

ANTICIPATED ACQUISITION BY CELESIO AG OF SAINSBURY'S UK PHARMACY BUSINESS

Parties' submissions in response to the Notice of Possible Remedies dated 29 April 2016

1 Introduction

This response contains the Parties' submissions in response to the CMA's Notice of Possible Remedies (the "**Notice**"), which sets out the actions that the CMA considers it might take for the purpose of remedying any substantial lessening of competition ("**SLC**") and resulting adverse effects that are ultimately identified by the CMA.

As will be set out in further detail in the Parties' forthcoming response to the Provisional Findings ("**PFs**"), the Parties do not believe that the CMA has adequately established the likelihood of any SLC or adverse effects arising from this merger. This response is therefore provided without prejudice to any submissions on the merits or substance of the Provisional Findings that either Party may make.

2 A behavioural remedy would be effective and proportionate given the parameters of the provisional SLC finding

As stated in the Notice, when deciding on an appropriate remedy, the CMA must apply the principle of proportionality. In particular, the CMA should ensure that no remedy is disproportionate in relation to any SLC and its adverse effects, and between two equally effective remedies, the CMA should choose that which imposes the least cost or restriction.

The CMA has provisionally found that the merger may be expected to result in an SLC in 13 local areas (the "**13 Provisional SLC areas**") (representing less than 5% of the target estate), 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.¹

It appears from the PFs that the CMA is most concerned about the possible deterioration of the competitive offer at Lloyds stores, as the Cooperation Agreement between the Parties and the ongoing incentive of Sainsbury's to preserve the quality of the pharmacies within its supermarket stores means it will be more difficult for Lloyds to materially change its offer at Sainsbury's pharmacies than at its own pharmacy stores.² In particular, the CMA seems to be concerned that Lloyds may have an incentive materially to reduce its opening hours at its own pharmacies following the merger.³

Limited scope of adverse effects identified

Given the very limited scope of the possible adverse effects that have been provisionally identified by the CMA, the Parties submit that it would be disproportionate to impose a structural remedy in this case. Instead, the CMA's concerns could be effectively addressed by a behavioural remedy that requires Lloyds not to reduce the opening hours at any of its pharmacies in the affected areas.

¹ Provisional Findings, Para 36.

² Provisional Findings, Para 7.243.

³ Provisional Findings, Para 7.111.

In particular, if the CMA maintains its provisional concerns in relation to some or all of the 13 Provisional SLC areas, Lloyds would be prepared to offer an undertaking:

- not to reduce the opening hours below those that were in place immediately prior to the date of the BSA (or such other date to be agreed with CMA);
- at any Lloyds pharmacy identified on the maps contained in Annex M to the CMA's Provisional Findings;
- for a period of three years, which is equal to the typical duration of a Pharmaceutical Needs Assessment (“PNA”), or such other period as deemed by the CMA to be appropriate, proportionate and reasonable in the circumstances;
- unless consent is sought and received from the CMA (for example, as a result of a material change in circumstances in a particular local area).

The remedy is unusually well-tailored to tackle the SLC concern

While the Parties accept that the CMA's general preference is for structural remedies to address an SLC at its source, they submit that the remedy outlined above would be sufficient to directly address the perceived adverse effects of the provisional SLC finding (which, as noted above, are considered to be of extremely limited scope).

In other words, to the extent the CMA's concern is that the pressure of rivalry from the Sainsbury's store is driving expanded opening hours at the relevant Lloyds store (e.g., for sake of argument, a concern that the Lloyds is open one hour longer, Monday-Friday, than it otherwise would be absent such rivalry from Sainsbury's), the direct and tangible issue in terms of consumer welfare is the reduction of opening hours (in the above example, by five hrs per week), and the harm that implies in terms of loss of convenience for those customers would otherwise prefer to shop within those extra five hours.

A remedy as described would have immediate and certain effect, because it ensures that those customers face no loss of convenience, and that the Lloyds store would stay open for those extra five hours. This would neuter any concerns from an opening-hours-driven SLC concern, would not result in any market distortion given the existing regulatory context (in which any decrease or increase in opening hours is already subject to regulatory consent), and would endure for at least the lifetime of the local PNA (at which point the local commissioner can consider whether additional pharmacy provision may be required in a given area, and could thus enable further entry if it so wished, by granting additional licences).

