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

The OFT's decision on reference under section 33 of the Enterprise Act 2002 given on 17 December 2004

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**Please note square brackets indicate text or figures either removed or replaced by ranges at the request of the parties for reasons of commercial confidentiality.**

1. **Phoenix Healthcare Distribution Limited (Phoenix)** is part of the Phoenix Group, which is active in pharmaceutical wholesaling and retailing throughout Europe. It 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 twelve 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 for [ ]. The transaction was notified to the OFT on 22 October 2004 and the administrative deadline expires on 20 December 2004.

### JURISDICTION

4. 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**

5. 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**

6. The parties overlap in the wholesale supply of pharmaceutical products (Pharmaceuticals) which include Ethicals; over the counter (OTC) medicines; and other OTC products.
7. 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.
8. 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. Retail pharmacies can be further categorised into independent pharmacies (with less

than five outlets), national or regional chains consisting of five or more independent or vertically integrated pharmacies and supermarket pharmacies.

9. 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 or supermarket pharmacies. Phoenix supplies Ethicals [ ] to its vertically integrated chain of Rowlands pharmacies,<sup>1</sup> as well as independent pharmacies and dispensing doctors. It currently supplies a minimal amount (less than [0.1 per cent]) of Ethicals supplied by full-liners to hospitals in the UK. It does not serve multiple pharmacy chains (other than its own tied Rowlands pharmacies) or supermarket pharmacies. The parties' main area of overlap therefore is in the supply of Ethicals to independent pharmacies and dispensing doctors.

#### *Demand side substitutes*

10. 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.
11. 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<sup>2</sup>. 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).
12. 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 revenues (up to 80 per cent)<sup>3</sup> and so they represent a significant competitive constraint.
13. 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

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<sup>1</sup> As noted at paragraph 1, there are no Rowlands pharmacies in EAP's main distribution area of East Anglia.

<sup>2</sup> Branded Ethicals may benefit from patent protection, whereas generic Ethicals do not because the patent has lapsed.

<sup>3</sup> Correction – this figure relates to units rather than revenue.

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.

14. 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 regulated under the Pharmaceutical Price Regulation Scheme (PPRS) (see paragraph 29). 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*

15. 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*

16. 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**

17. 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.

18. 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<sup>4</sup> do operate in most areas of the UK, there are a number of regional suppliers (including EAP) that operate on a sub-national basis. 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.
19. The parties' competitors state that full-liners can only deliver an effective service to customers located within approximately two 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.
20. 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.
21. 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.
22. 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.
23. 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

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<sup>4</sup> 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.

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.

## **HORIZONTAL ISSUES**

### **Shares of supply**

#### *National issues*

24. 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*

25. 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.
26. 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 [25-35] per cent (increment [15-25] per cent) in the East Anglia region. The merger would make them the second largest full-liner, after AAH with [40-50] per cent, with Unichem accounting for [20-30]<sup>5</sup>. The total number of full-liners serving this area to any substantial extent would reduce from four to three.
27. 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 smaller independent pharmacies. They cannot effectively supply chains of pharmacies (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 or Lloyds since these chains are vertically integrated with Unichem and AAH respectively. Similarly supermarkets look to source from a single national supplier and so currently can only source from the two national full-liners.
28. 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 [15-25] per cent (increment [10-20] per

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<sup>5</sup> All market share estimates in this assessment are sourced from the parties.

cent) with AAH having [45-55] per cent, Unichem [15-25] per cent and Mawdsley Brooks [<5] per cent. For dispensing doctors in the same area the parties have a combined share of supply of [75-85] per cent (increment [55-65] per cent) with AAH with [10-20] per cent and Unichem with [<5] per cent and minimal sales from Mawdsley Brooks. In the decision on the anticipated acquisition by AAH of EAP (see paragraph 5 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 32 below) means that its service is more suited to dispensing doctors in the area.

29. 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.
30. 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?
  - c. Are AAH and Unichem effective competitors in the supply of Ethicals to dispensing doctors?
31. 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 ([<10] per cent) in East Anglia, given its apparently advantageous geographic location in the region. There are a number of reasons for this.

