
Anticipated acquisition by AAH Pharmaceuticals Limited of East Anglian Pharmaceuticals Limited

The OFT's decision on reference under section 33 given on 3 December 2003

PARTIES

1. **AAH Pharmaceuticals Limited (AAH)** is part of the Celesio Group, which is active in pharmaceutical wholesaling and retailing throughout Europe. In the UK, AAH¹ has two business divisions, pharmaceutical wholesaling and retail pharmacy. The pharmaceutical wholesaling division operates through AAH. AAH is a pharmaceutical wholesaler to retail pharmacies, dispensing doctors and hospitals in the UK. It operates its business through a network of distribution depots located throughout the UK. The retail pharmacy division is operated mainly through Lloyds Pharmacy plc² (Lloyds). In the financial year to 31 December 2002, AAH's turnover was £2,762 million. In the same period, Lloyds had turnover of £1,078 million.
2. **East Anglian Pharmaceuticals Limited (EAP)** is owned by Jonathan and Gregory Briggs. The company's principal activity is the wholesale supply of pharmaceuticals to retail pharmacies, dispensing doctors and hospitals through a single distribution depot in Norwich. EAP is not active in retail pharmacy. In the twelve months to 28 February 2003, EAP's total UK turnover was £100.4 million.

TRANSACTION

3. AAH proposes to acquire the issued share capital of Briggs Family Holdings Limited, which is the principal holding company of EAP, for [see note 3]³. The transaction is conditional upon receiving confirmation from the OFT that the proposed merger will not be referred to the Competition Commission.
4. The transaction was notified by AAH on 10 October 2003 and the 40 working day administrative deadline expires on 4 December 2003.

JURISDICTION

¹ Information taken from the parties' written submission. AAH now states that this should be Celesio.

² Information taken from the parties' written submission. AAH now states that this should be Lloyds Pharmacy Limited.

³ Information excised at parties' request.

5. As a result of this transaction AAH and EAP will cease to be distinct. The UK turnover of EAP exceeds £70 million and so the turnover test in section 23(1)(b) of the Enterprise Act 2002 (the Act) is satisfied. The OFT believes, therefore, that it is or may be the case that a relevant merger situation has been created for the purposes of section 33(1)(a) of the Act.

RELEVANT MARKET

Product market

6. The parties overlap in the wholesale supply of pharmaceutical products (Pharmaceuticals). Pharmaceuticals is a broad term used to refer to ethical pharmaceuticals (Ethicals); over the counter (OTC) medicines; and other OTC products. Ethicals are prescription-only medicines (POMs) and pharmaceutical products that are prescribed to patients under prescription by a doctor or dentist and which can only be dispensed by a dispensing doctor, retail pharmacy or hospital. OTC medicines refer to pharmacy-only medicines (P medicines), which can only be dispensed under the supervision of a qualified pharmacist, and also to general sales list medicines (GSL medicines), which do not have to be dispensed by a pharmacist and are available in any retail outlet. Other OTC products include general hygiene and household products that are also readily available in retail outlets.
7. Within the supply chain, the immediate customers of Pharmaceuticals suppliers such as the parties are dispensing doctors, retail pharmacies, and hospitals. Retail pharmacies can be further categorised into single independent retail pharmacies, and national or regional chains consisting of five or more independent or vertically integrated retail pharmacies⁴. The parties estimate that, nationally, retail pharmacies account for 74 per cent of Pharmaceuticals sales with hospitals representing 21 per cent of sales and dispensing doctors accounting for 5 per cent of sales.
8. Customers can obtain their Pharmaceuticals from a range of suppliers. Vertically integrated retail pharmacies are an exception to this as they are self-supplied⁵. Independent customers, however, can source from a variety of suppliers. They include independent or vertically integrated full-line wholesalers⁶ (Full-liners), so called because they stock the complete range of Pharmaceuticals; short-line

⁴ Vertically integrated retail pharmacies are retail pharmacies which belong to the same group of companies as their Pharmaceuticals supplier so that they effectively self supply. Examples of vertically integrated retail pharmacies are Lloyds pharmacies which are self supplied by AAH; Moss pharmacies which are self-supplied by Alliance Unichem; and Rowland Pharmacies which are self supplied by Phoenix.

⁵ See note 4 above.

