

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

Provisional findings report

Notified: 29 April 2016

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The Competition and Markets Authority has excluded from this published version of the provisional findings report information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [✂]. Some numbers have been replaced by a range. These are shown in square brackets.

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## Glossary

## Summary

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 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.

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<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.

## 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 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,

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<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.

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.
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.

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<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.

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 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

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

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) Waringham

***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.

## Provisional findings

### 1. The reference

1.1 On 29 December 2015, the 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 Act, the CMA made a reference to its Chair for the constitution of a group<sup>7</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 an SLC within any market or markets in the UK for goods or services.

1.2 Our terms of reference, along with information on the conduct of the inquiry, are set out in Appendix A.

1.3 This document, together with its appendices, constitutes our provisional findings. Further information, including non-commercially-sensitive versions of the Parties' initial submission and summaries of evidence from third parties, can be found on our website.<sup>8</sup>

### 2. Industry background

2.1 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 MHRA:

- (a) Prescription-only medicines (POMs or ethical):<sup>9</sup> pharmaceutical drugs that require a prescription from a GP or other prescribing healthcare professional. Prescriptions can be either NHS or private. NHS prescriptions come under the essential services the pharmacist provides.

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<sup>7</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

<sup>8</sup> [Celesio Sainsbury's pharmacy business merger inquiry](#).

<sup>9</sup> POMs may be further segmented into Branded (product is branded according to the pharmaceutical company that initially developed and has/had the patent for the product) and Generic (where the patent has expired and the product may be produced by a number of manufacturers under licence).

- (b) Pharmacy-only medicines (or P-medicines): pharmaceutical drugs that do not require a prescription but can only be sold under pharmacist supervision.<sup>10</sup>
- (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.

### **Community pharmacies**

- 2.2 Pharmacies come in a range of different types and formats. They vary in terms of location, size of store, and the product categories that they sell alongside pharmaceuticals. We have used the term ‘community pharmacy’ to mean all pharmacies that provide services for the NHS irrespective of where they are situated, excluding outpatient and inpatient dispensaries.<sup>11</sup>
- 2.3 Community pharmacies 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.<sup>12</sup> 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. Local services such as needle exchange, sexual health services, support to stop smoking, support for weight loss, alcohol advice, etc are commissioned to target local health priorities. Private services, such as travel vaccinations, are outside the NHS. For further details on the variations by nation see Appendix B.
- 2.4 The large majority of pharmacies provide NHS services.<sup>13</sup>

### **Types of prescriptions**

- 2.5 Traditionally, patients have been given a paper prescription by their GP, which they then physically take to any pharmacy of their choice. In cases where the

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<sup>10</sup> Examples of pharmacy-only medicines include antibiotic eye drops and pharmacy-strength treatments for excessive sweating or fungal infections.

<sup>11</sup> Outpatient and in-patient dispensaries are located in hospital premises.

<sup>12</sup> In addition to pharmacists some doctors have the ability to dispense medicines – dispensing doctors – to patients that meet certain criteria. There are approximately 1,233 dispensing doctors, who dispense approximately 6% of prescriptions based on volume of products purchased. Source: [Parties' initial submission](#), paragraph 6.1.2.

<sup>13</sup> A minority of pharmacies do not hold a NHS pharmacy licence and so do not provide NHS services.

patient wishes to use the Electronic Prescription Service (EPS),<sup>14</sup> and the GP practice has the technology to use EPS, the patient may nominate a pharmacy to which the prescription is sent.<sup>15</sup> This system is most suitable for patients who repeatedly require the dispensing of medicines. Sainsbury's told us that, in October 2015, 37% of medicines in England were dispensed through EPS. This system has not been rolled out to the same extent in Wales and Scotland,<sup>16</sup> and electronic prescriptions are not available in Northern Ireland. To encourage free patient choice, the GP may not influence a patient to nominate a particular dispensing site.<sup>17</sup> If a patient asks for a recommended pharmacy, the GP must provide a list of all pharmacies that can accept electronic prescriptions in the area.

- 2.6 Patients may also nominate a pharmacy to receive their EPS medicines when they are in a pharmacy, and pharmacies try to convert as many of their customers into nominating customers as possible. [X] told us that most nominations were secured in this way. Pharmacies may not however offer inducements to encourage patients to make a particular choice.<sup>18</sup>

## **UK market size**

### *Turnover/expenditure*

- 2.7 The UK pharmacy market was estimated to be worth around £14.5 billion in 2014.<sup>19</sup> Growth in 2014 was estimated to be 2.1%. NHS receipts account for the majority of the market, and have been estimated at £10 billion. The number of NHS prescriptions has grown by some 4% per year over the last ten years but NHS receipts have grown by only 1% per year over the same period, indicating that NHS expenditure is decreasing in spend per item dispensed.

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<sup>14</sup> Strictly speaking, this is the second release of the Electronic Prescription System, which differs from the first release in that the prescription is sent from the prescriber to the dispensary, without the patient needing to carry a paper form that is scanned in by the dispensary. All references to EPS imply EPS2.

<sup>15</sup> In January 2016 around 98.5% of pharmacies were able to use EPS and 74% of GP practices. See the [Health & Social Care Information Centre](#).

<sup>16</sup> In Scotland and Wales patients are given a paper prescription which also includes a bar code for pharmacies to download information.

<sup>17</sup> [The National Health Service \(Primary Medical Services\) \(Miscellaneous Amendments\) Regulations 2005](#), Regulation 39B(4)(a).

<sup>18</sup> [The National Health Service \(Pharmaceutical and Local Pharmaceutical Services\) Regulations 2013](#), Regulation 30.

<sup>19</sup> Verdict (14 January 2015), Health and Beauty, Pharmacy UK market report.

## Pharmacy numbers

2.8 At present there are some 14,250 pharmacies in the UK. The larger specialist operators<sup>20</sup> (Boots, Lloyds, Rowlands, Superdrug and Well) account for some 44% of pharmacy licences. Within this, Lloyds has a share of [10–20]% of UK licences. Major supermarkets account for some 12%, of which Sainsbury's has a share of [0–5]% of UK licences. Independents and others account for 47% of UK licences.

**Table 2: Market shares**

<i>Retailer</i>	<i>Retail pharmacy market share (%)*</i>	<i>Market share of NHS revenue (%)†</i>
Independent/other	<b>44</b>	<b>44</b>
Boots	[20–30]	[20–30]
Lloyds	[10–20]	[10–20]
Well	[5–10]	[5–10]
Rowlands	[0–5]	[0–5]
Superdrug	[0–5]	[0–5]
Larger operators	<b>44</b>	<b>49</b>
Tesco	[0–5]	[0–5]
Sainsbury's	[0–5]	[0–5]
Asda	[0–5]	[0–5]
Morrisons	[0–5]	[0–5]
Big 4 supermarkets	<b>12</b>	<b>8</b>
<b>Combined Lloyds/Sainsbury's</b>	<b>14</b>	<b>16</b>

Source: Verdict UK pharmacy report (2015).

\* Calculated on the basis of percentage of licences.

† Calculated on the basis of sales revenue.

## History of pharmacy openings

2.9 In April 2005, the government relaxed 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 entirely. The exemption that accounted for the most new entry 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>21</sup> In 2012 the exemptions were abolished. There were much smaller changes in pharmacy numbers in Scotland, Wales and Northern Ireland where no similar exemptions were available. In Wales, for example, the number of pharmacies remained relatively stable throughout the period 2004/05 to 2014/15, increasing by only 11 from 705 to 716.<sup>22</sup>

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<sup>20</sup> Generally we have classified larger operators as those with over 500 pharmacies. Independent/other operators range from single store owners to operators with a significant number of stores (but fewer than 500) – for example Day Lewis plc has just under 250 stores.

<sup>21</sup> [General Pharmaceutical Services in England - 2004-05 to 2013-14, Appendix 1.](#)

<sup>22</sup> [StatsWales website: Community pharmacies by LHB and year.](#)

## ***Regulatory framework***

- 2.10 Pharmacies in the UK are subject to specific regulatory and licensing arrangements. England, Scotland, Wales and Northern Ireland each have their own regulatory controls. These are set out in Appendix B. The regulations are similar, though not identical, by nation: the licensing authority must be satisfied that the pharmacist is fit to practise and, in the case of an application for a new pharmacy, that there is an unmet need that the pharmacy will satisfy.
- 2.11 All pharmacy premises in Great Britain must be registered with the General Pharmaceutical Council, which is the regulator that enforces standards and regulates the pharmacy profession. In Northern Ireland the regulator is the Pharmaceutical Society of Northern Ireland. Pharmacies must comply with the Terms of Service. These govern a variety of the terms of services for pharmacies, including opening hours, access, professional standards and suitability of the premises. A pharmacy could be removed from the Pharmaceutical list due to failure to comply with the Terms of Service.
- 2.12 In addition to community pharmacies, certain individuals are also able to obtain prescriptions from dispensing doctors who are licensed to dispense pharmaceuticals to patients who live in areas with few or no community pharmacies. Dispensing doctors require a licence from the NHS to dispense pharmaceuticals in this way, and must confirm that patients are eligible to receive prescriptions from them.<sup>23,24</sup> In these circumstances a patient is free to choose to have their prescription dispensed by another pharmacy, but they are also able to choose for their prescription to be dispensed at the GP practice, even if the GP practice is in direct proximity to another pharmacy.

### ***Distance selling pharmacy contracts***

- 2.13 Regulation 25 (and the conditions set out in Regulation 64) of the Pharmaceutical Services 2013 Regulations provide for distance selling pharmacy (DSP) (often commonly referred to as ‘internet pharmacy’) contracts. Within the UK, DSP contracts are only currently differentiated in England (pharmacies in other parts of the UK can offer internet services on top of their ‘bricks and mortar’ offering, but cannot offer internet pharmacy services in isolation to NHS patients). DSPs must ensure no face-to-face access to essential pharmaceutical services, and the services must be made available to

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<sup>23</sup> Dispensing doctors dispense approximately 6% of prescriptions based on volume, according to the Parties.

<sup>24</sup> This may be the case where a patient satisfies the local health authorities that they would have serious difficulty in obtaining any necessary drugs or appliances from an NHS pharmacist by reason of distance or inadequacy of means of communication or a patient is resident in an area which is rural in character, known as a controlled locality, at a distance of more than 1 mile (1.6 km) from pharmacy premises (excluding any distance selling premises). The pharmacy premises do not have to be in a controlled locality.

any part of England. There are no equivalent regulations in Scotland, Wales or Northern Ireland.

### ***Pharmacy funding and pricing***

- 2.14 Pharmacies receive funding through the respective nation's NHS, for example NHS Scotland in Scotland. Funding includes:
- (a) reimbursement for prescription-only medicines and appliances, which includes retained buyer margin;<sup>25</sup> and
  - (b) fees and allowances.
- 2.15 The reimbursement amount and fees and allowances are set out in each nation's own Drug Tariff. The Drug Tariff sets out the rates payable for the provision of pharmaceutical services and the way in which reimbursement is calculated for drugs (both generic and proprietary products) and appliances supplied, and it lists those appliances which are approved for supply. It also sets out the remuneration (professional fees/allowances) which is paid as part of the pharmacy contract.
- 2.16 Whereas the reimbursement amount a pharmacy receives from the government is set through the Drug Tariff, the price paid by a pharmacy for a medicine is determined through negotiation with the wholesaler or the manufacturer. The government caps the profit that the pharmacy can make by buying products at a price lower than the reimbursement price (the retained buyer margin). This is done through the retained buyer margin mechanism. The retained buyer margin in England, for example, is a capped fund set at £800 million for both 2014/15 and 2015/16. In Scotland the equivalent Retained Purchase profit in 2013/14 was around £82.3 million.
- 2.17 The pricing of pharmacy-only medicines and GSL products are not regulated and are therefore set by the pharmacy. We understand that prices are usually set uniformly. Similarly, the cost for the pharmacy of pharmacy-only medicines and GSL products is negotiated between the pharmacy and the supplier.
- 2.18 Prescription charges only apply in England. There are no prescription charges in Scotland, Wales and Northern Ireland. The prescription charge – currently £8.40 per item (if a customer is not exempt from payment) – does not affect the revenue the prescription generates for the pharmacy. It is simply collected by the pharmacies and paid over to the UK government.

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<sup>25</sup> In Scotland the equivalent is Retained Purchase Profit.

- 2.19 Fees and allowances cover funding for general service provision including: Item Fees, Establishment Payments, the Repeat Dispensing Annual Payment, and Additional Fees. In England funding for fees and allowances is currently set at £2.0 billion for both 2014/15 and 2015/16. In Scotland funding in 2013/14 was around £200 million.<sup>26</sup>
- 2.20 In England, on 17 December 2015, the Department of Health and NHS England sent a letter to the Pharmaceutical Services Negotiating Committee (PSNC)<sup>27</sup> inviting it to enter into discussions with the Department of Health, supported by NHS England, on changes to the community pharmacy contractual framework for 2016/17 and beyond. The letter suggested there was a need for a clinically focused community pharmacy service that was better integrated with primary care. It also stated that the funding commitment for pharmacies in England would reduce from £2.8 billion in 2015/16 to £2.63 billion in 2016/17.<sup>28</sup> The consultation period extends to 24 May 2016. The letter noted that 40% of pharmacies are in a cluster where there are three or more pharmacies within 10 minutes' walk and that the development of large-scale automated dispensing, such as 'hub and spoke' arrangements, provides opportunities for efficiencies. Some pharmacies expressed concern at the proposed changes.<sup>29</sup> We did not consider that the exercise was relevant to our inquiry.

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

- 2.21 The outsourcing of OPD is a relatively new development in the market, and NHS commissioning bodies have only recently begun to outsource OPD pharmacies. The move to outsourcing has arisen as NHS trusts look at potential ways to increase efficiency.<sup>30</sup> Generally it has been larger NHS trusts to date that have decided to outsource OPD services.
- 2.22 OPD pharmacy contracts are publicly tendered, usually under the terms of the public procurement rules. OPD pharmacy contracts are awarded for pharmacies located within hospitals. Most OPD pharmacies do not hold community pharmacy licences, and are therefore prevented from dispensing prescriptions other than for ethical medicines to patients of that hospital.

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<sup>26</sup> In Scotland funding for retained purchase profit, fees and allowances was £279.6 million in 2013/14 with funding set to increase by 1.74% in 2014/15. [Community Pharmacy Scotland: Financial Framework 2015/16](#).

<sup>27</sup> [Department of Health and NHS England letter to Pharmaceutical Services Negotiating Committee on community pharmacy](#).

<sup>28</sup> The Department of Health proposed that the establishment payment would be phased out over a number of years. The existing value of the establishment payment in England is £270 million. The median average pharmacy receives £220,000 a year in NHS fees and allowances (including margin). See [Community pharmacy in 2016-17 and beyond - proposals - stakeholder briefing sessions](#).

<sup>29</sup> Day Lewis described the proposals as 'frightening'. WR Evans said that the Chief Pharmaceutical Officer had commented that there were 3,000 too many pharmacies in the UK.

<sup>30</sup> There are also VAT benefits.

Consequently, most OPD pharmacies cannot compete with community retail pharmacies. A small number of OPD pharmacies may also, in addition to their OPD pharmacy contract, have obtained a community pharmacy contract allowing them to fulfil other NHS prescriptions – but this is rare.

2.23 The main players in this sector are Boots and Celesio:

(a) Boots has 20 different NHS trust OPD contracts, some of which operate at more than one site within the trust.

(b) Celesio has 25 different NHS trust OPD contracts.<sup>31</sup>

2.24 In addition to contracts operated by Boots and Celesio, Sainsbury's, Well and Rowlands each operate three contracts; Healthcare at Home operates one and; at least six NHS trusts have set up wholly owned subsidiaries to provide OPD services within their trusts.

2.25 On 5 February 2016, Lord Carter published a report on productivity and performance in English NHS acute hospitals.<sup>32</sup> Part of the report concerned hospital pharmacy services. It noted that, on average, 55% of pharmacy staff time (43% of costs) is spent on infrastructure services,<sup>33</sup> with the largest element being supply chain activities (at 45% of staff time), encompassing the buying, making and supplying of medicines. The report highlighted a need for NHS trust hospital pharmacies to optimise the use of NHS personnel on the delivery of pharmacy services rather than on infrastructure services. The report noted that some trusts had outsourced outpatient dispensing to community pharmacy providers and stated that this was cost-effective and freed up clinical pharmacy staff to focus on clinical services.

### ***Pharmaceutical wholesaling***

2.26 In the UK most pharmaceuticals are distributed through wholesalers to pharmacies. There are around 44 pharmaceutical wholesalers in the UK.<sup>34</sup>

2.27 Wholesalers divide into 'broad-line' wholesalers (that supply a broad range of products – around 12,000) and 'short-line' wholesalers (that supply a more limited product range). Broad line wholesalers are further segmented into national and regional. Wholesalers supplying the UK market include:

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<sup>31</sup> With 24 NHS trusts.

<sup>32</sup> [Operational productivity and performance in English NHS acute hospitals: Unwarranted variations. An independent report for the Department of Health by Lord Carter of Coles.](#)

<sup>33</sup> Infrastructure services include procurement and dispensing of medicines, homecare, training provided to pharmacists and technicians, and medicine information. Ibid, p31.

<sup>34</sup> BMI Research.

- (a) Broad-line – national: Alliance Healthcare (Distribution) Limited (Alliance Healthcare) (part of Walgreens Boots Alliance), AAH (Celesio) and Phoenix (Rowlands).
  - (b) Broad-line – regional: Maltby, United Drug Sangers, Norchem, Sants, Mawdsley Brookes, Sangers (Maidstone).
  - (c) Short-line: include De Louis, Colorama/Waymade, Sigma, Ethigen, DE Pharms, Lexon, Trident and OTC Direct.
- 2.28 The market for distribution of medicines changed in 2007 when 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. Following Pfizer's decision, AstraZeneca, GSK, Eli Lilly and others have also introduced DTP distribution. In addition, a number of manufacturers have adopted a Restricted Wholesaler Model (RWS), where a limited number of wholesalers are selected by the manufacturer.
- 2.29 Within the supply chain there are a number of independent pharmacy networks/groups which provide buying group services as well as providing business advice to their members. A large proportion of single-owner independents and small chains belong to these buying groups.
- 2.30 Table 3 shows estimates of market shares. The three main players (Alliance Healthcare, AAH and Phoenix) account for around 79% of the prescription-only market by value, with regional broad line wholesalers making up around 6% and short line 12%. Others make up the remaining 3%. In pharmacy-only medicines the main three wholesalers make up around 75% of the market by value (including manufacturer direct sales), regional broad line 8%, short line 16% and others 1%.

**Table 3: Pharmaceutical market shares estimates**

Wholesaler	Prescription meds (value)			Pharmacy only - meds (value)		%
	Alliance estimate	AAH	Phoenjx estimate	Alliance	AAH	
	AAH	[X]	[X]	[X]	[X]	
Alliance	[X]		[X]	[X]		
Phoenix	[X]		[X]	[X]		
National total	79.0	80.3	79.3	75.2	57.9	
Regional broad line	[X]	[X]	[X]	[X]	[X]	
Short line	[X]	[X]	[X]	[X]	[X]	
Others incl manufacturer direct sales	[X]	[X]	[X]	[X]	[X]	

Source: the Parties and third parties.

### 3. The companies

#### ***Celesio and Lloyds***

- 3.1 Lloyds Pharmacy Limited (Lloyds) owns and operates the pharmacy chain branded LloydsPharmacy across the UK. It is a wholly owned subsidiary of Celesio AG (Celesio), which is in turn ultimately controlled by the McKesson Corporation (McKesson).<sup>35</sup> McKesson is a healthcare service business based in the USA with a turnover for the year ended 31 March 2015 of \$179 billion.
- 3.2 Celesio provides traditional prescription pharmaceuticals and non-prescription products and medical services. It operates under the Lloyds pharmacy brand in the UK, which it acquired in 1997.
- 3.3 Lloyds has around 1,540 pharmacies in the UK,<sup>36</sup> and operates 25 contracts for OPD pharmacies with 24 NHS trusts and a number of contracts with prisons, mental health trusts, private hospitals and community hospitals. Lloyds classifies its pharmacy business into Health and Medical pharmacies (located near a GP practice); Health and Community pharmacies (neighbourhood or village location where GP practices are present); Health and Skin Extra pharmacies (high street/town centre locations); and OPD pharmacies. Turnover for the 15 months ending 31 March 2015 was £2.3 billion.<sup>37</sup>

<sup>35</sup> Celesio AG was acquired by McKesson in February 2014.

<sup>36</sup> [X]

<sup>37</sup> The financial year end was moved to 31 March to bring it into line with McKesson's financial year end.

## AAH

- 3.4 Celesio also owns AAH Pharmaceuticals Limited (AAH) (acquired in 1995). AAH is a wholesale supplier to Lloyds pharmacies, third party pharmacies, hospitals, GP practices and other healthcare establishments across the UK. AAH is currently the main supplier to the Target Business for prescription-only and pharmacy-only medicines. The AAH group is a full-line wholesaler<sup>38</sup> but also operates direct-to-pharmacy and reduced wholesale models. Turnover for the 15 months ending 31 March 2015 was £3.6 billion.

