

# Anticipated acquisition by Celesio AG of Sainsbury's Pharmacy Business

## Summary of provisional findings

**Notified: 29 April 2016**

1. On 29 December 2015, the Competition and Markets Authority (CMA) referred the anticipated acquisition by Celesio AG (Celesio) of Sainsbury's Supermarkets Limited UK Pharmacy Business (collectively 'the Parties') for an in-depth phase 2 investigation. In exercise of its duty under section 33(1) of the Enterprise Act 2002 (the Act), the CMA made a reference to its Chair for the constitution of a group<sup>1</sup> in order to investigate and report on, within a period ending on 13 June 2016, the following questions in accordance with section 36(1) of the Act:
  - (a) whether arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a relevant merger situation; and
  - (b) if so, whether the creation of that situation may be expected to result in a substantial lessening of competition (SLC) within any market or markets in the UK for goods or services.

### The Parties

2. Lloyds Pharmacy Limited (Lloyds) owns and operates the pharmacy chain branded LloydsPharmacy across the UK. It is a wholly owned subsidiary of Celesio, which is in turn ultimately controlled by the McKesson Corporation (McKesson).
3. Celesio acquired Lloyds in 1997. Lloyds has around 1,540 pharmacies in the UK, and operates 25 contracts for outpatient dispensary (OPD) pharmacies with 24 NHS trusts and a number of contracts with prisons, mental health trusts, private hospitals and community hospitals. Celesio also owns AAH Pharmaceuticals Limited (AAH), which it acquired in 1995. AAH is a

---

<sup>1</sup> Section 33(1) of the Act provides that the group is to be constituted under Schedule 4 to the Enterprise and Regulatory Reform Act 2013.

wholesale supplier to pharmacies (including Lloyds), hospitals, GP practices and other healthcare establishments across the UK.

4. Sainsbury's pharmacy business is owned and operated by Sainsbury's Supermarkets Ltd (Sainsbury's), a wholly owned subsidiary of J Sainsbury plc. Sainsbury's operates 277 pharmacies and three OPD hospital trust contracts in four hospitals. Sainsbury's pharmacy is the second largest supermarket pharmacy chain, after Tesco. 46% of Sainsbury's supermarkets have a pharmacy.

## **Industry background**

5. Pharmacies dispense or sell medicines and non-pharmaceutical products (such as toiletries, beauty products and other consumer goods). Medicines are categorised into three groups by the Medicines and Healthcare products Regulatory Agency (MHRA):
  - (a) Prescription-only medicines (POMs or ethical): pharmaceutical drugs that require a prescription from a GP or other prescribing healthcare professional.
  - (b) Pharmacy-only medicines (or P-medicines): pharmaceutical drugs that do not require a prescription but can only be sold under pharmacist supervision.
  - (c) General sales list (GSL) medicines: medicines that can be bought from pharmacies, supermarkets and other retail outlets without a prescription or the supervision of a pharmacist.
6. Community pharmacies<sup>2</sup> provide a range of services which can be broadly categorised as essential services, commissioned services and private services. All pharmacies must provide essential services. These vary slightly between the UK nations but include the core services of dispensing medicines and appliances. Pharmacies can choose whether to provide commissioned services if they meet the specified requirements. The range of commissioned services provided and how they are commissioned varies according to the UK nation in which the services are offered. Private services, such as travel vaccinations, are outside the NHS.
7. The UK pharmacy market was estimated to be worth around £14.5 billion in 2014. Growth in 2014 was estimated to be 2.1%. NHS receipts account for

---

<sup>2</sup> We have used the term 'community pharmacy' to mean all pharmacies that provide services for the NHS, excluding outpatient and inpatient dispensaries (which are situated in hospitals). Unless we are explicitly referring to outpatient dispensary all references to pharmacies are to community pharmacies.

the majority of the market, and have been estimated at £10 billion. At present there are some 14,250 pharmacies in the UK.