Regulatory context avoids usual monitoring and enforcement concerns

The remedy would also be straightforward to implement, monitor and enforce, given that any change in pharmacy opening hours is already subject to regulatory approval. There is therefore no discretion for Lloyds pharmacy managers to make ad hoc changes to opening hours, and Lloyds would take additional steps to ensure internal compliance. Local regulatory bodies would also be aware of the remedy, and be able to detect any breaches, and regular reports could readily be provided to the CMA with details of any request for regulatory approval made in relation to opening hours for any of the relevant stores.

Accordingly, such a behavioural remedy is fit for purpose to remedy a provisional SLC whose adverse effects are exceptionally limited, given the regulatory context and the nature of competitive interaction (or lack thereof) between the Parties.

Residual issues of ‘quality reduction’ beyond opening hours

To the extent the CMA may have residual concerns about quality reductions beyond the apparent primary concern in relation to opening hours, the Parties submit that the CMA has not evidenced – or even articulated with sufficient precision – what form any such quality reductions might take.

The public policy justification for intervening in the property rights of merging parties by imposing divestitures (a highly intrusive remedy) exists when it is necessary to protect customers from expected harm; divestiture does not serve merely to preserve rivalry for the sake of rivalry if that rivalry did not likely benefit consumers, and its removal would not likely harm them. This is why, according to the CMA’s own guidelines, evidence of likely adverse effects plays a “*will play a key role*” in assessing mergers and “a merger that gives rise to an SLC *will be expected* to lead to an adverse effect for customers”.⁴ In order to reach an expectation of a substantial loss of close rivalry (i.e. the “S” in SLC), the CMA must underpin the “substantiality” of the loss of rivalry by articulating specific adverse merger effects that the evidence does not preclude as either impossible or unlikely.

Given the CMA has not identified evidence of any likely adverse effects other than in relation to opening hours – and in particular, has not raised specific provisional concerns about other quality parameters – a behavioural undertaking not to reduce opening hours should be considered an effective, proportionate and reasonable remedy in this case.

In the alternative, the Parties submit that any residual concerns about quality reductions beyond opening hours are *de minimis*, and that the appropriate course of action would be to treat them as immaterial. This would be the case, if, for the sake of argument, the CMA’s had residual (unarticulated) concerns about a parameter such as the timing of future refurbishments at Lloyds pharmacies. Treating such a remote and speculative factor as immaterial would be consistent with the approach taken by the CMA in its most recent Phase II retail merger case, *Poundland/99p*.⁵

3 Nature of any structural remedies (if required)

In the event that the CMA does not accept the Parties’ submission that a behavioural remedy would be an effective and proportionate means of addressing the CMA’s concerns, the Parties have set out below their submissions on what structural remedies would be most appropriate in this case. These submissions are made in the alternative and without prejudice to the Parties’ submissions above in relation to behavioural remedies.

3.1 If a divestment were required in any local area, it would be disproportionate to require more than one pharmacy to be sold

The CMA’s provisional view is that it would be appropriate to require the divestiture of one or more Lloyds pharmacies (both the licence and the store) in each relevant area⁶.

⁴ Merger Assessment Guidelines, paragraph 4.1.3. Emphasis added.

⁵ Poundland/99p Report, para. 6.128-6.129. In that case, the relevant concern was that customers would be inconvenienced by the store closures, because they would have to travel further to find an equivalent offering. This concern was dismissed by the CMA, on grounds that the inconvenience to customers was not sufficiently material to warrant a local-level inquiry – let alone an SLC finding that would probably require divestitures – because the average distance between the parties’ stores in overlap areas was very small (approx. 0.1 miles).

⁶ Notice, Para 8(a).

The Parties do not yet have any (formal) clarity on the areas in which the CMA considers that it may be necessary for Lloyds to dispose of more than one of its pharmacies. However, as a matter of general principle, the Parties consider that it would be disproportionate to require more than one pharmacy to be sold in any area, particularly given the limited nature of the CMA's provisional concerns. CMA guidance states that the CMA will normally seek to identify the “smallest, viable, stand-alone business that can compete successfully on an ongoing basis”.