### **Sainsbury's pharmacy business**

- 3.5 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 opened its first in-store/retail community pharmacy in Penzance in 1995, and its first hospital pharmacy OPD in South Tees in 2012. Sainsbury's operates 277<sup>39</sup> community pharmacies and three hospital trust OPD contracts in four hospitals.
- 3.6 The UK turnover of Sainsbury's pharmacy business was £[X] million in Financial Year (FY) 2015. This revenue was split between (a) retail pharmacy – approximately £[X] million, and (b) hospital OPD – approximately £[X] million (excluding convenience retail sales). Sainsbury's pharmacy is the second largest supermarket pharmacy chain, after Tesco. The hospital OPD contracts are with three NHS trusts (South Tees, Guy's & St Thomas', and King's College) at four sites. At Guy's & St Thomas' hospitals Sainsbury's also offers a convenience retail proposition.
- 3.7 46% of Sainsbury's supermarkets have a pharmacy (21% of total stores). Pharmacies tend to be in the larger stores, with 192 out of the 277 pharmacies (69%) in stores over 3,700 sq metres. Around 50% of pharmacies operate with 100-hour licences and typically open for 101 hours per week. All the 100-hour pharmacies were opened between 2004 and 2014, when entry restrictions were relaxed (see paragraph 2.9). The remaining pharmacies operate with 40-hour licences, but on average these are open for around 84 hours per week.
- 3.8 Sainsbury's website<sup>40</sup> shows that its pharmacies provide a standardised wide range of services including, for example, EPS, repeat prescriptions and new medicine reviews. Sainsbury's offers Stop Smoking services in selected

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<sup>38</sup> Pharmaceutical wholesalers can be broadly categorised as full-line, which carry up to 12,000 prescription medicine lines, and short-line which may stock just 2,000 items.

<sup>39</sup> At the time the BSA was entered into Sainsbury's had 278 stores. However its Nine Elms pharmacy currently has its licence suspended.

<sup>40</sup> [Sainsbury's website: Sainsbury's Pharmacy](#).

pharmacies and collection services in all but one of its retail pharmacies. Sainsbury's pharmacies do not generally offer a delivery service.

3.9 AAH supplies over 90% of the medicines dispensed by Sainsbury's.

### ***Other parties***

3.10 There are a number of larger pharmacy groups, which together with Lloyds have around 44% retail pharmacy market share (see Table 2). These are: Boots, Well (formerly the Co-operative Pharmacy), Rowlands and Superdrug. Of these, Boots (a subsidiary of Alliance Boots, acquired by US drugstore operator Walgreens in 2014) is the largest single chain, with over 2,400 pharmacy stores, ranging from small community and high street pharmacies to town centre outlets and large out-of-town retail outlets. It has a national share in the UK of [20–30]%. Boots also provides an online pharmacy service. Well (acquired by Bestway in 2014) has around 780 pharmacies and a national share of [5–10]%. Rowlands operates over 500 pharmacies throughout England, Scotland and Wales, as well as providing an online pharmacy service. Rowlands has a national share in the UK of [0–5]%. Superdrug has around 200 stores with a [0–5]% national share offering both a pharmacy service and a wider retail offering, and 15 stores also offering nurse clinics providing health checks. Superdrug also provides an online doctor service.

3.11 The four largest supermarket chains in the UK – Asda, Morrisons, Sainsbury's and Tesco – together have around 12% retail pharmacy market share (see Table 2). The largest pharmacy operator is Tesco, with 375 in-store pharmacies; 353 in England, 15 in Wales and seven in Scotland. Around 40% of its contracts are 100-hour opened under the relaxed entry restrictions in England (paragraph 2.9). Tesco has not opened any new pharmacies since the 100-hour exemption was removed. Morrisons operates 118 pharmacies in the UK; 98 in England, 13 in Scotland and seven in Wales. It has no 100-hour contracts. Asda operates 255 pharmacies. Between 2005 and 2012/13 Asda opened 156 new pharmacies, taking advantage of the 100-hour contract exemption. Since the 100-hour exemption was removed, Asda has not introduced any further pharmacies into its stores.

3.12 As shown in Table 2, 47% of the retail pharmacy market comprises independent pharmacies. These range from UK wide chains such as Cohens, with around 160 stores, to national operators such as Day Lewis, with 250 stores in England, to regional operators such as Weldricks (South Yorkshire and North Lincolnshire) and Gordon's Chemist (Northern Ireland), with around 60 stores each, to single-store operators.

## 4. The Transaction and relevant merger situation

4.1 Following a review of Sainsbury's pharmacy business in 2014, informal discussions were held with Celesio (Lloyds), [X] and [X] to assess their interest in acquiring the pharmacy business. A formal sales process commenced in April 2015. Bids were made by Celesio and [X]. The level of the Celesio bid and the attractiveness of the longer-term, post-deal partnership with Celesio were considered superior. Celesio was selected as the preferred bidder and the BSA was signed at the end of July 2015. Alongside the BSA a Cooperation Agreement was also signed. This agreement was necessary to cover the ongoing relationship between the Parties, as the Lloyds pharmacies would operate within the Sainsbury's supermarkets.<sup>41</sup> We refer to the combined effect of these agreements as the Transaction in this provisional report. The purchase price was £[X] and this was paid to Sainsbury's on 29 February 2016. [X] will also be paid.

### ***Rationale for the Transaction***

4.2 The Parties said that:<sup>42</sup>

- (a) For Lloyds the acquisition would complement Lloyds' existing business, enabling it to expand its format offering to include pharmacy store services within Sainsbury's grocery stores and realise a number of synergies across the business, as well as entering a number of new local markets where it currently does not compete. In addition, the acquisition enabled AAH, a subsidiary of Celesio, to retain its wholesale supply relationship with the Target Business.
- (b) For Sainsbury's the Transaction would provide its customers with an enhanced pharmacy service and ensure that the future services that are required can be delivered with expertise and confidence. Additionally, the Transaction would provide its staff with the benefit of enhanced training and specialist expertise, and the benefit of an ongoing partnership with a provider with significant industry expertise.

### ***The Cooperation Agreement***

4.3 The Cooperation Agreement concerns the arrangements for the continuing relationship that will exist between the Parties and is for an [X] term, [X]. The Cooperation Agreement details the products that may be sold by each party, aspects of the operation of the pharmacies in the Sainsbury's stores such as

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<sup>41</sup> Usually the pharmacies would operate around the middle of the Sainsbury's stores.

<sup>42</sup> Parties' initial submission, Part F, paragraph 1.

opening hours, exclusivity arrangements and the future development of the business. Appendix C contains a summary of the constraints on how Lloyds can operate the Sainsbury's pharmacy business post-merger under the Cooperation Agreement.

## ***Jurisdiction***

- 4.4 Under the Act<sup>43</sup> and our terms of reference (see Appendix A) we are required to decide whether arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation. We have considered whether certain events that have taken place since the Transaction was entered into (satisfaction of conditions precedent and payment of consideration) mean that the Parties are bound to such an extent as will result, on effect being given to their obligations, in the enterprise ceasing to be distinct. If that were the case, the point in time when that occurred is taken to be the time at which two enterprises cease to be distinct and a merger would be deemed to be completed.<sup>44</sup> In such circumstances, we have an ability to treat the reference of an anticipated merger<sup>45</sup> as if it had been referred to us as a completed merger.<sup>46,47</sup> However, it appears that this would not have any material impact on our analysis in this case and, as a result, we have provisionally decided not to exercise our discretion to treat the reference as if it had been referred to us as a completed merger. We may revisit this should it prove necessary to do so in considering remedies options. Accordingly we have provisionally concluded that the Transaction described in paragraphs 4.1 to 4.3 above constitutes arrangements in progress or contemplation for the purposes of the Act.
- 4.5 A relevant merger situation is created if two or more enterprises cease to be distinct enterprises (within the relevant statutory time frame) and either the UK turnover test or the UK share of supply test or both are satisfied.<sup>48</sup>

### *Enterprises ceasing to be distinct*

- 4.6 The Act defines an 'enterprise' as 'the activities or part of the activities of a business'. A 'business' is defined as including a professional practice and includes any other undertaking which is carried on for gain or reward or which is an undertaking in the course of which goods or services are supplied

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<sup>43</sup> Section 36 of the Act.

<sup>44</sup> Section 27(2) of the Act.

<sup>45</sup> ie under section 33 of the Act.

<sup>46</sup> ie under section 22 of the Act.

<sup>47</sup> Section 37(2) of the Act.

<sup>48</sup> Section 23 of the Act.

otherwise than free of charge.<sup>49</sup> The Jurisdictional and Procedural Guidance in paragraph 4.6 also makes it clear that the enterprise in question need not be a separate legal entity.<sup>50</sup>

- 4.7 The Target Business comprises 277 retail pharmacies (within or adjacent to Sainsbury's supermarkets) and the transfer of three existing contracts for pharmacies located in hospitals. The purchase will be made by Lloyds. Each of Lloyds and the Sainsbury's pharmacy business sells goods in retail outlets for reward and we are satisfied that each is an enterprise for the purpose of the Act. We are also satisfied that, as a result of the Transaction described in paragraph 4.1, both enterprises would be brought under the control of Lloyds and would therefore cease to be distinct for the purposes of the Act.

#### *Turnover test*

- 4.8 The second limb of the jurisdictional test seeks to establish that the Transaction has sufficient connection with the UK on the basis of the turnover test or share of supply test. The turnover test is satisfied where the value of the turnover in the UK of the enterprise acquired exceeds £70 million.
- 4.9 The turnover of the Target Business in the year ending 15 March 2015 was around £[~~8~~] million. In light of this, we consider that the turnover test is satisfied and we are not required to consider the application of the share of supply test to the Transaction.

#### *Provisional conclusion on jurisdiction*

- 4.10 In the light of the above assessment, we provisionally conclude 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 conclude that the jurisdictional test is satisfied in this case.

## **5. Market definition**

- 5.1 We considered the appropriate product and geographic market definitions. The purpose of market definition is to provide a framework for assessing the competitive effects of a merger. It contains the most significant competitive alternatives available to customers of the merged companies. However,

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<sup>49</sup> Section 129(1).

<sup>50</sup> [Mergers: Guidance on the CMA's jurisdiction and procedure \(CMA2\)](#). Nor is there a requirement that the transferred activities generate a profit or dividend for shareholders: indeed, the transferred activities may be loss-making or conducted on a not-for-profit basis.

market definition is not an end in itself and the boundaries of the market do not determine the outcome of the CMA's analysis of the competitive effects of the merger, as there can be constraints on merger parties from outside the relevant market.<sup>51</sup>

### ***Product market***

5.2 The Parties overlap in the retail supply of prescription-only medicines, pharmacy-only medicines and pharmacy services. Although the Parties also overlap in GSL items, Sainsbury's will retain its GSL business and therefore this is not relevant for our analysis of the merger (see also paragraph 5.5). This section discusses the definition of the relevant product markets, looking at decisional precedents, at the Parties' views and at other evidence collected in the course of the investigation.

### ***The Parties' views***

5.3 The Parties considered it appropriate to define three separate product markets for prescription-only medicines, pharmacy-only medicines and retail pharmacy services to consumers.<sup>52</sup> The Parties suggested that GSL products should not be considered as the sale of GSL products was not part of the Target Business, but noted that the prices of many pharmacy medicines were constrained by the sales of GSL products, and that this should be taken into account by the CMA.<sup>53</sup>

### ***Our assessment***

5.4 There appears to be limited demand-side substitution between prescription medicines and pharmacy-only products. It may sometimes be possible for a customer to substitute a pharmacy-only medicine for a prescription medicine, but the Parties told us that this would typically only be a consideration for customers in England who did not benefit from an exemption from the prescription levy (currently the case for only 11.5% of items dispensed).<sup>54</sup>

5.5 Lloyds will not, in general, be able to sell GSL products or non-pharmaceutical products within Sainsbury's.<sup>55</sup> The Parties told us that some pharmacy-only

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<sup>51</sup> [Merger Assessment Guidelines \(CC2 / OFT1254\)](#), paragraph 5.2.2. This was originally published jointly by the Office of Fair Trading (OFT) and the Competition Commission (CC) and has been adopted by the CMA board.

<sup>52</sup> [Parties' initial submission](#), Part G, sections 1.1 & 1.3.

<sup>53</sup> [Parties' initial submission](#), Part G, sections 1.2.

<sup>54</sup> For example, for minor health conditions there might be a pharmacy-only medicine which is similarly effective as a prescription medicine, and whose price might be lower than the prescription levy.

<sup>55</sup> [Parties' initial submission](#), footnote 10.

medicines were substitutable with GSL products, as the GSL product was either the same product in a smaller pack size, or a similar product to treat the same symptoms.<sup>56</sup> As a result, the Parties and some third parties considered that in some cases the pricing of pharmacy-only medicines was constrained by that of GSL products.<sup>57</sup> However, there are many pharmacy-only medicines for which a GSL substitute is not available. We therefore consider it appropriate to exclude GSL products from the relevant product markets, but their substitutability for pharmacy-only medicines will be taken into account, if necessary, in our competitive assessment. Neither prescription medicines nor pharmacy-only medicines are alternatives for pharmacy services (either for end consumers or the commissioning bodies of these services).

- 5.6 The boundaries of a relevant product market are generally determined by reference to demand-side substitution alone. However, there are circumstances where several narrow relevant markets can be aggregated into a broader one on the basis of supply-side considerations. In particular, this is appropriate when the same firms compete to supply these different products and the conditions of competition between the firms are the same for each product.<sup>58</sup> In this case, prescription-only medicines, pharmacy-only medicines and pharmacy services are only or predominantly supplied by pharmacies and the set of competitors supplying each product in any local area will largely be the same.<sup>59</sup> Furthermore, many of the competitive parameters are determined at the store level, although some can be set centrally and rolled out locally, and even those that are set at the product level (for instance, quality of pharmacy services) can have a knock-on impact on the other products sold by the pharmacy.<sup>60</sup>
- 5.7 We therefore consider it appropriate to aggregate the markets for prescription-only medicines, pharmacy-only medicines and pharmacy services and assess retail competition at the level of the pharmacy.

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<sup>56</sup> Parties' initial submission, Part C, section 2.4.

<sup>57</sup> Parties' initial submission, Part G, section 1.2; Morrisons. [X]

<sup>58</sup> CC2, paragraph 5.2.17.

<sup>59</sup> There are some limited exceptions that, however, do not change our assessment: patients living further than a mile from a pharmacy or having serious difficulties in obtaining medicines from pharmacies can obtain them from prescribing doctors (6% of prescription medicines are dispensed in this way); pharmacy-only medicines can be fulfilled through a pharmacy that does not hold an NHS pharmacy contract (Boots has a limited number of such stores). The principal difference is with respect to pharmacy services, where there may be a greater overlap between GPs, health centres and pharmacies for some commissioned services.

<sup>60</sup> For instance, if a pharmacy reduces the quality or number of its medicine use reviews, customers may switch to obtaining their prescription from another pharmacy. We note, however, that price is a competitive parameter that only applies to pharmacy-only medicines and to privately offered pharmacy services.

## **Customer markets**

5.8 Our Merger Assessment Guidelines state that we can define relevant markets for separate customer groups if the effects of the merger on competition to supply a targeted group of customers may differ from its effects on the other groups of customers, and require a separate analysis.<sup>61</sup> The Parties identify care homes as a customer group significantly different from individual consumers. However, they note that, with respect to care homes, the overlap between the Parties is minimal,<sup>62</sup> as Sainsbury's does not target care homes.<sup>63,64</sup>

## **Our assessment**

5.9 The differences between various groups of individual customers and the ways they are targeted by pharmacies do not appear to require the definition of separate customer markets. Any difference in pharmacies' focus towards specific types of customers is taken account of in the competitive assessment. Care homes present characteristics that set them apart from pharmacies' individual customers (see paragraph 5.8). However, as noted in paragraph 5.8, the overlap between the Parties in this segment is minimal. As a result, the merger may not be expected to have any significant impact on the supply to care homes and we do not consider this customer segment further in this report. Prisons and mental health trusts could also be seen as separate customer groups, but we do not consider it necessary to examine the impact of the merger on them, since Sainsbury's does not serve them.

## **Geographic market**

5.10 Our Merger Assessment Guidelines state that, when assessing mergers involving a large number of local geographic markets, we may examine the geographic catchment area within which the great majority of a store's custom is located. Catchment areas are a pragmatic approximation for a candidate market to which the hypothetical monopolist test can be applied.<sup>65</sup>

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<sup>61</sup> CC2, paragraph 5.2.28.

<sup>62</sup> Sainsbury's only serves [REDACTED] care homes.

<sup>63</sup> [REDACTED] Parties' initial submission, Part C, section 4.2.

<sup>64</sup> The Parties also consider prisons and mental health trusts as other separate customer groups, but note that no overlap exists between the Parties. Initial submission, Part C, section 4.1.

<sup>65</sup> CC2, paragraph 5.2.25.

## *The Parties' views*

- 5.11 In previous OFT decisions the geographic market was considered to be a 1-mile radius around each of the relevant pharmacies. The Parties said that there was no reason to depart from the 1-mile radius catchment area for Celesio's pharmacies, but suggested that for Sainsbury's we should adopt the standard catchment areas used for large grocery stores (10-minute drive-time in urban areas and 15-minute drive-time in rural areas).<sup>66</sup>

## *Our assessment*

- 5.12 We have calculated, for each Lloyds pharmacy and for a sample of Sainsbury's pharmacies,<sup>67</sup> the radius (in miles) of the catchment area that includes 80% of the pharmacy's prescription customers.<sup>68</sup> We have used this information to calculate the average catchment radius separately for Celesio and for Sainsbury's pharmacies, for each of four types of areas: 'conurbations', 'cities and towns', 'rural' areas, and 'very rural' areas. These area types were derived by aggregating in four groups the 10 rural/urban categories defined by the ONS.<sup>69</sup>
- 5.13 In principle, the data could allow us to use individual catchment areas for each Lloyds pharmacy rather than using averages across different types of areas. Individual catchment areas will vary across local areas as a result of the specific characteristics of each area. However, we have chosen to adopt a more pragmatic approach in defining geographic markets, using average catchment sizes as a starting point for assessing competitive constraints and developing the analysis of specific local features in the competitive assessment. This approach allows us to treat Sainsbury's and Lloyds catchments in the same way (given that we do not have customer catchment data for all Sainsbury's pharmacies), and is also easier to apply across a large number of overlap areas instead of calculating individual customer catchment areas in each case. We assume that other high street pharmacies have similar

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<sup>66</sup> [Parties' initial submission](#), Part G, section 2.1.

<sup>67</sup> The Parties were able to provide data on customer location for 40 Sainsbury's stores only.

<sup>68</sup> As noted in paragraph 5.7, we consider that the conditions of competition are very similar for prescription medicines, pharmacy-only medicines and pharmacy services, all of which we include in the same product market. Prescription medicines account for the vast majority of retail pharmacies' total revenues from medicines and services (92% for Celesio in 2015, 83% for Sainsbury's between January and October 2015) and we consider that catchment areas determined using data on prescription customers are broadly applicable to a pharmacy's customers more generally. As noted above, price competition is only relevant for pharmacy-only medicines and privately supplied pharmacy services.

<sup>69</sup> The ONS produces a rural/urban classification of output areas, which classifies each area as urban or rural, with 4 urban and 6 rural subcategories. An output area is based on census information and contains between 100 and 625 people, or between 40 and 250 households. There are 181,408 output areas in England and Wales. For more information, see [Rural/urban definition \(England and Wales\)](#).

catchment sizes to Lloyds pharmacies, and that other supermarket pharmacies have similar catchment sizes to Sainsbury's.

- 5.14 These average catchment areas are only intended as a starting point for our competitive assessment. In our competitive assessment we assess, for local areas, the features (and in particular, for the areas of potential concern, the locations of customers) which affect the extent of competition between pharmacies in that area. We note that, in general, customer catchment areas may be narrower than the geographical market identified using a hypothetical monopolist test, and, where relevant, we consider the constraints posed on the Parties by rivals located further away in our competitive assessment.
- 5.15 Table 4 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 in Table 4. Depending on the type of analysis, the relevant competitors are 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 4: Average radius of catchment areas**

Area type	<i>miles</i>	
	<i>Celesio</i>	<i>Sainsbury's*</i>
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 calculations.

\* The estimate for 'rural' areas is based on the only observation available; in the absence of observations, the estimate for 'very rural' areas is set equal to that for 'rural' areas.

### ***Provisional conclusion on market definition***

- 5.16 For product market definition we provisionally conclude that it is appropriate to aggregate the markets for prescription-only medicines, pharmacy-only medicines and pharmacy services, and assess retail competition at the level of the pharmacy.
- 5.17 We provisionally conclude the relevant geographic markets are those set out in Table 4.

## **6. Counterfactual**

- 6.1 The application of the SLC test involves a comparison of the prospects for competition with the merger against the competitive situation without the

merger. The latter is called the ‘counterfactual’.<sup>70</sup> Our Merger Assessment Guidelines set out that, to help determine ‘the likely future situation in the absence of the merger, the CMA may examine several possible scenarios ... but ultimately only the most likely scenario will be selected as the counterfactual.’ In the assessment the CMA will ‘typically incorporate into the counterfactual only those aspects of scenarios that appear likely on the basis of the facts available to it and the extent of its ability to foresee future developments.’<sup>71</sup>

### ***The Parties’ views***

6.2 The Parties said that, if a sale to Lloyds had not been agreed, Sainsbury’s would most likely have [X].

### ***Our assessment***

6.3 We considered the alternative bidders that Sainsbury’s could have sold the business to, and what would have been likely to happen in the event a sale would not have taken place.