⁶ Vertically integrated full-line wholesalers such as AAH, Alliance Unichem and Phoenix each supply to independent retail pharmacies as well as supplying their own chains of retail pharmacies. The exception to this is Boots which supplies only its own retail chain of pharmacies. EAP is an example of an independent Full-liner, as it is not active in the retail sector.

wholesalers (Short-liners), who supply a more limited range of products; and some Pharmaceuticals manufacturers that supply directly to customers.

9. The parties contend, and our enquiries confirm, that most customers tend to source their Pharmaceuticals from a combination of these different types of suppliers, in order to meet their product requirements⁷. This is largely because the range of available products, prices, levels of service, and frequency of deliveries tend to vary between the different supplier types. On the whole, the OFT's investigation suggests that dispensing doctors and retail pharmacies source predominantly from Full-liners and Short-liners; whereas hospitals tend to source mostly from Full-liners and direct from manufacturers. This is considered in greater detail below.
10. For purposes of the competition assessment, we begin by focussing on the supply of Pharmaceuticals to retail pharmacies, dispensing doctors and hospitals in order to identify the most immediate competitive constraints likely to operate on the parties' behaviour post merger.

Geographic market

11. EAP has only one distribution depot which is based in Norwich, in the East Anglia region. AAH has 19 depots nationwide of which the nearest depots to EAP are situated in Romford, Essex, and Weedon, Northamptonshire.
12. The parties consider that the relevant geographic frame of reference for the wholesale supply of Pharmaceuticals is national. Our enquiries confirm that some customers, such as national pharmacy chains, only source from national wholesalers as this is the most cost effective way of supplying their network. Similarly, hospitals seek their supplies through a tendering process that might be regional or sub-regional in effect. In contrast, most independent retail pharmacies and dispensing doctors appear to favour wholesale suppliers that are reasonably close, particularly given the need for most retail pharmacies to be able to receive twice daily deliveries.
13. As noted above most customers obtain their Pharmaceuticals from a combination of different suppliers. The distance over which suppliers can deliver these products varies, in part, according to their method of delivery. For example, Full-liners have indicated that they tend to be able to supply dispensing doctors and non-vertically integrated retail pharmacies up to two hours' drive away from their depots⁸. For supply to hospitals, the volumes will be larger and so the drive time appears to be longer. Information provided by the parties indicates that they both supply to hospitals based as far away as London. The delivery distance that the drive time covers depends largely on the features of the particular road network

⁷ As noted above, vertically integrated retail pharmacies are self-supplied. In addition, national pharmacy chains, such as supermarkets with in-store pharmacies, tend to source only from Full-liners with 'national' coverage.

⁸ Delivery distances are not the same for all Full-liners. For example, Phoenix suggests that most deliveries are within [Information excised at OFT's discretion] ; AAH considers [see note 3] to be an average drive time. Unichem considers its deliveries will be [see note 17] and EAP's average drive time is [information excised at OFT's discretion].

and the volume of traffic. Some Full-liners appear to be able to travel much longer distances than others within the same drive time, even though they are based in the same region. In contrast, the expectation of Short-liners is that they will courier products to their customers on a next day basis and they, therefore, appear to be able to deliver over a greater distance.

14. In this case, it would appear that the parties' common activities primarily take place in the East Anglia region extending to parts of the East Midlands and South East England. Therefore, in order to best assess the potential competitive impact of this merger, we concentrate on the supply of Pharmaceuticals in the East Anglia region extending to parts of the East Midlands and South East England (the Relevant Area).