8. There are a number of large pharmacy groups which together with Lloyds have around a 44% retail pharmacy market share. These are: Boots, Well (formerly Co-operative Pharmacy), Rowlands and Superdrug. Boots (a subsidiary of Alliance Boots, acquired by US drugstore operator Walgreens in 2014) is the largest single chain, with the highest market share. The four largest supermarket chains in the UK – Asda, Morrisons, Sainsbury's and Tesco – together have around 12% market share. Independent pharmacies, which range from substantial regional operators with many pharmacies to single pharmacies, account for the remaining 44% market share.
9. To operate a pharmacy in the UK a licence<sup>3</sup> is required and the granting of these licences is subject to strict criteria. In April 2005, the government relaxed some of the entry restrictions in England. Applications for new pharmacy contracts were then considered against a criterion of whether consumers had 'reasonable choice' in an area. There were four circumstances where applicants were exempt from the control of entry test. The exemption that accounted for the most new entries was the condition that the pharmacy store would be open for at least 100 hours a week. The number of pharmacies in England subsequently increased by 19.6% between 2004 and 2014, from 9,736 to 11,647.<sup>4</sup> In 2012 these exemptions were abolished.
10. We note that in England a consultation exercise is underway on changes to the community pharmacy contractual framework for 2016/17 and beyond. However, we did not consider that the exercise was relevant to our inquiry.

### ***Hospital pharmacy services – outpatient dispensary***

11. NHS commissioning bodies have in recent years begun to outsource OPD pharmacies. The move to outsourcing has arisen as NHS trusts look at potential ways to increase efficiency.<sup>5</sup> Generally it has been larger NHS trusts to date that have decided to outsource OPD services. The main OPD operators are Boots and Celesio. Celesio has 25 NHS Trust OPD contracts with 24 NHS trusts. Boots has 20 different NHS trust OPD contracts, some of which operate at more than one site within the trust.

---

<sup>3</sup> We use the term licence to mean when a pharmacy is listed on the relevant Nation's Pharmaceutical List and is able to provide services under that nation's pharmaceutical contract, for example in England the Community Pharmacy Contractual Framework.

<sup>4</sup> General Pharmaceutical Services in England 2004-05 to 2013-14, Appendix 1.

<sup>5</sup> There are also VAT benefits.

12. A number of other companies, including Sainsbury's, operate a smaller number of contracts and a number of NHS trusts have set up wholly owned subsidiaries to provide OPD services within their trusts.

### ***Pharmaceutical wholesaling***

13. In the UK most pharmaceuticals are distributed through wholesalers to pharmacies. There are around 44 pharmaceutical wholesalers in the UK. The largest are Alliance Healthcare (Distribution) Limited (Alliance Healthcare) (part of Walgreens Boots Alliance), AAH (Celesio) and Phoenix (Rowlands), which in total account for around 79% of the prescription-only market by value. In pharmacy-only medicines these three wholesalers account for around 75% of the market by value.
14. In 2007 Pfizer started supplying its products through a single wholesaler (Unichem – part of Alliance Boots) to pharmacies. This is known as direct-to-pharmacy (DTP). The role of a wholesaler in this model is purely as a logistics service provider (LSP), where it is simply paid a fee to deliver the medicines and the wholesaler is acting as an agent of the manufacturer. Several other manufacturers have also introduced DTP distribution.

### ***Regulation***

15. There is a range of regulations which apply to pharmacies which restrict their freedom to change elements of their offering, in a way not commonly seen in other retail markets. In particular, there is limited price competition between pharmacies because prescription-only medicines, which make up the bulk of their business, are either free at the point of delivery or are charged at the fixed NHS prescription levy. There are also regulatory constraints on certain quality parameters. For example, a pharmacy must open for a core number of hours (either 40 hours or 100 hours depending on the pharmacy's licence), must employ a qualified pharmacist and must be licensed to operate in a given location.

### **The Transaction and relevant merger situation**

16. Following a review of Sainsbury's pharmacy business in 2014, informal discussions were held with Celesio (Lloyds) and other pharmacy operators to assess their interest in acquiring the Sainsbury's pharmacy business. A formal sales process commenced in April 2015. Celesio was selected as the preferred bidder and the business sales agreement (BSA) was signed at the end of July 2015. Alongside the BSA, a Cooperation Agreement was also signed. This was necessary to cover the ongoing relationship between the Parties, as the Lloyds pharmacies would operate within the Sainsbury's

supermarkets. The purchase price was £[X]. [X] would also be paid by Celesio to Sainsbury's. We refer to the combined effect of these agreements as the Transaction in this provisional report.

17. We provisionally concluded that, by virtue of the Transaction, arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation. Consequently, we provisionally concluded that the jurisdictional test is satisfied in this case.