6.4 We considered a sale of the business to [X]. The size of [X] means that a sale to [X] would be likely to raise competition concerns which would have led to a significant risk that the duty to refer the Transaction for an in-depth phase 2 investigation would have been triggered, unless suitable phase 1 undertakings in lieu of a reference were accepted. In a case of two possible counterfactuals, one being a sale to an alternative bidder whose bid is likely to raise competition concerns and the other being the prevailing conditions of competition, our practice is not to have as the counterfactual a sale to a bidder that would itself be likely to require remedies to eliminate competition concerns.<sup>72</sup> As a result we do not consider that a sale to [X] would be the counterfactual in this case.

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<sup>70</sup> CC2, paragraph 4.3.1.

<sup>71</sup> CC2, paragraph 4.3.6.

<sup>72</sup> CC2, paragraph 4.3.22. If only one merger is referred, the counterfactual used by the [CMA] may be the premerger competitive situation or the sale of the target firm to one of the alternative purchasers. When deciding on the most appropriate counterfactual, the [CMA] will consider the circumstances of the sale, including the offers of the alternative purchasers. Depending on the circumstances, the appropriate counterfactual may be based on either the sale to an alternative bidder whose bid has not been referred or the prevailing conditions of competition. The [CMA] would not take into account the possibility of remedies being implemented to address competition concerns raised by the alternative mergers, ie a sale to a ‘remedied bidder’ would not become the counterfactual situation.

- 6.5 We considered other potential acquirers. We note that [redacted] and that Sainsbury's [redacted]. We note Sainsbury's view that, if a sale had not occurred, it would have most likely [redacted].
- 6.6 The evidence suggests that other parties would have been unlikely to have acquired the Sainsbury's pharmacy business in the short term. The bid from [redacted] would have been likely to raise substantial competition issues. [redacted]. If no sale had occurred, we consider that Sainsbury's would have continued to operate the pharmacy business. Therefore we provisionally conclude that the counterfactual is the continuation of the pre-merger situation.

### ***Outpatient dispensary***

- 6.7 Given the provisional conclusion in paragraph 6.6, we assessed OPD under the counterfactual of the pre-merger situation. Sainsbury's said that it had [redacted]. We consider that under a continuation counterfactual Sainsbury's would have continued to run its three contracts with no foreseeable changes. It would have also continued to tender for OPD contracts as and when they fell due and were commercially attractive.

## **7. Assessment of the competitive effects of the merger**

- 7.1 In this section we assess the competitive effects of the acquisition and consider whether the merger may be expected to result in an SLC within any market or markets in the UK for goods or services.<sup>73</sup> We first consider the way that pharmacies compete presently (ie pre-merger). We then assess the effects of the merger against the competitive position in the absence of the merger.
- 7.2 Given the market shares, and particularly the small increment to Lloyd's market share as a result of the merger, detailed in paragraph 2.8, we do not consider that national effects on community pharmacy competition are likely and so focus in this section on local competitive effects. In contrast, when considering vertical aspects and competition in the OPD market we have considered national effects as:
- (a) Wholesalers are active in the supply of drugs on a regional or national basis, with three large national players.

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<sup>73</sup> Section 36 of the Act.

- (b) Although OPD contracts are typically for a single hospital site, competition to be the OPD supplier to a particular hospital occurs between larger regional or national players.

### ***Pre-merger conditions of competition***

- 7.3 As set out in Section 2, there is a range of regulations which apply to pharmacies and 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 employ a qualified pharmacist and must be licensed to operate in a given location.
- 7.4 This means that there are fewer competitive parameters for a pharmacy to alter than is normally the case when analysing a merger between local retail chains. For this reason, we have considered what factors influence customers' choice of pharmacy, and then gone on to assess the extent to which pharmacies can compete on these parameters given the regulatory constraints.
- 7.5 The remainder of this section is structured as follows:
- (a) We first consider evidence on what customers value and how they choose between local pharmacies.
  - (b) We then set out evidence on how pharmacies compete to deliver what customers value. This includes both documentary evidence on how pharmacies respond to competitors, and evidence on how market outcomes vary with competition.
  - (c) Finally, we set out evidence on how closely Lloyds pharmacies compete with Sainsbury's and other supermarket pharmacies.

### ***What matters to pharmacy customers?***

- 7.6 How pharmacies compete with each other at a local level will depend on what matters to customers and how they choose their pharmacy. Pharmacies have an incentive to respond to customers' preferences in order to win business, increasing the volume of pharmacy prescriptions they dispense and generating higher revenues. We have therefore sought to gather evidence on what matters to customers in choosing their pharmacy. We have used two main

sources of evidence: our own consumer survey, and surveys conducted by the Parties in the normal course of business.

#### *Evidence from the CMA consumer survey*

- 7.7 We commissioned a consumer survey to understand the characteristics of Sainsbury's and Lloyds' pharmacy customers. The survey was based on face to face interviews with customers within Lloyds and Sainsbury's pharmacies. Interviews were completed at 32 stores across 16 areas across the UK. The areas were selected to include a disproportionate number of areas with a high concentration of the Parties' pharmacies. A total of 2,167 interviews were completed in Lloyds, and 3,059 were completed in Sainsbury's. More detail on the methodology and findings of the survey is included in Appendix D.
- 7.8 The results of our survey (see Appendix D) suggest that, for both Lloyds and Sainsbury's customers, 'convenience of location' is the most important factor driving pharmacy choice. However, quality of service and a range of other factors also play a part in determining customers' preferences.
- 7.9 Figure 1 shows how customers responded when asked which factors were most important when deciding which pharmacy to visit. Over 85% of customers mentioned 'Convenience of Location' as one of the top three most important factors in determining their choice of pharmacy. 73% of Lloyds' customers and 57% of Sainsbury's customers considered 'Convenience of Location' as most important. A further 13% of Sainsbury's customers considered 'Pharmacy located in supermarket' the most important factor.<sup>74</sup>
- 7.10 Customers were also asked for the reason they chose a Sainsbury's or Lloyds pharmacy on that particular day. A higher percentage of respondents mentioned convenience, although other factors which received a notable proportion of responses were related to service and staff quality, habit and (for Sainsbury's) late/weekend opening hours.
- 7.11 The Parties submit that the nature of 'convenience' differs for Sainsbury's and Lloyds customers. We agree that, for some customers of Sainsbury's, convenience will relate to being able to combine visiting the pharmacy with their grocery shop. For example, as noted above, in our survey 13% of Sainsbury's customers considered 'Pharmacy located in supermarket' the most important factor, and 40% said that it was in the top three reasons

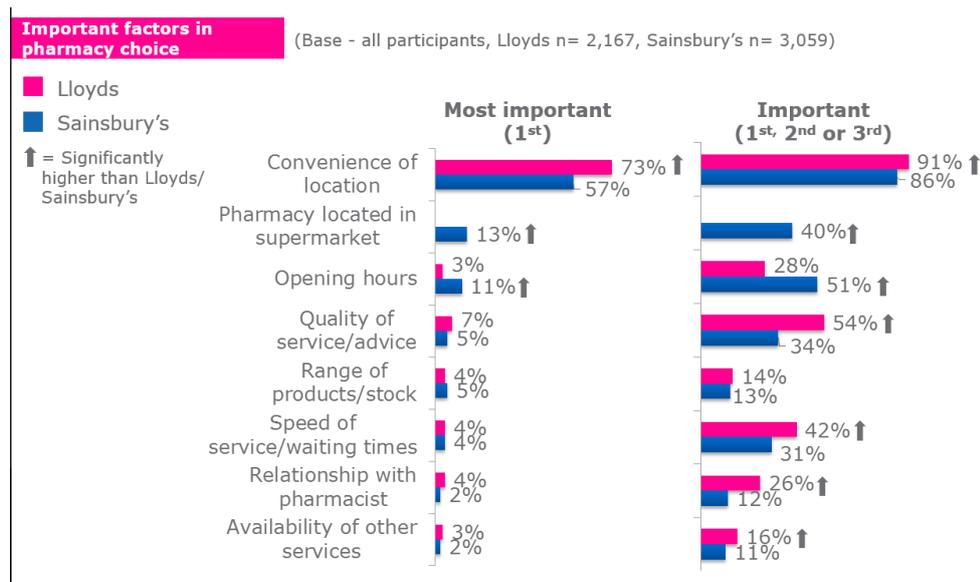
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<sup>74</sup> We also asked an unprompted question (Q16: Why did you choose this pharmacy in the first place?). 66% of Lloyds customers responded with 'Convenience' whereas 76% of Sainsbury's customers responded 'Convenience' or 'Visiting Supermarket'. We consider that this is evidence that convenience is a particularly important driver of choice.

influencing their choice. We consider the difference between supermarket and high street pharmacy customers in more detail in paragraphs 7.61 to 7.103.

7.12 Aside from convenience, a range of other factors were also considered important when consumers first chose their pharmacy.<sup>75</sup> Opening hours were in the top 3 for 28% of Lloyds' customers and 51% of Sainsbury's customers; Quality of Advice/Service was in the top 3 for 54% of Lloyds' customers and 34% of Sainsbury's customers; and speed of service/waiting times were in the top 3 for 42% of Lloyds' customers and 31% of Sainsbury's customers.

**Figure 1: Results for Question 17 of our survey showing the drivers of pharmacy choice**



Source: DJS analysis of data collected in our survey.

Note: Question 17 read: 'Which of these factors are most important to you when deciding which pharmacy to visit? Please tell me your top 3 in order of importance, with 1 being the most important.'

### *Evidence from surveys conducted by the Parties*

7.13 Evidence from the Parties' own internal consumer surveys conducted in the ordinary course of business was in line with the findings of the CMA survey. When reviewing these surveys, we found substantial consistency in what consumers value, and the weight they assign to each factor.

<sup>75</sup> Consumers were asked for the reasons that drove their 'original' choice of pharmacy, rather than why they visited on that particular occasion, as some customers will have a repeat prescription and only be visiting the pharmacy on a particular occasion as their prescription is there.

7.14 For example, Sainsbury's research shows that the factors which Sainsbury's **grocery** customers rank in the top four are the same across users of Sainsbury's pharmacy, [REDACTED].<sup>76</sup> These factors are:

(a) [REDACTED]<sup>77</sup>

(b) [REDACTED]

(c) [REDACTED]

(d) [REDACTED]

7.15 We have also reviewed Lloyds' internal documents, including [REDACTED]. This survey contained a prompted question for prescription customers which, like the Sainsbury's survey, asked for the reasons which drove respondents' choice of pharmacy. The document compared Lloyds' respondents with all respondents. Lloyds' customers' rankings were [REDACTED], with the largest differences being a [REDACTED]. While there were differences in the options given to respondents across the Lloyds survey and the Sainsbury's survey, the overall picture is similar.

#### *Evidence from the demand estimation model*

7.16 In addition to considering survey evidence, we have also analysed data on the volume of prescriptions for each GP practice in England broken down by the pharmacy that fulfilled the prescription. This has allowed us to model the factors driving customer demand, as described in Appendix E.

7.17 In order to construct a consumer choice model we have had to make a number of simplifying assumptions, in particular:<sup>78</sup>

(a) Since we do not have data on customers' home addresses, we assume that GP location can be used as a proxy for customer location.

(b) We only have limited data on quality parameters which might be driving customer choice. We have used data on store opening hours as a proxy for quality.

7.18 In spite of these limitations, we consider that the overall findings of the model are consistent with the survey evidence on what drives customer choice. The high-level results from the choice model are:

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<sup>76</sup> [REDACTED]

<sup>77</sup> Of course, different types of locations may be differently convenient for different customers. Specifically, regular supermarket shoppers may consider supermarket pharmacies to be convenient, whilst others who work in town centres may consider the community high street pharmacies to be conveniently located.

<sup>78</sup> See Appendix E for more detail on these limitations.

- (a) When choosing a pharmacy, customers trade off the distance to a pharmacy and the quality of the pharmacy. In the estimated choice model, we find that our distance variable and quality variable, as measured by opening hours, both have statistically significant coefficients, which suggest that they are important factors in a customer's choice of pharmacy.
- (b) The model suggests that supermarket and non-supermarket pharmacies are substitutes from the perspective of the customer, and in particular that supermarket pharmacies are closer substitutes for non-supermarket pharmacies than vice versa. While the choice model suggests that customers are more likely to divert to a pharmacy that is within the same group of pharmacies (supermarket and non-supermarket) as initially chosen by the customer, this effect is not very strong for either of the groups.

#### *Provisional conclusion on what matters to consumers*

7.19 The results of both the CMA survey and the Parties' surveys and the demand estimation model suggest that convenience of location is the most important driver of pharmacy choice. However, there are a number of other drivers of choice which consumers also value, including quality and speed of service, opening hours, stocking levels and waiting times. We infer from the evidence that customers take these elements of the offering into account when choosing which pharmacy to visit. This gives pharmacies the incentive to compete on these parameters in order to attract customers.

#### ***How do pharmacies compete?***

7.20 In light of the evidence on what drives customer choice, in this section we consider the extent to which pharmacies are able to compete to attract customers. We set out:

- (a) the Parties' views on how they compete;
- (b) our assessment of which parameters pharmacies have the ability to flex at a local level;
- (c) evidence from internal documents and third parties on the extent to which pharmacies currently compete on these parameters; and
- (d) whether there is any empirical evidence of the Parties adjusting any of these parameters at a local level in response to changes in local competition.

7.21 Closeness of competition between supermarket pharmacies and other pharmacies is considered in the next section.

*The Parties' views on how they compete*

7.22 The Parties told us that there was limited scope for price competition on pharmacy-only medicines as a result of General Pharmaceutical Council ethical standards<sup>79</sup> and ASA regulations. They said that it was difficult to compare the pricing of pharmacy-only medicines,<sup>80</sup> which limited the extent to which pharmacy operators could vary their pricing in response to the activities of their rivals. The Parties said that they both set their prices for pharmacy-only medicines centrally, without any local or regional variation.

7.23 The Parties said that ranging decisions were determined centrally and applied uniformly throughout each party's estate [✂].

7.24 The Parties stated that reimbursement prices for services were generally fixed either nationally by the NHS (eg for Medicine Use Reviews (MURs) and New Medicine Service (NMS)) or locally by Clinical Commissioning Groups (CCGs) (eg for smoking cessation services). They said that there were also, typically, service level agreements in place for the provision of pharmacy services which set out key standards.

7.25 The Parties said that, taking the above factors into account, the residual variables over which competition may take place were broadly:

- (a) the location of the pharmacy;
- (b) the pharmacy format/environment, including consultation space;
- (c) opening times;
- (d) the provision of services, including health services and other services such as prescription collection and home delivery services; and
- (e) the provision of staff over and above the regulatory minimum (and the quality and experience of those staff).

7.26 The Parties said that they differed in the way they set these variables.

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<sup>79</sup> See General Pharmaceutical Council (July 2012), [Standards of conduct, ethics and performance](#).

<sup>80</sup> This was because there is a lack of comparable data on price.

**Table 5: Parties' comparison of how they set the variables above**

<b>Proposition</b>	<b>Sainsbury's</b>	<b>Lloyds</b>
<b>Location/format</b>	Within/adjacent to supermarket Counter + consultation room	High street/community/health centre Range of formats
<b>Access</b>	More customers access by car Car parking at all stores (usually free of charge) Wider catchment area Minimal home delivery	More customers access on foot or by public transport Limited parking available Narrower catchment area Home delivery
<b>Opening hours (regulated)</b>	Longer, but driven by supermarket hours (not in response to other pharmacies or GP practices)	Not open as long, driven by local GP practice hours (no competition for 'after-hours')
<b>Customer demographic</b>	Generally representative of population (consistent with profile of grocery shoppers)	Older demographic/lower socio-economic profile. Higher proportion of repeat prescriptions/free prescriptions.
<b>Customer acquisition strategy</b>	[REDACTED]	[REDACTED]
<b>Prescription collection (GP practice)</b>	Yes	Yes/more broadly
<b>Enhanced facilities/services</b>	[REDACTED]	[REDACTED]
<b>Staff</b>	[REDACTED]	[REDACTED]

Source: The Parties.

\* [REDACTED]

- 7.27 Lloyds said it considered that its key competitors were Boots and independent pharmacies. Lloyds considered that [REDACTED] were one of the key differentiators of its stores and that one of the main drivers for customers using independent pharmacies was [REDACTED].
- 7.28 The Parties also said that neither party reacted to the proposed entry of the other to any greater extent than another competitor. The Parties suggested that, when they became aware of a potential new entrant in an area in which they operated, they would always object to the licence application. [REDACTED]
- 7.29 If entry occurs, Lloyds later said that it only flexed two aspects of its local store offer and this was only in response to local competition from small format rivals ([REDACTED] – see Table 6). It said that it did not vary its offering in response to what supermarket pharmacies were doing and it did not flex any aspects in

response to the entry of a Sainsbury's store. Sainsbury's said it did not flex any aspects of its offer in response to local competition.

**Table 6: Lloyds' view on how it responds to local competition**

<i>PQRS</i>	<i>PQRS parameter</i>	<i>Lloyds' approach to strategy on this variable?</i>	<i>Does Lloyds flex local store offer due to local competition?</i>	<i>Does Lloyds flex local store offer due to Sainsbury's?</i>	<i>Potential harm to consumers</i>
<b>Price</b>	Prescription prices	[X]	[X]	N/A	N/A
	P-med prices	[X]	[X]	N/A	Higher prices
	GSL prices	[X]	[X]	N/A	Higher prices
<b>Quality</b>	Staff training	[X]	[X]	No	Service quality/patient health
	Quality of advice	[X]	[X]	No	Service quality/patient health
	Permanent/locum mix	[X]	[X]	No	Service quality
<b>Range</b>	P-med range	[X]	[X]	No	Smaller range/GSL substitution
	Prescription stocking	[X]	[X]	No	Need to return/go elsewhere
<b>Service</b>	Staffing levels	[X]	[X]	No	Inconvenience: longer wait
	Waiting times	[X]	[X]	No	Inconvenience: longer wait
	Opening hours	[X]	[X]	No	Inconvenience: store closed
	Refurbishments	[X]	[X]	No	Store ambience
	Additional services	[X]	[X]	No	Inconvenience: service unavailable
	Prescription collection	[X]	[X]	No	Inconvenience: no collection
	Home delivery	[X]	[X]	No	Inconvenience: no home delivery
<b>Convenience</b>	Information to GPs	[X]	[X]	No	Unclear
	Site location (proximate to GP practice)***	Local	[X]	No	Inconvenience: location
	Site format: large free car park	N/A (outside LP control)	N/A	N/A	N/A
	Site format: one stop/large grocery offer	N/A (outside LP control)	N/A	N/A	N/A

Source: The Parties.

Note: PQRS = price, quality, range and service.

### *Pharmacies' ability to flex parameters of competition*

7.30 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. In assessing the extent of competition in the pharmacy market, we first considered whether pharmacies have the ability to vary parameters that matter

to consumers at a local level. We recognise that, 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. We have investigated the extent to which regulation fixes the level of a parameter or sets a minimum level for a parameter.

7.31 Appendix F sets out in detail the evidence on existing pre-merger competition in the pharmacies market. That evidence shows that pharmacies, including Lloyds and Sainsbury's, are constrained by regulation in their ability to compete, but are nevertheless able to (and do in practice) vary a number of competitive parameters at a local level. In particular, we find that:

- (a) Non-supermarket pharmacies do relocate reasonably frequently, particularly when there is the opportunity to leapfrog a rival in being the closest pharmacy to a GP practice.<sup>81</sup> Such competition can reduce the time taken for consumers to travel to a pharmacy and so improve consumer outcomes.
- (b) Pharmacies focus on improving the information given to GP practices in areas where they may face higher competition.
- (c) There are no restrictions on the range of pharmacy-only medicines or services which can be offered (above and beyond the pharmacy services which are essential, and must be offered by all operators, such as MUR, and the local commissioning arrangements which may limit the funding for NHS services in any given local area).
- (d) Pharmacies can determine their own stocking practices for prescription-only medicines (although they must be able to provide the full list, and comply with the obligation under the terms of the NHS pharmacy licence to provide prescriptions medicines with 'reasonable promptness').
- (e) Pharmacies appear also to be able to influence waiting times, which are not regulated.<sup>82</sup>

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<sup>81</sup> Smaller-format high-street pharmacy operators such as Lloyds (independents, Boots, Well, Rowlands, Day Lewis, etc) typically have shorter-term leases (around five years, or if longer than five years, with a break clause after five years or less), relative to supermarket operators, who have larger stores and longer leases. See: [Parties' initial submission](#), Part B.

<sup>82</sup> These may be of lesser importance in supermarket pharmacies, some of whose customers drop off their prescriptions at the start of their grocery shopping and collect at the end.

- (f) Opening hours are in practice often substantially above minimum levels, (termed core hours; additional hours above core hours are termed supplementary hours), particularly for pharmacies which have a standard (40-hour) licence. Although changes in opening hours must be notified to the NHS, approval for changes in hours above the core minimum are granted automatically.<sup>83</sup>
- (g) Pharmacies are able to flex the level of training given to staff, and the coverage and quality of delivery/collection services at a local level.
- (h) Pharmacies also make changes to the pharmacy environment above the minimum standards set by regulation through refurbishments, for example in response to local competition.

