OFFICE OF FAIR TRADING

Anticipated acquisition by Phoenix Healthcare Distribution Limited of East Anglian Pharmaceuticals Limited

The OFT's decision on reference under section 33 given on 16 June 2005. Full text of decision published 29 June 2005.

Please note square brackets indicate information excised for reasons of commercial confidentiality.

PARTIES

1. **Phoenix Healthcare Distribution Limited (Phoenix)** is part of the Phoenix Group, which is active in pharmaceutical wholesaling and retailing throughout Europe. Phoenix itself is owned by Phoenix Medical Supplies Limited, a non-trading company. Phoenix is a pharmaceutical wholesaler to retail pharmacies and dispensing doctors in Great Britain. Phoenix also operates a small chain of retail pharmacies but has no outlets in the East Anglia area. It operates its wholesaling business through a network of distribution depots located throughout Great Britain.

2. **East Anglian Pharmaceuticals Limited (EAP)** is owned by Jonathan and Gregory Briggs via a holding company, Briggs Family Holdings Limited. The company's principal activity is the wholesale supply of pharmaceuticals to retail pharmacies, dispensing doctors and hospitals through a single distribution depot in Norwich. EAP is not active in retail pharmacy. In the 12 months to 29 February 2004, EAP's total UK turnover was £110.8 million.

TRANSACTION

3. Phoenix proposes to acquire the entire issued share capital of Briggs Family Holdings Limited and its subsidiaries. The transaction was initially considered by the OFT in 2004: the OFT decided not to refer the merger to the Competition Commission on 17 December 2004 ('the original decision'). Following an appeal to the Competition Appeal Tribunal (CAT) by a competitor, UniChem Limited (UniChem), the CAT quashed the OFT's decision on 1 April 2005 and remitted the decision back to the OFT for reconsideration of certain aspects of the original decision to take account of the points raised by UniChem during the course of the appeal proceedings before the CAT.

4. Taking 1 April 2005 as the beginning of this reconsideration the OFT's 40 day administrative deadline expired on 31 May 2005.

JURISDICTION

5. As a result of this transaction Phoenix and EAP will cease to be distinct. The UK turnover of EAP exceeds £70 million, so the turnover test in section 23(1)(b) of the Enterprise Act 2002 (the Act) is satisfied. The OFT therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

BACKGROUND

6. On 3 December 2003, the OFT referred the proposed acquisition by AAH Pharmaceuticals Limited (AAH) of EAP to the Competition Commission. The OFT investigation found that the merged entity would be the largest full-line wholesale supplier of ethical pharmaceuticals (Ethicals) to dispensing doctors, retail pharmacies and hospitals in East Anglia extending to parts of the East Midlands and the South East of England. Lack of information made it difficult to assess the constraint that other full-line wholesale suppliers would offer on the behaviour of the merged entity in relation to the supply of Ethicals to dispensing doctors and retail pharmacies. Adverse effects (reduction in the level of discounts paid to customers; and/or other less favourable terms of supply; and/or a general reduction in service levels) were expected to arise in the supply of Ethicals to hospitals. The parties decided not to proceed with the merger. Therefore, the reference was laid aside.

FRAME OF REFERENCE

Product scope

7. The parties overlap in the wholesale supply of pharmaceutical products (Pharmaceuticals) which include Ethicals; over the counter (OTC) medicines; and other OTC products.

8. OTC medicines refer to pharmacy-only medicines (P medicines), which can only be dispensed under the supervision of a qualified pharmacist, and also to general sales list medicines (GSL medicines), which do not have to be dispensed by a pharmacist and are available in any retail outlet. Other OTC products include general hygiene household products that are also readily available in retail outlets. The OFT does not believe that there is a realistic prospect that the merger will lessen competition substantially in the wholesale supply of OTC medicines and other OTC products, given the wide range of suppliers of these products. Therefore this sector is not considered further.

9. Ethicals are prescription-only medicines and pharmaceutical products that are prescribed to patients under prescription by a doctor or dentist, and which can only be dispensed by a dispensing doctor, retail pharmacy or hospital.

10. Retail pharmacies can be further categorised into: independent pharmacies (less than five outlets and not vertically integrated with a wholesaler); national or regional chains of five or more pharmacies, including pharmacies within supermarkets, which are not vertically integrated ('pharmacy chains'); and pharmacies which are vertically integrated with wholesalers ('tied chains').

11. From its base in Norwich, EAP supplies Ethicals to independent pharmacies, dispensing doctors and hospitals. It is unable (given its limited coverage) to serve pharmacy chains (other than those located in or within reach of East Anglia). Phoenix supplies Ethicals to its vertically integrated chain of Rowlands pharmacies,[1] as well as independent pharmacies and dispensing doctors. It currently supplies a minimal amount (less than 0.05 per cent) of Ethicals supplied by full-line pharmaceutical wholesalers (described below) to hospitals in the UK. It does not serve pharmacy chains (other than its own tied Rowlands pharmacies). The parties' main area of overlap therefore is in the supply of Ethicals to independent pharmacies and dispensing doctors.

