

OFFIC O  D

JURISDICTION

4. The transaction meets the thresholds for notification to the European Commission (the Commission) under the EC Merger Regulation (ECMR). Following a request by the parties, the Commission decided to transfer the transaction to the UK under Article 4(4) of the ECMR on 30 November 2005.
5. As a result of this transaction Boots and UniChem will cease to be distinct. The UK turnover of UniChem 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. The 45 day statutory deadline for consideration of this case expires 9 February 2006. The administrative deadline expired on 30 January 2006.

RELEVANT MARKET

6. The parties overlap in the operation of retail pharmacies. In so far as Boots conducts a degree of self-supply in pharmaceutical wholesaling for its retail operations, some third parties have suggested that there may also be a horizontal overlap in wholesaling. In addition, possible vertical issues arise in respect of:
 - a. UniChem's wholesale operations and Boots' retail operations;
 - b. UniChem's wholesale and retail operations and Boots' manufacturing operations (following the BHI transaction).
7. In assessing this case the OFT has therefore considered the sectors of retail pharmacy and wholesaling, along with the contract manufacturing of specials and certain beauty and personal care products.

Retail Pharmacy – product scope

8. Within the UK, there are currently around 12,500 pharmacies with a NHS contract granted by a local Primary Care Trust (PCT). There are also a number of dispensing doctors, but GPs are only allowed to provide NHS dispensing services in rural areas and to patients who live more than one mile away from their nearest pharmacy. Given the discussion of geographic scope that follows, it is not considered that dispensing doctors will be a sufficient constraint on retail pharmacies in this case.
9. Within retail pharmacies, the MMC, in its 1996 report on UniChem/ GEHE AG/

Lloyds,² considered it appropriate to treat the supply of the three different product categories by pharmacies – ethicals, P medicines and General Sales List (GSL) medicines – as distinct.

10. Ethicals are prescription only medicines. In the vast majority of cases, there is no demand side substitution either within ethicals or between prescription and non-prescription (over the counter (OTC)) medicines. From the supply side, a pharmacy contract with a primary care trust is required for a pharmacist to be able to dispense NHS prescriptions. There is no price competition to attract customers due to the price of the prescription being set by the NHS. The pharmacies are remunerated by the NHS, and reimbursed (less the 'clawback'³) for the costs of the drugs dispensed.
11. P medicines are 'pharmacy only' medicines (such as certain hayfever remedies or stronger variants of some GSL medicines) that do not require a prescription but can only be dispensed by a pharmacist. While pharmacists supplying P medicines do not require a PCT contract, in practice, only about 1 per cent of pharmacies dispense without a PCT contract. One key reason for continuing to make a distinction between the provision of P medicines and ethicals – as the MMC did in its 1996 report - is that the pricing methods of the two types of medicines differ. Following the prohibition of resale price maintenance in 2001, pharmacists now have the ability to set the retail price of P medicines. In terms of the distinction between P and GSL medicines it is noted that around 40 per cent of P medicines have a GSL alternative (in the form of a smaller pack size for instance) and, while we do not need to conclude on this issue when defining the product scope, the impact of such alternatives is considered in the horizontal assessment below.
12. GSL medicines do not need to be sold in pharmacies and can therefore be found in supermarkets, convenience stores, petrol stations etc. In addition, pharmacies also stock non-pharmaceutical products such as toiletries, baby food and health food. Due to the vast array of alternative suppliers of these non-pharmaceutical products (and the lack of third party concerns) no competition issues are considered to arise in this segment as a result of the merger and the supply of non-pharmaceutical products is not considered further in this assessment.
13. On the basis of the above and given that the OFT has not received evidence to suggest definitions different to those considered by the MMC in 1996, the product scope in this assessment is considered to be the provision of retail pharmacy services across the range of products and, given differences in pricing

² Monopolies and Mergers Commission, UniChem plc/Lloyds Chemists plc and GEHE AG/Lloyds Chemists plc, A report on the proposed merger, July 1996, Cm 3344

and methods of supply, the provision of ethicals, P medicines and GSL medicines separately.

Retail pharmacy – geographic scope

14. There may be an element of national competition between large chains. Both of the merging parties have provided evidence to suggest that the vast majority of their pricing policies are set nationally. However, the OFT notes that the extent to which national chains face each other in local areas may well be a factor in determining the extent to which they can influence each other's decision making at the national level, e.g. on pricing policies. The extent of national competition is considered in the assessment below.
15. Demand for retail pharmacies is predominantly local. The OFT report on the control of entry regulations⁴ found that 78 per cent of consumers travel less than one mile to get to a pharmacy, and 96 per cent travel less than three miles. This is in line with the 1996 MMC report in UniChem/ GEHE/ Lloyds, which suggested consumers would travel 'at most one or two miles'. Some third parties have said that a radius of one mile is appropriate; others have suggested a more limited radius, of half a mile. Many third parties noted that the exact scope of geographic competition may vary by locality – for example, to encapsulate a town centre or a village as a whole. It has also been submitted that supermarkets with pharmacies may exert a constraint over larger catchments – in line with the Competition Commission report on the Safeway mergers⁵, of 10-15 minute drive time isochrones.
16. UniChem's internal documents which examine the effects of competitors on UniChem's prescription numbers and revenues consider a [] radius when measuring the impact of non-supermarket competitors and a [] radius when supermarkets are included. However, UniChem has also provided evidence which shows that only [35-45] per cent of its pharmacy customers fall within a half-mile radius as opposed to [65-75] per cent being within one mile. Boots told us that in its internal analysis it tends to use a [] catchment area. DoH regulations state that pharmacies can relocate only within a mile of their original location. On the basis of all the available evidence, the OFT has concluded that, on balance, the geographic scope of this assessment should be considered to be a one-mile radius around each of the relevant pharmacies.