Divesting a single pharmacy would introduce an additional pharmacy operator into the area in question that is able to compete with Lloyds on an ongoing basis, and would (in terms of fascia) restore competition to its pre-merger levels. Indeed, due to the fact that the parties are quite differentiated in terms of their offering, any new pharmacy operator of a divestment site – particularly if it is a Lloyds store – is likely to provide a level of competitive pressure that is *greater* than that currently exerted by Sainsbury's. As the CMA has acknowledged in the PFs, the results of the research separately carried out by the Parties suggest that the “*the closest competitors to Lloyds are independent pharmacies along with other major chains, rather than supermarket pharmacies*”.⁷

3.2 Celesio should be given the choice of which pharmacy it is required to divest in each relevant area

It is suggested in the Notice that the CMA may specify the pharmacy/ies that it considers should be divested in each relevant area. While the Parties are unable to comment in precise detail pending receipt of the “list” mentioned in the Notice, as a matter of general principle, they consider that Celesio should be able to choose which pharmacy is to be divested in each relevant local area (within reason, of course, subject to considerations such as location, size of pharmacy relative to the Sainsbury's pharmacy, proximity to GP surgeries and sufficient interest from suitable purchasers), as the divestment of a single Lloyds pharmacy should at least restore competition to its pre-merger level.

As discussed further below, Celesio expects strong interest from a range of pharmacy operators, and any concerns around divestiture composition or purchaser risk could be addressed via the inclusion of an alternative divestiture package if necessary.

3.3 Celesio should be permitted to transfer the “non-retail” business out of any divestment store prior to its sale

The CMA has stated in its Provisional Findings that, with respect to care homes, the overlap between the Parties is minimal and the merger is not expected to have any significant impact on the supply to care homes.⁸ Similarly, no issues arise in the no-overlap areas of supply to [REDACTED], the “**B2B**” business).

Celesio therefore assumes that the B2B business of any ultimate Lloyds divestment store could be transferred to another Lloyds store prior to any such divestment, given that this part of the business would not form part of any SLC which required remedying. Furthermore, we note that B2B contracts make up a [REDACTED] of the activities of the Lloyds stores identified by the CMA in its Provisional Findings as being of particular interest, and therefore [REDACTED].

⁷ Provisional Findings, Para 7.100.

⁸ Provisional Findings, Para 5.8 and Para 5.9

4 Possible combination of a behavioural remedy and a structural remedy

The CMA has indicated that it will “consider whether a combination of measures is required to achieve a comprehensive solution, and will evaluate the cumulative impact of any such combination of measures on the SLC.”⁹

In the event that the CMA does not accept the Parties’ submissions that in one or more relevant areas:

- a behavioural remedy alone would effectively address its concerns; and
- it would be disproportionate to require more than one pharmacy to be sold,

then the Parties submit that a behavioural remedy of the kind described in Section 2 above, combined with the divestiture of only one pharmacy in a given area, would be an effective remedy in each such area. The Parties submit that such a combined remedy would be far more proportionate than a remedy which required the divestiture of two or more pharmacies in any relevant area.

These submissions on combined remedies are made in the alternative and without prejudice to the Parties’ submissions above in relation to behavioural and structural remedies.

5 Alternative approach to structural remedies in specific local areas

Celesio considers that an alternative option, if a potential purchaser so wished, would be to divest a pharmacy as a “going concern”, subject to a *relocation of the pharmacy licence* from the existing site to an alternative site nearby. This would enable the purchaser to operate what is, in effect, a new pharmacy with the same services (e.g. where the divested pharmacy has a 100 hour contract, the benefit of that would equally transfer), while creating a new fascia independent of the Parties in the local market. Such an approach may be particularly appropriate in a location where Lloyds leases its pharmacy premises from Sainsbury’s, as it would allow the approved third party purchaser to operate independently of the Parties.

As the CMA is aware, pharmacy licence relocations are relatively common in the industry. While there is no specific limitation on the distance of the relocation, in light of the fact that the new premises must be accessible to the relevant customer group, all relocations tend to remain within a ½ to one-mile radius. In this case, the approved third party purchaser would be required to ensure that the relocation is accessible for existing patients and it would be required to offer at least the same pharmacy services. The sale of a pharmacy subject to a minor relocation should, therefore, equally address any identified SLC concern in a relevant local area.