Demand-side substitutes

12. Pharmacies and dispensing doctors in general have two different channels through which to source Ethicals. The first option is to source from a full-line wholesaler. Full-liners stock the whole range of products (over 12,000 product lines) that may be required (but not necessarily at every depot) and for the majority of customers offer a twice-daily delivery service.

13. For a limited number of products (circa 3,000 lines), pharmacies and dispensing doctors can source products from short-liners. Short-liners tend to supply the faster moving products that sell in large quantities. They also tend to supply more generics rather than branded Ethicals.[2] Generics may be of limited use to pharmacists since they must supply the drug specified in the prescription. The branded Ethicals that short-liners do supply are often parallel imports, although an increasing number of short-liners now offer UK branded Ethicals (particularly for fast moving products).

14. The parties maintain that although short-liners compete on only a small number of product lines, they should be included in the relevant frame of reference because these fast moving products make up a large proportion of total units (up to 80 per cent) and so they represent a significant competitive constraint.

15. However, short-line suppliers do not provide a same-day or twice-daily delivery service (the majority operating on a next-day courier delivery basis). Pharmacies and dispensing doctors do not have the storage capacity to stock all 12,000 plus products; they therefore rely on full-line suppliers to supply those products on a same day, or overnight basis. The parties have also themselves confirmed that no customer can source their entire requirements from short-liners and all must have at least one full line supplier.

16. In addition, full-liners price differently for generic and branded Ethicals. Generics are supplied on a unit price basis, as generic prices are not subject to regulation. The parties have also supplied evidence that they monitor short-line prices for generics and seek to match them. Branded Ethicals on the other hand are price

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[1] As noted at paragraph 1, there are no Rowlands pharmacies in EAP's main distribution area of East Anglia.

[2] Branded Ethicals may benefit from patent protection, whereas generic Ethicals do not because the patent has lapsed.

regulated under the Pharmaceutical Price Regulation Scheme (PPRS) (see paragraph 31). They are supplied at the regulated list price and pharmacists are paid a retrospective discount based on volume. Full-liners can therefore effectively price differently for the products that are supplied by short-liners.

Supply-side substitutes

17. On the basis of the evidence available, the OFT does not consider that there would be any supply side switching between short-line and full-line supply, in terms of short-liners becoming a full-liner. However there is the possibility of supply side switching on a line by line basis i.e. with short-liners expanding into new product lines previously sold by full-line suppliers only. An increase in prices (or reduction in discount) by full-liners is likely to make more of the product lines on the margin between 'fast' and 'slow' moving more viable for short-liners to supply. The breadth of the constraint would therefore be likely to increase for this limited number of product lines.

Conclusion on product scope

18. In summary, although there is some evidence that the strength and breadth of the constraint offered by short-liners is increasing, they still cannot offer the same service as a full-liner. Furthermore, there remains a rump of product lines that are solely the preserve of the full-liners. While recognising the potential constraint from short-liners for some product lines, the relevant product frame of reference is therefore considered to be the supply of Ethicals to pharmacies and dispensing doctors by full-line wholesalers only.

Geographic scope

19. EAP has only one distribution depot located in Norwich in East Anglia. Phoenix has 13 depots nationwide of which the nearest depot to EAP is situated in Cambridge.

20. The parties argue that the relevant geographic frame of reference is national because the sector is characterised by national players supplying national customers. However, while it is true that AAH, UniChem and to a lesser extent Phoenix do operate in most areas of the UK, there are a number of regional suppliers (including EAP) that operate on a sub-national basis. [3] It is also not wholly accurate to characterise the customer base as national since roughly 50 per cent of the sector is made up of independent pharmacies and dispensing doctors.

21. The parties' competitors state that full-liners can only deliver an effective service to customers located within approximately 2 hours drive time from their depots. It is claimed that it is difficult to service customers further than this because the order cut-off times involved would be unacceptable and the full-liner would be unlikely to be able to offer a twice daily delivery service.

[3] On 1 December 2004, Phoenix opened a new depot at St Albans giving it greater access (via the M25) to the South East region, where it previously had limited coverage.

22. As the distance from the full-liners' depot increases, the 'gap' in time between order cut-off and the delivery will tend to increase. This is unlikely to impact on the morning order drop since these orders are received late the previous day (following evening surgery) and are processed and packed overnight ready for delivery early the next day. However, it makes an afternoon drop less viable, since the orders have to be received, processed and packed so that the delivery drop can be made before the customer closes for the evening. Customer responses in this and previous cases indicate that pharmacists (though not necessarily dispensing doctors) value a twice-daily service.