7.32 The ability to flex the offering at supermarkets such as Sainsbury's is somewhat more limited than the flexibility at Lloyds because of the particular characteristics of supermarket pharmacies. In particular:

- (a) The location of the pharmacy is determined by the physical location of the grocery store. Supermarkets can decide whether to open a pharmacy in an existing store in response to local market conditions, but cannot practically relocate the licence to an alternative location outside of the grocery store.
- (b) Supermarkets have a higher proportion of 100-hour contracts compared with Lloyds: approximately 2% of Lloyds stores have licences acquired under the 100-hour exemption whereas this figure is almost 50% for Sainsbury's. Where a pharmacy has a 100-hour licence, it has significantly less flexibility to respond to competition by changing opening hours since it is already open for long hours.<sup>84</sup>

7.33 We therefore provisionally conclude that pharmacies, including Lloyds and Sainsbury's, have an ability to compete at a local level by flexing these parameters of quality, range and service in response to their competitors. However, the ability to flex some parameters is more limited at supermarkets such as Sainsbury's than at Lloyds.

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<sup>83</sup> The National Health Service (Pharmaceutical and Local Pharmaceutical Services) Regulations 2013; Part 3, paragraph 23, also see [NHS England document: Policy for dealing with changes to pharmacy and dispensing appliance contractors' opening hours](#).

<sup>84</sup> A very small proportion of pharmacies with a 100 hour licence open for more than the hours mandated in their licence.

### *Evidence that pharmacies respond to local competition*

- 7.34 Given that pharmacies are able to flex elements of their offering that matter to customers at a local level, pharmacies will have an incentive to compete on these parameters to attract consumers. Since pharmacies' main revenues come from dispensing prescriptions, there is a strong incentive to win a higher share of prescriptions in a local area, as this results in a higher revenue.
- 7.35 In addition to noting these incentives, we have also looked for direct evidence of competition between pharmacies at a local level. We have considered:
- (a) evidence of competition from the Parties' internal documents and third party submissions; and
  - (b) quantitative evidence of how competitive outcomes vary across local areas.

### *Evidence on competition from internal documents and third party submissions*

- 7.36 The Parties told us that they did not produce reports that discussed local competition and so did not have any local documents that illustrated how they reacted to local rivals. However, the Lloyds 'Competitive Edge' document, dated June 2011 (the Competitive Edge Document) was created to assist local managers in responding to competitor applications for pharmacy licences; protect at-risk pharmacies in advance of applications being made; and then, where applications are granted, defend existing prescription volumes. We also reviewed other material provided by the Parties and other parties about how pharmacies compete locally.
- 7.37 The evidence suggests that pharmacies generally respond to competition in three main ways at a local level:
- (a) by objecting to applications for new pharmacies;
  - (b) by relocating the pharmacy licence; and
  - (c) by varying quality, range and service parameters.
- *Objections to new pharmacy licences*
- 7.38 The Competitive Edge document sets out how field managers should respond to entry. It states that a new pharmacy opening in close proximity can have a significant effect on a pharmacy's business and sets out that:
- (a) [✂]

(b) [REDACTED]<sup>85</sup>

(c) [REDACTED]

7.39 Other pharmacies also told us how they reacted to new entry by a competitor. Several said they would object to the application for a pharmacy licence.<sup>86</sup> Sainsbury's said that it regularly objected to applications for new pharmacy licences in areas where it currently operated.<sup>87</sup>

- *Relocating the pharmacy licence*

7.40 The majority of pharmacy revenue is derived from prescription customers. Before receiving their medicine, these customers need a prescription, which must be issued by a health professional, most often a GP. By locating closer to a GP practice, a pharmacy may be expected to receive a higher share of prescriptions from that GP practice.

7.41 Although relocations of pharmacies are regulated and require approval before a move takes place, the Competitive Edge document suggests that Lloyds may compete over this parameter. In particular, it states that an appropriate response to possible entry in a local area may be to '[REDACTED]', where '[REDACTED]'. However, we note that relocation decisions would typically be part of a longer-term response to competition, rather than being a competitive parameter which could be flexed in the short term.

7.42 We do not consider that Sainsbury's would relocate its stores to benefit pharmacy customers, given that this business represents a small part of its turnover.<sup>88</sup> However, in areas where a Sainsbury's pharmacy opened in a more convenient location for a GP practice, Lloyds could have had the incentive to relocate its store to ensure it retains its business.

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<sup>85</sup> We note in paragraph 7.28 that Lloyds said its approach depended on whether [REDACTED]. However, we note that [REDACTED]. For example, where Lloyds objected to the entry of a Sainsbury's pharmacy in Wolverhampton, Lloyds noted that the appellant focused on opening hours as part of its appeal and said the applicant did not propose to provide any core hours after 5pm on weekdays nor any core hours over the weekend and failed to provide any supporting evidence as to why such extended hours were required and no evidence that the current opening hours of existing pharmacies were not sufficient to meet patient needs. Lloyds said it failed to see how the application could be approved to secure improvements or better access to pharmaceutical services and asked for the appeal to be dismissed. (See NHS Litigation Authority, [Ref SHA/17690](#): Appeal against Birmingham, Solihull & The Black Country Area Team, NHS Commissioning Board ("NHS England") Decision to refuse an application by Sainsbury's Supermarkets Ltd for inclusion in the Pharmaceutical List offering unforeseen benefits under Regulation 18 at Sainsbury's Supermarket, Raglan Street, Wolverhampton, West Midlands WV3 0ST).

<sup>86</sup> Boots told us that it would object to an application depending on the circumstances, if it thought that would threaten its business or if it thought it was not in the right interests of health provision in a particular location.

<sup>87</sup> Boots, Day Lewis. Sainsbury's said that it would object to every application for an independent or a Boots because it is just what the market does and it is just the 'nature of the thing'.

<sup>88</sup> Parties' initial submission.

- *Competition on other parameters of quality, range and service*

7.43 Lloyds' internal documents and responses from third parties suggest that it competes at a local level with other pharmacies on several other parameters of quality, range and service, which can be flexed in the short run. By contrast, we found only limited evidence from internal documents that Sainsbury's sets parameters for its in-store pharmacies in response to competition, relating to a smaller number of parameters.

7.44 The most important competitive parameters appear to be:

- (a) **Opening hours** – Lloyds said that its opening hours were always set at the local level, and were generally set to be consistent with those of local surgeries. The Competitive Edge document states that opening hours should be reviewed following new entry, and [REDACTED]. Almost all Lloyds pharmacies open for more than the minimum number of hours (around 90% open for at least 45 hours and less than 100 hours), and therefore are subject to a reasonable degree of flexibility. Moreover, Boots told us that, in response to the entry of a competitor, it may, on occasions, change opening hours to better match a GP surgery or to make sure the Boots pharmacy was open longest with the ultimate focus of providing the best customer care within that pharmacy.
- (b) **Store ambience and refurbishments** – Lloyds said that 'refurbishment of stores is undertaken for the purpose of increasing a pharmacy's competitive position.' Lloyds also told the CMA that it operated a regular refurbishment schedule for its stores, but that it might [REDACTED]. Third parties have also told us that they considered the environment and facilities offered in store to be relevant to local competition. In contrast, Sainsbury's said that pharmacy refurbishments were carried out as part of an overall store refurbishment, and that [REDACTED].<sup>89</sup>
- (c) **Staffing and quality of advice**<sup>90</sup> – the Competitive Edge document states that area managers should consider '[REDACTED]' if another pharmacy has or might set up in the area. Lloyds also said that staffing was crucial to overall customer satisfaction. It said that 'the quality of its staff is a highly positive distinguishing factor, in terms of their availability, ability to listen to customer needs, and the quality of their advice'. The Competitive Edge document states that area managers should '[REDACTED]' where there is potential for new entry. Other parties also suggested that staffing levels could be

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<sup>89</sup> [REDACTED]

<sup>90</sup> By regulation, pharmacies may only operate if there is a pharmacist present, and must fulfil prescriptions with 'reasonable promptness'.

changed as a result of local competition. Tesco said that in response to the entry of a competitor in a local area it would [REDACTED]. Boots said it would ensure that all staff were properly trained. By contrast, there is no evidence in any Sainsbury's internal document seen by the CMA that Sainsbury's flexes staffing levels in response to competition. Sainsbury's told us that staffing above the minimum was determined by [REDACTED].

- (d) **Provision of additional services** – pharmacies have a degree of freedom in the range of NHS and private services they offer, although some services must be available at all pharmacies, not all services are commissioned in every local area and all pharmacies must provide a set of 'essential services'.<sup>91</sup> Sainsbury's told us that its range of services might vary from area to area to meet the needs of the local populations, and that it placed reliance on local pharmacy managers to assess risk and decide if they could provide enhanced services. A Sainsbury's internal document stated that [REDACTED] and outlined an intention to [REDACTED]. Further, the Competitive Edge document indicates that Lloyds pharmacies should provide as [REDACTED].
- (e) **Waiting times** – Lloyds said that it had an [REDACTED] waiting time target that applied nationally; however, we note there is significant variation in performance across local areas (see Figure 1 in appendix G). This demonstrates that waiting times do vary at a local level.<sup>92</sup> The Competitive Edge document shows that, where there has been a store opening, pharmacies are encouraged to review their performance to ensure they are meeting their target of [REDACTED] average waiting time. Lloyds told us that waiting and dispensing times were key differentiators against competitors – particularly those that were not purely health or pharmacy focused. Lloyds also told us that decisions on whether to make additional expenditure with the aim of reducing waiting times were made taking into account local factors, and could be approved if considered to be the limiting factor to efficient dispensing or improving customer service. Further, Sainsbury's monitored waiting times in a customer satisfaction survey [REDACTED].<sup>93</sup>
- (f) **Prescription collection** – This parameter is set at the local level for Sainsbury's stores, although it is run at more informally than with Lloyds, with staff using their own vehicles to collect prescriptions. Further, the Competitive Edge Document states that area managers should [REDACTED].

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<sup>91</sup> Such as: promotion of healthy lifestyles, disposal of unwanted medicines, support for self-care, and signposting.

<sup>92</sup> The total variation in waiting times is between [REDACTED] with the bulk between [REDACTED].

<sup>93</sup> Sainsbury's submitted that [REDACTED].

7.45 There are also other parameters which pharmacies have the ability to flex at a local level. However, we found limited direct evidence that these decisions were currently related to local competition:

- (a) Range of prescription medicines – There are no minimum stocking requirements for pharmacies, although they must be able to source ‘a full range of prescription products’.<sup>94</sup> Although a pharmacy may have the incentive to hold a larger range of prescription medicines in stock where customers could easily go somewhere else as opposed to areas where there are no alternatives, we have not seen evidence that stocking decisions for prescription medicines are related to local competition and consider that this is unlikely to be a source of competition.
- (b) Pharmacy-only medicines – Pharmacies do not face restrictions on the range of pharmacy-only medicines and GSL items which they can stock. [redacted]<sup>95</sup> We consider that pharmacies do not currently compete by setting range differentially in response to local competition for these products.

*Empirical evidence of competition between pharmacies*

7.46 In addition to the documentary evidence on local competition between pharmacies, we considered whether there was any observable variation in quality parameters and margins at a local level which might indicate that pharmacies respond to competition. The analysis is described in more detail in Appendix G.

7.47 The Parties submitted their own analysis, plotting the relationship between four quality parameters at Lloyds pharmacies and the fascia count in the local catchment of each store. The quality parameters they considered were: average waiting time; years since refurbishment; locum hours; and mystery shopper ratings. The Parties found no significant relationship between these individual quality indicators and fascia count. They said that this indicated that there was no evidence of competition at a local level on any of the parameters.

7.48 However, the Parties’ analysis does not prove there is not a relationship, only that there is limited correlation between individual quality parameters and fascia count, which might be explained by other features of the local areas aside from the strength of competition.<sup>96</sup> Their analysis did not attempt to control for these other factors. As noted above, the Parties’ own documents and statements indicate that some of these parameters are flexed in response

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<sup>94</sup> Parties’ initial submission, section 2.1.

<sup>95</sup> Parties’ initial submission, section H2.2.

<sup>96</sup> For example, some elements quality parameters might be affected by the level of demand in a local area, which in turn might be correlated with the number of fascia in the area.

to competition. Their analysis also confirms that there is substantial variation in all four of the quality parameters between individual local stores.

- 7.49 We carried out our own analysis on a range of other quality parameters, including opening hours and opening late at night or on Sundays. We plotted these quality measures against the number of stores in a local area. We controlled for some of the factors which could lead to either higher or lower quality.<sup>97</sup> Our analysis suggests that:
- (a) Lloyds' opening hours are positively correlated with the number of competitors in a local area. This relationship does not hold for Sainsbury's pharmacies.
  - (b) Lloyds pharmacies are more likely to offer an extended hours service where there are more competitors in a local area. As with opening hours more generally, this pattern does not hold for Sainsbury's pharmacies.
- 7.50 We also considered whether there was evidence that quality parameters had changed over time in response to entry by a competitor. In particular, we analysed whether Lloyds stores in locations where an alternate fascia had entered had been refurbished more recently than others.<sup>98</sup> We found that Lloyds was likely to refurbish 3.1 years earlier when a supermarket<sup>99</sup> entered within 0.2 miles of its location, than when another Lloyds entered within that same distance.<sup>100</sup> However, we note that we were not able to control for other factors which might be driving the timing of refurbishments, so cannot conclude that competition is causing stores to be refurbished more quickly.
- 7.51 Finally we considered whether there is any relationship between margins and concentration. Since an increase in quality at a pharmacy is generally associated with an increase in costs, we would expect margins to be lower in areas where quality is high and vice versa. We analysed the relationship between Lloyds' margins and the number of stores in a local area. The results of our analysis did not identify a clear relationship between margin and concentration. We consider that this is likely to be due to a quantity effect – a

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<sup>97</sup> In addition, we used the number of stores the focal store competes with, which is a continuous variable. In contrast, the Parties used indicator variables for the number of competing fascias (from 0 up to '4 or more' competing fascias), which is a discrete variable. We preferred to use a continuous variable, because it allows us to estimate a more general relationship between the quality parameters and the degree of competition.

<sup>98</sup> We tested to see whether there was a relationship between time since last refurbishment and concentration and did not find a relationship.

<sup>99</sup> Not excluding Sainsbury's, which we analysed separately for direct evidence of competition.

<sup>100</sup> We also found that the mean number of years since refurbishment was smaller when a Sainsbury's entered than in our comparator group. This difference was not statistically significant, although we note that the sample size was small. We do not have corroborating evidence to suggest that Lloyds would respond differently to entry by other supermarket fascias than entry of Sainsbury's.

large proportion of costs are fixed in the short run<sup>101</sup> so the margin increases as quantity increases. Consequently stores with a higher prescription volume are likely to have a higher margin, and we are not able to adequately control for this relationship.<sup>102</sup>

- 7.52 Overall, our own empirical analysis and the analysis provided by the Parties suggests that there is substantial variation in quality parameters between local Lloyds stores, including on: opening hours; average waiting times; years since refurbishment; locum hours; and mystery shopper ratings. We do not find a clear relationship between individual quality variables and indicators of competition in a local area. However, we note that neither our analysis nor that of the Parties has been able to control adequately for other local factors which might be affecting levels of quality.

*Provisional conclusion on the nature of competition between pharmacies*

- 7.53 We recognise that this is a market in which regulation plays an important role. Several of the quality parameters we have considered are subject to minimum levels below which quality cannot be reduced, and there are well-defined assurance procedures to ensure that pharmacies adhere to regulations. The prices of prescription goods are regulated. Consequently, we consider that the scope for competition is reduced compared with many other retail operations. However, such competition may still be sufficiently significant that its loss would be a matter of concern to us.
- 7.54 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 improve the quality of their offer try to attract additional customers. This is likely to manifest itself in pharmacies improving the quality of their offering, as they are unable to alter the prices of prescription goods to try to win extra customers.
- 7.55 Specifically, we consider that pharmacies currently compete at the local level on opening hours, range of services, staffing levels and staff training (which

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<sup>101</sup> A pharmacist must be present if the store is open, so a significant proportion of costs are fixed in the short term.

<sup>102</sup> The Parties have suggested using the margin relative to the number of prescriptions as the dependent variable. We do not agree with this approach because it results in an ambiguous effect of entry/exit on relative margin, which is assumed to be a function of the prescription quantity at a pharmacy. For example, entry of a pharmacy close to the focal pharmacy results in an increase in the prescription volume and an increase in the margin. Therefore the relative effect is ambiguous.

jointly affect quality of advice), waiting times, location,<sup>103</sup> store refurbishments, and provision of prescription collection services.

- 7.56 In particular, we note that Lloyds has substantial discretion as to its opening hours and makes two references in its internal documents to setting these in response to local competition. Lloyds also linked store refurbishments, waiting times, staffing and range of services directly to local competition.
- 7.57 We consider that, in practice, Lloyds would be likely to improve its offering on at least some of these parameters were the level of competition in an area to increase. We consider that it may likewise worsen its offering on some of these parameters were local competition to decrease.<sup>104</sup>
- 7.58 We consider that Sainsbury's has less scope to respond to competitor pressures at a local level. We nevertheless found evidence to suggest that Sainsbury's did consider competition between pharmacies in setting its offering, for example when [redacted]. We also found evidence that it had considered whether to [redacted].
- 7.59 For other parameters, we either do not have evidence that these variables are set with respect to local competition, or have evidence that this is not the case. Pharmacies do not have the ability to compete on pricing for prescription-only medicines (not including the delivery of such medicines). They are also generally unable to compete on parking. In our view Sainsbury's pharmacies do not have the ability to compete on location, and we note the [redacted].
- 7.60 We provisionally conclude that, taken in the round, the evidence from our assessment of internal documents, third party evidence and data on indicators of quality, range and service in our view shows that there remains scope and incentive to flex a number of aspects of quality, range and service in response to competitive conditions at the local level.

### ***How closely do Lloyds and Sainsbury's pharmacies compete?***

- 7.61 In the previous section we considered how pharmacies in general compete at a local level. In this section we focus on the extent to which the Parties compete with each other and particularly the extent to which supermarket pharmacies compete with more traditional high street pharmacies and vice versa.

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<sup>103</sup> We note that location decisions would typically be taken in the longer term, rather than being flexed in the short term in response to competition.

<sup>104</sup> Including regulated parameters where, as noted in paragraph 7.54, Lloyds would be able to worsen its offer to the level set by regulation.

7.62 We have gathered evidence from the following sources, described in more detail below:

- (a) The Parties' submissions.
- (b) Internal documents provided by the Parties.
- (c) Information provided by third parties.
- (d) The CMA consumer survey.
- (e) Entry/exit analysis

*Parties' submissions on closeness of competition*

7.63 The Parties considered that there was very limited competition between Lloyds and Sainsbury's pharmacies. They stated that the majority of Sainsbury's customers visited the store on a grocery shopping mission and used the pharmacy as it was convenient within the scope of this shopping mission. In contrast, since Lloyds is a stand-alone pharmacy business, customers must either visit on a stand-alone shopping mission, or in combination with a visit to another store or the GP practice.

7.64 The Parties also noted that Lloyds' offerings were differentiated from those of Sainsbury's and supermarkets in general in terms of locations and formats. Lloyds' branches were located within the community and were often within or very close to a GP practice. This was reflected in the make-up of their respective pharmacy estates. Lloyds operates:

- (a) [REDACTED] Health and Medical stores that are located within or less than 100 metres of a GP practice;
- (b) [REDACTED] Health and Community stores that are located more than 100 metres but less than 500 metres from a GP practice; and
- (c) [REDACTED] Health and Skin Extra stores which are located in high streets or town centres.

7.65 In contrast, supermarket pharmacies are located within grocery stores, and their locations are driven by the interests of the wider grocery business. Generally, supermarkets locate pharmacies within their larger grocery stores, where there is sufficient floor space for them to have a non-grocery offering. This was confirmed by Asda and Tesco. For Sainsbury's, the Parties said that pharmacies were typically located in stores in excess of 30,000 sq ft that had sufficient space for a pharmacy to be added without impinging upon the core

grocery offering. The Parties noted that stores of this size were typically located out of town.

- 7.66 As a result of the different store formats there are a number of differences between the characteristics of the stores. As supermarket pharmacies are located in grocery stores they normally offer customer parking, which is generally free of charge, and tend to mirror the opening hours of the store at large. In contrast, Lloyds' stores do not consistently offer parking, and the hours are typically set to mirror those of the local GP practice(s).
- 7.67 The Parties said that the different store characteristics led to differences in the characteristics of the customers who visited each party's stores. In particular, they said that Lloyds' customers were often aged over 55 and from lower socio-economic groups than Sainsbury's customers, who tended to be more representative of the population as a whole. This is reflected in the proportion of customers who paid the NHS prescription levy at each of the Parties, with approximately [redacted]% paying the levy at Sainsbury's compared with approximately [redacted]% at Lloyds.<sup>105</sup>
- 7.68 The Parties noted that this difference was reflected in the collection and delivery services offered by each of the Parties, with Lloyds providing a repeat prescription service both online and in-store,<sup>106</sup> collecting prescriptions from GP practices and offering a prescription delivery service to customers. In contrast, Sainsbury's did not offer any formal collection or delivery services, but did collect prescriptions from local GP practices using existing Sainsbury's staff. It also offered a home delivery service, but only from [redacted] of its stores.<sup>107</sup>
- 7.69 The Parties also noted that Lloyds offered a fuller range of pharmacy services than Sainsbury's and was more proactive at tendering for them, and that it employed more pharmacists and placed less reliance on the use of locums.<sup>108</sup>
- 7.70 The Parties said that differences in the store setting led to differences in their customer acquisition strategy and by implication the customer acquisition strategy of supermarkets and high street pharmacies more generally. The Parties said that Sainsbury's focused on converting existing in-store grocery customers into pharmacy customers, whereas Lloyds sought to establish links with GP practices and offered a wide range of additional services to try to entice additional customers to visit its stores.

