2001 and again in 2004 for a further five years. Large changes in shares in the near future are therefore unlikely and it appears reasonable to include the vaccine contract in the shares of Farillon.
20. The parties argue that their businesses are largely complementary in the healthcare logistics sector. Farillon's business is largely geared towards cold-chain distribution, which represents some 75 per cent of its business, while only some 3-5 per cent of HSG's business is focused on this area. The parties add that, because of this, it has been rare for Farillon and HSG to bid against each other in the past; the recent NHS childhood vaccines contract being an exception. Bidding data supplied by the parties do, however, suggest that Farillon and HSG have bid

against each other, and third parties confirm that the firms have been in direct competition. It therefore appears that the parties were competitors pre-merger, even if HSG only entered the cold-chain sector in 2000.

21. It has been suggested that there are few competitors in cold-chain logistics. However, third party views were mixed with some competitors and customers raising concerns about cold-chain distribution, and others expressing no concerns. Two customers and a competitor have suggested that the transaction may result in a reduction of suppliers from 3 to 2 in cold-chain healthcare logistics and that there will only be one realistic competitor to the merged entity. Another customer has suggested that the parties' combined share in cold-chain may be as high as 70-80 per cent on the basis that it believed that there were only three firms in the sector.
22. However, data available to the OFT identify at least three regular pre-merger competitors to the merged entity, including Exel, UDG and PolarSpeed. Bidding data for cold-chain healthcare logistics contracts supplied by the parties suggest that, as well as this core of four firms, there are a number of other providers or potential providers such as Parcelforce, Fresenius, Dachser, Unipart, Wincanton, Tibbett & Britten and New Wave Logistics that have bid for cold-chain contracts. Evidence has also been provided showing that winners of cold-chain contracts have subsequently contracted out either the storage or the transportation of the products, or that customers have split contracts among at least the companies named above.
23. Competition occurs at the time of tendering for contracts with providers competing on a variety of factors in addition to price. These additional factors include a proven track record, the scale and security of operation, the level of IT competence and service levels.
24. In summary, the evidence suggests that post-merger at least four firms will be active in cold-chain healthcare logistics. Taken as a whole, most third party comment supports this and bidding data suggest that all of these firms have won contracts in the sector. Smaller firms have also participated in bidding rounds and have, in some cases, won contracts. Further, the option of firms contracting out cold-chain transportation after winning a contract exists. The nature of the bidding market and the buyer power of manufacturers are also likely to counter any non-coordinated effects of the proposed acquisition.

BARRIERS TO ENTRY

Healthcare logistics

25. According to the parties, an entrant would need one central warehouse with a cold storage facility from which to distribute products throughout the UK. For a purely ambient operation cold storage would not be necessary. There is no shortage of capacity. Farillon leases its main warehouse at an annual cost of approximately []. A number of regional depots would be required, which the parties submit are cheap and relatively easy to find.
26. In order to manage its sales order processing, an entrant would require an appropriate IT system. Whilst some functions are specialised, the parties submit that these systems are relatively inexpensive and do not need to be highly customised.
27. MHRA licences apply to both ambient and cold-chain storage, and are granted on prior inspection of facilities. The nature of healthcare logistics leads to customers placing a high value on accuracy and due care in relation to the services provided. Reputation is relatively easily acquired, according to the parties, which point to entry by general logistics providers, for example generalist providers such as Exel are already active in healthcare logistics, and potential entry in that there are suggestions that other generalists are attempting entry. A third party competitor said that customers look for expertise, a proven track record and scale of operation, although these barriers are surmountable. The increased growth in the sector, particularly due to increased outsourcing, noted by both the parties and third parties, may attract new entrants into healthcare logistics.

Cold-chain healthcare logistics

28. There are two main barriers to entering cold-chain healthcare logistics – storage and distribution.
29. Considering cold storage, the parties submit that a fridge is required – the size of which depends on the volume of storage required. According to the parties, costs range from £1,000 for a small domestic fridge to £20,000 or more for a fridge capable of holding numerous pallets of stock. The principal requirement is that temperatures comply with those demanded by MHRA guidelines and their licence requirements. These guidelines note that domestic fridges are not suitable for high risk products because they do not have precise temperature control and there is a risk from products freezing. As a result, the OFT has concluded that for many products, the use of cheaper methods of entry is not realistic.