³ The clawback is based on an assumed level of discount that pharmacies may get from wholesalers. This is set by reference to the 'annual discount enquiry' held jointly by the Department of Health and the Pharmaceutical Services Negotiating Committee.

⁴ The control of entry regulations and retail pharmacy services in the UK – A report of an OFT market investigation (January 2003).

⁵ Safeway plc and Asda Group Limited; Wm Morrison Supermarkets plc; J Sainsbury plc; and Tesco plc: A report on the mergers in contemplation.

Supply of pharmacy services to the NHS

17. In addition to providing services to customers, pharmacies have contractual relationships with the NHS, in particular:
 - in negotiating the national pharmacy contract with the Department of Health, which specifies the core services to be undertaken by the pharmacies and the remuneration levels for the pharmacies; and
 - in negotiating enhanced service level initiatives with individual PCTs.
18. The impact of the merger within the frame of reference for the national and local (PCT) supply of pharmacy services to the NHS has also therefore been considered.

Wholesaling – product scope

19. UniChem also operates as a full-line wholesaler (full-liner) of pharmaceutical products – ethicals and OTC products (including P medicines). Pharmaceuticals can be sourced either from a full-line wholesaler stocking the whole range of products (over 12,000 product lines) that may be required, and for the majority of customers offer a twice daily delivery service. Alternatively, for a limited number of products (circa 3,000 lines), pharmacies can source from short-line wholesalers. Short-liners tend to supply the faster moving products that sell in large quantities. Boots acts as its own short-liner, and self-supplies the [more than 1000] fastest-moving products on a daily basis and, nationally, uses UniChem as its full-line wholesaler for the remainder.
20. In previous mergers of full-line wholesalers⁶, the OFT concluded that short-liners were not a sufficient constraint on full-line wholesalers (even though they sell the fast moving products making up a large proportion of total volumes (up to 80 per cent)). Short-line suppliers tend to deliver only once a day and since customers are constrained in terms of storage capacity they rely on full-line suppliers to supply the remaining products just in time either on a same day, or overnight basis. In Phoenix / EAP it was considered that no pharmacy customer can source their entire requirements from short-liners and require at least one full-line supplier. No evidence has been received as a result of this enquiry which would suggest changing this conclusion and including short-liners in the frame of reference in this case.

⁶ For instance, the anticipated acquisition by Phoenix Healthcare Distribution Ltd of East Anglian Pharmaceuticals Ltd – OFT decision of 16 June 2005 (hereafter referred to as 'Phoenix / EAP').

21. Therefore the OFT takes the view that the appropriate frame of reference here is the supply of ethicals to pharmacies and dispensing doctors by full-line wholesalers only.

Wholesaling – geographic scope

22. There are both national and regional aspects to wholesale supply. On the one hand, national customers require national wholesale coverage. However, the pharmacy sector is fragmented with many independent pharmacies (and individual dispensing doctors) on the 'demand' side and a number of regional and national wholesalers competing to supply them. In Phoenix/ EAP, the OFT considered both national and regional aspects of competition. No evidence has been received as a result of this enquiry which would suggest adopting a different approach in this case.

Contract manufacturing

23. Boots, even after its disposal of BHI, continues to be active in the (contract) manufacture of 'specials' and non-sterile and aqueous cream pharmaceuticals and beauty care products which gives rise to vertical relationships with UniChem's downstream retail business.

Contract manufacturing - specials

24. As noted at footnote 1, 'specials' are medicinal products prescribed by doctors when a licensed off-the-shelf product does not exist, normally in cases where a patient is intolerant or allergic to an ingredient contained in the licensed product or requires a dosage different to that of the licensed product. Boots has confirmed that it has less than a 15 per cent share of contract manufacturing of specials in the UK. Due to the relatively low share of production in the sector, and the fact that no third party concerns were raised, this sector is not considered further in this assessment.

Contract manufacturing - non-sterile liquid and aqueous cream products

25. These contract manufacturing operations are retained by Boots after the sell-off of BHI because the majority ([] per cent) of their manufacturing output relates to products for Boots' retail business and third party contract manufacturing business, not for BHI. Boots has confirmed that it has less than a 15 per cent share of UK contract manufacturing in these sectors. Due to the relatively low share of production in these sectors, and the fact that no third party concerns were raised, the sectors are not considered further in this assessment.

HORIZONTAL ISSUES

Retail pharmacy – provision of services to consumers

National overlap

26. Nationally, the retail pharmacy sector in the UK is highly fragmented, with large numbers of independent pharmacies. Table 1 shows the UK shares of supply by numbers of outlets. Taken together, the parties would be the largest retail pharmacy chain with 19 per cent of outlets in the UK with the increment from the merger being 8 per cent.

