

# OFFICE OF FAIR TRADING

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## Anticipated acquisition by Intercare Group Plc of Eldon Laboratories Ltd

The OFT's Decision on reference under section 33 given on 10 September 2004

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**Please note square brackets indicate commercial confidential text or figures removed or replaced at the parties' request**

### PARTIES

1. **Intercare Group plc (Intercare)** is involved in the manufacture of pharmaceutical products on an outsourced basis, as well as the manufacture and supply of its own generic, branded and special pharmaceuticals. **Martindale Pharmaceuticals (Martindale)**, a United Kingdom (UK) subsidiary of Intercare, manufactures special pharmaceuticals.
2. **Eldon Laboratories Ltd (Eldon)** is a wholly owned subsidiary of **Alliance UniChem** and is involved in the supply of special pharmaceuticals to pharmacies. Eldon's turnover in the year ending 31 December 2002 amounted to less than £70 million.

### TRANSACTION

3. Intercare proposes to acquire the entire issued share capital of Eldon from Alliance. The transaction was notified 12 July 2004 and the extended administrative deadline is 15 September 2004.

### JURISDICTION

4. As a result of this transaction Intercare, including Martindale, and Eldon will cease to be distinct. The parties overlap in the supply of special pharmaceuticals (specials) and the share of supply test in section 23 of the Enterprise Act 2002 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

5. The parties overlap in the manufacture of non-sterile specials and the wholesale supply of non-sterile, sterile and aseptic specials. 'Specials' are unlicensed medicinal products prescribed by doctors when a licensed product for a particular indication does not exist<sup>1</sup>. Prescribing a special is necessary where a patient is

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<sup>1</sup> The manufacture of specials is regulated by the Medicines and Healthcare Products Regulatory Agency (MHRA).

intolerant or allergic to an ingredient contained in the licensed product or where a patient requires a dosage form different to the licensed product (eg as a liquid rather than tablet). They are supplied to hospital inpatients or, on prescription, to hospital outpatients or patients of a general practitioner.

#### Type of special manufactured

6. Three types of specials can be distinguished
  - **Sterile specials** such as eye drops and injections are subject to sterilisation after the production process.
  - **Aseptic specials** are manufactured in the cleanest environment and rely purely on the processing to make them sterile.
  - **Non-sterile specials** (which account for about 90 per cent of all specials) such as creams, lotions, gels and powders are not designed to be free of micro-organisms.
7. On the demand side, the prescription is provided to a pharmacist, who is responsible for dispensing the product as specified. These are bespoke products and there is no demand-side substitution.
8. On the supply side, the parties submit that manufacturers of non-sterile products could manufacture aseptic or sterile specials with relatively modest investment. However, third party responses were more mixed suggesting there was an asymmetry between sterile/aseptic manufacturing and non-sterile manufacturing. Switching production to sterile and aseptic specials was said to be costly, but conversely supplying non-sterile products could be achieved with relative ease. Given these uncertainties a cautious view is taken and the manufacture of non-sterile specials will therefore be considered as distinct from the manufacture of aseptic and sterile specials.

#### Routes to market

- Direct from commercial specials manufacturers
9. Pharmacies can purchase from commercial manufacturers such as Martindale, Eldon, Mandeville or Rosemont. Responses from third parties indicate that commercial manufacturers supply both community and hospital pharmacies and Intercare submits that Martindale and Eldon do not differentiate their prices according to whether they are supplying community or hospital pharmacies.
- Direct from hospital manufacturing units
10. Hospital manufacturing units, in addition to supplying the requirements of the NHS Trusts which own them, also supply community pharmacies. Intercare estimates that around 25 hospital manufacturing units make commercial sales, although responses from third parties maintain that there is minimal supply.