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<sup>105</sup> Parties' initial submission, Part H, section 3.5.

<sup>106</sup> This system allows the automatic ordering of repeat prescriptions at the customer's request.

<sup>107</sup> Note that [redacted].

<sup>108</sup> Lloyds currently employs [redacted] pharmacists and has [redacted] locums on its books. In contrast Sainsbury's employs [redacted] pharmacy managers and used [redacted] locums during 2015.

7.71 Third party information suggests that other supermarkets also seek to convert existing grocery customers into pharmacy customers. Asda stated that it assumed that Asda pharmacy customers were mostly existing grocery customers. Tesco stated that [REDACTED] so the introduction of a pharmacy was driven by the customer.

#### *Evidence from internal documents*

7.72 The Parties submitted research on customer perceptions and their use of supermarket pharmacies and high street pharmacies conducted during the normal course of business. The Parties said that the research showed that customer perceptions of each party were different in terms of their relative strengths and weaknesses and that independents were rated very highly by customers on a number of variables. The Parties considered that the differentiation between their offerings, coupled with customers' differing perceptions of supermarket and high street pharmacies, indicated that they were not close competitors to one another. Further details are shown in Appendix H.

7.73 Collectively, the internal documents from across both Sainsbury's and Celesio showed that both Parties consider that high street and supermarket pharmacies can compete and that the other merging party is a competitor. However, the results of the research they conducted also appears to suggest that the closest competitors to Lloyds are independent pharmacies along with other major chains, rather than supermarket pharmacies. For example, Sainsbury's research found that [REDACTED]. Similarly, when Lloyds asked customers about the type of healthcare purchases they would make at each store, Lloyds was perceived as [REDACTED]. In another piece of analysis, Sainsbury's considered the disadvantages it faced compared with specialist pharmacies and identified several ways in which its services were differentiated from businesses such as Lloyds, including [REDACTED].

#### *Evidence from third parties*

7.74 The general view among competitors was that the main determinant of choice for pharmacy customers was location and that competition between supermarket pharmacies and high street pharmacies was no different from competition between any two pharmacies. In particular:

- (a) Tesco told us that supermarket pharmacies 'certainly competed' with high street, health centre, community and all other types of pharmacies. Tesco said that all had the same offer. It said that it had been a growing business over the last ten years and had seen customers switch from competitors to Tesco and, equally, customers switch from Tesco back to competitors.

- (b) Boots said that, because pharmacies were such a local business, there would be some supermarket pharmacies that were extremely well run and close to a Boots store and, therefore, would be very important to it. Equally, there would be some supermarket pharmacies who were not as well run or not as close to a Boots store and would therefore present less of a threat. It said that this could be the same for Lloyds or Day Lewis or Superdrug or any other part of the pharmacy profession. Boots said that pharmacies were a very localised business, so it would not consider one particular pharmacy chain a bigger threat than another. Boots also said that supermarket pharmacies had a share of the UK pharmacy prescription market and therefore, by default, they were competitors within that market. It said that the customer offer of supermarkets was more towards a dispensing service of prescriptions than a range of OTC, GSL and pharmacy medicines products. Boots thought that supermarkets would provide some pharmacy services, but on the whole fewer than Boots.
- (c) Day Lewis said that competition from supermarkets was felt from further than a mile. It said that when a supermarket added a pharmacy it would affect other pharmacies within 3, 4, or 5 miles, because the grocery offer would attract a lot of footfall; prescriptions would get diluted and all the pharmacies would feel 'a little bit of a pinch.'
- (d) Well also noted that, while the entry of a high street pharmacy tended to have an impact on their sales when the pharmacy was located within 1 mile, there was an impact from supermarket pharmacies located 1.5 to 2 miles away.

7.75 Several third parties, however, also pointed out that the Parties' propositions were somewhat differentiated. Asda and Day Lewis noted that traditional pharmacies could offer more services than supermarket pharmacies. Day Lewis and W R Evans noted that supermarkets, on the other hand, might be more popular with younger generations and, having longer opening hours, had greater opportunities to convert patients to their pharmacies using the EPS. Well told us that the Parties were not close competitors to one another, as they had different business models; similarly, Boots noted that the Parties' pharmacies tended to be in different locations.

7.76 Third parties did not consider that there would be problems at a national level, but several thought there would be local areas that might be problematic.<sup>109</sup>

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<sup>109</sup> [REDACTED]

### *Evidence from the CMA consumer survey*

- 7.77 The CMA consumer survey indicates that there are some differences between the reasons why consumers choose to visit Lloyds or Sainsbury's.<sup>110</sup> However, the survey has also shown that the Parties are capable of being very close competitors in some local areas.
- 7.78 The Parties argued that the results of the consumer survey should be treated with caution because it was not based on a random sample of stores. The selected survey stores were almost all in areas where Lloyds and Sainsbury's overlapped,<sup>111</sup> and were skewed towards more *prima facie* problematic areas (based on concentration measures). We also surveyed all overlap areas in Scotland and Northern Ireland.
- 7.79 The sample of areas in our survey was not intended to be completely representative of the national characteristics of all Sainsbury's and Lloyds customers. However, the sample represents a broad cross-section of different types of area. We also surveyed a large number of customers in total (5,226 completed interviews). Therefore, we consider that the overall survey findings are likely to give a robust indication of the characteristics of Lloyds' and Sainsbury's customers and will be particularly informative when considering the competitive conditions in individual local markets. We have considered these findings alongside the other internal survey evidence provided by the Parties.

### *Survey findings on customer characteristics*

- 7.80 The Parties operate slightly different business models, with Sainsbury's targeting a pool of existing grocery customers. The majority of Sainsbury's customers are on a 'grocery-led' shopping mission, visiting the pharmacy because it is convenient to combine this with their grocery shop. The CMA consumer survey suggested that 73% of Sainsbury's pharmacy customers would have still visited the store if it did not have a pharmacy. In contrast, Lloyds is a stand-alone pharmacy business so does not have an existing pool of customers to draw on. 20% of customers indicated that the ability to combine a pharmacy purchase with grocery shopping was an important factor for visiting Sainsbury's, and 83% of Sainsbury's pharmacy customers bought products besides pharmacy items in the Sainsbury's store.
- 7.81 However, 27% of Sainsbury's pharmacy customers said they would not have visited the grocery store if it did not have a pharmacy, and 17% of Sainsbury's

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<sup>110</sup> The full results of the consumer survey can be found in Appendix C.

<sup>111</sup> Two surveyed stores were in non-overlap areas.

pharmacy customers did not make any other purchases. This suggests that a portion of customers are willing to visit the store solely in order to visit the pharmacy, and might be expected to substitute between Sainsbury's and any other retail pharmacy depending on convenience and relevant quality, range and service factors.

- 7.82 Demographically, the survey suggests a similar age distribution for Lloyds' and Sainsbury's customers.<sup>112</sup> Sainsbury's attracted a slightly higher proportion of women than Lloyds (67% against 59%). Around one-third of both Parties' customers are retired, with a higher percentage of Sainsbury's customers in full- or part-time employment than Lloyds' (55% against 43%).
- 7.83 Sainsbury's customers were more likely to travel to the store by car (85% against 53%) and were more likely to buy a pharmacy-only product (29% against 11%). In contrast, Lloyds' customers were more likely to travel to the store by foot than Sainsbury's customers (38% against 11%). But for both Parties the majority of customers travelled to the store by car, from their home, and did so to drop-off/collect a prescription.
- 7.84 Convenience was the most important factor in both Sainsbury's and Lloyds' customers choosing to visit the store, with proximity to home/work/GP practice being the most important convenience factor. When asked their primary reason for visiting the pharmacy (Question15) the responses of customers of both Parties were similar, with convenience the most important for both. It was only when second and third preferences were included that Lloyds' customers differed significantly in terms of speed of service, relationship to pharmacist and availability of service.

#### *Evidence on customer diversion*

- 7.85 In addition to asking about customers' reasons for visiting a store, the CMA consumer survey also asked which pharmacy they would go to if a store closed. By analysing the results to these questions we are able to estimate the diversion ratio between the Parties. This provides some indication of customers' preferences and the relative closeness of alternatives.

- *Calculating the diversion ratio*

- 7.86 Our consumer survey asked a number of questions about consumers' reasons for visiting the store and their general preferences, before going on to ask them what they would do if the store was closed. The responses to this second

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<sup>112</sup> 21% of Lloyds' customers were 18-35 vs 19% of Sainsbury's; 39% of Lloyds' customers were 36-59 vs 44% of Sainsbury's; 40% of Lloyds' customers were 60+ vs 36% of Sainsbury's.

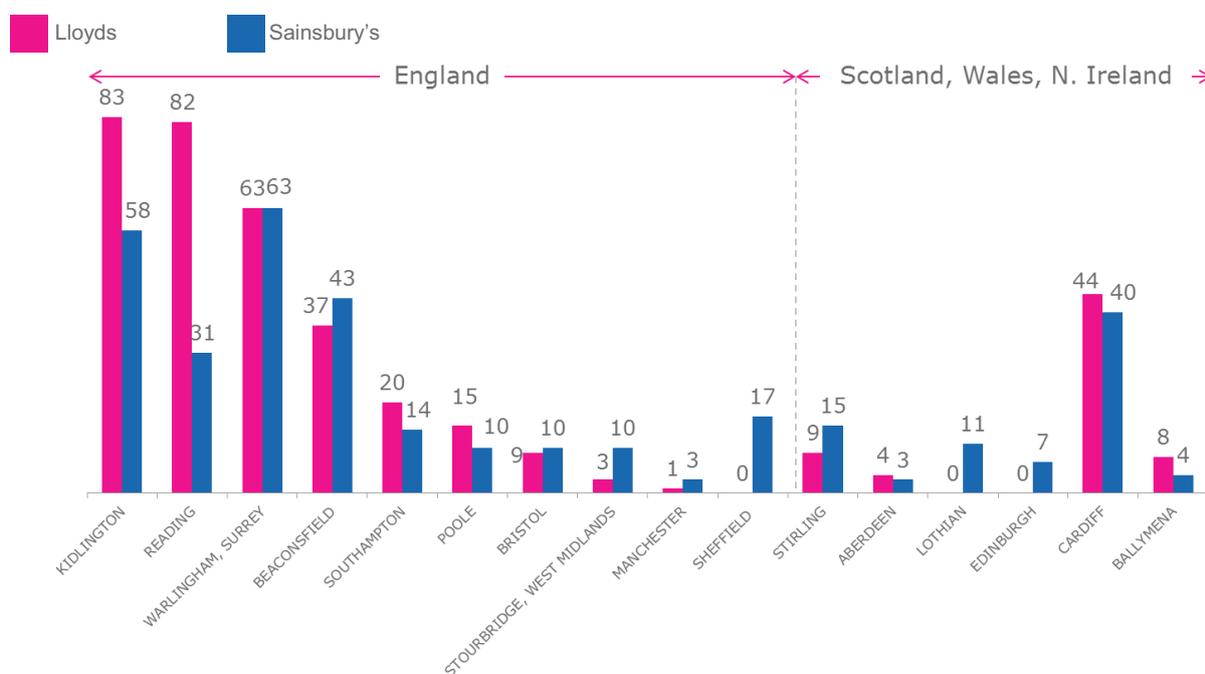
set of questions was used to calculate the diversion ratio between the Parties in that local area. The diversion ratio was used to measure the closeness of competition between different stores in a local area. The higher the diversion ratio, the more closely two firms are considered to compete.

- 7.87 It is standard practice in consumer surveys that seek to provide an empirical estimate of diversion to ask consumers what they would do in response to the closure of a store. Although we are principally interested in the behaviour of marginal customers, we can infer diversion ratios based on the behaviour of all customers by making the assumption that the diversion behaviour of marginal and infra-marginal customers is similar. There are no particular features of this market to suggest that this assumption is an unreasonable one.
- 7.88 In order to calculate the diversion ratio we asked:
- (a) 'Imagine that you had known before setting out today that this pharmacy was permanently closed. What would you have done instead of visiting this pharmacy today?'
  - (b) 'For customers who responded that they would have either gone to another pharmacy or had their prescription sent to another pharmacy we then asked: which other pharmacy would you have used?'
- 7.89 Where the Parties have multiple stores in an area, an existing Lloyds customer may respond to the second question that they would have gone to another Lloyds pharmacy. Where surveyed customers indicated that they would divert to a different store of the same fascia, they were asked a further diversion question:
- (a) Now imagine that all Lloyds/Sainsbury's (ask as appropriate) pharmacies were permanently closed. What would you have done instead of using this pharmacy today? (Question 21)
  - (b) For customers who responded that they would have either gone to another pharmacy or had their prescription sent to another pharmacy we then asked Question 22: Which other pharmacy would you have used?
- 7.90 We used the results of these questions to calculate diversion ratios, excluding own party diversion. This measure can be interpreted as giving an estimate of the proportion of sales that would be lost by the Lloyds fascia to the relevant Sainsbury's store. It provides an indication of the post-merger competitive constraint on a Lloyds store. We also calculated the diversion ratios including own party diversion, which can be interpreted as an estimate of the proportion of sales that would be lost by an individual Lloyds store to an individual Sainsbury's store.

7.91 We have used the diversion ratio excluding own party diversion in order to inform our filtering approach and when considering how closely individual parties compete in a local area. We have chosen to use this measure in the filter to ensure that we capture all areas where there is a risk that the merger may give rise to a unilateral effect, as including own party diversion could potentially give low diversion ratios in very concentrated markets. This is because, in these areas, the merger is likely to weaken the competitive constraint on other Lloyds stores as well as the surveyed stores. The filtering approach is described in more detail at paragraphs 7.114 to 7.144.

7.92 We have calculated the diversion ratio in the surveyed areas between the Parties' stores and, separately, to third party stores for each area.<sup>113</sup> The diversion ratios between the Parties are shown in Figure 2. The pink bars represent diversion from Lloyds to Sainsbury's and the blue from Sainsbury's to Lloyds.

**Figure 2: Diversion ratio – all parties' stores closed**



Source: DJS survey.

7.93 We make a number of observations about these diversion results:

- (a) First, the diversion ratios between the Parties are very high in a small number of the surveyed local areas. The survey shows that diversion to the Parties was above 80% in Kidlington and Reading and above 40% in Cardiff, Beaconsfield and Warlingham. This indicates that customers

<sup>113</sup> Where a customer indicated that they would divert to a different branch of the same fascia we have used the response to questions 21 and 22.

consider a Lloyds pharmacy to be a good alternative to a Sainsbury's pharmacy and vice versa in order to fulfil a prescription, depending on the local convenience of doing so.

- (b) Second, the diversion ratios are broadly symmetric between Lloyds and Sainsbury's in some areas – ie a broadly similar proportion of customers would divert from Lloyds to Sainsbury's and from Sainsbury's to Lloyds. This is particularly the case in Warlingham (63%<sup>114</sup> in both directions) and Cardiff (40%<sup>115</sup> and 44%<sup>116</sup>), but is also true in a number of areas with lower levels of diversion.<sup>117</sup> This indicates that customers in these areas consider Lloyds and Sainsbury's pharmacies to be a good alternatives to one another.
- (c) Diversion between the Parties was low in a number of areas suggesting that they are at least no closer competitors than any other pair of pharmacies. If the Parties were very close competitors we would expect to see high diversion between them even in areas where there are a number of other rivals.

7.94 Figure 3 shows how the estimated diversion ratio from the survey varies with the number of competitors in a local area and with the distance between the surveyed stores. Figure 3 suggests that the Parties' customers consider them to be good alternatives to one another (with high estimated diversion between them) in areas where the stores are close together (within less than a mile) and where there are relatively few other competitors in close proximity. While these results are based on a relatively small number of local areas, we consider that they give a clear indication of the situations in which we would expect the Parties to be close competitors in particular local markets. We consider likely diversion in more detail in our assessment of the effect of the merger below.

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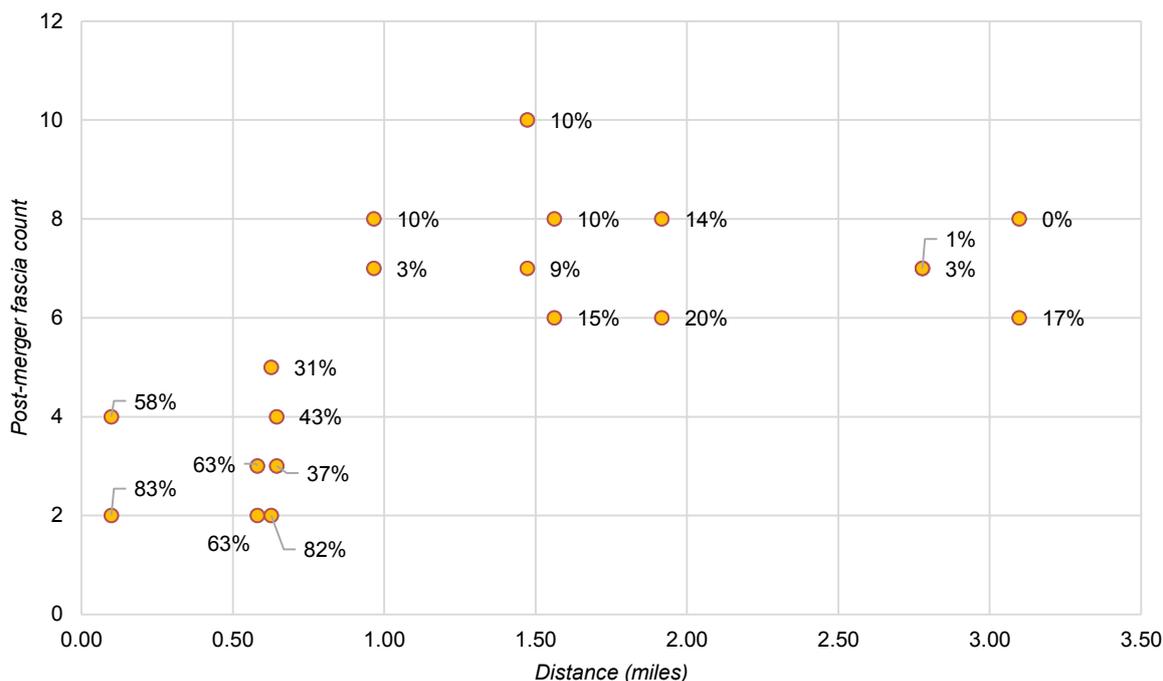
<sup>114</sup> When own party diversion is excluded.

<sup>115</sup> When own party diversion is excluded.

<sup>116</sup> When own party diversion is excluded.

<sup>117</sup> We note that when diversion is lower it can be more difficult to observe differences between diversion ratios.

**Figure 3: Relationship between survey diversion ratio, distance between surveyed stores, and number of competitors in the local catchment area**



Source: CMA calculations based on consumer survey findings and data on local pharmacy location.  
 Note: The percentages on the chart represent estimates of diversion based on survey responses at each of the individual surveyed pharmacies in England. Surveyed stores in Scotland, Wales and Northern Ireland are not included.

### Entry and exit analysis

7.95 By using an econometric model to analyse the impact of entry or exit of pharmacies on incumbent pharmacies across different local markets, we are able to observe the effect of entry or exit of supermarket pharmacies on Lloyds and vice versa. We have chosen to test the effect of entry and exit on volumes of prescription items dispensed at an individual pharmacy, because pharmacies are generally remunerated on a per-item basis.<sup>118</sup>

7.96 Full results can be found in Appendix I. In summary the model suggests that:

- (a) Lloyds experienced a statistically significant decline in volume when there was entry by both large and small/independent pharmacy chains and supermarkets (excluding Sainsbury's),<sup>119</sup> in urban areas.

<sup>118</sup> The analysis is able to demonstrate that two parties or types of store do compete with one another, but it is not able to prove that they do not compete with one another. Therefore, if the model does not find an effect of entry (or exit) by one party on another, it should be interpreted as the model being unable to prove an effect, not that the model has proved there is no effect

<sup>119</sup> Sainsbury's stores were excluded from this part of the analysis. However, we note that the Parties have not argued that Sainsbury's pharmacy offer is significantly different from that of other supermarkets.

- (b) Sainsbury's stores experienced a statistically significant change in volumes as a result of entry by other supermarkets in urban areas.
- (c) The model was not able to identify a statistically significant impact of entry or exit of either of the Parties on the other.<sup>120</sup>

- 7.97 We note that there is a limited number of entry and exit events by some parties and by Sainsbury's in particular. This makes it harder for us to identify an impact of entry by Sainsbury's on Lloyds.
- 7.98 Further, to the extent that entry involved the opening of a new grocery store rather than the opening of a new pharmacy in an existing store, this could lead to a footfall effect that would increase the volume of consumers attracted into the area. This makes it more difficult to identify the competitive constraint imposed by supermarket pharmacies on Lloyds.
- 7.99 In general we note that the entry/exit analysis suggests that there may be an asymmetry in the constraint between supermarket and non-supermarket pharmacies. For instance, it suggests that supermarkets may be only constrained by other supermarkets, whereas Lloyds is constrained by both supermarket and non-supermarket pharmacies. This would suggest that we might expect to see high diversion from Lloyds to Sainsbury's in some areas, but not vice versa. It may be the case that footfall effects, or some other source of bias is confounding the model's ability to measure the effect of entry/exit by supermarkets.