HORIZONTAL ISSUES

15. As mentioned above, Pharmaceuticals include Ethicals; OTC medicines and other OTC products. Our assessment shows that the merger does not lead the OFT to believe that there is a significant prospect that the merger may be expected to result in a substantial lessening of competition in the wholesale supply of OTC medicines and other OTC products, given the wide range of suppliers of such products. Therefore, these products are not discussed further.
16. Ethicals can be branded products, which are subject to patent protection, or generic products. The supply of branded Ethicals is subject to price regulation under the Pharmaceutical Price Regulation Scheme (PPRS). Under this scheme, the Department of Health (DoH) sets the 'list price' at which manufacturers supply these products to wholesalers. Wholesalers can offer their customers a discount, equivalent to a maximum of 12.5 per cent off the list price. The DoH then claws back most of the discount from the pharmacists (the current overall average claw back rate is 10.75 per cent). As a result of the scheme, wholesale customers are incentivised to achieve the highest level of discount available in order to maximise their profits. The prices of generic products are not subject to government regulation, and as such price competition in the supply of these products appears to be more vigorous.
17. The parties initially provided share data delineated between supply to dispensing doctors and retail pharmacies on the one hand and to hospitals on the other. The parties argue that customer demand features dictate that their trading relationship with dispensing doctors and retail pharmacies is similar but differs from their relationship with hospitals. One third party commented that supply to dispensing doctors should be further segmented from supply to retail pharmacies owing to the high degree of inertia in the dispensing doctors segment and differences in their purchasing patterns (requiring smaller quantities) and product requirements (focus on branded Ethicals). Our own investigation confirmed that hospitals have different product needs and purchasing and delivery patterns compared with retail pharmacies and doctors. However, there was insufficient evidence to suggest that supply to dispensing doctors exhibits sufficiently different characteristics from supply to retail pharmacies. Overall, therefore, it seems appropriate to

consider the competitive impact of the merger on dispensing doctors and retail pharmacies separately from its impact on hospitals.

Retail Pharmacies and Dispensing Doctors

18. The share data shows that in East Anglia⁹, taking into account all supply routes to market, the parties together would supply 25-35 per cent [see note 10¹⁰] of Ethicals to independent retail pharmacies and dispensing doctors. The merger would make them the largest supplier in this area.
19. The parties, however, argue that the data is likely to be misleading in that it fails to reflect the actual patterns of competition in the Relevant Area and East Anglia. In particular, the parties contend that there is limited overlap in terms of their existing and potential retail pharmacy and dispensing doctor customers. Their customer base differs in that AAH primarily supplies to national pharmacy chains; whereas EAP is a regional supplier and therefore cannot compete for national customers. In addition, their physical delivery capabilities and geographic ranges of delivery also differ; AAH asserts that it is currently unable to supply, or can only offer a limited service, to those customers serviced by EAP in East Anglia.
20. Contrary to the parties' assertions, information provided by them on the geographic location of their customers and our own third party enquiries indicate that a degree of actual or potential overlap may exist between the parties in the supply of Ethicals to retail pharmacies and dispensing doctors in the Ipswich and Colchester areas. AAH argues that it is unable to provide a reliable and effective service into large parts of East Anglia from its Romford and Weedon depots, largely because of the poor road network. However, from its Norwich depot, EAP does appear to be able to provide a very effective service into Essex and parts of the South East of England (particularly London), closer to AAH's Romford depot and in the heart of the region serviced by AAH. This would also suggest that the actual and potential competition between the parties may be greater than the parties themselves suggest. On this basis, our investigation shows that there does appear to be some existing or potential overlap between the parties in terms of the geographic area that they do, and can potentially, serve. The full extent of the overlap, however, remains unclear.
21. Having identified a potential loss of competition for some retail pharmacies and dispensing doctors in certain parts of the Relevant Area, our investigation subsequently focussed on identifying the likely source of actual and potential constraint on the merged business and how effective such constraints are likely to be.
22. As mentioned above, our investigation suggests that dispensing doctors and retail pharmacies source predominantly from Full-liners and Short-liners. The parties strongly argue that Short-liners are direct and effective competitors to Full-liners. Their data suggests that Short-liners supply 10 per cent of Ethicals to dispensing

⁹ The parties' definition of East Anglia for these purposes includes Cambridge, Colchester, Chelmsford, Ipswich, Peterborough and Norwich.

¹⁰ Exact figure replaced by a range at the parties' request.

doctors and retail pharmacies in East Anglia, compared with around 67 per cent supplied by Full-liners.

