

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

## Summary of final report

**29 July 2016**

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

### The Parties

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

---

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

4. Sainsbury's pharmacy business is owned and operated by Sainsbury's Supermarkets Ltd (Sainsbury's), a wholly owned subsidiary of J Sainsbury plc. Sainsbury's operates 277 pharmacies and three OPD hospital trust contracts in four hospitals. Sainsbury's pharmacy is the second largest supermarket pharmacy chain, after Tesco. 21% of Sainsbury's stores (46% of Sainsbury's supermarkets) have a pharmacy.

## **Industry background**

5. Pharmacies dispense or sell medicines and non-pharmaceutical products (such as toiletries, beauty products and other consumer goods). Medicines are categorised into three groups by the Medicines and Healthcare products Regulatory Agency (MHRA):
  - (a) Prescription-only medicines (POMs or ethical): pharmaceutical drugs that require a prescription from a GP or other prescribing healthcare professional.
  - (b) Pharmacy-only medicines (or P-medicines): pharmaceutical drugs that do not require a prescription but can only be sold under pharmacist supervision.
  - (c) General sales list (GSL) medicines: medicines that can be bought from pharmacies, supermarkets and other retail outlets without a prescription or the supervision of a pharmacist.
6. Community pharmacies<sup>2</sup> provide a range of services which can be broadly categorised as essential services, commissioned services and private services. All pharmacies must provide essential services. These vary slightly between the UK nations but include the core services of dispensing medicines and appliances. Pharmacies can choose whether to provide commissioned services if they meet the specified requirements. The range of commissioned services provided and how they are commissioned varies according to the UK nation in which the services are offered. Private services, such as travel vaccinations, are outside the NHS.
7. The UK pharmacy market was estimated to be worth around £14.5 billion in 2014. Growth in 2014 was estimated to be 2.1%. NHS receipts account for the majority of the market, and have been estimated at £10 billion. At present there are some 14,250 pharmacies in the UK.

---

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

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

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

11. NHS commissioning bodies have in recent years begun to outsource OPD pharmacies. The move to outsourcing has arisen as NHS trusts look at potential ways to increase efficiency.<sup>5</sup> Generally it has been larger NHS trusts to date that have decided to outsource OPD services. The main OPD operators are Boots and Lloyds. Lloyds has 25 NHS Trust OPD contracts with 24 NHS trusts. Boots has 20 different NHS trust OPD contracts, some of which operate at more than one site within the trust.
12. A number of other companies, including Sainsbury's, operate a smaller number of contracts and a number of NHS trusts have set up wholly owned subsidiaries to provide OPD services within their trusts.

---

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

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

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

## ***Pharmaceutical wholesaling***

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

## ***Regulation***

15. There is a range of regulations that apply to pharmacies which restrict their freedom to change elements of their offering. In particular, there is limited price competition between pharmacies because NHS POMs, which make up the bulk of their business, are either free at the point of delivery or are charged at the fixed NHS prescription levy. There are also regulatory constraints on certain quality parameters. For example, a pharmacy must open for a core number of hours (usually core hours are either 40 hours or 100 hours depending on the pharmacy's licence), must employ a qualified pharmacist and must be licensed to operate in a given location.

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

16. Following a review of Sainsbury's pharmacy business in 2014, informal discussions were held with Celesio (Lloyds) and other pharmacy operators to assess their interest in acquiring the Sainsbury's pharmacy business. A formal sales process commenced in April 2015. Celesio was selected as the preferred bidder and the business sale agreement (BSA) was signed at the end of July 2015. Alongside the BSA, a Cooperation Agreement was also signed. This was necessary to cover the ongoing relationship between the Parties, as the Lloyds pharmacies would operate within the Sainsbury's supermarkets. The purchase price was [REDACTED]. [REDACTED] would also be paid by Celesio to Sainsbury's. We refer to these agreements collectively as the Transaction in this report.

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

### Market definition

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

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

Area type	miles	
	Lloyds	Sainsbury's
Conurbation	1.4	2.4
City and town	1.4	3.4
Rural	2.3	4.7
Very rural	3.6	4.7

Source: CMA analysis.