*Provisional conclusions on how closely Lloyds and Sainsbury's pharmacies compete*

- 7.100 Lloyds and supermarkets are differentiated to some degree, with supermarket customers having slightly different characteristics and motivations for visiting the pharmacy to Lloyds' customers. The Parties' internal documents suggest that both Parties consider that high street and supermarket pharmacies can compete and that the other merging party is a competitor. However, the results of the research they conducted also appears to suggest that the closest competitors to Lloyds are independent pharmacies along with other major chains, rather than supermarket pharmacies.
- 7.101 Third parties have told us that although there may be differences between high street pharmacies and supermarkets, they consider that high street and supermarket pharmacies compete with each other to attract the same

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<sup>120</sup> The exception to this is entry (or exit) by Lloyds within 3 miles of a Sainsbury's branch in rural areas, which resulted in a 5% increase in Sainsbury's sales volumes. Although this result is statistically significant, it has the wrong sign and could suggest that in general the Parties are not close competitors. It could be driven by market expansion that we have not been able to control for.

customers. This is consistent with the results of our entry exit analysis, which suggests that Lloyds loses customers in response to entry by other pharmacies including both independent pharmacies and supermarkets.

7.102 We have not seen any evidence to suggest that the competitive constraint on Lloyds from Sainsbury's differs significantly from the constraint from other supermarket pharmacies. Therefore, we consider that the evidence that Lloyds is constrained by supermarkets in general also suggests that Lloyds would be constrained by Sainsbury's.

7.103 The evidence from the CMA consumer survey supports the other evidence that there are some differences in the characteristics of Sainsbury's pharmacy customers and Lloyds' customers. However, the diversion estimates from the survey show that the Parties can be close competitors in specific local markets, where their stores are close together and where there are a limited number of alternative options for consumers.

#### ***Provisional conclusions on pre-merger competition***

7.104 Based on our overall assessment of the extent of pre-merger competition between pharmacies generally, and specifically between the Parties, we provisionally conclude the following:

- (a) Retail pharmacy competition takes place at a local level.
- (b) 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.
- (c) Since revenue is largely dependent on the number of prescriptions dispensed, pharmacies have the incentive first to seek to prevent entry of competitors through objections to applications and second to improve the quality of their offering to secure existing customers and attract additional ones.
- (d) We recognise that this is a market in which regulation plays an important role. Competition on price is constrained by regulation. Some of the quality parameters valued by customers are subject to minimum levels below which quality cannot be reduced. However, some of them are frequently set above the minimum level. While the scope for competition is reduced compared with many other retail operations there remains the ability to flex

quality, range and service in response to local competitive conditions. We note evidence from both Parties that they do compete locally, but we consider that Sainsbury's tends in practice to compete less on some aspects.

- (e) Internal documents from the Parties and third party views show that high street and supermarket pharmacies can and do compete, although some evidence suggests the level of competition may be less strong than between high street pharmacies. Lloyds and supermarkets are differentiated to some degree, with many supermarket customers having slightly different characteristics and motivations for visiting the pharmacy to Lloyds' customers. The diversion estimates from our consumer survey suggest that the Parties can be close competitors in specific local markets.
- (f) 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***

7.105 In this section we assess the effects of the merger against the situation in the counterfactual. Since our counterfactual is the continuation of the pre-merger situation in which Celesio and Sainsbury's competed in the pharmacy market we first examine how existing competition at a local level would be affected by the merger. We then identify the geographic areas where we provisionally conclude that competition would be adversely affected such as to cause us to find that the merger may be expected to result in an SLC in that area.

7.106 Then we assess the effect of the merger on the OPD market and vertical effects that may arise from the merger.

### ***How the merger might affect the Parties' ability to compete locally***

7.107 After the merger, Lloyds and Sainsbury's pharmacies will no longer compete with one another. In areas where the merger causes competition to be reduced to the extent that there is insufficient competitive constraint after the merger, the Parties will have an incentive to degrade the competitive offer.

7.108 In this merger, although Sainsbury's is selling its entire pharmacy operation to Lloyds, the pharmacies will continue to be located within the main floor space of the supermarket and share both the store premises and a relatively common pool of customers. It is possible that if Sainsbury's altered some element of the grocery offering, or if Lloyds altered some element of the

pharmacy offering, it would have an impact on the sales of the other party. For instance, if Lloyds worsened the quality of the pharmacy this may result in customers going elsewhere and Sainsbury's losing associated grocery sales.

7.109 In view of this continuing interaction between them, the Parties have put in place a Cooperation Agreement which places constraints on how Lloyds can operate the Sainsbury's pharmacy business post-merger. We note that part of the rationale for Sainsbury's to enter into the transaction was [redacted]. These constraints are summarised in Appendix C and reduce Lloyds' ability to degrade competitive parameters at Sainsbury's, although it still has some ability to change the offering.<sup>121,122</sup>

7.110 In practice therefore, although we do not discount fully the risk that the offer in the Sainsbury's stores may deteriorate in some areas, we consider that it will be more difficult for Lloyds to change its offer materially or close the pharmacy counter at Sainsbury's than at its wholly owned pharmacy stores.

#### *The incentive on Lloyds to deteriorate the offer at its stores*

7.111 We have conducted an illustrative profitability analysis on the incentive for Lloyds to deteriorate the competitive offer. Further details are given in Appendix J. The analysis only focuses on one aspect of how the offer could be deteriorated – a reduction in opening hours.<sup>123</sup> The indicative calculation assesses the profitability of Lloyds pharmacies and assumes that a reduction in opening hours will lead to a reduction in payroll costs. The illustrative calculation finds that, if a 1% reduction in opening hours reduces payroll costs by 0.5%,<sup>124</sup> the reduction in opening hours would be profitable where more than 40% of Lloyds customers divert to Sainsbury's. Our survey indicates that diversion ratios above this level are likely in concentrated areas.

7.112 This is an indicative calculation, which only considers one aspect of the local offer. We note that other aspects of the offer could be worsened to achieve cost savings. We consider that there would be an incentive to deteriorate the offer in concentrated local areas, most likely in the Lloyds pharmacies rather than the Sainsbury's stores given the Cooperation Agreement.

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<sup>121</sup> There is scope for either store closures or reductions in opening hours, but these have to be evidenced and agreed by Sainsbury's, and there is a limit on the number of stores at which these changes can be made.

<sup>122</sup> However, [redacted] suggests that Lloyds will have the ability to worsen some of the quality and service parameters at Sainsbury's as a result of a reduction in competition.

<sup>123</sup> As we note in paragraph 7.44, most stores which are not 100-hour contract stores operate for supplementary hours above their core hours. The vast majority of these pharmacies have 40 core hours but some have either more or less than 40 core hours. In England the supplementary hours can be reduced by giving 3 months' notice to NHS England and no approval is required (see paragraph 7.31(f)).

<sup>124</sup> We consider this likely to be the case given that, for the pharmacy to be open, the pharmacist must be present. The pharmacist is likely to be the most expensive member of staff.

## *Identifying local areas where there may be a substantial lessening of competition*

7.113 In this section we:

- (a) set out our overall strategy for identifying potentially problematic local areas;
- (b) establish a preferred filtering methodology to screen out non-problematic areas and identify local areas where we consider that the merger might lead to an SLC and further analysis is required; and
- (c) set out our more detailed analysis of individual local areas where we provisionally find that the merger is likely to lead to an SLC.

### *Approach for identifying potentially problematic local areas*

7.114 Out of the 1,816 Sainsbury's and Lloyds combined total of pharmacy stores, the catchment areas of 929 stores overlap with each other based on the average catchment sizes for different types of areas shown in Table 4. There is a range of different types of overlaps, from areas where the Parties are very close together and there are few competitors to areas where they are far apart and there are many competitors. Our overall approach has been to look first for mechanistic rules which can filter out unproblematic areas, and then to carry out more detailed competitive assessments in the remaining local areas.

7.115 Given the number of overlaps we considered it impractical to survey all of the potentially problematic local areas to obtain direct estimates of diversion between the Parties' stores. Instead we surveyed a sample of potentially problematic areas, using these as case studies to illustrate the factors causing customers to divert between the Parties in particular locations.

7.116 In developing filtering rules, we have taken account of all the evidence that informed our assessment of pre-merger competition, including the consumer survey, our demand estimation model and wider evidence on pre-merger competition. We adopted a conservative approach to the initial screening process so that we were confident we would identify all the potentially problematic areas. However, we recognised that, in view of our conservative initial approach, a large number of these areas were likely to be unproblematic after more detailed scrutiny.

7.117 We then examined the surveyed areas in more detail to determine features of the local markets that could explain the closeness of competition between the Parties. By examining detailed maps of the other non-surveyed areas, we filtered out areas that were unproblematic on the basis of these features.

7.118 Finally we looked in detail at the areas that remained by further examining detailed maps of the areas, considering in more detail more granular features such as the locations of customers in relation to the wider features and considering submissions from the Parties, in order to decide whether the merger may be expected to result in an SLC in any given area.

7.119 The following sections set out in more detail how we applied this approach.

*Initial filters to identify potentially problematic local areas*

7.120 The first stage in our approach has been to identify mechanistic rules which could filter out unproblematic areas. We have used evidence from the consumer survey, our demand estimation model and the other evidence on pre-merger competition to inform our choice of filters. The aim has been to come up with a set of filters which could identify areas where the Parties might be particularly close competitors and where the merger might therefore lead to an SLC, so that we could analyse these individual local areas in more detail.

- *Using survey diversion results to test possible filters*

7.121 As described in paragraphs 7.85 to 7.94 and Figure 2 the survey showed that diversion between the Parties was high in some local areas – for example, it was above 80% in Kidlington and Reading and above 40% in Cardiff, Beaconsfield and Warlingham.

7.122 Initial filters are commonly based on the readily observable characteristics of an area, such as the level of concentration, as more detailed information (such as surveys) is only collected once the initial screening process has been conducted. In this case, we had access to survey results from a sample of areas when we were constructing our initial filter. We were able to take this information into account by evaluating how different initial filters correlated with the results of the survey. This section describes the competition metrics that we used to identify other local areas of possible concern. Further detail is provided in Appendix J.

7.123 The Parties argued that the survey was based on an unrepresentative sample of stores across a relatively small number of local areas, so there was no reliable means to draw broader conclusions from the survey results to non-surveyed stores.<sup>125</sup> In particular, they argued that it was not possible to extrapolate estimates of diversion from the surveyed areas to other non-surveyed stores.

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<sup>125</sup> See also the comments on survey methodology (paragraphs 7.78–7.79).

7.124 We agree with the Parties that there is insufficient variation between the different survey areas in the relevant characteristics which might determine diversion in order to model diversion ratios across all non-surveyed areas quantitatively. However, we consider that the cross-section of areas surveyed provide case studies which form a robust basis for producing an initial set of filters to exclude unproblematic local areas. We also consider that the characteristics of the individual survey case studies provided valuable qualitative information on the features of local areas that are likely to lead to close competition between the Parties' stores. We consider these characteristics in more detail after explaining our initial filtering approach.

- *Filter based on share of stores weighted by distance*

7.125 We have considered a number of different competition indicators which might form the basis for a local area filter, as described in more detail in Appendix K. These indicators include:

- (a) Fascia count within the catchment area of each of the Parties' stores – measuring the number of separate pharmacy fascia within the local market.
- (b) Store count within the catchment area of each of the Parties' stores – similar to the fascia count, but counting the number of individual stores, rather than separate fascia.

7.126 We have chosen to focus on the store count measure rather than fascia count for two main reasons. First, the store count is particularly appropriate in markets where customers choose between individual stores rather than brands, and where the offering at different stores is similar – this broadly matches our understanding of how local pharmacy markets operate. Second, the store count measure correlates closely with the level of diversion measured in the survey areas, as explained in Appendix K.

7.127 In addition, we observe that distance is an important driver of competition in many retail markets.<sup>126</sup> In this case the consumer survey has shown that 73% of respondents indicated that convenience was the most important reason for them deciding to visit the pharmacy on that day.<sup>127</sup> This is also consistent with broader evidence from internal documents and third party evidence suggesting that proximity and location is a key parameter of competition. Therefore we have tested different approaches to weighting the share of stores to take

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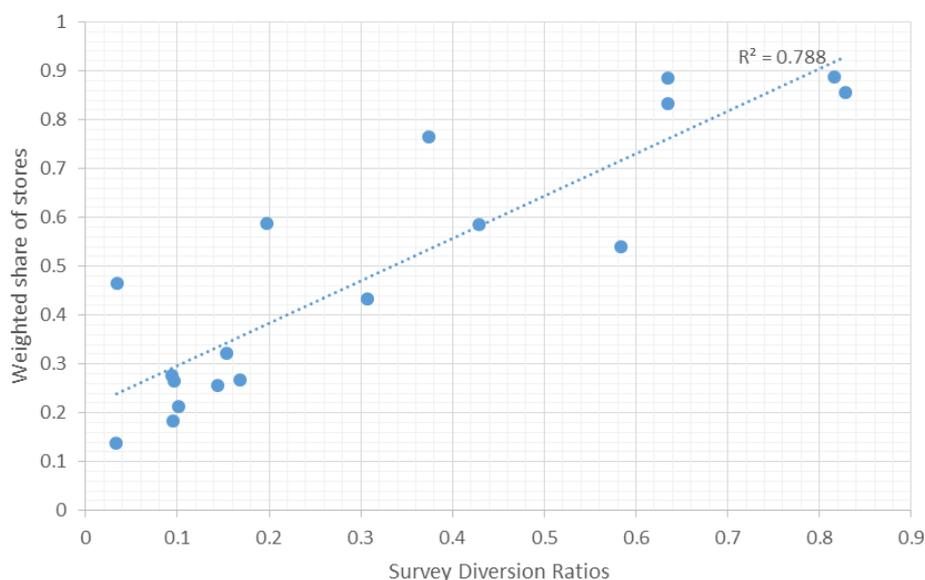
<sup>126</sup> OFT/CC (March 2011), [Commentary on retail mergers](#).

<sup>127</sup> We note that convenience can have many different elements, however the most important individual element of convenience for customers of both Parties was close to home/work.

account of distance between a given focal store and its competitors, giving more weight to stores that are closer to the focal store.

7.128 Figure 4 shows the relationship between the share of stores, weighted according to linear distance<sup>128</sup> for England, and the estimates of diversion for each of the survey areas.<sup>129</sup> The Figure shows a strong relationship between this weighted share of stores measure and estimated diversion from the survey.<sup>130</sup> We tested alternative approaches to weighting the share of stores, as described in Appendix K, but these were less closely correlated with the survey diversion estimates. Therefore we have chosen to use weighted share of stores to form part of our initial filter to identify potentially problematic areas.

**Figure 4: Relationship between share of stores weighted by linear distance and diversion (England)**



Source: CMA analysis.

7.129 The Parties argued that our measure of weighted share of stores would overweight Sainsbury's and other supermarkets relative to a high street pharmacy because the supermarket had a larger catchment area. In order for the supermarket weighting not to drop to zero between 1.4 and 2.4 miles, the

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<sup>128</sup> We apply a decreasing weight to each competitor located within the catchment area of the focal store based on its straight-line distance from the focal store. This means that a store located near the edge of the catchment area counts for less when calculating the share of stores than a store located near the focal store. For example, in an urban area a Lloyds has a catchment area of 1.4 miles, each high street pharmacy in its catchment area is weighted by dividing the distance that it is from Lloyds by 1.4 and subtracting this from 1. So a pharmacy located 1 mile from Lloyds will receive a weighting of 29%. See Appendix J for further details.

<sup>129</sup> In each of the following charts the concentration variable is plotted against the diversion ratio. Each chart is fitted with a trend line, which shows the relationship between the two variables and reports an R<sup>2</sup> value. The R<sup>2</sup> value is a measure of how well the trend line fits the data. If it is 100% the line fits perfectly and passes through all of the points. As the number of points lying a long way from the line increases, the R<sup>2</sup> value falls.

<sup>130</sup> There is also a strong relationship across the UK, with R<sup>2</sup> of 69%, however we are only concerned with applying the filter in England and Wales since the overlaps in Scotland and Northern Ireland were surveyed.

supermarket must have a higher weighting than the high street pharmacy, at least for a proportion of distances.

7.130 We accept the Parties' argument that weighting supermarkets' share of stores in this way risks flagging more areas as potentially problematic than is actually the case, given the nature of the Parties' businesses. However, at this stage we are considering an initial filter to identify areas for further analysis, and any over-weighting at this stage does not affect our ultimate assessment of whether the merger may be expected to result in an SLC arises in an area.

- *Relative proximity of pharmacies*

7.131 In addition to measures of concentration such as the share of stores or the fascia count, we have considered other metrics which might reflect other important factors that determine the strength of competition between pharmacies.

7.132 Based on the evidence on pre-merger competition including from internal documents and third party evidence, we would expect that the Parties are more likely to be close competitors in areas where they are geographically close together, particularly when there are few rivals between them.

7.133 This is supported by the findings of our consumer survey, which suggest that convenience of location is the most important factor when deciding to visit the store for 73% of Lloyds' customers and 57% of Sainsbury's customers. It also ranked among the top three reasons for 91% of Lloyds' customers and 86% of Sainsbury's customers. The survey indicated that proximity to home/work and proximity to a GP practice were the most important convenience factors for both Sainsbury's and Lloyds.

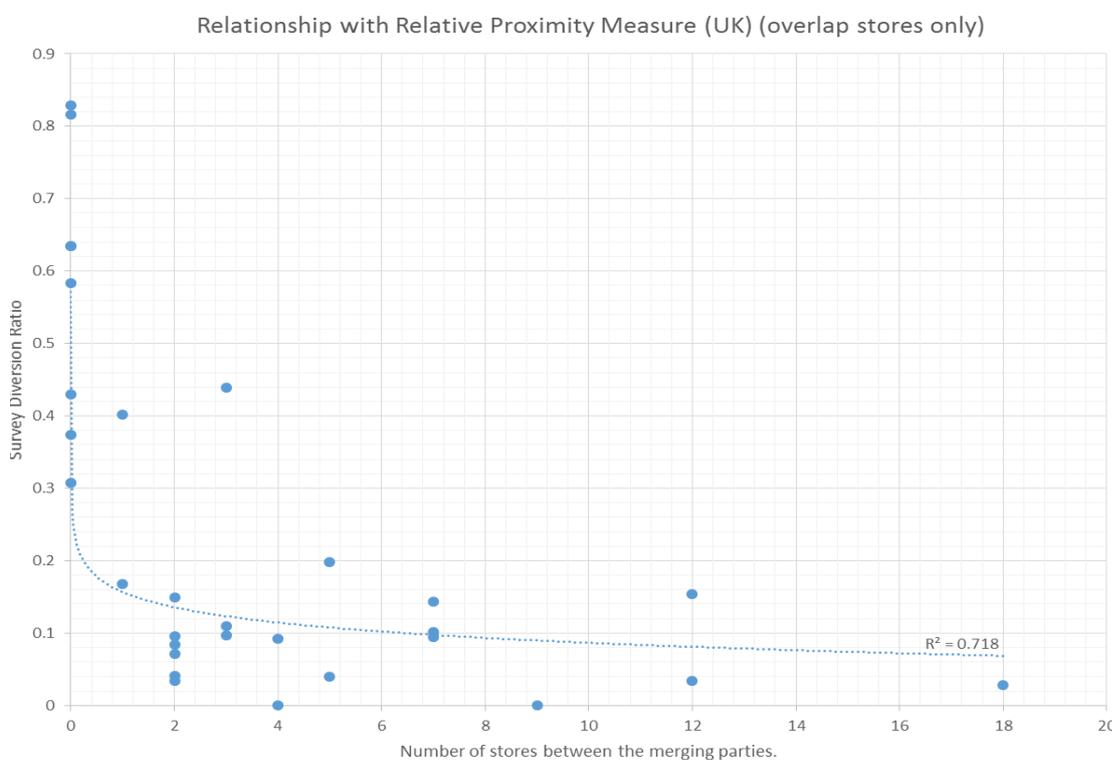
7.134 We used an econometric model to analyse the relationship between survey diversion estimates and distance between the Parties. This is set out in detail in Appendix L. The model shows a strong relationship between diversion and distance, particularly when the other merging party is the closest geographic competitor.

7.135 Taken together, this evidence suggests that there is more likely to be a reduction in competition as a result of the merger in cases where the Parties are geographically close competitors in a local area. In order to develop a filter to reflect this, we have used data on the straight-line distance between a focal

pharmacy and a competitor to identify whether there were other pharmacies closer to the Parties than the Parties were to each other.<sup>131</sup>

7.136 We can compare this ‘relative proximity filter’ with the diversion estimates in the survey areas. Figure 5 shows that there is a relatively strong correlation between the two.

**Figure 5: Relationship between relative proximity and diversion ratio**



Source: CMA analysis.

- *The demand estimation model*

7.137 Finally, the demand estimation model<sup>132</sup> can give an alternative estimate of the likely diversion between the Parties in each local area in England and Wales.<sup>133</sup> These diversion ratios have been estimated by looking at the sensitivity of consumers to a change in the opening hours of the pharmacy, controlling for distance and other unobserved quality factors.