30. A competitor said that the installation of a cold-chain store that meets MHRA regulations costs £100,000. The parties submit that a large fridge with capacity for up to 2,500 pallets would cost approximately []. In addition to a main warehouse entrants would require regional depots and vehicles, although these can be rented as needed. Setting up a cold-chain warehouse and supporting infrastructure appears expensive in relation to the estimated £15m value of the sector. Some third parties commented that speculative entry was unlikely in this sector; but that they would consider entry should a contract be won. The parties submit that many pharmaceutical manufacturers use separate healthcare logistics providers for cold-chain storage and delivery.³
31. Considering distribution, MHRA regulations do not cover transportation of cold-chain products. Guidelines for cold-chain distribution are, however, published by the MHRA. Access to transportation facilities with a refrigeration facility can be achieved by using either refrigerated vans or conventional vans with refrigerators installed. The European Commission noted in 'Ocean Group/Excel'⁴ that ownership of assets was not necessary to provide logistics services and refrigerated trucks appeared to be sufficiently available from third parties. The possibility of contracting out transportation does exist. The evidence from the parties and third parties available to the OFT suggested that there appear to be a large number of firms that are able to take on such work. As noted, a potential entrant on a large scale would also require warehousing (which large companies such as Exel and UDG already possess). According to one competitor, problems may however exist with sharing facilities with products other than pharmaceuticals.
32. Entry into cold-chain distribution is possible using cheaper methods than refrigerated trucks. These involve using cool boxes or pouches for transportation, which can be obtained for as little as £15. According to the parties existing firms use such methods although potentially at risk of spoilage if the products are undelivered in the necessary time frame (see paragraph 33 below). Farillon uses both refrigerated vehicles and cool boxes, whilst HSG uses cool boxes and battery operated chilled units. Parcelforce (used by Glaxo) uses similar methods. It should, however, be noted that MHRA guidelines call for refrigerated vehicles to be used when transporting high risk products. In the absence of these guidelines having force in law, the rationale for maintaining a refrigerated fleet appears to lie in risk and volume.
33. The high value of pharmaceuticals means that insurance costs are high and risk reduction is important. A third party noted that if a product is undelivered, it is written off, unless a proper cold-chain infrastructure with refrigerated trucks is in place. Drugs in a small box could be worth up to £17,000. The cheapness of the

³ For example, Roche is said to use HSG to carry out its deliveries, and Exel for storage.

⁴ Case No. COMP/M1895 (EC decision of 3 May 2000)

cool box method may be outweighed by the risk of products being undelivered. An additional problem relates to customers finding methods of disposal for cool boxes in a way that meets environmental regulations. In addition, when transporting a large volume of goods, it becomes time consuming to pack cool boxes, according to both the parties and competitors. As a result, in order to bid for large contracts, such as for certain vaccines, a firm must either have a cold-chain distribution network, i.e. refrigerated vehicles or arrange to contract out, according to a competitor.

34. There has been entry into the cold-chain sector in the last ten years – HSG entered in 2000 – leading the parties to suggest that there is nothing to hinder entry.⁵ A competitor suggests that a new cold-chain fleet and infrastructure could be set up, but would be expensive, with total entry costs in the region of £1m, which is high relative to a segment estimated to be worth £15m in total. Third parties consider speculative new entry to the sector to be unlikely: lead-in times are up to 16 weeks in duration and, in order to bid for a contract, arrangements already need to be in place for transportation (which may include arranging outsourcing).
35. Taking the above into account, the OFT considers that barriers to entry into cold-chain healthcare logistics are higher than for ambient healthcare logistics. It would be difficult for an existing ambient healthcare logistics provider to enter the cold-chain sector on any scale, although the possibility of small contracts being won and contracted out to cold-chain couriers may exist. It appears unlikely, therefore, that new entry will act as a significant constraint on existing cold-chain logistics providers.

BUYER POWER

36. The contract healthcare logistics services sector is characterised by bidding. Customers are, in the main, large, sophisticated multinational pharmaceutical manufacturers, and, the parties submit, are able to switch healthcare logistics providers. Most third parties state that while switching is possible, it is expensive and time consuming, although one customer with experience of switching did state that switching costs were minimal as their new provider paid for collecting stocks from the existing healthcare logistics provider. Contracts tend to be for two to three years (a small number are longer or shorter) and customers secure a healthcare logistics provider through a bidding process. Customers do believe that they have a degree of buyer power and are able to negotiate advantageous terms in many cases.

⁵ HSG entered from ambient healthcare logistics.

37. The parties also submit that customers have the option of bringing logistics provision in-house. However, third parties have stated that this would be difficult and the costs prohibitive. On the whole, therefore, whilst switching tends to only take place at the point of tender, it appears that customers can exert buyer power.

VERTICAL ISSUES

38. Celesio also owns AAH Hospital, a full line wholesaler. Third parties identified AAH as a competitor in the tender for the NHS childhood vaccines contract. The parties, however, disputed this suggestion in view of AAH's role as a wholesaler rather than a contract logistics supplier. The parties contend that the acquisition, which relates only to the provision of contract logistics, would have no effect on AAH's existing wholesale and retail activities. The parties note that the function of a contract logistics provider is limited to the provision of warehousing, transport and delivery on behalf of the customer, with no ability to influence the price or the destination of the products, and that AAH is just one of many final destinations for their customers' products. No third parties raised concerns about vertical issues. The OFT has therefore concluded that, on the evidence available to it, no vertical competition concerns arise from the transaction.