32. 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 [2,000-4,000] 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.
33. In addition, 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 make a 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. Phoenix by contrast has no volume in many areas of East Anglia. Therefore its marginal cost of servicing customers, in a new area, is by contrast relatively high since adding a new van route rather than altering an existing route is relatively expensive.
34. Regarding the question of whether AAH and Unichem are effective competitors in the outlying North and Eastern areas of East Anglia, both competitors deliver to tied chains and supermarkets in these areas already. It should therefore be relatively easy and cost effective to add one or more drops to an existing 'round'. The parties have shown that both AAH and Unichem are serving independent customers in these areas. AAH and Unichem maintain that they are unable to offer a good enough service in these areas; however, the level of service that they provide is evidently good enough for some independent customers and for the national supermarkets.
35. Phoenix and EAP have provided detailed spreadsheets setting out the distances between and cut-off times for independent sector customers supplied by all full-liners operating in the region. The spreadsheets suggest that the service levels of all suppliers (including AAH, Unichem and Mawdsley Brookes) do not necessarily deteriorate significantly in response to distance and undermine the suggestion that AAH, Unichem or Mawdsley Brooks cannot effectively compete in parts of East Anglia, since they clearly do provide services for all types of customers in this area.

36. AAH and Unichem are relatively well placed to compete for business throughout East Anglia by virtue of their full size depots and the network benefits they gain from existing customer density, and from customer clusters over longer distances. It therefore seems that any customer of the merged entity could switch to AAH or Unichem (or in the West of the region, Mawdsley Brookes). Furthermore, a number of third parties have indicated that they would switch in the event of poor service from EAP, and none has identified any significant barriers to switching to an alternative supplier.
37. Customer responses in relation to this case indicate that cut-off and delivery times are one of a number of aspects to service quality which customers value highly. Other important factors cited by customers, that do not vary with geography include: customer service levels, order accuracy, flexibility, discounts and friendliness of staff.
38. In terms of the supply of Ethicals to dispensing doctors, there are no particular barriers on either the demand or supply side between pharmacies and dispensing doctors. A dispensing doctor is essentially another drop on the route, so if AAH and Unichem are supplying pharmacists in the region, there appears to be no reason why they should not be able to add dispensing doctors to their existing route network. Furthermore, responses from dispensing doctors indicate that they are less demanding in their requirements, many preferring only one daily drop. Third parties have indicated that dispensing doctors are reluctant to switch unless service levels fall, and are relatively insensitive to price as they are reimbursed at cost for the Ethicals that they prescribe to patients. This implies that they have less incentive to shop around in search of cheaper drugs. For them, service quality is a key consideration in choosing their full-liner. However the dispensing doctors contacted by the OFT indicated that there were no barriers to switching supplier and a number stated that in principle there is no reason not to use AAH or Unichem. They are reluctant to switch because they are happy with their current supplier and because there is little difference in the offers from full-line competitors.
39. 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.

#### **Rivalry enhancing benefits**

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

41. 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.

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

42. 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,<sup>6</sup> 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 all of the new entry observed in the past five years has been by acquisition rather than organic growth.
43. Further barriers exist at the route level, where the parties estimate that in order to make a new route in a new geographic area viable, the route needs to carry a turnover of approximately £150k per month (equivalent to 5-6 customers) in order to break even. However, the parties maintain that all full-liners use sophisticated routeing software to optimize their networks. As a result, the addition of a new customer to the network will typically be followed by a re-organization of the entire route network. The marginal cost of supplying a new customer, where existing customer drops are nearby, should therefore be very low. However opening a route in an area where the full-liner has no pre-existing drops (even within the 2-hour drive time radius) is likely to carry a higher incremental cost.

### **Buyer power**

44. 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.
45. 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

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<sup>6</sup> The parties submit that the cost of a new depot is up to £12 million.

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.

## **VERTICAL ISSUES**

46. 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**

47. Competitors to the parties raised concerns about the acquisition, suggesting that for certain customers in certain areas, the merger would severely reduce customer choice. 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**

48. In the East Anglia region, the merged entity will be the second largest full-line wholesale supplier of Ethicals 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.
49. 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 and 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.

50. 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**

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