- In-house supply

11. Pharmacists can manufacture specials themselves, or purchase from other self-supplying pharmacies (referred to as extemporaneously dispensing pharmacies). The majority of customers only conduct minimal in-house supply. Although in-house supply may constrain commercial manufacturers to a degree, third party evidence indicates that pharmacies are unlikely to increase in-house supply. This is due to pharmacies not being price-sensitive because they are fully reimbursed by the NHS and often a lack of capacity on the part of the pharmacy. In-house supply and commercial manufacture are therefore not considered within the same frame of reference.

- Wholesalers

12. While with respect to manufacturing the parties only overlap in the manufacture of non-sterile specials, with respect to wholesale supply they overlap in the wholesale supply of non-sterile, sterile and aseptic specials. Wholesalers source specials from: commercial manufacturers; hospital manufacturing units; and/or from abroad (products that are licensed in the country of origin but not in the UK). Responses from third parties indicate that wholesalers provide a central ordering and invoicing point for pharmacies, with products being dispatched directly by the manufacturer to the pharmacy, e.g. by courier.
13. The reduction in the number of wholesalers post-merger is not considered to effect competition adversely. Wholesalers merely act as ordering and invoicing agents. Specials customers do not have to use wholesalers but can instead choose to source directly from the manufacturer should they be dissatisfied with the wholesaler's service. These incentives are not going to alter as a result of this merger and wholesaling will therefore not be considered further.

- Conclusion on route to market

14. There is mixed evidence on whether commercial and hospital manufacturing units should be considered under the same frame of reference. With regard to the parties' overlap in non-sterile specials there is evidence that commercial and hospital manufacturing units supply both community and hospital pharmacies. However, some third parties maintain hospital manufacturing units are primarily concerned with self-sufficiency and do not have the capacity to increase supply.
15. Given that, for the reasons explained below, even on the narrowest possible frame of reference (commercial manufacturers considered in isolation excluding hospital manufacturers) the OFT does not believe that it is or may be the case that this merger may be expected to result in a substantial lessening of competition, it is not necessary to conclude on this point.

Type of customer

16. Customers of specials comprise community pharmacies (including dispensing doctors) and hospital pharmacies.

- Community pharmacies

17. Intercare submits that around one-third of community pharmacies are operated by the large pharmacy multiples such as Lloyds, Moss Chemists<sup>2</sup>, National Co-Operative Chemists and Rowlands and a further third are members of buying groups such as the AIM Group, Numark, Avicenna and Nucare. Community pharmacies are reimbursed by the NHS for the invoice price of the special. All respondents indicate this sector is generally not price sensitive and that they choose suppliers on the basis of service provided, e.g. speed of delivery and quality of the product.

- Hospital pharmacies

18. Hospital pharmacists have to manage within their budgets and many source internally from hospital manufacturing units. There is limited information available on the proportion of the specials supplied to hospital pharmacies that is provided by internal manufacture and the proportion by commercial manufacturers. Third parties maintain that hospital pharmacies are more price sensitive than community pharmacies.

- Conclusion on type of customer

19. Given the different incentives for community pharmacies and hospital pharmacies, in this assessment they will be considered separately.

#### **Product scope**

20. As set out above, the OFT does not propose to conclude on the relevant frame of reference. For the purpose of this assessment the OFT will consider separately the supply of non-sterile specials provided by commercial manufacturers to community pharmacies and the manufacture and supply of non-sterile specials to hospital pharmacies.

#### **Geographic scope**

21. The parties submit, and third parties and the available data confirm, that the geographic scope for the manufacture and supply of specials is the UK.

### **HORIZONTAL ISSUES**

#### **Market shares**

22. The narrowest possible relevant frame of reference is the supply of non-sterile specials by commercial manufacturers to i) community pharmacies and ii) hospital pharmacies. The parties were unable to provide segmented share of supply data. Through third party enquiries, competitors have estimated the proportion of sales sold to community and hospital pharmacies.
23. Post-merger, for the supply of commercial manufactured non-sterile specials to community pharmacies the parties combined share of supply is estimated to be

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<sup>2</sup> Moss Chemists is owned by Alliance Unichem who also own Eldon.