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

## **Counterfactual**

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

## **Competitive effects**

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

## ***Pre-merger competition***

24. We first considered the way that pharmacies compete presently (ie pre-merger).
25. We recognise that this is a market in which regulation plays an important role. As noted in paragraph 15 several of the quality parameters we have considered are subject to minimum levels below which quality cannot be reduced. The prices of POMs are regulated. We consider that regulation may inhibit to some extent the degree of competition compared with some other retail operations. However the amount of competition may still be sufficiently significant that its loss would be a matter of concern to us. Regulations set a minimum standard for some quality parameters but pharmacies are free to offer higher levels of service.
26. We considered evidence on customer preferences. Convenience of location is the most important driver of pharmacy choice for both Parties' customers. However, there are a number of other drivers of choice which customers of both Parties also value, including quality and speed of service, opening hours, stocking levels and waiting times. Customers take these elements of the offering into account when choosing which pharmacy to visit. Although there are some differences in the demographics between Sainsbury's and Lloyds, they did not point to significantly different customer preferences and we found that supermarket and non-supermarket pharmacies are regarded by

---

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

customers as substitutes. We also found that customer diversion between the Parties was high in some local areas, particularly where they were close geographically.

27. Internal documents from across both Sainsbury's and Celesio collectively show that although there is some differentiation between their offerings, both Parties consider that non-supermarket and supermarket pharmacies can compete. Third party comments also supported the view that Lloyds and Sainsbury's (and supermarket and non-supermarket pharmacies more generally) compete with one another to attract prescriptions and that consistent with the consumer evidence, closeness of competition depends on local market characteristics.
28. We found that Lloyds has the ability to compete at a local level by flexing parameters which customers value of quality, range and service (QRS) in response to their competitors, including Sainsbury's. Sainsbury's also has the ability to flex competitive parameters at a local level, but to a more limited extent. In addition there is an incentive for individual Lloyds and Sainsbury's pharmacies to compete to maximise their share of the number of prescriptions in the local area in order to increase profits. We also consider that the remuneration structure for Lloyds' local management gives them the incentive to ensure that the offering is strong where there is more competition while also giving the incentive to reduce the level of offer, to cut costs and increase profitability where there is less competition.
29. We found examples from internal investment documents showing that Lloyds responds to competition from other pharmacies in a local area and, in areas where supermarkets are present in the area, responds to competition from supermarkets. We found that there were no references in the documents to Lloyds taking specific action in response to a Sainsbury's pharmacy, although in several instances Sainsbury's is mentioned in the review of local competitors. However, we have not found in our investigation that Sainsbury's pharmacies are different to other supermarket pharmacies and we concluded that Lloyds competes at a local level by flexing parameters which customers value of QRS in response to their competitors, including Sainsbury's.
30. We consider that the above provides clear evidence that the Parties compete pre-merger and that the extent of the competitive constraint imposed by Sainsbury's on Lloyds would be material in particular local areas where the two are in each other's catchment areas and where there are few other competitors nearby to constrain the Parties.

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

31. We then assessed the likely effect of the proposed merger against the situation in the counterfactual. Our assessment indicated that there would be an incentive for Lloyds to deteriorate aspects of its offer in certain local areas. We found that this would be most likely in the Lloyds pharmacies rather than the Sainsbury's stores given the effect of the Cooperation Agreement, which constrains Lloyds' ability to reduce QRS in the Sainsbury's pharmacies after the merger.
32. We sought to identify the local areas where the merger would cause an SLC as a result of the reduction in the number of pharmacy operators in the area. Out of the 1,816 Sainsbury's and Lloyds total pharmacies, the catchment areas of 929 overlap (ie the Sainsbury's and Lloyds pharmacy catchment areas overlap). We conducted a consumer survey in 16 local overlap areas which we used as case studies to illustrate the features causing customers to divert between the Parties in particular locations. We then applied these features to other areas using available data, and used this assessment to identify areas of possible concern.
33. Our overall approach was to look first for mechanistic rules which could filter out unproblematic areas, and then to carry out more detailed local area assessments in the remaining local areas. We adopted a conservative approach to the selection of the mechanistic rules so that we were confident we would identify all the potentially problematic areas. We focused mainly on the Lloyds pharmacies because of the effect of the Cooperation Agreement. Using the mechanistic rules, we filtered the 929 overlaps into 171 stores of potential concern. We also included Cardiff as an area for further investigation, even though this was not identified as potentially problematic through use of the filter. We chose to include Cardiff as the area was characterised by high diversion between the Parties and the consumer survey revealed that the nearest competitor to the Sainsbury's store received little diversion.
34. By looking in detail at maps of the local markets we surveyed in our consumer survey we identified the local market features that were associated with high diversion ratios. We then used these features to assess the characteristics of the areas around the 171 stores that had been identified using the initial filters. We examined maps of each area (plus the additional area within Cardiff) and examined the specific circumstances of each store. We considered characteristics of the areas in detail including:
  - (a) the location of customers and GP practices relative to pharmacies in the area and whether the Parties were materially closer to each other, their



customers and GPs than other competitors (note that this applied even if a competitor(s) was within the radius of a catchment area but significantly further away). This identified whether, within the catchment area, a substantial proportion of customers would only be able to choose between the Parties, or the Parties and a small number of other pharmacies;

(b) specific geographic features associated with the location of the pharmacies that could affect the ease with which customers could access specific pharmacies;

(c) journey routes and other relevant factors (such as local bus services) that could also affect the ease with which customers could access specific pharmacies. This included identifying where the Parties were not particularly close but there was a direct road route between the Parties' stores and another competitor would not be passed before reaching the other party; and

(d) finally, where available we considered diversion ratios.