Table 1: Retail pharmacies in the UK, share of supply by outlet numbers

Pharmacy	Number of outlets	Share (per cent) ¹
Lloyds (AAH)	1,385	11
Boots	1,350	11
UniChem	958	8
Rowland (Phoenix)	380	3
NCC	352	3
Superdrug	225	2
Tesco	198	2
Others	7,550	61
Total	12,398	

¹Numbers may not add up due to rounding

²These numbers include the very small number of non-NHS contract pharmacies which provide private prescriptions and P medicines only. The parties submit that Boots accounts for the vast majority of the non-NHS pharmacies.

27. The parties' shares of supply, by value of different product categories are shown in table 2, below. As can be seen dispensing shares are not dissimilar from those based on outlet numbers. In OTC (i.e. P and G SL) medicines, post-merger shares of supply are higher, although the increments from UniChem are lower. This is indicative of the fact that of UniChem's total retail sales about [80-90] per cent is accounted for by dispensing: for Boots the comparable figure is [20-30] per cent.

Table 2: Boots/ UniChem, UK shares of supply by value, for different product categories

	Dispensing		GSL medicines		P medicines	
	Revenue (£m)	Share (%)	Revenue (£m)	Share (%)	Revenue (£m)	Share (%)
Boots	[1,000 -1,200]	[10-20]	[300-500]	[15-25]	[100-200]	[25-35]
UniChem	[700-900]	[0-10]	[0-100]	[0-10]	[0-100]	[0-10]
Boots/ UniChem	[1,700-2,100]	[15-25]	[300-600]	[20-30]	[100-300]	[30-40]

28. In GSL medicines, currently the largest competitors to Boots are Tesco and Superdrug, with [5-15] per cent and [0-10] per cent of supply respectively. The increment to Boots arising from the merger with UniChem is very limited, with GSL medicines only accounting for about [less than 5] per cent of UniChem's pharmacy turnover.
29. In P medicines, supermarkets' shares are more limited than in GSL. Currently Boots is significantly larger than its competitors, with [25-35] per cent share, with Lloyds and UniChem being the second and third largest suppliers with [0-10] per cent and [0-10] per cent of supply respectively. While this merger removes the third largest supplier in P medicines and strengthens Boots' position in this area, the OFT considers there are a number of reasons why this is not likely to lead to reduced competition at the national level. Evidence provided by the parties suggests that pre-merger UniChem is not a particularly aggressive competitor to Boots in this segment; P medicines only account for [less than 5] per cent of UniChem's revenues. The parties have told us that they consider supermarket pharmacies [the most significant individual competitors in] P medicines as well as GSL medicines and the merger will not alter this position. Boots has provided [].⁷
30. The OFT report on the control of entry regulations (see footnote 4) refers to the increased availability of low-priced P medicines. Paragraph 41.1 of the report notes that shortly after the ending of RPM in 2001, supermarket pharmacies reduced prices for a basket of P-medicines to levels up to 30 per cent lower than other pharmacies. Additionally around 40 per cent of P medicines have a GSL alternative (mostly of a smaller pack size) such that GSL prices provide some constraint on those P medicines.
31. Moreover, the parties and some third parties would argue that competition in retail pharmacy is in the main driven by local competition. In respect of the argument at paragraph 14 above about local competition influencing national policies, the parties would note that, on the whole, Boots and UniChem do not tend to be

located close to each other; Boots stores tend to be based in high street locations, while UniChem's pharmacy stores fit the 'community pharmacy' model and are generally found in residential areas, health centres or smaller shopping centres. Boots' own analysis of catchment areas breaks down pharmacy coverage across classes of shopping centre areas. Boots appears most frequently ([10-20] per cent of stores) in 'major regional centres', with an average catchment population of [100,000 - 200,000], a category which accounts for only [less than 5] per cent of UniChem's pharmacy's portfolio. UniChem's most frequent location is 'small district centres', with an average catchment population of [0-5000]; only [less than 5] per cent of Boots' stores fit this profile. However, both appear with relatively high frequency in rural towns⁸ (and such locations form the majority of the local overlap analysis discussed below). Overall, the evidence suggests limited competition between the parties in respect of the pricing of P medicines. However, any pricing concerns which may arise on a local level will be addressed below.

32. Looking at the sector overall, the shares of supply held by the supermarkets and others counteract any suggestion that adverse competitive effects could arise simply by the merger resulting in a reduction from three to two truly national pharmacy chains (Boots, Lloyds and UniChem). By number of stores as in certain product categories, supermarkets are gaining significant shares of supply and the parties' internal documents show that they consider themselves to compete with a number of other players than just the other two top chains, including Superdrug, National Cooperative Chemists, Rowlands, the supermarkets as well as regional chains and independents.

Local area overlaps

The substantial lessening of competition test

33. One third party submitted that a fascia approach is not appropriate in this case, and that local area analysis based on shares of supply would be more appropriate. This was on the basis that Boots was a significantly different type of retail pharmacy which meant that it should not be treated on the same terms as any other fascia. The OFT considers that this could suggest more that Boots is not a close competitor to other types of pharmacies rather than that a fascia approach would not be appropriate in this case. No other comments were made by third parties to suggest that the fascia test was inappropriate.
34. In 1996 when it looked at UniChem/ Gehe/ Lloyds, the MMC only examined two-to-one overlaps on a one mile basis – and even in these areas concluded that the

⁷ []

⁸ Boots, [internal document]

customer benefits of the mergers would in each case outweigh any reduction in competition. However, at the time of the MMC inquiry, resale price maintenance was still in place in OTC (GSL and P) medicines such that scope for competition, especially on price, might be expected to have been more limited than it is today.