7.138 For the reasons set out in Appendix E, we consider that the demand model is likely to underestimate the overall rate of diversion between pharmacies in a local area. However, we consider that the results of the model can be used as

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<sup>131</sup> Note at this stage the filter did not account for the spatial location of the pharmacies and could not say whether the competitors were located between the Parties.

<sup>132</sup> The demand estimation model is described in detail in Appendix E.

<sup>133</sup> The demand estimation is based on data from England and Wales, so we do not have diversion ratio estimates for Scotland and Northern Ireland.

part of an initial filter, by identifying those areas where the estimated level of diversion between the Parties is high relative to the average across all areas. This can provide a cross-check on the other filters, minimising the risk of inadvertently excluding an area which might raise competition concerns.

- *Conclusion on which filters to use*

7.139 Given the assessment in paragraphs 7.125 to 7.138 we have provisionally decided to use the share of stores weighted by the linear distance from the focal store as the primary filter. To avoid the risk that this filter alone might fail to capture some problematic areas where competition issues could arise we have supplemented this with two secondary filters: the geographical proximity filter; and the diversion ratio predicted by the demand estimation model.

- *Thresholds for use in the filter*

7.140 Since the diversion ratio is a measure of closeness of competition in a local area, we can use the diversion ratio to infer a threshold for the filter, using the line of best fit, which is shown on each figure.

7.141 In a more traditional retail merger where diversion thresholds have been used in the initial filter, such as supermarkets, a diversion threshold of around 15% was used as the threshold.<sup>134</sup> In the current merger, the Parties do not have the ability to flex the price of the majority of their products. Prices are fixed for prescriptions and regulation also has an impact. Therefore the Parties can only compete over a narrower than normal range of parameters. However, the Parties do compete on aspects of quality. We also note the illustrative calculation in paragraph 7.111 which suggests that there is an incentive to deteriorate quality if diversion is high enough.

7.142 Taking the evidence in the round, in view of the more limited range of parameters that the Parties are able to compete over, we consider that we should use a higher diversion threshold than in a conventional retail merger to filter the initial set of overlap areas for further analysis.

7.143 We have provisionally decided that we should filter in local areas for more detailed assessment where one or more of the following conditions is met:

- (a) The Parties have a combined distance weighted share of stores of at least 40% following the merger, with an increment of 15% (the 'share of stores' filter). This reflects that we would be concerned about situations where the

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<sup>134</sup> See [Somersetfield / WM Morrisons plc](#) (and subsequent supermarket mergers).

Parties currently have a relatively high combined weighted share of stores in a particular local area and the merger would lead to a high increment to market share. It is also consistent with filtering in areas where the estimated diversion ratio from the survey is around 30% or higher (see Figure 4), based on the relationship we observe between weighted share of stores and diversion across the survey areas.

- (b) The Parties are either the geographically closest competitors or there is only one competitor closer than the merging party, and where the Parties have at least a 30% combined share of stores with an increment of 10% from the merger. (the 'proximity' filter)<sup>135</sup>. This reflects the fact that we observe a strong relationship between closeness of competition and relative location of the Parties and other competitors. Therefore, even where the Parties' market shares are below the level that would meet the first condition, there might be a substantial reduction in competition if they are geographically very close and there are limited alternative pharmacies in the area.
- (c) The demand model suggests relatively high rates of diversion between the Parties in a local area (the 'demand estimation filter'). We have included this condition as a way of picking up areas where the Parties' are predicted to be relatively close competitors, even where the share of stores and proximity measures do not suggest that there is likely to be a problem. We have used a threshold of 5% for the filter, which is broadly consistent with filtering in areas where the estimated diversion ratio from the survey is around 30% or higher.

7.144 Table 7 sets out the results of our initial filtering. One hundred and fifty-four overlaps, out of the initial 929, are not excluded by the filters and require further assessment.<sup>136</sup>

**Table 7: Initial filtering of stores**

		<i>Number failing filter</i>	<i>Remaining overlaps</i>
Total stores	1,816		
Overlap stores	929		
Share of stores filter		112	817
Proximity filter		33	784
Demand estimation filter		9	775
<b>Totals</b>		<b>154</b>	<b>775</b>

Source: CMA analysis.

<sup>135</sup> This would be consistent with a diversion ratio of between 40 and 50%.

<sup>136</sup> Note that the number each filter fails is dependent on the order they are applied.

7.145 We have included one additional area for further analysis that did not fail the initial filter – this was Cardiff. We chose to include this area as we conducted a consumer survey which revealed that there was high diversion between the Parties and the nearest competitor to the Sainsbury’s store received very little diversion. Further analysis revealed this was at least in part because it is located within an occupation health centre that does not appear to advertise the presence of an NHS pharmacy. Given the need to adopt an approach which did not exclude any areas where competition concerns could arise without detailed consideration, we also assessed this area in more detail.

*Further assessment of filtered areas to identify the areas where we find a provisional SLC*

7.146 The initial filter was used to identify areas for further analysis.<sup>137</sup> We used the survey case studies with maps of each surveyed area to identify local market features that are associated with high diversion ratios and used these features to assess the characteristics of the areas around the 154 stores that failed our filters.

7.147 We continued to focus mainly on the Lloyds pharmacies because we considered that the Cooperation Agreement (see paragraph 4.3) would constrain the ability of Lloyds to deteriorate the offer at the Sainsbury’s stores. It would be easier, and therefore more likely, that the offer would be degraded at the Lloyds pharmacy. By looking in detail at local markets we surveyed we identified the local characteristics which were likely to affect closeness of competition between parties. This is described in more detail in Appendix K. We found that:

- (a) Geographic closeness<sup>138</sup> is clearly very important and we found that in like-for-like cases the closest pharmacy receives the highest diversion, but we also found that overall convenience needs to be considered:
  - (i) Diversion to a geographically close competitor is higher if it is located on the same road as the target pharmacy.
  - (ii) Diversion to a closely located pharmacy is lower if the route to it is not direct and, in particular, if it requires customers to first drive towards the town centre and then away from it.

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<sup>137</sup> We also included Cardiff in our assessment although it did not fail the filter (see paragraph 7.145).

<sup>138</sup> We note our survey report, which stated that: overall, convenience is the primary reason why customers choose to visit Sainsbury’s and Lloyds. More specifically, convenience tends to mean the location of the pharmacy (particularly for Lloyds’ customers), although it also includes opening hours and car parking (particularly for Sainsbury’s).

- (iii) For similar distances, diversion from Lloyds to supermarkets tends to be higher than from Lloyds to other pharmacies.
  - (iv) In some cases Sainsbury's pharmacy customers appear to divert to local pharmacies close to their homes, which are not necessarily the closest ones to Sainsbury's, or to choose another supermarket if this is very close. Sainsbury's customers may be reluctant to drive to another retail park, even if very close, if this has a pharmacy but not a supermarket.
  - (v) Diversion to some pharmacies, although close, is relatively low, which may be due to the pharmacy having a relatively poor location, e.g. little visibility from the street.
  - (vi) Where several pharmacies are clustered close together diversion is spread across the individual pharmacies in the cluster.
- (b) Diversion is higher to Boots than to other pharmacies, for equivalent distances. This may be because the particularly strong brand of Boots means that it tends, for equivalent distances, to attract a higher customer diversion than other brands. This is particularly the case for Boots pharmacies located in shopping centres. On the other hand, diversion to Superdrug is low.

7.148 As a result of this analysis we applied the following characteristics in our filtering process:

- (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; and
- (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.

7.149 Applying these rules to maps of other non-surveyed local areas, we identified 32 areas, containing 78 stores, which were potentially problematic.

7.150 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 diversion 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. These local 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

7.151 Maps of each area are shown in Appendix M. A summary of the key features in each area is shown below.

- *Beaconsfield*

7.152 Three pharmacies are present in the new town centre: a Sainsbury's, a Boots and a Lloyds. There is also a Lloyds pharmacy located approximately a mile away in Beaconsfield old town. A Tesco is located 2.7 miles by road to the West of Lloyds old town, near the M40 exit to Loudwater.

- 7.153 Lloyd's customers are spread throughout Beaconsfield, with two areas of higher concentration, one in Beaconsfield old town to the East of the Lloyds branch and the other in Beaconsfield new town to the South of Sainsbury's. The Lloyds pharmacy in the old town is co-located with a GP practice. There is a further GP practice in the new town near the train station. Boots and a second Lloyds are located on the high street in the new town, around 70 to 80 metres apart. The Sainsbury's, while only around 200 metres away, is not on the same road.
- 7.154 Given the location of the customers, GP practices and competitors in this area, we consider that Sainsbury's and Lloyds would be the close competitors in the local area, with Boots the only significant competitor.
- 7.155 Surveys were conducted at the Lloyds in the old town and at Sainsbury's. The diversion ratio was found to be 37% from Lloyds to Sainsbury's and 43% from Sainsbury's to Lloyds. For Sainsbury's, around half of all consumers would divert towards the Lloyds and Boots pharmacies in the town centre, with fewer diverting to the Lloyds in the old town and Tesco Loudwater. For Lloyds (in the old town), 85% of consumers would choose to divert to one of the three pharmacies in the new town (ie Lloyds, Sainsbury's or Boots). This would be in almost equal proportions. However, if people could not divert from the Lloyds in the old town to the Lloyds in the new town, 47% of survey respondents said they would then divert to Boots and 37% to Sainsbury's. Therefore, although Boots may be the closest competitor to Lloyds, Sainsbury's is a significant competitor and the only other pharmacy in Beaconsfield.
- 7.156 Given our assessment we provisionally conclude that the merger may be expected to result in an SLC in the area.
- *Bracknell*
- 7.157 There are three Lloyds branches in Bracknell. Two failed the filtering process and one did not.
- 7.158 We are primarily interested in one store, 97 Liscombe.<sup>139</sup> This store is located 0.9 miles by road from Sainsbury's. There is one competitor fascia in the catchment area, Boots, with two stores, one located 2 miles by road (although 1.2 miles by foot) and the other located 2.4 miles by road.
- 7.159 We note that a significant proportion of Lloyds' customers are located to the immediate south of Lloyds. Furthermore, we note that the two closest GP practices to Lloyds (out of five) in the area are located closer to Sainsbury's

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<sup>139</sup> 97 Liscombe, Bracknell, Birch Hill, Berkshire.

than to Lloyds. This is potentially reflected in the overall prescription volumes for the Parties, with Sainsbury's fulfilling 13,380 prescriptions per month, compared with 8,436 for Lloyds.

7.160 Given the location of the customers, GP practices and competitors in this area, we consider that Sainsbury's and Lloyds would be the closest competitors in the local area, and that Boots would exert a relatively weak competitive constraint on the Parties in this area as it is located over 2 miles from Lloyds. Therefore, we consider that the Parties are close competitors in the area.

7.161 Given our assessment we provisionally conclude that the merger may be expected to result in an SLC in the area.

- *Cardiff*

7.162 Cardiff was surveyed and the diversion ratios were found to be 44% from Lloyds to Sainsbury's and 40% from Sainsbury's to Lloyds. The surveyed pharmacies are both located in a residential area north of Cardiff, less than a mile from each other. The area presents a large number of other pharmacies; one (Insync) is located in a medical centre in front of the Sainsbury's store.

7.163 We note that the Lloyds and Sainsbury's stores are linked through a local, but almost direct route. There is also a bus connection, although this does not take a straightforward route. A nearby Boots and another Insync pharmacy, located on the main road towards Cardiff's centre, also get significant diversion. The pharmacy closer to the Sainsbury's gets only 10% diversion. However, it appears not to be very visible from the road and would be mostly used by the patients of the medical centre within which it is located.

7.164 The Parties note that this area has a complicated history, given that Lloyds sold Sainsbury's its licence in 2010, and also moved its pharmacy from the location of the Boots to their new location.<sup>140</sup> Lloyds considers that this explains the diversion between the Parties (which is higher than might be expected looking at the geography of the area), although it does not dispute

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<sup>140</sup> Lloyds sold Sainsbury's its business (licence, employees, and patient records) in 2010, and sold a second licence to Boots (which it relocated to the nearby retail park), while acquiring a third business (licence, employees, patient records, and premises) of an independent pharmacy which was converted to the LloydsPharmacy format. It considered that these unique circumstances could explain the diversion between the Parties (which is higher than might be expected looking at the geography of the area), as they may have led to greater awareness of the LloydsPharmacy brand among customers in this local area than one might otherwise have expected.

that many customers appear to have Sainsbury's as their second preference pharmacy.

7.165 Most of the Lloyds customers would divert to either the nearby Boots or the Sainsbury's.

7.166 Given our assessment we provisionally conclude that the merger may be expected to result in an SLC in the area.

- *Christchurch (Highcliffe)*

7.167 There are two Lloyds pharmacies located close to one another in Christchurch, with no other pharmacies within their 1.4-mile radius. The principal alternative pharmacies in this area are:

(a) Sainsbury's located 1.9 miles by road to the west of Lloyds;

(b) Wessex pharmacy located 2 miles by road to the west of Lloyds; and

(c) Day Lewis located 1.8 miles by road to the east of Lloyds.

7.168 The majority of the customers of both Lloyds branches are located in the Highcliffe area, which is the residential area in the centre of the catchment area. Of customers not located in this area more lie to the west than to the east. There is a single GP practice in the catchment area, which is located near or within the same premises as one of the Lloyds branches.

7.169 The nearest supermarket grocery store to Lloyds is Sainsbury's, although there is a Co-operative and a Tesco Express in Highcliffe. Alternative large grocery stores are a Lidl 2.1 miles to the west or a Tesco 2.9 miles to the west, which has a pharmacy.

7.170 In the event of either the closure of one or both Lloyds branches or a deterioration of quality sufficient to cause customers to divert, we consider that they are most likely to visit Sainsbury's as there are no high street pharmacies within the Lloyds catchment area. Since Sainsbury's is also the nearest supermarket for individuals living in Highcliffe, it is likely that a reasonable proportion of Lloyds' customers are already visiting Sainsbury's.

7.171 For those customers who do not already shop in Sainsbury's, Day Lewis may represent a constraint for those whose daily routes take them to the east rather than the west of Highcliffe. The Parties said that the Tesco in New Milton also draws customers from Highcliffe alongside others, although these stores are further away from the Lloyds pharmacies.

7.172 We consider that Lloyds and Sainsbury's would be close competitors in this area. In this case, despite the Parties being located more than 1.4 miles apart, Sainsbury's is the nearest alternative pharmacy. Furthermore, Sainsbury's is also the nearest large supermarket to Highcliffe and likely to be drawing a large number of shoppers from Highcliffe. Consequently it is likely that it would represent an obvious alternative for consumers in Highcliffe.

7.173 Given our assessment we provisionally conclude that the merger may be expected to result in an SLC in the area.

- *Kempston*

7.174 Lloyds has three pharmacies in Kempston. The Sainsbury's and the three Lloyds are located on the same road. Two of the Lloyds pharmacies are located within 140 metres, one within 0.5 km. Of particular interest is the Lloyds branch in 242 Bedford Road, which is located next to the Sainsbury's. There are four independent pharmacies and one Boots within the catchment area of the Lloyds which is nearest to the Sainsbury's. However:

(a) All of the independents are situated near the edge of the Lloyds catchment area, with the closest being 1.4 miles away by road. The others are located 1.9, 2 and 2.4 miles away by road. Since the Lloyds pharmacies are located far closer we do not consider that any of these pharmacies would receive more than a small amount of diversion.

(b) Boots is located on a retail park around 1 mile from the nearest Lloyds as the crow flies, but since it is the other side of a railway line, it is 1.9 miles away by road. For this reason we do not consider it will receive significant diversion.

(c) Lloyds' data shows that, for all three of its pharmacies, the large majority of its customers live on the same side of the railway line as both merging parties (and the opposite side to Boots), and many live within a very short walk of both Sainsbury's and Lloyds.

7.175 The Parties said that Sainsbury's customers on a 'mixed shopping mission' in Kempston could go to the M&S Food Hall and the Boots which are located on the same retail park. Using similar intuition, we consider that Lloyds customers on a mixed shopping mission may similarly use the Sainsbury's located close to the Lloyds and could therefore easily use Sainsbury's pharmacy, were the quality at the Lloyds to fall.

7.176 Therefore, we consider that the vast majority of the diversion in this area will be between the merging parties, as in this case the nearest alternative pharmacy is 1.4 miles away.

7.177 Given our assessment we provisionally conclude that the merger may be expected to result in an SLC in the area.

- *Kidlington*

7.178 There are 4 pharmacies located in Kidlington, a Lloyds branch with a Sainsbury's located opposite and a further Lloyds branch located 1 mile to the north on the same road, with an independent located nearby. The only other pharmacy within a 1.4 mile radius of Lloyds is an independent in the village of Yarnton, which is located 2.4 miles to the West by road, with some further pharmacies located outside of this radial along the road leading to Oxford.

7.179 Lloyds and the adjacent Sainsbury's fulfil a similar number of prescription items per month, 4,726 and 4,123 respectively. Lloyds customers are located mainly in the area around Sainsbury's and Lloyds, and around a GP practice that lies 0.4 miles to the North.

7.180 Due to the proximity of Lloyds and Sainsbury's and the location of customers and GPs in the area, we consider that the Parties are likely to be close competitors. Kidlington was surveyed and the diversion ratios were found to be 83% from Lloyds to Sainsbury's and 58% from Sainsbury's to Lloyds when own party diversion is excluded. The surveyed Lloyds is opposite the Sainsbury's, across the road.

7.181 Half of the surveyed Lloyds' customers would divert to the nearby Sainsbury's, but 40% would choose the other Lloyds, although further away. While an independent is located very close to that Lloyds, very few would choose it, either in response to the Lloyds store closure or Lloyds fascia closure questions, with customers preferring to divert to Sainsbury's if Lloyds was unavailable. This may suggest that the independent is an unattractive option for those not using the GP practice it is located in.

7.182 Given our assessment we provisionally conclude that the merger may be expected to result in an SLC in the area.

- *Leeds*

7.183 In the area of interest, (Alwoodley, some 5 miles north of central Leeds), there are four pharmacies within a 1.4-mile radius of the Lloyds pharmacy of interest (2 the Avenue, Leeds, Alwoodley). These are:

- (a) Sainsbury's, 1.1 miles away by road;
- (b) Living Care, 1 mile away by road;
- (c) Adel, 1.4 miles away by road; and
- (d) Living Care (south), 1.4 miles away by road.

7.184 Lloyds is the largest of these pharmacies in terms of prescription volume, fulfilling 9,073 prescriptions per month, it is followed by Sainsbury's with 5,650, Adel 3,803 and Living Care with 3,049 and 3,380 prescriptions per month.

7.185 Lloyds' customers are primarily located around King Lane, which runs north to south between Lloyds and Sainsbury's and around the A6120, which again runs north to south, but is located to the east of both stores. The three GP practices in the Lloyds catchment area are also spread along King Lane, between Lloyds and Sainsbury's.

7.186 Due to the location of customers and GP practices in this area, we do not consider that Adel pharmacy will compete closely with Lloyds. This is because it is located on the edge of the village of Adel, where very few Lloyds' customers are located. We consider that diversion from the Lloyds would primarily be split between Sainsbury's and the two Living Care pharmacies, although there may be some customers that go outside the Lloyds catchment area.

7.187 Of the two Living Care pharmacies, the southern one is located south of both the main areas of Lloyds' customers and the three GP practices nearest Lloyds. It is also located on the opposite side of the A6120, which is a dual carriageway, although there is a direct driving route to it from Lloyds. For these reasons, we do not consider that it will receive significant diversion from Lloyds.

7.188 Therefore, we consider that the Lloyds presently competes most closely with the northern Living Care pharmacy and the Sainsbury's. Although Living Care is closer to Lloyds than Sainsbury's, it is located in a small self-enclosed residential area, with only a single entry and exit point.

7.189 In contrast Sainsbury's can be accessed from both King Lane and the A6120 and is more likely to be more convenient for customers. There is also a bus route which connects the Sainsbury's and the Lloyds, both of which have nearby stops. For these reasons we consider that Sainsbury's would receive more diversion than Living Care and estimate diversion to Sainsbury's would be high.

7.190 Given our assessment we provisionally conclude that the merger may be expected to result in an SLC in the area.

- *Liverpool*

7.191 The pharmacy of particular interest is the Rice Lane pharmacy. There are a number of pharmacies in the 1.4-mile catchment area around the Lloyds branch, but in the centre of the catchment area there are only another Lloyds branch (County Rd) and a Sainsbury's (also on Rice Lane). In this case the customer data is incomplete and we cannot infer much from the customer locations that we have been able to plot. The pharmacies we consider to be most relevant are located as follows:

(a) Sainsbury's, which is located 0.3 miles to the north of Lloyds by road.

(b) A second Lloyds branch is located 0.2 miles to the south on Country Road.

(c) Walton pharmacy is located 0.6 to 0.8 miles to the east by road.

7.192 The Lloyds branch in Rice Lane, which is co-located with a GP practice, receives the most prescriptions of these four pharmacies, fulfilling 14,998 prescriptions per month. The other three pharmacies fulfil similar numbers, between 6,000 and 6,800.

7.193 We do not consider that any of the other pharmacies in the catchment area are relevant competitors to the pharmacies listed in paragraph 7.191 as the area seems to be fairly self-contained in between a set of two railway lines. Furthermore, the cluster of GP practices and pharmacies located to the west of Lloyds would seem to form a natural micro-market, as there are a number of pharmacies and GP practices all located close to one another. We would not expect many customers to travel either to or from this area to have a prescription fulfilled.