35. Our assessment required an exercise of judgement and the level of detail required in the assessment depended on the specific characteristics of each area. In some cases it was easy to dismiss areas as not representing a concern (for example, where the proximity filter identified two stores as close in straight-line distance but the road network meant that they were unlikely to be close competitors). In other cases each aspect detailed above had to be assessed in detail in order to allow us to form a view of whether we would expect there to be a competitive problem.
36. We also assessed further information provided by the Parties after we had published our provisional findings, including a consumer survey that the Parties had commissioned in six of the areas where we had provisionally identified SLCs but had not surveyed the area: Christchurch; Leeds; Liverpool; Luton; Sandy/Potton/Biggleswade; and Sutton Coldfield.
37. As a result of our assessment we found SLCs in 12 areas: Beaconsfield; Bracknell; Cardiff; Christchurch; Kempston; Kidlington; Leeds; Liverpool; Luton; Reading/Theale; Sandy; and Warlingham. In these local areas the Parties are the closest competitors with very few alternatives. We found that in these areas Lloyds has the ability to compete at a local level by flexing the parameters which customers value of QRS. These were the same areas where we had provisionally found that the merger may be expected to result in an SLC, except that we no longer found an SLC at Sutton Coldfield.

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

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

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

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

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

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

### ***Remedies***

42. We considered whether action should be taken for the purpose of remedying, mitigating or preventing the SLC or any adverse effects which may be expected to result from such an SLC, having regard to the effect of any action on any relevant customer benefits (RCBs) (as defined in the Act) in relation to the merger.
43. In our notice of possible remedies (Remedies Notice) we invited views on potential structural remedies involving prohibition of the merger or requiring the divestiture of one or more Lloyds pharmacies (licence with premises) in each local market where we had provisionally found that the merger may be expected to result in an SLC as a result of the Transaction. We also invited views on behavioural remedies.
44. Celesio initially submitted a behavioural remedy consisting of an undertaking not to reduce the opening hours at any Lloyds pharmacy in the affected areas.

Later, Celesio said that the remedy could be expanded to cover the range of pharmacy services offered at Lloyds' stores in the SLC areas and suggested that such a remedy would be proportionate. Celesio submitted that this would address the CMA's concern about the possible deterioration of the competitive offer at these Lloyds stores.

45. We considered the behavioural remedy proposal carefully. We note that our guidance sets out that the CMA generally prefers measures that remove obstacles to competition rather than those that control market outcomes. Remedies must be practical and capable of effective implementation, monitoring and enforcement. In addition, remedies that act quickly in addressing competitive concerns are preferable to those which take longer to implement or where the timing of the effect is uncertain. Remedies must be in place for the likely duration of any SLC. The behavioural remedy proposed by Celesio seeks to control market outcomes. We considered that the remedy would be difficult to specify and there would be no obvious end date for the remedy. We were concerned that the remedy may cause significant market distortions over time, such as inhibiting innovation. We therefore did not consider that the behavioural remedy proposed would be an effective remedy.
46. In our view prohibition of the merger would be an effective remedy. We also considered that divestiture of a Lloyds pharmacy in each of the 12 local markets where we had found an SLC would also be an effective remedy. We decided that the divestiture of a Lloyds pharmacy in each of the 12 local markets where we had found an SLC would be more proportionate and we decided to apply this remedy. We did not consider that there are any RCBS which are relevant to our assessment.
47. We decided that the appropriate time frame for completion of the 12 local divestitures was [X]. We have also decided that a number of other safeguards are required to protect the pharmacies to be divested to ensure that there are no risks of asset deterioration occurring during the sale process. Undertakings would be required pending the divestitures and a monitoring trustee would be required, with a suitably focused brief to ensure that the trustee concentrates on key areas of potential harm. We did not consider that a divestiture trustee would be required but reserved the right to appoint one if we have reason to expect that Celesio will not divest the relevant pharmacies to a suitable purchaser within [X].