35. The OFT report on control of entry regulations (see footnote 4) – published after the removal of RPM – found that competition, particularly price competition, between pharmacies and between pharmacies and other retailers was still muted. It did however find some correlation between local concentration and quality of service on matters such as extended opening times, provision of consultation areas and home delivery.
36. There is no price competition between retail pharmacies in the supply of ethicals, which account for [80-90] per cent of UniChem's turnover ([20-30] per cent of Boots turnover) and a number of retail outlets other than pharmacies supply GSL medicines and non-pharmaceutical products. Price competition between retail pharmacies in the product categories we are considering is therefore mainly limited to P medicines. A number of third parties suggested that competition between pharmacies on service levels was also limited because NHS service contracts specify national minimum standards for pharmacies. The NHS contract is restrictive in terms of its imposition of service standards and required opening times for instance. Such restrictions serve to limit the parameters of competition. In fact, third parties suggested that the main form of competition takes place on initial choice of location – a factor of competition which, on the basis of third party comments, still appears to be highly regulated by PCTs.
37. However, the parties' internal documents clearly show that there is some competitive interaction between different retail pharmacies. Both Boots and UniChem monitor a number of different price and service quality variables and compare themselves to competitors. Possible aspects of competition mentioned in Boots' consumer research documents include product availability, store layout, ease of shopping and shopping environment.⁹ At a local level, waiting times for obtaining a prescription and the provision of deliveries seem to be key measures of competition too. For instance, a Boots' internal document [].¹⁰
38. Even though locality appears to be the main factor determining customers' choice of pharmacy, there is nonetheless some evidence to suggest that a reduction in pharmacy fascia numbers could bring about a reduction in competition, whether by lowering service/ quality levels, by reducing choice (on a quality level) or, less so, affecting prices, particularly for P medicines.

⁹ See [Boots internal document].

¹⁰ Boots, [internal document].

39. On the question of what is the appropriate level of competition in a locality, differing views have been provided to the OFT. One third party told us that it would expect to face at least two competitors within a one-mile radius. The parties, on the other hand, state that there is no realistic prospect of a substantial lessening of competition arising in any local area due to the limited nature of competition in the sector. This is particularly true in this case, they submit, because Boots and UniChem have different business models and therefore should not be considered to be particularly close competitors.

Entry

40. The OFT has also looked at whether the possibility of entry might mitigate against any local competition concerns. The key entry barrier in retail pharmacy continues to be the control of entry regulations. These regulations were amended (following the OFT report) in 2005; in terms of reducing the barriers to entry, the key change is that automatic exemptions by the PCT from the control of entry test have been introduced, if the applicant pharmacies are, for instance, based in large out of town developments or intend to open for more than 100 hours a week. In addition, the Department of Health has said that PCTs must consider issues of choice and competition within the overall assessment.
41. Reliable data on which to judge the impact of these changes is not yet available and third party responses on entry have also been mixed with a number of third parties saying that the changes have not made entry easier with the exemptions being difficult to meet. Other third parties contradict this however. There is limited evidence of the impact of the 'choice and competition' consideration, although a number of PCTs (particularly those in Boots / UniChem overlap areas) did say that they felt that the 'choice and competition' consideration would make it easier for them to grant new applications for contracts. However, not all PCTs considered that a reduction in fascia, as opposed to a reduction in actual numbers of pharmacies, was problematic (and there was no suggestion that the merger would lead to a reduction in pharmacy numbers).

Buyer power

42. It is not considered that individual consumers possess buyer power.

Conclusion on local overlap analysis

43. In looking at local areas overlaps the starting point of our analysis has been the 1996 MMC report which found that a reduction in pharmacy fascia from two to one in a one mile radius would be against the public interest. The OFT notes, however, that this was before RPM on OTC medicines was removed, suggesting that the scope for competition in 1995 might have been more limited than it is currently. On the other hand, UniChem is a relatively small player in the OTC sector and this could suggest a similar approach being taken here. Additionally, the fact that there has been further deregulation in the form of the relaxation of entry rules could militate in favour of a less intrusive approach, although it is noted that the evidence on this issue provides far from conclusive backing to such an approach. The parties' internal documents do, however, show that a level of competitive interaction between retail pharmacies does exist and that new entry will usually prompt some competitive response. Such evidence would clearly suggest that a reduction in pharmacy fascias from two to one within a one mile radius could lead to a reduction in the incentives to compete and have a detrimental effect on matters such as the standard and quality of the services provided by the pharmacies concerned (over and above the levels stipulated by the NHS contract).
44. In many respects the pharmacy sector is unique in terms of being a highly regulated retail sector where matters such as entry and even opening hours are, to a large extent, controlled by the local PCTs. However, a level of competition does exist and the OFT has sought to ascertain whether it is possible to establish, to a reasonably conclusive degree, the number of fascias required to maintain adequate competition in a local area. To this end, in addition to the two to one analysis referred to above, the OFT looked in detail at those local areas where the merger will result in a reduction in competitor fascias from three to two. Even in these areas, switching of customers between Boots and Unichem stores may be high, and for a large proportion of customers, Boots and Unichem would be the closest competitors. This may arise particularly in those localities where the merging parties' pharmacies are located close together. In such a situation the competitive scenario post merger does not significantly differ from that in the two to one areas.
45. This has to be considered alongside the high barriers to entry in this sector combined with what the parties' internal documents say on the issue of competition – see, for instance, the references at paragraph 37 above to the monitoring of various competitor price and service quality variables. On balance, the OFT believes that a substantial lessening of competition may go beyond those areas outlined at paragraph 43 and may also arise where fascia are reduced from three to two within a one mile radius.