23. The parties submit that around 70 per cent of pharmacists' requirements are satisfied in the morning drop and that the afternoon drop is less important. They also submit that, as stock ordering and tracking systems become more sophisticated, this ratio is increasing. This view is supported by third parties who agree that the majority of their daily requirements arrive with the morning delivery. This is particularly true for dispensing doctors, many of whom only wish to receive a morning drop.

24. The once-daily requirements of dispensing doctors might suggest a potentially wider catchment area for these customers. However, no wholesaler supplies only dispensing doctors and so such customers have to be integrated within 'rounds' supplying pharmacies also.

25. In summary it is clear that, on geographic scope, whilst there may be national aspects to competition, there are clearly local and regional aspects as well, which cannot be ignored. It is therefore most appropriate to consider the impact of this transaction at both the national and regional levels, with the regional level in this case being the area of most common activity, the East Anglia region. In addition, in view of the evidence put before the CAT, the OFT has considered, in particular, the impact of the merger on competition in that part of East Anglia north of the A14.

HORIZONTAL ISSUES

Shares of supply

National Issues

26. The transaction raises no concerns at a national level. The merger will give Phoenix and EAP a combined share of full-line supply to pharmacies and dispensing doctors of 10 per cent with an increment of 1 per cent.

Regional Issues

27. As mentioned above, EAP's depot is located in Norwich and Phoenix's nearest depot is located in Cambridge. The parties' closest rivals are situated in Romford (AAH) and Letchworth (UniChem). The East Anglia region is also served to a limited extent by two other independent full-liners, Mawdsley Brooks, based in Milton Keynes and, to a lesser extent, Maltbys based in Lincoln.

28. According to the parties' data on the wholesale supply of Ethicals by full-liners to pharmacies and dispensing doctors, post merger, they would have a

combined share of 27.96 per cent (increment 19.49 per cent) in the East Anglia region. The merger would make them the second largest full-liner, after AAH with 44.83 per cent, with UniChem accounting for 25.87 per cent.[4] The total number of full-liners serving this area to any substantial extent would reduce from four to three.

29. In terms of their respective customer bases, the parties may be considered each other's closest competitors. Both EAP and Phoenix specialise in supply to dispensing doctors and independent pharmacies. They cannot effectively supply chains of pharmacies (sometimes referred to as multiples – such as Superdrug, Boots and the supermarket chains) due to their lack of national coverage and they cannot supply 'tied' chains such as Moss[5] or Lloyds since these chains are vertically integrated with UniChem and AAH respectively. Supermarkets look to source from a single national supplier and so currently can only source from the two national full-liners.

30. Looking at shares of supply based upon independent pharmacies and dispensing doctors only (i.e. excluding those customers who are not free to choose Phoenix or EAP as their supplier), the parties have a combined share of supply for independent pharmacies in East Anglia of 21.3 per cent (increment 14.2 per cent) with AAH having 52.8 per cent, UniChem 22.9 per cent and others 3 per cent. For dispensing doctors in the same area, the parties estimated their combined share of supply in 2004 to be 83.1 per cent (increment 59.4 per cent) and that of AAH to be 14.2 per cent.[6] In the decision on the anticipated acquisition by AAH of EAP (see paragraph 6 above), the OFT found that there was insufficient evidence to suggest that supply to dispensing doctors exhibits sufficiently different characteristics from supply to retail pharmacies to justify separate analysis. The OFT has not received any evidence as a result of this investigation to contradict that view. The high combined share figure is, however, indicative of the similarity in the types of customer that the parties supply. EAP contends that it has always had a strong presence in the dispensing doctors sector and Phoenix contends that the lack of a full range twice-daily delivery service from its Cambridge depot (see paragraph 34 below) means that its service is more suited to dispensing doctors in the area.

31. The price of branded Ethicals is subject to price regulation under the PPRS. Under this scheme, the Department of Health (DoH) sets a 'list price' at which manufacturers supply these products to wholesalers. The parties claim that wholesalers can offer their customers a discount, equivalent to a maximum of 12.5 per cent off the list price. The DoH then claws back most of the discount from the pharmacists (the rate of the clawback is currently around 10.5 per cent). The result of this is that the margin within which full-liners can offer differential discounts is small and as a result there tends to be very little difference in the level of discounts offered by wholesalers to pharmacies. This has been backed up by third party comment which tends to focus on levels of service as being the deciding factor in the choice of wholesale supplier.

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[4] All market share estimates in this assessment are sourced from the parties.
[5] The Moss Pharmacy chain is now known as Alliance Pharmacy.
[6] The figures supplied by EAP/Phoenix in relation to 2004 also estimated UniChem's share of supply of this segment to be 1.5 per cent but during the CAT hearing (see paragraph 3 above) these customers were found not, in fact, to be dispensing doctors.