[35-40 per cent] (increment [10-15 per cent]). For the supply of commercial manufactured non-sterile specials to hospital pharmacies the parties combined share of supply is estimated to be [25-30 per cent] (increment [less than 1 per cent]).

[Table]

#### Hospital manufacturing units

24. As mentioned above hospital manufacturing units may offer some constraint to the parties. With the inclusion of hospital manufacturing units, shares of supply of non-sterile specials to all pharmacies would be reduced with the parties supplying a combined [15-20 per cent] share. For community pharmacies, the inclusion of hospital manufacturing units is likely to reduce the merged entities' share of supply but the precise proportion is unknown.
25. No accurate estimates are available on the proportion of hospital manufacturing unit sales to community and hospital pharmacies. Third-party evidence indicates that hospital manufacturing units supply the majority of the NHS needs and might supply between 2.5 per cent to 35 per cent of their production to community pharmacies. Given that there is a minimal increment to the share of supply of non-sterile specials to hospital pharmacies and they are primarily supplied in-house 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 in the commercial supply to hospital pharmacies. In addition, following a £42 million investment into hospital manufacturing units, the DoH maintain that hospital manufacturing units should have the capability to produce the full range of specials manufactured in the commercial sector.

#### Competition issues

26. Some third party respondents raised concerns about a reduction in choice and quality and some raised questions as to the extent that competitors compete with the merging parties. However, responses from competitors indicate that they all manufacture non-sterile specials. The parties are not aware of any non-sterile products that only they supply. Third parties may be unaware of particular specials produced because commercial manufacturers are prevented from advertising lists of products they can make available. As noted in the table above, post-merger, five commercial manufacturers remain. In carrying out this assessment the OFT has considered a number of potential competition issues which are addressed below.
27. Prices for specials are essentially uncontrolled and commercial manufacturers are prevented from advertising lists of products. For community pharmacies, the cost of a special does not appear to be relevant as they are fully reimbursed by the NHS. Third parties maintain that as most specials are a one-off purchase, it is unlikely that the pharmacist would know in advance the price for a particular product.
28. The transaction does not appear to change the parties' incentives when setting prices. Community pharmacies currently appear to be insensitive to price and this will not alter post-merger. Furthermore, there are a number of alternative

commercial suppliers present and hospital manufacturing units may act as a constraint on the merged entity's activities.

29. As there appears to be little competition on price, rivalry appears to be limited to service (such as speed of delivery) and the quality of the product. Some customers maintain that if service levels were reduced this would be a concern. However, the OFT does not consider that the merged entity will have any incentive to do so. Given the low levels of capital investment and know-how, it appears to be possible for existing suppliers of non-sterile specials to broaden their product range. If the merged entity increased prices or offered a lower service level, the larger pharmacy chains could supply their own requirements through an in-house manufacturing unit or sponsor capacity expansion.
30. One third party suggested that the acquisition might result in a reduction in capacity. This could be made up over the medium term but competitors might be unable to respond instantly to meet excess demand. However, as noted at paragraph 35, third party evidence suggests that competitors are able to respond to changes in demand, if staff are available, and could expand capacity within months.

#### National contracts

31. Some third parties voiced concerns that only Martindale and Eldon could supply nationally. However, post-merger, there would remain five commercial manufacturers three of which appear to have won national contracts. Other factors indicating that this is not a concern include:
  - national supply arrangements not being exclusive i.e. the branch pharmacists of the community pharmacy chain can place orders with the manufacturer it chooses;
  - all suppliers are able to deliver nationally through the utilisation of national courier services therefore smaller players are not constrained to local supply;
  - capacity can be increased in response to demand. The parties estimate that the break even point for any additional capital investment is reached within a period of one to two years; and
  - there is evidence of multi-sourcing.

#### Bundling

32. One third party raised the issue of potential bundling of licensed and unlicensed pharmaceutical distribution networks. However, it appears that because products are mainly despatched on a one-off basis, there is no advantage in seeking to combine the distribution of Martindale's licensed pharmaceuticals with its specials service. It maintains that its licensed pharmaceutical distribution works on the basis of large, regular scheduled deliveries and fast stock turnover, which would not be practicable to combine with a warehousing and/or distribution function for specials. The transaction is therefore considered not to change the parties' incentive to bundle.