7.194 In this area although there are some fringe competitors who would pick up some diversion, the base assumption would be most of the diversion, in broadly equal amounts, would be to Sainsbury's and Walton pharmacy. However, since Sainsbury's is located much closer to Lloyds than Walton we would expect it to get more diversion. Either way we consider that diversion to Sainsbury's in this area would be high.

7.195 Given our assessment we provisionally conclude that the merger may be expected to result in an SLC in the area.

- *Luton*

7.196 In the area of interest, to the north of Luton, Lloyds has two pharmacies. We are primarily interested in the Lloyds Bramingham Park pharmacy.<sup>141</sup> This has volume of 4,926 prescriptions per month and is located 0.2 miles by road from the nearest Sainsbury's. There are a number of other pharmacies in the catchment area, including:

(a) Featherfield Pharmacy, 0.8 miles away by road;

(b) Warden Hill pharmacy, 1 mile away by road; and

(c) Calverton pharmacy, 1.3 miles away by road.

7.197 The majority of Lloyds' customers are located in the immediate vicinity of the Lloyds and Sainsbury's stores, as are two GP practices, one of which is co-located with Lloyds. Lloyds is the larger of the two pharmacies fulfilling 7,916 prescriptions per month, compared with 3,901 for Sainsbury's, likely due to Lloyds' location within a GP practice.

7.198 The two nearest independent pharmacies fulfil a similar number of prescriptions per month to Sainsbury's. However, they are located further away. Furthermore the walking routes are not straightforward and the independent – with a volume of 3,894 prescriptions per month – is across a major road. These factors suggest that Sainsbury's would capture a higher proportion of customers diverting from the nearby Lloyds in the event of a quality drop.

7.199 We consider that Sainsbury's is well positioned both relative to Lloyds and the local GP practices to capture the majority of any diversion from Lloyds.

7.200 Given our assessment we provisionally conclude that the merger may be expected to result in an SLC in the area.

- *Reading (Calcot)/Theale*

7.201 Lloyds is located in Theale to the West of Reading, with Sainsbury's located 0.9 miles away by road in Calcot on the outskirts of Reading. There are no further NHS pharmacies located within the Lloyds catchment area. We note that there is a Boots located in the same retail park as Sainsbury's, but that this does not have an NHS licence.

7.202 Lloyds' customers are primarily located in Theale, with a small number located in Calcot. Sainsbury's draws customers from a wider area including from

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<sup>141</sup> 2 Whitehorse Vale, Luton, Bramingham Park Centre.

Theale. There is a single GP practice located in Theale, a short distance to the West of the Lloyds branch.

7.203 The Lloyds pharmacy (High Street Theale) and the Sainsbury's pharmacy (Bath Road, Calcot) were surveyed and the diversion ratios were found to be 82% from Lloyds to Sainsbury's and 31% from Sainsbury's to Lloyds. The surveyed pharmacies are both located in suburbs west of Reading, less than a kilometre away on two sides of the M4.

7.204 It is not surprising that almost all of Lloyds' customers would divert to the Sainsbury's. On the other hand only 25% of Sainsbury's customers would divert to the Lloyds; this is also unsurprising given the location of the Sainsbury's customers. Many live in Reading, which is in the opposite direction to the Lloyds Theale pharmacy.

7.205 We note that 15% of Sainsbury's customers said they would divert to a Boots located in the same retail park as the Sainsbury's. However, that Boots pharmacy does not have an NHS contract. It is likely that most of the respondents were not aware of this. The Parties said that this pharmacy still provided pharmacy-only medicines and some services, and therefore posed some constraint on the Parties. We consider that this constraint will be small given that prescriptions account for the vast majority of pharmacy medicines.

7.206 Given our assessment we provisionally conclude that the merger may be expected to result in an SLC in the area.

- *Sandy/Potton/Biggleswade area*

7.207 There are two Lloyds branches and a Boots branch located close together in the centre of Biggleswade. Sainsbury's is located on the northern edge of the town, by the main road leading to Sandy with an independent located to the east of the town. Two GP practices are located in the centre of the town, with a further GP practice somewhat isolated to the north-west. In this area we have customer location data for both Sainsbury's and Lloyds.

7.208 The customer location data shows that Sainsbury's and Lloyds both draw customers from the same area. Despite this we consider that the proximity of Boots to the Lloyds branches in the centre of Biggleswade means that Boots would receive the majority of the diversion from Lloyds. However, since most Lloyds customers are not located near to the independent, we do not consider this will receive significant diversion, therefore we consider that Sainsbury's is the main alternative destination other than Boots.

7.209 A particular concern is Lloyds Sandy, which is located 3.4 miles to the north of Sainsbury's by road. There are two Lloyds pharmacies on Market Square within 20 metres of each other. Sainsbury's is the closest alternative pharmacy to Lloyds, with customer location data showing that Sainsbury's draws a reasonable proportion of its pharmacy customers from Sandy, despite the presence of a Tesco (non-pharmacy) superstore in the town. Therefore, despite the distance between the Parties, Sainsbury's would be the major constraint on the Lloyds branch in Sandy. Although Sainsbury's is located substantially more than 1.4 miles away and therefore may not pose a strong constraint on Lloyds, the lack of an alternative suggests that what constraint it does pose may be particularly important.

7.210 To the north-east of Biggleswade is the village of Potton. This has another Lloyds pharmacy with volume 7,409 prescriptions per month and no alternatives in the village itself. To the north of this lies an independent, which may be the second choice of those living in the village who commute along the road going northwards. Sainsbury's may be the second preference for those going southwards, particularly as it has parking and already draws some pharmacy customers from the village. Others may use the Sainsbury's for the grocery store even if they do not currently use the pharmacy.

7.211 An unusual complicating factor is that Lloyds has a very high share of stores within the Sainsbury's radial catchment area. There appear to be more alternatives in the south: there is a Boots and two independents in or near Biggleswade (where the majority of Sainsbury's customers live), and a further independent right on the edge of the catchment area. The Sainsbury's also draws a significant proportion of its customers from close to the villages of Sandy and Potton in the north however, where we do not consider there to be much choice for customers. Nevertheless we consider there to be less scope for the Parties to weaken the competitive offering at Sainsbury's post-merger and note that a 100-hour licence currently exists in the store, which reduces this flexibility further.

7.212 Considering all these issues in the round, we have concluded that there is likely to be close competition between the Parties in the area as a whole.

7.213 Given our assessment we provisionally conclude that the merger may be expected to result in an SLC in the area.

- *Sutton Coldfield*

7.214 There are two Lloyds pharmacies located in Sutton Coldfield (228 and 290 Lichfield Road) along with a Boots (Mere Green Close) and a Sainsbury's (30

Mere Green Road). The other pharmacy of relevance is also a Boots which is located 1 mile to the north-west of the middle Lloyds branch.

7.215 Customers are primarily located either to the north-west, or to the north-east of Lloyds. The Lloyds branch at 228 Lichfield Road is co-located with a GP practice, with another GP practice co-located with the Boots in the centre of the catchment area. The Boots pharmacy received lower volumes than each Lloyds and the Sainsbury's, however we note that it is currently being refurbished and may therefore pose a stronger constraint once this is completed. Customers travelling from the north-west are likely to either divert to the Boots branch on their route or to visit Sainsbury's, although there is also a Waitrose supermarket in the local area, which may affect the number of customers visiting Sainsbury's for their grocery purchases. Customers living to the north-east are likely to divert either to Sainsbury's or Boots. Therefore we consider that diversion from Lloyds to Sainsbury's in this area is likely to be high.

7.216 Given our assessment we provisionally conclude that the merger may be expected to result in an SLC in the area.

- *Warlingham*

7.217 Warlingham is a village south of Croydon. There is a Lloyds branch, which was surveyed by the CMA, located in the centre of the village, while the Sainsbury's is less than a mile away along the road. Another Lloyds is located on the road leading to Croydon. The only other pharmacy in the surveyed Lloyds catchment area is an independent near the train station.

7.218 There is a GP practice located between the surveyed Lloyds and Sainsbury's with Lloyds drawing most of its customers from the area around the pharmacy and around this GP practice. This area was surveyed and the diversion ratio was found to be 63% from Lloyds to Sainsbury's and 63% from Sainsbury's to Lloyds. Moving from the Sainsbury's store, the first pharmacy to be encountered is always the surveyed Lloyds (the road on the other direction leads towards the countryside).

7.219 Most Lloyds customers would divert either to the other Lloyds or to the Sainsbury's. Similarly, half of Sainsbury's customers would divert to the surveyed Lloyds, the rest spreading between the other local Lloyds and pharmacies in nearby towns.

7.220 Given our assessment we provisionally conclude that the merger may be expected to result in an SLC in the area.

### *Adverse effects on customers*

7.221 In light of our provisional findings on the nature of competition in the pharmacy market (paragraph 7.104), the SLCs we have provisionally found resulting from the merger in the areas described in paragraphs 7.151 to 7.220 may be expected to result in adverse effects for customers in terms of a reduction in the quality of service in those areas.

### *Effects of the merger on outpatient dispensary*

7.222 We assessed whether the merger is likely to give rise to an SLC in the OPD market through horizontal unilateral effects. The OPD market is discussed in Section 2. The concern we examined was that if the two merging parties are both significant suppliers to NHS trusts, and if they are commonly among the top ranked bidding firms, the merger may create incentives to worsen their bids. This is because if one of the Parties did not win a contract there would be a high likelihood of it being awarded to the other party.

7.223 The large majority of OPD contracts are currently held by Boots and Celesio.

**Table 8: Numbers of OPD contracts with NHS trusts**

<i>Provider</i>	<i>Number of contracts</i>
Celesio (Lloyds)	25*
Sainsbury's	3
Boots	20
Well	3
Rowlands (Phoenix)	3
Pharmaxo	1†
Healthcare at Home	1
Trust subsidiaries	6 (at least)

Source: Celesio, Boots, Pharmaxo.

\* Celesio has 25 contracts with 24 trusts (it has two separate contracts with one trust).

† Pharmaxo's OPD service is not contracted through an NHS hospital, but commissioned by Circle Partnership for the Nottingham NHS Treatment Centre.

7.224 We examined bidding data for OPD contracts. Boots and Celesio won all the contracts for which Sainsbury's submitted a bid between 2013 and 2015. In only [redacted] did Sainsbury's finish second in a tender won by Celesio between 2013 and 2015, suggesting that the competitive constraint imposed by Sainsbury's on Celesio is limited. [redacted] This suggests that Sainsbury's offering might be closer to that of Boots than to Celesio's, as Boots is also in a position to offer a retail solution to NHS trusts. In contrast, Celesio does not have a convenience retail proposition and its bids have focused on providing an OPD pharmacy with additional GSL products.

7.225 Where we have been supplied with tender scoring data for each firm, [redacted].

7.226 The evidence, therefore, suggests that Sainsbury's and Celesio are not close competitors: Boots is the main competitor to Lloyds, and Sainsbury's is a closer competitor to Boots than to Celesio. Additionally, Rowlands appears to be a strong bidder among the second-tier bidders, although its retail offering is weaker than that of Sainsbury's. We note that Rowlands recently won two OPD contracts in April 2015 and January 2016. This firm will remain in the market post-merger and will be able to exert a competitive constraint on Celesio and Boots similar to that which Sainsbury's exerted pre-merger. We also received evidence to suggest that an in-sourced self-supply option can be attractive for trusts, and that these firms are also able to bid for the OPD contracts of other NHS trusts.

*Conclusions on competitive effects of the merger on outpatient dispensary*

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

*Effect of the merger on foreclosure*

7.228 Celesio is active as a pharmaceutical wholesaler through its subsidiary AAH. AAH is the second largest wholesaler operating in the UK, after Alliance Healthcare, which is part of the Walgreens Boots Alliance group. The third largest national wholesaler is Phoenix, which is vertically integrated with Rowlands pharmacies. These three national wholesalers account for the vast majority (75 to 80%) of the value of the wholesale market (see Table 9). A much smaller market share by value is held by regional wholesalers, by short-line wholesalers or directly by manufacturers, as shown in the following table. Table 9 shows market shares as estimated by the three largest wholesalers; estimates refer to the year up to November 2015 and include only medicines distributed to retail pharmacies, therefore excluding dispensing doctors and hospitals.

**Table 9: Market shares by value for the wholesale distribution of medicines to retail pharmacies (December 2014 to November 2015)**

	Prescription medicines			Pharmacy-only medicines	
	AAH (Celesio) estimates	Alliance (Boots) estimates	Phoenix (Rowlands) estimates	AAH (Celesio) estimates	Alliance (Boots) estimates
<i>Wholesaler</i>					
AAH (Celesio)	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Alliance (Boots)	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Phoenix (Rowlands)	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total national full line	78.2	79.0	79.3	57.9	75.2
Regional full line	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Short line	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Direct from manufacturer	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

Source: the Parties and third parties.

7.229 Vertical theories of harm are generally classified into the categories of input foreclosure and customer foreclosure. In the present case:

- (a) Input foreclosure refers to the possibility that the merged Parties may foreclose rival retailers by denying the wholesale supply of medicines or by offering worse contractual terms. There may be an incentive to foreclose if the market shares of the merged entity lead to a sufficiently high retail diversion from the foreclosed rival to the Parties' pharmacies.
- (b) Customer foreclosure refers to the possibility that the Parties may foreclose rival pharmaceutical wholesalers by denying them access to Sainsbury's as a customer.

7.230 Sainsbury's pharmacy business accounts for approximately [0–5]% of the downstream retail pharmacy market.<sup>142</sup> For this reason, the merger is unlikely to lead to the foreclosure of any wholesaler. [REDACTED]<sup>143</sup> The merger would not therefore result in a reduction of volumes for any rival wholesaler and there would be no risk of customer foreclosure.

7.231 We considered the risk of input foreclosure. While the Parties' small national retail market shares ([0–5]% for Sainsbury's and [10–20]% for Lloyds)<sup>144</sup> make it unlikely that there would be the incentive after the merger at national level to foreclose rival retailers, we examined whether there might be an incentive in local areas where the Parties had high market shares.

7.232 The Parties argued that they did not have ability to foreclose rival retailers. They said that:

<sup>142</sup> Parties' initial submission, Part D, Section 9.

<sup>143</sup> [REDACTED]

<sup>144</sup> Parties' initial submission, Part D, Section 9.

- (a) branded manufacturers required wholesalers to offer uniform national service and an obligation to deliver, therefore preventing any discrimination risk against retail operations of rival wholesale groups;<sup>145</sup>
- (b) several large manufacturers had adopted a 'direct to pharmacy' model, in which wholesalers simply operated as agents of the manufacturer; and
- (c) with the exception of products distributed under exclusive wholesale arrangements, customers were able and willing to switch wholesale suppliers.

7.233 We recognise that for medicines distributed under a 'direct to pharmacy' scheme, discrimination against rival retailers may not be possible. However, in 2015 these medicines accounted for only approximately [REDACTED]% of the value of prescription medicines distributed by AAH to third party customers. For the remaining medicines, wholesalers have the ability of offering different terms to different customers, depending on the respective bargaining power.

7.234 While it is true that retailers can switch to alternative suppliers, market shares suggest that the market is dominated by three wholesalers, and some retailers told us that wholesale competition was limited.<sup>146</sup> Representatives of independent community pharmacies<sup>147</sup> told us that the level of service provided by the major wholesalers to independent pharmacies was poor and that independent pharmacies felt that these wholesalers did not ensure a fair and equitable supply.<sup>148</sup> Switching may also be limited by the existence of contracts between retailers and AAH.

7.235 As we noted in paragraph 7.231, given the Parties' small national market shares, an input foreclosure strategy could potentially be profitable only if targeted at independent retailers operating in those local areas where diversion to the Parties can be expected to be particularly large. We consider that a substantial constraint on Celesio's ability to target competitors in specific local areas is given by the existence of buying groups, many of them including thousands of independent pharmacies. Buying groups negotiate with suppliers on behalf of their members, allowing them to get better terms than if they dealt with the wholesalers independently.<sup>149</sup> All but a small number of independent pharmacies are members of a buying group and it appears easy for

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<sup>145</sup> Parties' initial submission, Part J, Section 3.2.

<sup>146</sup> [REDACTED]

<sup>147</sup> [REDACTED]

<sup>148</sup> [REDACTED]

<sup>149</sup> Cambrian Alliance told us that some of its members saw an increase in profitability [REDACTED] as a result of collective negotiation.

independent pharmacies to join them.<sup>150</sup> A significant proportion are a member of more than one group.<sup>151</sup> According to Cambrian Alliance, pharmacies could and did switch between different groups, as they offered differentiated services.<sup>152</sup>

7.236 We consider that, since most independent pharmacies are members of such buying groups and can easily join one or switch between them, it would be difficult for Celesio to adopt a foreclosure strategy to target specific retail competitors in a limited local area. This was also supported by margin analysis, which showed that at least [X]% of the lost wholesale sales to the foreclosed pharmacy would have to divert to one of the Parties' pharmacies for foreclosure to be profitable.<sup>153</sup> Even in a concentrated local area, unless the foreclosed pharmacy is forced to close, the loss of retail sales that would result from increased wholesale costs is likely to be limited.

*Provisional conclusion on the effect of the merger on foreclosure*

7.237 We do not consider that the merger will substantially increase Celesio's ability and incentive to foreclose rival retailers or rival pharmaceutical wholesalers. Therefore we provisionally conclude 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***

*Market entry/expansion*

7.238 In line with our guidelines<sup>154</sup> we assessed whether entry by new companies or expansion by existing ones might mitigate the effect of the merger on competition.

7.239 We note the following for our local effects assessment:

- (a) Regulation controlling entry to pharmaceutical lists acts as a high barrier to entry in Community pharmacy. The actual extent of the barrier, however, depends on local conditions – in some areas entry may be likely and may mitigate the effects of the merger.

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<sup>150</sup> Independent pharmacies are here defined as those having at most 15 retail stores. According to Cambrian Alliance, pharmacy chains with more than 15 retail stores tended to deal with wholesalers directly.

<sup>151</sup> Between [X] of Cambrian Alliance members are also members of at least one other buying group.

<sup>152</sup> Some buying groups may be stronger than others in negotiating for particular types of products or in offering particular support services. Moreover, some buying groups source most of their medicines through a single wholesaler; for example, Cambrian Alliance sources through AAH, while Numark sources through Phoenix.

<sup>153</sup> [X]

<sup>154</sup> CC2, section 5.8.

- (b) Regulations regarding practising as a pharmacist are a barrier but in the context of entry we consider that they are not significant.
- (c) While entry and exit costs are a consideration for any entrant, they are not a significant barrier to entry and we do not therefore consider that in general entry costs act as a barrier to entry.

7.240 We have not been provided with any evidence that entry may mitigate the effects of the merger in any of the local areas highlighted by our filtering process and provisionally conclude that entry is unlikely to mitigate the SLC in any of the local areas highlighted in paragraph 7.150.

#### *Other competitive constraints*

7.241 We have not found any other competitive constraints that might offset the effects of the merger.

#### ***Summary of effect of the merger on competition***

7.242 We have assessed the effects of the merger against the situation in the counterfactual and have examined the effect of the merger in each of the 929 local overlap areas. We initially used a mechanistic filtering process to focus down on areas of potential concern and then performed an increasingly detailed assessment of the local areas more likely to be of concern. In developing filtering rules, we took account of all the evidence that informed our assessment of pre-merger competition, including the consumer survey, our demand estimation model and wider evidence on pre-merger competition.

7.243 We have focussed on the possible deterioration of the competitive offer at Lloyds stores because the Cooperation Agreement means it will be more difficult for Lloyds to materially change its offer at Sainsbury's pharmacies than at its own pharmacy stores.

7.244 We have used substantially higher diversion thresholds in our initial filter than in more traditional retail mergers such as supermarkets. This is because the Parties do not have the ability to flex the price of the majority of their products and can only compete over a relatively narrow range of parameters.

7.245 As a result of our assessment we provisionally conclude that the merger may be expected to result in an SLC in the markets identified in paragraph 7.150. Given our provisional findings on the nature of competition in the pharmacy market, this SLC resulting from the merger may in turn be expected to result in adverse effects for customers in terms of a reduction in the quality of service provided in those areas.

7.246 We examined the effect 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 conclude that the merger may not be expected to result in an SLC in the provision of outsourced OPD services to NHS trusts.

7.247 We also considered vertical effects of the merger. We do not consider that the merger has substantially increased Celesio's ability and incentive to foreclose rival retailers or rival pharmaceutical wholesalers. Therefore we provisionally conclude that the merger may not be expected to result in an SLC as a result of foreclosure.

## **8. Provisional findings on the SLC test**

8.1 As a result of our assessment we have provisionally concluded that:

(a) arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

(b) As a result of the assessment described in Section 7 we provisionally conclude that the merger may be expected to result in an SLC in the following local 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:

- (i) Beaconsfield
- (ii) Bracknell
- (iii) Cardiff
- (iv) Christchurch
- (v) Kempston
- (vi) Kidlington
- (vii) Leeds
- (viii) Liverpool
- (ix) Luton
- (x) Reading (Calcot)/Theale
- (xi) Sandy/Potton/Biggleswade area

(xii) Sutton Coldfield

(xiii) Warlingham