32. In assessing whether this merger may substantially lessen competition, the OFT considers that the following considerations are relevant:

a. What level of constraint does Phoenix confer upon EAP pre merger?
b. Are AAH and UniChem effective competitors in the outlying North and Eastern areas of East Anglia?

The constraint exercised by Phoenix on EAP

33. On the basis of the evidence available, the constraint that Phoenix currently offers to EAP in East Anglia is considered to be low. Phoenix has what could be considered a surprisingly low share of supply (8.47 per cent) in East Anglia, given its apparently advantageous geographic location in the region – it currently operates only two van routes out of its Cambridge depot which primarily deliver into the area north of the A14.[7] There are a number of reasons for this.

34. First, the Phoenix depot at Cambridge is a 'link' depot rather than a full-line depot. This means that the site at Cambridge only carries a limited range of 3,000 lines, which can be dispatched the same day. The remaining 7-10,000 product lines need to be ordered from a feeder depot in Birmingham and can only be delivered on a next day basis. The service that Phoenix can offer from Cambridge could be considered therefore more like a quick delivery short-line service than a full-line offering.

35. Second, although Phoenix has its own chain of tied pharmacies (Rowlands), it has no outlets in East Anglia. This puts Phoenix at a competitive disadvantage to the other players because it cannot build up the requisite network densities to operate efficiently. AAH, UniChem and EAP have hospital contracts, and AAH and UniChem have business with their own tied chains and supermarkets. This allows them to build up customer clusters which can make an additional stand alone van route viable. For example, the OFT considers that these parties should indeed be able to offer a pharmacy near to an existing route a service at negligible marginal cost since they already make drops in the area. EAP is very successful in relatively distant geographic areas, because it can offer a drop to a customer in the same van that is going to a hospital contract. Having accumulated such additional drops, EAP (along with competitors with existing customers networks) is then in a position to make an additional van route viable. Phoenix by contrast has no volume in many areas of East Anglia.

36. In short, Phoenix appears to exercise a limited competitive constraint on EAP, notwithstanding the proximity of its Cambridge depot to that of EAP in Norwich.

The competitive constraint exercised by AAH and UniChem

37. In considering the question of whether AAH and UniChem will be effective competitors to the merged entity in East Anglia and, in particular, the area north of the A14 the OFT notes that both competitors deliver to tied chains and

[7] It has four other van routes which make deliveries on the fringes of that area. These include, for example, one which runs along the A14 making deliveries in Ipswich and Felixstowe before heading south.

supermarkets throughout East Anglia. Such drops provide both UniChem and AAH with a network density in the area. AAH and UniChem also serve independent customers across East Anglia.[8] Such drops add to the network density and show that all types of customer (independents, tied chains and national pharmacy chains) consider the service provided by AAH and UniChem to be acceptable.

38. Furthermore, a number of third parties have indicated that they would switch in the event of poor service from the merged entity, and none has identified any significant barriers to switching to an alternative supplier.

39. UniChem and AAH state that they have limited success in attracting new business in the relevant area and claim this is due to their cut-off time for orders to be placed for the afternoon (PM) drop being too early for many customers. However, customer responses in relation to this case indicate that cut-off times are only one of a number of aspects to service quality which customers value highly. Other important factors cited by customers include reliable delivery times and other factors that do not vary with geography including: customer service levels, order accuracy, flexibility, discounts and friendliness of staff. To some extent this has been borne out by UniChem's own canvassing of pharmacies in the relevant area and the number that indicated a willingness to switch if the merger led to an adverse effect on terms or service levels. This might be because the majority of delivery volumes are carried by the AM delivery for which all the wholesalers have a very similar cut-off time of close of play, usually 7pm, the previous evening. This is particularly true for dispensing doctors. Responses from them indicate that they are less demanding in their requirements, many preferring only one daily drop. Furthermore, the fact that the parties, and EAP in particular, have been so successful in gaining customers that are closer to the depots of either AAH or UniChem although they might be expected to have a later PM cut-off time, suggests that cut-off times are not as key as AAH and UniChem contend.

40. In view of these factors, the OFT's starting position is that both AAH and UniChem are able to deliver across East Anglia (including the area north of the A14) and the service they offer is an acceptable alternative for the merged entity's customers (including dispensing doctors). In addition, their existing customer networks in East Anglia appear to give them an advantage in attracting new customers in the area. Therefore, notwithstanding their limited success rates to date in attracting new customers from EAP and Phoenix, the OFT's preliminary position, as set out in its original decision, is that both AAH and UniChem will be an effective competitive constraint going forward.

41. AAH has not put forward any further evidence to support its contention that it will not be able to compete with the merged entity beyond its limited success rate to date and its less attractive cut off times. The OFT therefore has no reason to revise its preliminary view and continues to believe, in the light of all the factors cited above, that AAH will be an effective competitor to the merged entity.