### **Market definition**

18. We assessed the relevant market definition for the inquiry. We first considered the product market and provisionally concluded that it is appropriate to aggregate the markets for prescription-only medicines, pharmacy-only medicines and pharmacy services and to assess retail competition at the level of the pharmacy.
19. Pharmacies do not appear to adopt a conscious policy of targeting specific types of customers in a way that directly affects their ability to compete for other customers. We provisionally concluded that the differences between various groups of individual customers and the ways they are targeted by pharmacies did not require the definition of separate customer markets.
20. We then considered the appropriate scope of the geographic market. We looked at the distance between a pharmacy and its customers' homes when defining the relevant geographic market. We estimated the radius of the circle that would include 80% of the pharmacy's prescription customers and calculated the radius separately for Celesio and for Sainsbury's pharmacies.
21. Table 1 summarises the average radius of the catchment areas for the various area types. We have therefore identified the average customer catchment of any of the Parties' pharmacies as being the circle centred on the pharmacy with radius as shown in Table 1. Depending on the type of analysis, the relevant competitors were defined either as those rival pharmacies located within the catchment area around the pharmacy being considered, or the rival pharmacies whose catchment areas intersect that of the pharmacy being considered.

**Table 1: Average radius of catchment areas**

| Area type     | miles   |             |
|---------------|---------|-------------|
|               | Celesio | Sainsbury's |
| Conurbation   | 1.4     | 2.4         |
| City and town | 1.4     | 3.8         |
| Rural         | 2.2     | 4.7         |
| Very rural    | 3.6     | 4.7         |

Source: CMA analysis.

\* The four types of area were defined by aggregating in four groups the ten rural/urban categories defined by the Office for National Statistics (ONS).

## Counterfactual

22. We assessed what would have happened in the absence of the merger (the counterfactual). We provisionally concluded that the counterfactual was the continuation of the pre-merger situation in retail pharmacy and OPD.

## Competitive effects

23. We assessed the competitive effects of the acquisition and considered whether the merger may be expected to result in an SLC within any market or markets in the UK for goods or services.<sup>6</sup> The Parties' combined national market share in community pharmacy, and the small increment to Lloyd's market share as a result of the merger, led us to conclude that national effects on retail competition were unlikely. We therefore focused on local competitive effects. For vertical aspects of competition and OPD we considered national effects.

## Pre-merger competition

24. We first considered the way that pharmacies compete presently (ie pre-merger).
25. There is a range of regulations which apply to pharmacies which restrict their freedom to change elements of their offering, in a way not commonly seen in other retail markets. In particular, there is limited price competition between pharmacies because prescription-only medicines, which make up the bulk of their business, are either free at the point of delivery or are charged at the fixed NHS prescription levy. Several quality parameters are subject to minimum levels below which quality cannot be reduced, and there are well-defined assurance procedures to ensure that pharmacies adhere to

---

<sup>6</sup> Section 36 of the Act.

regulations. However, some of these parameters are frequently set by operators above the minimum level set by regulation.

26. While the scope for competition is reduced compared with many other retail operations, in our assessment there remains the ability and incentive to flex a number of aspects of quality, range and service in response to competitive conditions at the local level. Regulations place a minimum on some quality parameters but pharmacies are free to offer higher levels of service. Furthermore, since revenue is largely dependent on the number of prescriptions dispensed, this gives pharmacies the incentive to try to attract additional customers.
27. We conducted a consumer survey which showed that, while customers are likely to regard convenience of location as the most important driver of pharmacy choice, there are other drivers of choice which consumers also value, including quality and speed of service, opening hours, stocking levels and waiting times. Customers are likely to take account of these elements when choosing between pharmacies. This gives pharmacies the incentive to compete on these parameters in order to attract customers.
28. We considered the extent of competition between Lloyds and supermarkets (and between Lloyds and Sainsbury's specifically). Evidence from our consumer survey suggested that there were some differences in the characteristics of Sainsbury's and Lloyds pharmacy customers, with supermarket customers having slightly different characteristics and motivations for visiting the pharmacy to Lloyds' customers. Nevertheless, internal documents from the Parties and third party views showed that high street and supermarket pharmacies can and do compete, although the level of competition may be less strong than between high street pharmacies.
29. The survey also found that the diversion ratios between the Parties were very high in some of the surveyed areas. This indicated clearly that customers would be willing to switch from a Lloyds pharmacy to a Sainsbury's pharmacy and vice versa in some local areas to fulfil a prescription, depending on the local convenience of doing so. This showed that the Parties could be close competitors in specific local markets where the number of competitors was low (concentrated local markets).
30. Since regulations place minimum quality levels on some dimensions of competition, competition on some parameters besides price is likely to be more muted than would otherwise be the case. However, such competition may still be sufficiently significant that its loss would be a matter of concern to us. Overall we concluded that there was sufficient evidence of competition between pharmacies generally and that the Parties could exert a sufficient

competitive constraint on one another in specific local markets that it was necessary to assess the effect of the merger on competition.