46. Any higher reduction in fascia number than this (e.g. four to three or higher) could also give rise to a lessening of competition but on the basis of the evidence before the OFT, it believes that this cannot be expected to be substantial. One major competitor suggested that it would be usual to face two other competitors within a local area. Moreover, the CC's 1995 report considered only two to one fascia reductions. While there have been small changes to the market since then (primarily the removal of resale price maintenance on OTC medicines) which might suggest some small increase in the scope for potential competition, these changes do not support an argument that reductions from four to three fascias might give rise to competition concerns.

Overlap areas

47. On the basis of a one mile radius centred around both Boots and UniChem pharmacies, there are 38 local areas of overlap where post-merger there will not be any other competitors present (i.e. two to one overlaps). There are a further 61 local areas where, on a one-mile radius basis, the merger will result in there only being two competitors in a locality.
48. In two areas on a one-mile basis, however, Boots stores are non-NHS pharmacies. However, in so far as they can still provide P medicines and have trained pharmacists, we have considered that they will at least provide some competitive constraint in the area and have included such non-NHS pharmacies in the analysis.

Consortia pharmacies

49. One issue raised by the parties late in the analysis is that of certain health-centre pharmacies where the contract was by (past) government policy awarded to a consortium of all the local pharmacy owners. We note that at these consortium pharmacies are a historical throwback and that they might be in less competition with other local pharmacies because of their position in health centres. It is nonetheless arguable that other Boots or UniChem pharmacies in the area would have, pre-merger, considered the benefits of only their own shareholding when considering diversion to these stores, whereas post-merger, they will also internalise the benefits of the shareholding of the other merging party. There are, at most, potentially five further areas where inclusion of the consortia pharmacy would result in the creation of an overlap on a three to two basis.

Retail pharmacy – provision of NHS and PCT services

50. For dispensing of ethicals, pharmacies also contract with the NHS, in two primary ways: in negotiating the national pharmacy contract with the Department of

Health, which specifies the core services to be undertaken by the pharmacies and the remuneration levels for the pharmacies, and in negotiating enhanced service level initiatives with individual PCTs.

51. Both nationally and locally, these negotiations are carried out through associations of pharmacists that have been recognised by the government as the appropriate bodies. Nationally, pharmacies negotiate through the Pharmaceutical Services Negotiating Committee (PSNC). Within the structure of the PSNC, multiples (with 100 or more outlets) are represented by the Company Chemists Association (CCA). At the local level, negotiations with PCTs are conducted via Local Pharmaceutical Committees (LPCs), each of which has representatives of the CCA and of independent pharmacies.
52. The parties argue that within the negotiating framework, there is little room for the merged entity to influence negotiations. However, we have nonetheless considered whether the merger will give the parties market power relative to the DoH or the PCTs. On a national level the issue would be whether the merged entity would be in a position to influence national negotiations. The parties' bargaining power at this level is reflected by the national shares of supply by dispensing, and the OFT considers that the [15-25] per cent share of supply in dispensing which will arise as a result of the merger would not be sufficient to bring about changes to Boots' bargaining position. Moreover, in so far as the DoH and the NHS together have control over the granting of new contracts through the PCTs, they have the ability to allow new entry and thereby reduce the share of supply in dispensing controlled by Boots/ UniChem.
53. As regards the provision of additional services to the PCTs, third parties suggested three concerns which may be of particular concern in PCTs where the merged entity will have significant shares of pharmacy numbers:
 - a. that Boots/ UniChem would have significant negotiating power in certain PCTs;
 - b. that Boots/ UniChem may be unwilling to engage in the provision of enhanced services and by its scale the merged entity could therefore limit the development of these services; or
 - c. that Boots/ UniChem would be in a much better position to bid for exclusive contracts for enhanced services than any of its competitors, by virtue of having a greater store presence.
54. Third party inquiries from the PCTs suggested that the minimum number of pharmacies (or indeed, in cases where PCTs are financially constrained, the maximum number of pharmacies) needed for initiatives can be very low – sometimes only one or two. The highest figure we were given for starting up a

new initiative was the support of between one third and one half of all pharmacies within the PCT. Although there are a small number of PCT areas where the parties share of pharmacies is above 50 per cent, the OFT notes that the PCTs are able to induce entry in their areas by granting licence applications for pharmacies which are much in demand. Our third party inquiries highlight that encouraging entry is being considered by some PCTs where the merging parties' shares of supply are high. PCTs' ability to threaten to allow entry certainly provides them with a strong negotiating position vis-à-vis the merged entity. Specifically in relation to 53(c) above it is noted that exclusive contracts are not prevalent in the industry and there is no barrier to prevent competitors forming bidding consortia if this was an issue.

55. In view of the above, the OFT does not consider that the merger may be expected to result in a substantial lessening of competition in the provision of the NHS and PCT services outlined above.