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[8] [ ]

42. UniChem, on the other hand, has put forward a range of arguments as to why it is not able to exercise a competitive constraint. These and the relevant evidence are considered in the following paragraphs.

Relevant facts: the UniChem delivery network in East Anglia

43. UniChem operates a national delivery network that offers twice-daily delivery (if required) to hospitals, pharmacies and dispensing doctors throughout Great Britain. Out of all the full-line wholesalers, UniChem supply nationally from the smallest number of depots. In order to supply customers located some distance from its depots, UniChem relies on trunking arrangements as described below.

44. UniChem serves its customers in East Anglia out of its Letchworth depot and uses three 'trunking points' located at Peterborough, Thetford and Colchester respectively. UniChem dispatches an [ ] lorry from the Letchworth depot to each of these trunking points twice a day. The lorries meet the smaller delivery vans at the trunking point, in a secure compound, where the lorry is unloaded and the vans loaded. The vans then go on to complete their rounds while the lorry returns to the depot to be re-filled; the [ ] trunking vehicle also completes a small number of drops on the return journey.

45. [ ] van routes originate from the Thetford trunking point, each of which cover the area north of the A14. Of the [ ] routes operating out of Peterborough, [ ] serves the area north of the A14 while of the [ ] operating out of Colchester, [ ] enters that area.[9] By way of comparison, Phoenix, as noted above, has only two routes from its Cambridge depot that predominantly serve the area north of the A14 (and four that make some deliveries on the fringes of that area). Phoenix has approximately 28 drops in the area,[10] compared to UniChem's total of [ ] drops in the area from the Thetford link alone.[11]

46. UniChem's van routes have been subject to minor modifications [ ] (UniChem estimates that in East Anglia it has occurred [ ]. These modifications involved the movement of single customer drops between routes, and were undertaken when it became clear that a particular route's schedule was not practical or a customer's needs could be better met by a different route.

47. In addition, UniChem has undertaken two more significant reorganisations of its network in East Anglia since 2000. These occurred in September 2003 and February 2005 and are described in UniChem's submission of 21 April 2005.

September 2003 re-organisation: key facts

- A large re-organisation affecting [ ] accounts [ ] served from Thetford, Colchester (and impacting on Peterborough).
- [ ].
- Customers were moved between routes and moved between trunking points; routes were reconfigured.

[9] However, [ ] only goes as far as Ipswich, on the very edge of the relevant area.
[10] According to Phoenix maps.
[11] Source: UniChem response of 21 April 2005.

- Two new routes were added in total (two 'half' routes were made full and a new route added).

February 2005 re-organisation: key facts

- A smaller re-organisation prompted by the acquisition of the national [ ] account.
- The re-organisation concerned Colchester van routes only.
- [ ] account consisted of [ ] drops nationally, [ ] of these were in East Anglia.
- [ ] customers (mostly 'tied' customers) were switched between routes.

48. The above shows that UniChem carries out re-organisations of its routes on an 'as needed' basis, and that such re-organisations can occur as a result of the acquisition of a very small number of new accounts.

49. Indeed, the September 2003 re-organisation, which resulted in an increase in the UniChem network capacity in the relevant area, was not prompted because of UniChem winning any specific new customers but rather because of a gradual increase in customer numbers [ ]. At the time of the reorganisation, there was no incremental addition to UniChem's revenue as a result of new customers to offset these additional costs. The rationale was to ensure that existing customers were retained.

UniChem's contention that it is capacity constrained in East Anglia

50. UniChem has contended to the OFT that its ability to expand its network in the area north of the A14 is limited by capacity constraints with the result that it cannot add more than a handful of customers to its existing network, and, that, it could not therefore offer an effective constraint to the merged entity. [ ].

51. UniChem has said that its network in East Anglia is subject to capacity constraints due to a number of factors:

- [ ]
- The rural nature of East Anglia means that the added time needed to accommodate a new customer is likely to be large.
- [ ]
- [ ]

52. [ ].

53. UniChem has provided data which show that in order to make an additional van profitable, in itself, it would need to expect to win or have already won an additional £[ ] of turnover per month. This figure concurs with responses from other full line wholesalers in the region, including Phoenix and EAP. In order to make an additional trunking vehicle profitable, UniChem would need an increase in revenue of £[ ]. If expansion required both vehicles to be added to the network, incremental turnover above £[ ] would be required to make the investment profitable.[12] UniChem accepts, however, that for a limited number of

[12] [ ] UniChem [ ] maintains that the margins that full line wholesalers operate under are exceedingly tight, at around [ ] of total turnover and therefore even relatively low costs need to

new customers, a smaller (and hence cheaper) trunking vehicle, similar to a delivery van, might be sufficient.