23. Our enquiries, however, show that compared with Full-liners, Short-liners specialise in the supply of a smaller range of products delivered on a less frequent basis. Full-liners are able to provide a comprehensive range of Pharmaceuticals (around 25,000 product lines) at short notice and deliver to their customers by van twice daily. In contrast, Short-liners concentrate on a limited product range (around 3,000 products), which can vary, but which consist mainly of so called fast-moving, high margin and high volume lines¹¹. They tend to supply parallel imports¹² and generic products. In terms of delivery, at best Short-liners can only offer next day deliveries using third party courier services. All of the customers contacted confirm that they source at least some of their product requirements from Full-liners, indicating that none of them rely wholly on Short-liners to meet their demands. The evidence suggests that Short-liners are able to compete with Full-liners in the supply of some product categories, most notably generics and some fast moving branded Ethicals. This competition may represent a potential constraint on Full-liners in that customers can to a limited degree make use of Short-liners if dissatisfied with the price or service of their Full-line suppliers. Nonetheless, it appears that there remains a significant core of Ethicals in which Full-liners face no competition from Short-liners and, thus, in order to have access to these products retail pharmacies and dispensing doctors need to have a supply arrangement with one (or more) Full-liners.
24. Given the above, we assessed the likelihood of other Full-liners operating as a constraint on the parties post merger. According to the parties' data on the supply of Ethicals by Full-liners to dispensing doctors and independent retail pharmacies¹³, post merger, they would have a combined share of 50-60 per cent [see note 10]. The merger would make them the largest Full-liner in the region, followed by Alliance Unichem (based in Letchworth) with 25-35 per cent [see note 14¹⁴] and Phoenix (based in Cambridge) with 10-20 per cent [see note 15¹⁵]. The number of suppliers would reduce from four to three and would result in the loss of the major non-vertically integrated wholesaler.
25. Again, however, the parties' estimated share data alone might not be the best guide to the strength of the remaining Full-liners as a constraint on the merged business. As noted above, Full-liners deliver supplies to their customers twice daily by van. Almost all customers cite reliable delivery and service as the most important factor in choosing their Full-liner. Some customers use one full-line supplier as their first choice and have a second Full-liner as back up. Others, however, rely simply on one Full-liner to meet their needs. The ability of Full-

¹¹ The parties estimate that the top 3,000 product-lines supplied by wholesalers represent up to 80 per cent of total sales made by pharmacy customers.

¹² Parallel imports refer to branded Pharmaceuticals imported into the UK and resold by companies other than their manufacturers.

¹³ For these purposes, independent retail pharmacies do not include national chains of pharmacies as EAP does not have the necessary national coverage to compete for their business.

¹⁴ Exact figure replaced by a range at third party request.

¹⁵ Exact figure replaced by a range.

liners to meet the delivery and service standards expected by their customers appears to vary according to the location of their depot and the features of the road network surrounding it, as well as the efficiency of their delivery operations. Competitors unanimously state that their service levels deteriorate the longer they travel from their depot and it is clear that the degree of effectiveness of the remaining competitors as alternative suppliers to the parties varies throughout East Anglia. The parties were invited to provide full-line supplier details for a sample of independent retail pharmacies in East Anglia to better assess the true pattern of competition, the extent of the overlap, and the presence of other major players in the region. However, they were unable to provide the information.

Hospitals

26. The parties' share data shows that in East Anglia¹⁶, taking into account all supply routes to market, the parties together would supply 15-25 per cent [see note 10] of Ethicals to hospitals (Alliance Unichem would have 5-15 per cent [see note 14] and Mawdsley Brooks less than 10 per cent [see note 15]). Direct supply by manufacturers accounts for 56 per cent of supply. The parties contend that direct supply is a constant competitive threat to Full-liners, not least because the PPRS (see paragraph 16 above) incentivises manufacturers to abandon wholesale distribution arrangements in favour of direct supply.
27. However, our discussions with third parties suggest that, as appears to be the case with Short-liners, manufacturers tend to focus on supplying only fast moving high volume Ethicals and operate a lower standard of delivery than that offered by Full-liners. Given these differences, it would seem that direct manufacturer supply might pose some constraint on Full-liners; however, this covers a limited range of products. Overall, the evidence would suggest that the most likely source of constraint on the combined business would appear to come from other Full-liners.
28. Given the above, we assessed the likelihood of other Full-liners operating as a constraint on the parties post merger. Data obtained by the OFT suggests that post merger, the parties would supply over half of the full-line supply of Ethicals to hospitals in the Relevant Area, making them by far the largest full-line supplier in this area. The parties provided a list of hospital contracts won by full-line wholesalers in East Anglia and the South East to show that, post merger, there will still be three other Full-liners active in the region.
29. The OFT contacted all three firms. Phoenix (based in Cambridge) said that they do not presently supply Ethicals to hospitals and do not consider themselves to be a potential supplier to this sector. Mawdsley Brooks (based in Milton Keynes) stated that [see note 17¹⁷]. Overall, therefore, the evidence collected by the OFT suggests that in parts of the Relevant Area, the merger may be expected to result in a reduction in the number of full-line suppliers to hospitals from four to three or three to two.