Wholesaling

56. Some third parties argued that in so far as Boots self-supplies its top [more than 1,000] lines, and has a national supply network, it should be considered to be a potential competitor in full-line wholesale supplies to third parties. Traditionally, the two national full-liners have been AAH (with a UK share of supply of [35-45] per cent) and UniChem (with a UK share of [15-25] per cent). Phoenix has [5-15] per cent of UK full-line wholesale supply.¹¹ However, Boots has never supplied (or sought to supply) any third party customers and confirmed to the OFT that it had no immediate intention of doing so. The 1996 MMC report (see footnote 2) concluded that Boots should be excluded from the consideration of the wholesale market and the OFT has received no evidence as a result of this enquiry to warrant a different conclusion.

VERTICAL ISSUES

Wholesale/ retailing

57. Third parties have put forward a number of possible vertical concerns resulting from the addition of Boots' retail business to (the already vertically integrated) UniChem. These are outlined and assessed below.
 - a. The new company might have an increased incentive and ability to cross subsidise wholesale operations by retail operations.

¹¹ Source of share of supply figures: UniChem estimates based on IMS data.

58. In the first instance, the question of whether UniChem has the incentive post-merger to cross-subsidise in this way needs to be considered. On the one hand the ability to engage in price competition at the retail level is, as noted above, limited, which might create an incentive to cross-subsidise the competitive wholesale activities by the less competitive retail activities (if retail operations were sufficiently profitable to do so). Moreover, given that there are network effects and economies of scale in wholesale supply, there may be cost advantages to be gained from increasing the size of wholesale supply. Against this, however, cross subsidisation of wholesale activities by retail effectively means lowering transfer prices to the merged entity's retail competitors. In addition, any increases in wholesale discounts to pharmacies may translate into increases in 'clawback' (see footnote 3) applied by the DoH. These appear to be effective disincentives against such behaviour.
59. As regards the merger's impact on the ability for cross subsidisation, the OFT does not consider that the merger will increase the firm's ability to cross-subsidise by increasing retail prices. This is the case for two main reasons:
- sales of ethicals are regulated;
 - competition in the supply of GSL medicines is much wider than just pharmacies and (assuming any local competition issues that arise are dealt with) the evidence suggests that there will be sufficient post-merger competition to prevent price increases in P medicines.
- b. UniChem and AAH are the only viable full-line wholesale suppliers for the larger pharmacy multiples. Boots' retail competitors may not, post merger, be willing to use UniChem as a full-liner, because of information flow between the wholesale and retail arms in the new company. This could have the effect of undermining the competitive constraint that UniChem places on AAH.
60. This concern centres around the proposition that vertical integration of the two companies would lead to Boots gaining access to detailed data on competitors' levels of pharmacy business in particular localities and therefore adjust the extent of its competition accordingly. As a result, competitors would only have a choice of AAH as their national wholesaler, and could therefore be open to price increases at the wholesale level, which would in turn raise their costs vis-à-vis Boots.
61. The parties have put forward a number of arguments to defend against this theory. First, they argue that the data that would be available would not be much use to Boots, and would not provide it with any competitive advantage. Second, they argue that evidence suggests that many multiples do not see this as a

concern. Third, they argue that it is not the case that AAH would be the only alternative open to competitors.

Use of data in question

62. The parties have told us that UniChem only wholesales prescription medicines to large multiples, who obtain OTC medicines separately. Therefore UniChem would only have access to data on the volume of prescription medicines being dispensed. In this regard, the parties make a number of points:

- Competitors can already make an educated guess at the number of prescriptions dispensed by their competitors, from PCT information on the total number of prescriptions and qualitative local information on competitor quality.
- The additional data on volume of prescription medicines dispensed would be of limited use, particularly as there is – for Boots and therefore most likely for other multiples – little linkage between prescription volumes and non-dispensing retail revenues.¹²

Evidence from other national multiples

63. It is of note that many national multiples do not share these concerns. The parties point out that since the proposed merger between Boots and UniChem was announced, UniChem won the wholesaling contract for [a major grocery multiple]. []. A number of other relevant third parties contacted by the OFT have confirmed that the merger does not raise any concerns to them in this respect. Moreover, UniChem and AAH are already both vertically integrated from wholesaling into pharmacy retailing; as far as prescription medicines are concerned (and this is the only information involved) the merger does not appear to alter the supply side structure in any material way.

Alternative options for wholesale supply

64. We have also considered whether AAH and UniChem are indeed the only full line wholesalers able to supply national pharmacy retailers. The parties have provided bidding information for major wholesale contracts which shows that while UniChem and AAH are the main bidders, other bidders have taken part and while no contract has been won by a single other competitor, there have been instances of joint bidders being offered a contract. Using a combination of regional wholesalers may therefore be an option which is open to the national chains. Self-supply of wholesale pharmaceuticals, along the lines of the model operated by Boots may also be an option open to national retailers. Although the companies would, like Boots, still rely on some element of full-line wholesale supply, this may

well be a small proportion of their costs (in Boots case it is only [0-10] per cent of its total retail costs), such that the effect of price increases would not be significant.