54. The number of customers that these revenue figures correspond to varies, since no two customers are the same. In the original decision (at paragraph 43) the OFT noted that £150,000 of turnover might be generated by roughly 5 or 6 customers [ ]. Using this figure, an additional [ ] average sized customers would warrant (profitably) the addition of one van to the network, [ ] would warrant an additional trunking vehicle and [ ] would warrant, and make profitable, the addition of both a new van and a new trunking vehicle.

55. When this point was put to UniChem, it adjusted its estimate of turnover per customer since it claimed that its estimated turnover figure for an average customer was artificially inflated due to the larger than average size of Moss accounts. On the basis of its revised figure of £[ ] for each independent customer, a new van would be profitable at [ ] new independent customers and [ ] new independent customers would be sufficient to make the addition of both a trunking vehicle and a new van profitable (or [ ] if a smaller trunking vehicle was to be used).

OFT assessment of UniChem's arguments

56. The OFT has considered UniChem's submissions but looking at them in the round, in the light of all the evidence it has collected, it does not find them persuasive and continues to believe that UniChem will be an effective competitor to the merged entity.

UniChem's contention that it is capacity constrained

57. The OFT does not accept that UniChem is capacity constrained as it has contended. On the basis of the material provided to it by UniChem and in the light of its understanding of the industry as a result of its investigations, the OFT does not consider it plausible that UniChem, one of the largest wholesalers in the country which already has a supply network operating across East Anglia, would be unable to compete for new business across that region and, in particular, north of the A14.

58. As noted at paragraph 276 of the CAT judgment of 1 April 2005, the MMC found in its 1996 report of the UniChem/Lloyds Chemists and GEHE/Lloyds Chemists proposed acquisitions that UniChem had the capacity to deliver throughout the United Kingdom. In addition, UniChem submitted in 2003 to the OFT in relation to the AAH/EAP investigation and in its initial submissions to the OFT in 2004 in relation to this transaction that it 'has the expertise and resources to be a credible competitor across the UK as well as in East Anglia', which is inconsistent with its subsequent submissions that it is capacity constrained in the region.

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be offset with much higher volumes of additional turnover. UniChem apply their standard [ ] margin to these costs to arrive at the above turnover figures that would make the above investments profitable.

59. The contention that UniChem is capacity constrained is also inconsistent with evidence of both its historic and present conduct, which suggests that it has both the ability and the incentive to make any modifications necessary to its delivery network in East Anglia to serve new customers.

60. As to UniChem's historic conduct, although it says that it does not have the incentive to reorganise its network, it has undertaken major reorganisations of its delivery network in and around East Anglia on two previous occasions in the recent past (as described in paragraph 47 above), in addition to a number of minor route modifications. The reorganisation in September 2003 required investment in new vehicles and that investment was made for the purpose of retaining existing customers rather than acquiring new ones. The evidence of the extent to which UniChem has adjusted its delivery routes in East Anglia in the past demonstrates that it can, in fact accommodate new customers and will adjust route configuration to do so.

61. In relation to its current conduct, [ ]. This is also indicative of willingness on the part of UniChem to compete for and seek to attract new customers to its network in East Anglia.

62. [ ].

63. Again, this evidence highlights UniChem's willingness to serve additional customers in the area [ ]. UniChem's conduct in this regard would not be rational unless it was also willing to make investments in new delivery vehicles if that were required.

64. UniChem has also accepted that it has never refused to supply a customer in East Anglia. Furthermore, its view that it is unable to serve more than a handful of additional customers in the region is not shared by such prospective customers. A number have told the OFT during its investigation that they regard UniChem as a viable, alternative supplier and, as noted above, there is evidence that UniChem has sought to ascertain whether such customers would be interested in switching supplier to UniChem.

65. In relation to the specific aspects of the capacity constraints identified by UniChem, the OFT considers the following counter arguments to be relevant.

- Based on UniChem's existing network, the OFT calculates that the number of potential customers which are located on or very near to existing routes or in larger East Anglian towns, where UniChem already has a number of existing customers, is larger than UniChem estimates (based on average distances). In view of this proximity, such customers could be accommodated within existing routes. To this extent, the OFT considers that UniChem overstates the extent to which lack of slack in its existing network inhibits its ability to accommodate new customers in the future.

- [ ]. As noted above, the OFT does not consider cut-off times to be the key determinant of customer choice but just one of a number of factors that customers take into account. Furthermore, cut-off times are less relevant for a significant number of the merged entity's customers since they are dispensing doctors who only receive a single delivery daily. [ ].

- [ ].

- In relation to the costs of adding new vehicles to UniChem's network, the OFT does not consider these to be prohibitive. As explained above, the cost of a new trunking vehicle and delivery van can be offset by the acquisition of between [ ] customers. Given that UniChem accepts that it can accommodate a handful of additional customers by making minor modifications to its existing network, there is, at most, only a very small gap [ ], where, [ ]. To the extent that such a gap exists, the OFT does not believe that the merged entity will be in a position to exploit it for the reasons set out in paragraph 71 below.