### ***Effect of the merger on competition***

31. We then assessed the likely effect of the proposed merger against the situation in the counterfactual. Our assessment indicated that there would be an incentive for Lloyds to deteriorate aspects of its offer in certain local areas. We found that this would be most likely in the Lloyds pharmacies rather than the Sainsbury's stores given the Cooperation Agreement, which constrains Lloyds' ability to change quality, range and service in the Sainsbury's pharmacies after the merger.
32. We sought to identify the local areas where the merger would cause an SLC as a result of the reduction in the number of pharmacy operators in the area. Out of the 1,816 Sainsbury's and Lloyds total pharmacies, the catchment areas of 929 overlap (ie the Sainsbury's and Lloyds pharmacy catchment areas overlap). We used the areas we surveyed as case studies to illustrate the features causing customers to divert between the Parties in particular locations. We then applied these features to other areas using available data, and used this assessment to identify areas of possible concern.
33. Our overall approach was to look first for mechanistic rules which could filter out unproblematic areas, and then to carry out more detailed local area assessments in the remaining local areas. We adopted a conservative approach to the selection of the mechanistic rules so that we were confident we would identify all the potentially problematic areas. We focused mainly on the Lloyds pharmacies because of the Cooperation Agreement. Using the mechanistic rules, we filtered the 929 overlaps into 154 stores of potential concern. We also included Cardiff, even though this did not fail the filter. We chose to include Cardiff as the area was characterised by high diversion between the Parties and the consumer survey revealed that the nearest competitor to the Sainsbury's store received little diversion.
34. The initial filter was used to identify areas for further analysis. We then examined the survey case study areas in more detail to identify local market features that were associated with high diversion ratios and used these features to assess the characteristics of the areas around the 154 stores that failed our filters. We filtered out areas which we concluded were unproblematic on the basis of these features. In identifying these features, we took account of the following characteristics:

- (a) The Parties were materially closer to each other than to other competitors (note that this applied even if a competitor(s) was within the radius of a catchment area but significantly further away).
  - (b) The Parties were geographically close to one another and a competitor would not be passed before reaching the other party.
  - (c) The Parties were not particularly close but there was a direct road route between the Parties' stores and another competitor would not be passed before reaching the other party.
  - (d) Within the catchment area a substantial proportion of customers would only be able to choose between the Parties, or the Parties and one other pharmacy.
- 35. Applying these characteristics to other non-surveyed local areas, we identified 32 areas, containing 78 stores, as potentially problematic.
- 36. Finally, we examined maps of these 32 areas, considering characteristics of the local areas in more detail including in relation to the location of customers and GP practices, specific features associated with the location of the pharmacies, journey routes and other relevant factors together with demand estimates where available. This enabled us to assess how closely the Parties compete in those specific areas and the likely extent of competitive constraints provided by third parties. As a result of this analysis we identified 13 areas where we considered the Parties to be sufficiently close competitors such that we provisionally found that the merger may be expected to result in an SLC in those areas and that this may be expected to lead to adverse effects for customers in terms of a reduction in the quality of service provided in those areas.
- 37. These areas are:
  - (a) Beaconsfield
  - (b) Bracknell
  - (c) Cardiff
  - (d) Christchurch
  - (e) Kempston
  - (f) Kidlington
  - (g) Leeds

- (h) Liverpool
- (i) Luton
- (j) Reading (Calcot)/Theale
- (k) Sandy/Potton/Biggleswade area
- (l) Sutton Coldfield
- (m) Warlingham

### ***Competitive effects of the merger on outpatient dispensary***

38. We examined the effects of the merger on OPD. In view of the limited competitive constraint exerted by Sainsbury's on Celesio and the presence of alternative bidders, we provisionally concluded that the merger may not be expected to result in an SLC in the provision of outsourced OPD services to NHS trusts.

### ***Vertical effects of the merger***

39. We examined the vertical effects of the merger. We did not consider that the merger has substantially increased Celesio's ability and incentive to foreclose rival retailers or rival pharmaceutical wholesalers and provisionally concluded that the merger may not be expected to result in an SLC as a result of foreclosure.

### ***Other competitive constraints which might offset the effect of the merger***

40. We assessed whether entry by new companies or expansion by existing ones might mitigate the effect of the merger on competition. We noted that regulation controlling entry to pharmaceutical lists acted as a high barrier to entry, although the extent of the barrier depends on local conditions. We have not been provided with any evidence that entry may mitigate the effects of the merger in any of the local areas listed above and provisionally concluded that entry is unlikely to mitigate the SLC in any of these local areas.
41. We did not find any other competitive constraints that might offset the effects of the merger.