Conclusion

65. While there do appear to be possible alternatives to full line supply by AAH and UniChem for national multiples, some of the options could be considered speculative to a certain extent (e.g. self-supply). However, as it appears that the data that is available to UniChem is of limited use to Boots, and given that the majority of national customers do not share this concern, the OFT does not consider that the merger will have an adverse effect on competition in this regard.
- c. The new company may not be willing to supply its main competitors (either nationally or locally) on a wholesale level, or may increase wholesale prices / reduce wholesale service levels, which could have the effect of raising (retail) rivals' costs, or foreclosing them in certain areas of the country.
66. A number of variants on this theory of harm have been offered. One is that by merging with Boots, UniChem may no longer have the incentive to wholesale pharmaceutical supplies to third parties. However, UniChem is already a full-line wholesaler to Boots, the figures show that it is unlikely that the addition of Boots' short-line supplies will be sufficient to make up for UniChem's current third party wholesaling business. The value of Boots' wholesale supplies currently met by UniChem is £[150-250] million. Boots' cost of sales in healthcare – which includes OTC products and vitamins and minerals as well as prescription only medicines – is estimated at £[900-1,100] m. Even assuming that all of this cost is accounted for by Boots' short-line self-supplies, the value to UniChem of obtaining the Boots self-supply business (£[800-1,000]m) is less than its value of its current sales to third parties (£[900-1,100] m, after Boots' current full-line supplies have been subtracted). Additionally, as UniChem already supplies Boots, it would not benefit (as much) from reductions in the costs of operating its 'network' by the addition of Boots' short-line supplies (but there could be some benefit arising from the increased volumes – and therefore profitability – of each run on which Boots is currently present). However, UniChem would potentially face significant network cost increases by a reduction in drop off points were it to lose third party business. In the Phoenix/ EAP decision (see footnote 7), the benefits to the delivery network of additional wholesale customers were explicitly noted. Moreover, nowhere in the parties' internal documents relating to the merger is there any mention of a move away from wholesale, and [].

¹² []

67. It is also considered that any attempts by the new company to increase prices (i.e. reduce discounts at the wholesale level) would be of benefit to wholesale competitors (most particularly AAH). In Phoenix/ EAP, customer responses indicated pharmacies would switch in the event of poor service, and no significant barriers to switching to an alternative supplier were identified. Any increases to wholesale prices in order to weaken retail rivals would therefore be limited to pockets of the country (if any) where UniChem may face no wholesale competition – however, if there were any such areas UniChem would already be in a position to exploit its position in this way (and there has been no suggestions that it has sought to do so).
68. Third parties have brought to our attention that Boots and UniChem would supply (as wholesaler) between 70 per cent and 80 per cent of NHS pharmacy contracts in Cornwall. As Boots' full line supplier, UniChem already supplies all of Boots pharmacies. If UniChem currently did have a monopoly position pre-merger, then it would currently be able to increase prices/ reduce service levels to third party retail pharmacies in Cornwall. If this were the case the merger would therefore only be likely to impact on the merged parties' incentive to refuse supply and fully foreclose retail competitors.
69. UniChem's incentive might be increased by the merger in local areas where there is a Boots and a UniChem pharmacy present together with a retail competitor also supplied by UniChem, as squeezing out the competitor would mean that UniChem would gain from diversion to Boots as well as to its own UniChem pharmacy. Moreover, UniChem's ability to do so might be increased because the addition of Boots' short-line supplies would make UniChem's delivery routes more profitable, such that the need to supply third party independents in order to ensure route profitability may be reduced.
70. However, this would nonetheless be a risky strategy for the parties, for a number of reasons:
- First, while UniChem might have a larger number of contracts in Cornwall, there is no reason to suppose that it is not constrained by competitors. AAH supplies third parties, including national chains, and its own Lloyds pharmacy in the Cornwall area. The parties told us that Phoenix has just recently won a supply contract from UniChem in [redacted], Cornwall. UniChem is not considered to have any geographic advantage in terms of depot location in supplying this area as its depot is further east than its two competitors',¹³ which based on the OFT's experience of previous mergers in this sector, would tend to suggest that both AAH and Phoenix have the potential to supply pharmacies

¹³ UniChem's depot is in Exeter while AAH and Phoenix have depots in Paignton and Plymouth respectively.

in Cornwall that wished to or need to switch a way from UniChem as pharmaceutical wholesaler.

- Second, even if the merged entity did refuse to supply a third party pharmacy the NHS licence is a saleable asset. Both the parties and third parties indicated that NHS contracts are [a significant source of revenue] and that there is much demand for them. Even if an independent pharmacy were to be pushed out of business, that pharmacy contract could be bought up by a national chain that might well have an agreement to be supplied by AAH or Phoenix. Therefore any attempt to drive out independents could be a risk to both the wholesale and retail business.

71. It is of note that neither Phoenix nor AAH identified any competition concerns with respect to the wholesale supply of ethical pharmaceuticals in Cornwall.

d. The merged entity might choose to push Boots branded products (on non-healthcare) to non-Boots retailers, which might give it an advantage in wholesaling

72. It is not obvious that Boots would have an incentive to dilute its retail brand in this way for the vast majority of products. However, for products that Boots might want to supply more broadly via UniChem's wholesale operation, in so far as this offers greater choice to third party retailers, it is likely to improve and not lessen competition at the wholesale level.

e. The new company may have an incentive to withhold stock to ensure sufficient supply for its retail operations; this could further have an impact on prices on manufacturer supply / reimbursement prices.

73. It is not obvious that the incentives for holding stock are any different for the merged company than they are for the two companies separately. The one exception may be the full line wholesaling that UniChem carries out for Boots, which it would now treat as self-supply rather than third party supply.