  In any event, the OFT considers that a simple cost versus revenues analysis is overly crude since it takes no account of strategic and network considerations that a rational network operator would take into account. In a network driven industry such as full line wholesaling, where the ability of the wholesaler and their competitors to compete is contingent on the density and reach of their customer drop network, there are a plethora of other reasons, other then the strict revenue benefits, that a full liner would take into account. First, the acquisition of a customer will add value in terms of added revenue; and second, will also increase the value of the network as a whole. The addition of capacity is beneficial in itself when existing routes are operating at capacity since it will improve the level of service to existing customers (that might be moved to 'new' routes) and prevent them from switching away.[13] Acquiring a drop from a competitor also confers a strategic benefit, in that the addition of a particular drop to the UniChem network will deny that drop, and the associated network benefit, to a rival.

  The fact that UniChem continues actively to seek new customers in East Anglia [ ] may be explained by these alternative network benefits. [ ].

- Finally, [ ].

66. In conclusion, the OFT does not accept that UniChem is capacity constrained. Its existing network in East Anglia is sufficiently extensive that it is able to add new customers incrementally to the point where it becomes worthwhile to expand its network by adding a new delivery van and, if necessary, trunking vehicle. This is supported by evidence of UniChem's past and present conduct in the region. As might be expected with such a large and well established wholesaler, the evidence shows that UniChem is flexible and adaptable and configures and reconfigures its delivery network in order to accommodate existing and new customers with maximum efficiency. It also highlights its continuing willingness to compete for those customers [ ]. The OFT therefore concludes that it is not plausible that UniChem is capacity constrained in its ability to compete for new business in East Anglia, including the area north of the A14.

[13] [ ].

UniChem's contention that it is not a competitive constraint

67. In any event, to the extent that UniChem is subject to existing capacity constraints, the OFT does not consider that this means that UniChem is not a meaningful competitive constraint upon the merged entity.

68. [ ].

69. The OFT accepts that in order to act as a real competitive constraint on the merged entity in East Anglia, UniChem must be able to supply new customers in the area.

70. As already noted, UniChem's existing delivery network operates across East Anglia and it has a relatively high network density in the area north of the A14. In terms of geographical scope, its network therefore appears to give it the ability to serve new customers across East Anglia, including the area north of the A14. However, the OFT does not consider that in order to be an effective competitive constraint UniChem needs to be able to supply all or a large portion of those customers immediately and simultaneously. Rather any price increase or loss of service quality would be made unprofitable if a sufficient number of customers were to be lost. Therefore, UniChem acts as a real competitive constraint if it is able to supply any one or a number of customers in an area. In other words, if a particular customer or customers can switch to UniChem, then that threat of switching will act as a competitive discipline upon the service provided by the merging entity to all those customers.

71. Of course, were it to be the case that UniChem could only supply a handful of additional customers and thereafter would be unable to supply any others, then UniChem might be a more limited competitive constraint, were that fact known to customers and the merged entity. For the reasons set out above, the OFT considers that UniChem has the incentive to make the investment necessary to supply more than a handful of additional customers. To the extent there is a gap before financial incentives materialise (see paragraph 65 above), it is minimal and not one that the merged entity could plausibly exploit to the disadvantage of its customers. It will not have the precise understanding of the constraints to which UniChem (or any other competitor) is subject which it would need in order to raise prices or cut service levels without enabling customers to switch to another supplier.

72. Moreover, the simple fact that if UniChem were to be successful in obtaining large numbers of new customers across East Anglia it would, undoubtedly, have to invest in new distribution assets (vans or trunking vehicles for example) does not mean that it is not a currently competitive constraint in relation to a large number of customers. So long as UniChem is realistically perceived by potential customers and competitor wholesalers to be a viable alternative supplier, the effect is that it acts as a competitive constraint on those other wholesalers. Evidence from both potential customers and EAP and Phoenix confirms that it is so perceived.

Conclusion

73. On the basis of the above, the OFT does not expect that there will be an adverse impact from the reduction of choice among full-liners in East Anglia. In the OFT's view there will not be an appreciable impact on discounts or on service levels.

Barriers to entry and expansion

74. Barriers to entry in full-line wholesaling are considered to be high. This is because of the high cost of establishing and stocking a depot[14], the low returns that would be expected and the difficulty in achieving a critical mass of customers to make a depot viable. As a result, almost all of the new entry observed in the past 5 years has been by acquisition rather than organic growth (although Phoenix has recently opened a new depot at St Albans).