### **Barriers to entry and expansion**

33. To start supplying specials a manufacturer would need a clean room; trained staff; and a licence. The parties estimate that the cost of entry is approximately £250,000. A competitor estimates that de novo entry would cost £1-£1.5 million and would probably take in excess of a year, however, Intercare submits it is possible to start the manufacture of a limited range of non-sterile specials with a capital investment of around £100,000-150,000. Intercare maintains that Medicines and Healthcare products Regulatory Agency (MHRA) regulatory requirements are not difficult to overcome.
34. There is no evidence of recent de novo entry. However, Eldon was built up from a start up by a pharmaceutical wholesaler in 1988 and was acquired by Alliance Unichem in 1995. Furthermore, Mandeville was previously an NHS manufacturing unit and became an independent commercial business in 1994.
35. The parties submit and third parties confirm that in theory commercial and hospital manufacturing units could expand following any changes in demand. Commercial manufacturers maintain they could increase production at a cost, and one competitor estimates it would cost approximately £1 million to increase capacity by 50 per cent. Although, in theory hospital manufacturing units could also expand and the DoH maintains that hospital manufacturing units should have sufficient capacity, some responses maintain the NHS would be unable to meet increased demand and others maintain the incentives are not in place.
36. Although there has not been any new entry, barriers to entry and expansion do not appear to be insurmountable.

### **Buyer power**

37. The parties submitted that community pharmacies are becoming increasingly consolidated. The large pharmacy multiples such as Moss Chemists (owned by Alliance Unichem) and Lloyds Pharmacy (currently a customer of Intercare) each represent between 20 per cent and 30 per cent of the parties total sales. In addition, voluntary buying groups such as Numark and the pharmacy operations of large grocery multiples would exercise considerable buyer power.
38. The majority of pharmacy chains have stated that their ability to exert any buyer power in the specials sector is limited. Similarly hospitals and other customers noted that their positions are weak. Pharmacies are reimbursed by the NHS and although there does not appear to be strong price competition there is some evidence that pharmacies may shop around for discounts.

### **VERTICAL ISSUES**

39. Eldon Laboratories (a subsidiary of Alliance Unichem) is vertically integrated with the retail chain Moss pharmacy. Post-merger the vertical link within Alliance Unichem will be removed and therefore the anticipated transaction is not considered to raise any vertical competition issues.

## **THIRD PARTY VIEWS**

40. Some third parties have raised a number of competition issues which are discussed under horizontal issues. However, a majority of third parties were unconcerned.

## **ASSESSMENT**

41. The relevant economic frame of reference is the manufacture and supply of non-sterile specials manufactured by commercial manufacturers in the UK (possibly including hospital manufacturing units) to community pharmacies and hospital pharmacies in the UK.
42. At a horizontal level, post-merger, for the supply of commercial manufactured non-sterile specials to community pharmacies the parties' combined share of supply is [35-40 per cent] (increment [10-15 per cent]). For the supply of commercial manufactured non-sterile specials to hospital pharmacies the parties' combined share of supply is [25-30 per cent] (increment [less than 1 per cent]). With the inclusion of hospital manufacturing units, the parties' shares of supply would be expected to fall but it has not been possible to split this output between community and hospital pharmacies. However, for the entire pharmacy sector, the inclusion of hospital manufacturing units reduces the parties' share of supply to [15-20 per cent] share of non-sterile specials.
43. Although some third parties have raised potential concerns, post-merger five commercial manufacturers remain and on the basis of the evidence, competitors could increase supply to meet demand. Moreover, the transaction does not appear to change the parties' incentives when setting prices.
44. The NHS may also constrain the merged entity and could increase capacity to meet increased demand.
45. Barriers to entry do not appear to be insurmountable.
46. 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 a market or markets in the UK.

## **DECISION**

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