Moreover, it appears from the Notice that the CMA is minded to address any SLC via the divestment of one or more *Lloyds* pharmacies. The Notice does not make any mention of the possibility of divesting a Sainsbury’s pharmacy. While Celesio’s current expectation is that Lloyds pharmacies would represent at least the significant majority of any final divestment package, in the absence of the list of possible divestment stores from which Celesio may be allowed to choose (if Celesio is to be given a choice of possible divestment stores), as referred to in paragraph 15 of the Notice, Celesio reserves its right to comment further on possible alternative divestment solutions.

⁹ Notice, Para 11.

6 There are no possible grounds for prohibiting the merger

The Parties' agree with the CMA's provisional view that divestiture(s) in the SLC areas would represent an effective and more proportionate remedy to the provisional SLC, in light of the fact that the number of markets in which the CMA has provisionally found that the merger may be expected to result in an SLC is small in relation to the total number of stores to be acquired, and that prohibition of the merger would not therefore be a proportionate solution.

7 Characteristics of a suitable purchaser

Celesio considers that there is a range of potential purchasers who will without doubt be independent, capable of acquiring and running one or more of the divested pharmacies as an effective competitor, committed to the market, and free from competition or other regulatory concerns. The market for the sale and purchase of pharmacies is buoyant, and pharmacies change hands frequently without difficulty.

Celesio's expectation is that any divestment pharmacies would be sold to one or more existing pharmacy operators, who by definition will already meet the regulatory requirements to operate in the market. [REDACTED]. Celesio also anticipates that there may be strong interest from [REDACTED]. Celesio does not therefore anticipate any difficulty in identifying suitable purchasers in any of the 13 Provisional SLC Areas. While Celesio would be willing to consider [REDACTED].

8 The divestiture process

Appropriate timescale for divestiture

The Parties' welcome the CMA's provisional view that "it would not be necessary to require that any divestiture(s) is completed before the merger would be allowed to complete."¹⁰

In Celesio's view, the standard timescale of six months to identify suitable purchasers for the affected sites and conclude signed agreements would be sufficient in this case. As noted above, Celesio does not anticipate any difficulty in attracting interest given the buoyant nature of the pharmacy market.

Necessary procedural safeguards

Celesio proposes to appoint [REDACTED], an independent auction house which is experienced in running sales processes for pharmacies, to run the divestiture process. This will have the advantage of ensuring an efficient, fair and transparent process for all involved parties, and remove any risk that Celesio may be incentivised to make divestitures to weaker competitors (as [REDACTED] would be engaged to secure the sale to the most appropriate bidder, provided of course that participating bidders are deemed to be suitable purchasers for the purposes of the CMA remedy). Celesio had initial discussions with [REDACTED] during the CMA's Phase I investigation, and [REDACTED] has confirmed that it would be in a position to move quickly if required.

[REDACTED] has substantial experience and expertise in the sale of pharmacy businesses, and of the [REDACTED] pharmacies it has already sold, it has received an average [REDACTED] offers per pharmacy. Celesio is therefore confident in [REDACTED]'s ability to find a suitable purchaser for any divestment business. Additionally, both Celesio and [REDACTED] understand the CMA divestment

¹⁰ Notice, Para 19.

process and the active role which the CMA would wish to play, in particular in approving a proposed purchaser as being suitable to acquire the divestment business. Both Celesio and [X] would ensure a continuous dialogue with the CMA during any divestment process to enable the CMA to be satisfied with the divestment.

Swap as consideration in lieu of sale

Celesio also considers that a “swap” in lieu of a sale could also fulfil all relevant CMA criteria (provided that the swap did not raise any competition issues of its own, of which Celesio would in any event be particularly mindful before making any such proposal to the CMA).

No justification for appointment of a divestment trustee or a monitoring trustee

In the Parties’ view, there is no need to appoint a divestment trustee or a monitoring trustee. As noted above, Celesio does not anticipate any difficulty in attracting interest from a number of suitable potential purchasers given the buoyant nature of the pharmacy market, and the appointment of a third party auction house to run the sales process will ensure a fair and transparent process. A divestiture trustee is therefore clearly unnecessary.

The Parties also remain of the view that a monitoring trustee is not required. As indicated previously, Lloyds would be willing to provide regular reporting information to the CMA to provide any assurance required that divestment pharmacies continue to be operated in the ordinary course pending the conclusion of the divestment process.