75. Further barriers may exist at the route level, where the parties estimate that in order to make an entirely new route viable (serving wholly new demand), the route needs to carry a turnover of approximately £150k per month in order to break even. However, customers can be and are added to suppliers' existing networks on an individual basis and accommodated by modifying routes at minor incremental cost. At some point, these additional customers make an additional route viable (and indeed necessary as the existing routes become stretched). As discussed further in terms of the UniChem evidence above, the cost of such expansion is not considered to be substantial, especially if it is considered that it results from a number of incremental changes to the overall network.

Buyer power

76. Whilst there are a number of large national buyers of Ethicals in the UK (for example supermarkets and large chains like the Co-op) their choice of supplier is extremely limited since only AAH and UniChem are able to supply on a national basis.

77. For smaller customers in the East Anglia area the choice is more varied as they can source from AAH, UniChem and Phoenix and regional full-liners. However due to their small size their buying power is not significant. The parties submit that buying groups confer buyer power upon smaller customers. However buying groups tend to supply generics under the group brand, for which short-line alternatives are already available. Buying groups do not therefore have a significant impact on the competitive assessment. There is therefore little prospect of customers being able to exercise any buyer power.

Rivalry enhancing benefits

78. The parties submit that this transaction will in fact increase rivalry between full-line wholesalers. This is because the merger will increase the coverage of Phoenix from the much larger EAP depot - so giving it greater economies of scope and scale. In addition Phoenix will be able to use the expertise and customer base of EAP in the hospitals sector in order to create its own hospital

[14] The parties submit that the cost of a new depot is up to £12 million.

supply business nationwide. Currently only AAH and UniChem are active in hospitals nationally.

79. The parties' case regarding rivalry enhancing benefits, particularly regarding hospitals, seems plausible. However, due to the information asymmetries between the OFT and the merging parties in assessing efficiency claims, the OFT is generally sceptical about efficiency gains. Specifically, the OFT requires clear and compelling evidence that: the benefits would indeed arise, are merger specific and that the benefits would be passed on to customers. In this particular case the OFT does not consider that the parties have provided sufficiently clear and compelling evidence to warrant the inclusion of rivalry enhancing efficiencies within its analysis.

VERTICAL ISSUES

80. Neither of the parties has tied pharmacies in East Anglia (although Phoenix owns pharmacies in other regions in the UK), therefore no vertical issues arise as a result of this merger.

THIRD PARTY VIEWS

81. Competitors to the parties raised concerns about the acquisition, suggesting that for certain customers in certain areas, the merger would severely reduce customer choice. Following the remitting of the case back to OFT extensive further enquiries were undertaken with competitors which are reflected at paragraphs 37 to 73 above. A number of customers who were contacted currently use EAP and Phoenix as main and back up full-liners. While a number of these customers were concerned over their potential reduction in choice, many were not and expressed the view that adequate competition would remain in the area post-merger.

ASSESSMENT

82. In the East Anglia region, the merged entity will be the second largest full-line wholesale supplier of Ethical pharmaceuticals. At this regional level, the merger will effectively reduce the number of competing full liners from four to three. In addition, in terms of their geographic coverage and respective customer bases (namely, a focus on dispensing doctors) the parties could be considered close alternatives.

83. It might be the case that, in certain circumstances, short-liners will be able to provide some constraint on the parties. However, competition to the parties is expected to come from other full-liners operating in the region, namely AAH and UniChem. In assessing the extent of this constraint, the OFT notes that both AAH and UniChem currently offer a service to tied chains, supermarkets and independent customers throughout the East Anglia region and can be considered well placed to compete for additional custom in the region. The OFT also considers there is nothing specific about dispensing doctors as customers, which would prevent these competitors from servicing their needs. Added to this is the fact that overall Phoenix currently offers a limited constraint on the activities of EAP.

84. The original decision was remitted back to the OFT to consider the additional evidence presented by UniChem relevant to its ability to provide an effective competitive constraint on the merging parties, particularly in the area to the north of the A14. The OFT has carefully considered all of the evidence provided by UniChem, both to the CAT and subsequently to the OFT. For all the reasons set out in the paragraphs above, the OFT does not accept that UniChem lacks the ability and the incentive to compete for the merged entity's customers in this area. In particular, UniChem's conduct in the recent past demonstrates its willingness to modify its network (including making investments in new vehicles) in order to retain customers and accommodate new ones. Its on-going conduct in the region is consistent with a business which is actively seeking to compete for new customers [ ]. Furthermore, even on UniChem's own figures, there is a very small gap between the number of additional customers which UniChem is currently able to accommodate and the number where investment to overcome capacity constraints becomes profitable. The possibility that the merged entity might be in a position to exploit this gap is not, in the OFT's view, plausible.

85. Therefore, the OFT remains of the view that UniChem and AAH represent, and will continue to represent, an effective competitive constraint upon the merging parties throughout the East Anglia region.

86. Consequently, the OFT does not believe that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

DECISION

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