Barriers to entry and expansion

¹⁶ See note 9 above.

¹⁷ Information excised at third party's request

30. In terms of new entry, third parties suggest that the costs of setting up a depot with the comprehensive range of products necessary to provide a credible full-line service to all customers are high. The parties state that margins in this sector are low at less than 2 per cent. Thus, third parties assert that it is difficult to achieve the critical mass of customers required to sustain the costs incurred in building a depot; holding large quantities of stock; establishing an efficient distribution system; and providing a reliable delivery service twice daily. The most recent new entrant is Phoenix. However, their entry has come through the acquisition of existing regional wholesalers. From the evidence obtained by the OFT, it appears unlikely that new entry within the Relevant Area will occur within less than two years¹⁸.

Buyer power

31. National pharmacy chains have stated that their ability to exert any buyer power on Full-liners is limited by an inability to switch since realistically there are only two potential national suppliers (AAH and Alliance Unichem). However, since EAP is not a supplier to 'national' accounts, the merger itself does not reduce competition for such business – indeed the merger may improve AAH's ability to serve national accounts represented in certain parts of East Anglia. Other customers note that their ability to switch is weak given the limited choice of full-line suppliers able to service certain parts of East Anglia.

THIRD PARTY VIEWS

32. The OFT sought the views of a broad spectrum of customers and competitors as part of its investigation. Views were mixed. However, a large number of customers voiced concerns that AAH would not, post merger, maintain the high level of service provided by EAP. Hospitals, in particular, were concerned about the reduction of choice arising from the merger and the potential adverse effects upon service levels.

ASSESSMENT

33. The merged entity will be the largest Full-line supplier of Ethicals to dispensing doctors, retail pharmacies and hospitals in East Anglia extending to parts of the East Midlands and the South East of England (the Relevant Area). However, share data is not considered, of itself, to be an accurate indicator to actual or potential competition in this case.
34. In the supply of Ethicals to dispensing doctors and retail pharmacies, it might be the case that in limited circumstances, Short-liners will be able to provide some constraint on the parties. The evidence suggests, however, that the most likely source of competition to the parties is expected to come from other Full-liners.

¹⁸ The OFT's substantive assessment guidance states that in order that new entry may be considered a sufficient competitive constraint, it must be sufficiently timely. Entry within less than two years will generally be timely, but this must be assessed on a case by case basis.

These may, however, be limited in their ability to provide effective competition given the location of their depots and the ability to serve customers located some distance from those depots. Third party comments tended to suggest this was a limiting factor in certain parts of East Anglia. Further detailed investigation is required to determine how effective such competition is likely to be in constraining the behaviour of the merged business.

35. In the supply of Ethicals to hospitals, direct supply by manufacturers may operate as a constraint on the parties in respect of a limited product range. The evidence, however, indicates that the most likely source of constraint may be expected to come from other Full-liners. It appears that the merger may create a duopoly among Full-liners in some parts of the Relevant Area and lead to a reduction in potential suppliers from four to three in other parts. Hospitals expressed particular concerns about this reduction in choice and potential adverse impact upon service levels.
36. In these circumstances, the OFT believes that it is or may be the case that the creation of the relevant merger situation may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom for goods or services, namely the supply of Pharmaceuticals to retail pharmacies, dispensing doctors and hospitals in the East Anglia region, extending to parts of the East Midlands and the South East of England. The likely adverse effects might be expected to be: a reduction in the level of discounts paid to customers; and/or other less favourable terms of supply; and/or a general reduction in service levels.

UNDERTAKINGS IN LIEU OF REFERENCE

37. The OFT therefore considers that it is under a duty to make a reference under section 33(1) of the Act. Pursuant to section 73(2) of the Act, the OFT may, instead of making such a reference, accept undertakings for the purposes of remedying, mitigating or preventing the substantial lessening of competition concerned or any adverse effect which may be expected to result from it. Having reached a reference conclusion, the OFT has considered whether there might be undertakings in lieu of reference which would address the concerns outlined above. Given that this transaction concerns the acquisition of a single depot, the OFT does not believe that divestment undertakings would be appropriate. The concerns identified above relate largely to service levels and it is not considered that behavioural undertakings would adequately remedy such concerns.

DECISION

38. This merger will therefore be referred to the Competition Commission under section 33(1) of the Act.