COORDINATED EFFECTS

39. Healthcare logistics contracts are tendered by bidding. There appears to be no or limited transparency as to either prices or the identity of competitors.⁶ Firms are not symmetric in terms of size or cost structure (cost bases are likely to vary, depending on whether distribution is carried out internally or contracted out). A large number of firms will remain post-merger able to compete for ambient healthcare logistics. While, in cold-chain, there may be only four main firms post-merger, there is also a competitive fringe which competes for and wins contracts. In light of the above reasons which undermine any incentive to coordinate prices, the OFT considers that coordination remains unrealistic.
40. In any event, the likelihood of coordination being sustained, if reached, is reduced by the buyer power that customers possess in this bidding market. Contracts are not frequent, increasing the temptation to deviate in order to win a large contract and reducing the opportunity for punishment strategies to be implemented. In ambient healthcare logistics, new entry may also act as a competitive threat. Therefore, the likelihood of coordination would not be increased by this transaction.

⁶ As noted, third parties have had considerable difficulty in suggesting the identity of competitors.

THIRD PARTY VIEWS

41. The top five customers and competitors of Farillon and HSG were contacted. Two further significant customers of Farillon were also contacted. A range of additional manufacturers of cold-chain pharmaceuticals were also contacted, as was the MHRA and Department of Health. Third parties were unconcerned about ambient logistics, although some concerns about pre-wholesaling were raised. (These have been discussed in paragraph 11.) The views of customers and competitors were more mixed about cold-chain logistics, with some third parties expressing concerns about the resultant reduction of providers.
42. A third party competitor raised concerns about the fact that the NHS childhood vaccines contract would, after the transaction, be held by the merged parties. It was considered that this one contract would be sufficient to cover the base costs of a nationwide chilled distribution fleet and would enable the combined entity to offer lower prices that potential competitors could not match. The parties have stated that this contract was publicly advertised and that consequently there was real competition at the point of tendering. The NHS was unconcerned, noting that there were five bidders for this contract (one of which was apparently AAH, another HSG) and believes that Exel is growing in cold-chain healthcare logistics. The NHS contract was, however, exceptional as it required a dedicated fleet and was unusually large in size. From bidding data and other third party evidence (with the exception of one customer) the OFT considers that there are more than three main firms active in cold-chain.

ASSESSMENT

43. Healthcare logistics is a specialist sector within contract logistics. Some generalist logistics providers have switched or expanded into healthcare logistics and may act as a competitive constraint to the existing specialist healthcare logistics providers. Therefore, generalist providers with healthcare logistics activities have been included in the product scope, alongside specialist healthcare logistics providers such as Farillon.
44. Third parties identified two sub-sectors within healthcare logistics – pre-wholesaling and cold-chain – that merited further investigation. Pre-wholesaling involves a subset of logistics activity and, due to supply side substitution, is not considered by the OFT to be a distinct sector. There is, however, little evidence of ambient healthcare logistics providers switching into cold-chain logistics and the costs of doing so may be high for speculative entry. Cold-chain healthcare logistics are therefore considered as a distinct sector.

45. The parties' combined shares of supply for all healthcare logistics provision are low at approximately [10-20] per cent. Some 96 per cent of the value of the estimated total healthcare sector is represented by products requiring ambient distribution. Third parties were, apart from the concerns rehearsed above about pre-wholesaling, unconcerned about the transaction in this area or, more generally, in healthcare logistics.
46. Although concerns were raised by some third parties about the cold-chain logistics sector specifically, others were unconcerned. The combined share in this sector is estimated at [35-45] per cent and there are fewer competitors than in ambient logistics. The largest contract in this sector is for NHS childhood vaccines (which makes up about [] of the sector) and this attracted five bidders (including both parties) in 2004. This contract – unlike others – required a dedicated fleet leading to high entry costs in relation to a sector valued at £15m. It is unlikely that new firms capable of bidding for such a large contract would be able to enter the sector, although it is possible to contract out distribution to smaller firms. The contract will not be re-tendered for five years. The NHS is unconcerned about the proposed acquisition.
47. Entry into smaller volume cold-chain operations can be achieved through cheaper methods, such as distribution using cool boxes. MHRA regulations do not cover transportation of cold-chain products, although providers are encouraged to follow MHRA guidelines. A larger number of firms are operational at this level.
48. Evidence suggests that at least four sizeable firms will be active in cold-chain healthcare logistics post merger, in addition to a number of smaller providers. HSG only entered the sector in 2000 and has about 3-5 per cent of its activity focused on cold-chain healthcare logistics. Customers have consistently stated that they possess buyer power and that contracts, apart from the NHS childhood vaccines contract, are tendered every two years, on average. Therefore, the OFT considers that it is unrealistic that the transaction might be expected to result in a substantial lessening of competition in cold-chain healthcare logistics.
49. Consequently, the OFT does not believe that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within any market or markets in the United Kingdom for goods or services.

DECISION

50. This merger will therefore **not be referred** to the Competition Commission under section 33(1) of the Act.