74. In any case, the parties argue that this theory fails on the 'ability' test in that manufacturers keep strict control over wholesalers' stock.¹⁴ Also, indications from the past cases OFT has examined in pharmaceutical wholesaling (see Phoenix / EAP for instance) suggest that pharmacists are sensitive to service quality issues

¹⁴ Both of the parties told us that they received a letter from [a manufacturer] informing them that it will discontinue the supply of its ethical products. Also [another manufacturer] supplies its products on an agency basis and retains ownership until the product is supplied to the pharmacies.

and could well switch away if the policy of withholding stock was pursued by the merged entity.

75. Some third parties also argued that in the case of supply shortages, the new company would be the inevitable trading partner of choice for pharmaceutical companies, creating shortages elsewhere. In this regard, we note that any such shortage would be temporary. In any case, it is to be expected that the largest customers in most sectors will always have the strongest choice due to their higher levels of purchasing; the merger is only likely to change the identity of these preferred customers. Additionally it was suggested that the use of only one wholesaling supplier might generate service problems in Boots stores when there are supply shortages. However, there is nothing to preclude the merged firm from using a secondary wholesaler. Also, for the slower moving products where supply shortages are more likely, Boots was pre-merger already reliant on UniChem.

Buyer power

76. Some third parties also expressed a concern regarding the new company's buyer power relative to the manufacturers, and that this purchasing power could lead to rival wholesalers' input costs being increased post-merger. This buyer power could come from the merged company's size or from the fact that the proportion of its wholesaling that will be accounted for by in-house supplies will be high, creating more stable demand patterns which are of appeal to manufacturers. As to the second of the sources of buyer power, we asked the third party that made this claim to provide evidence on this point which was not forthcoming. This aspect is therefore not considered in any more detail. Intuitively this proposition seems unlikely since wholesalers can only supply what pharmacies order - which, in turn, is determined by what is prescribed by the GP. It is difficult to see how the wholesaler could seek to influence GP prescribing habits to its own advantage.
77. The parties' shares of purchasing of pharmaceuticals are shown in the table below.

Table 3: Shares of purchases in the UK, 2003 /4 (per cent)

Product category	Boots	Alliance UniChem	Combined
Prescription medicines	[5-15]	[10-20]	[20-30]
OTC medicines	[15-25]	[5-15]	[25-35]
P medicines	[25-35]	[10-20]	[40-50]
GSL medicines	[10-20]	[5-15]	[20-30]
Other OTC products	[20-30]	[0-5]	[20-30]
Generics	[5-15]	[10-20]	[20-30]
Branded pharmaceuticals	[10-20]	[20-30]	[30-40]

Note: Data by value, although there is very little difference between volume and value data.

78. The parties' highest shares of procurement are in P medicines, where the parties have [40-50] per cent which in general is not a percentage level at which buyer power issues are considered to arise. Additionally, in so far as pharmaceutical manufacturers tend to produce both ethicals and OTC medicines, considering shares by product category in this way is not considered to be a meaningful measure of buyer power relative to the manufacturers. It may be more appropriate to consider the split between branded and generic pharmaceuticals where the parties have a lower combined share of [30-40] per cent of UK purchases in branded pharmaceuticals.
79. Some third parties did suggest the possibility of 'waterbed' effects in this case; namely that if the merged parties would be able to achieve lower purchase prices from manufacturers, it would have the effect of increasing prices to other wholesalers or retailers. However, that would assume that the pharmaceutical manufacturers currently have the ability to increase prices to other wholesalers which they are not exploiting. There is no evidence to suggest that is the case here.

THIRD PARTY VIEWS

80. A large exercise to consult third parties was undertaken in this case and, as can be seen above, a number of concerns were raised. Some PCTs were concerned about local competition in their particular areas and about the parties' willingness to engage in, and negotiating strength in respect of, PCT initiatives.
81. A number of competitors also expressed concerns about the merger, however, some of these appeared directed at the fear that a combined Boots / UniChem would be a stronger competitor, which may in deed have a positive effect on competition, and it is noted that not all competitors were concerned by the

merger. A suggestion was also made that the complexity of the issues raised meant that they were not capable of being resolved by a first stage investigation.

ASSESSMENT

82. The parties overlap in the provision of retail pharmacy services. In terms of national competition, no concerns arise. However, on a local level on the basis of a one mile radius around both Boots and UniChem pharmacies there are 38 areas where the merger would result in a two to one reduction in the number of competing pharmacies ('fascias') and a further 61 areas where it would result in a reduction in the number of fascias from three to two. The evidence considered during this assessment clearly shows that a reduction in pharmacy fascias from two to one in a local area is, despite the restrictive terms of the NHS contract, expected to result in a substantial lessening of competition (SLC). Such an SLC could take the form of reductions in quality or the level of service provided (over and above the levels stipulated in the contract). There may also be an impact on pricing, particularly of P medicines. The evidence on whether an SLC would arise in the case of three to two overlaps is less conclusive but, on balance, the OFT takes the view that it may be the case that the merger may be expected to result in an SLC within these three to two overlap areas given the high barriers to entry present in this market as a result of the control of entry regulations. It is also likely that the consortia pharmacies referred to at paragraph 49 above would fall within the three to two analysis in terms of those instances where the merger leads to a change in control which has an impact on the incentives on the merged entity. In any event, this assessment does not influence the overall outcome either way in this case.
83. Although concerns were raised by some third parties, the OFT concludes that no competition concerns arise in respect of the provision of NHS and PCT services as a result of the merger, due both to a lack of evidence that this concern was justified and the fact that, in any event, the relevant statutory bodies have the means to address such concerns themselves by promoting new entry.
84. No horizontal overlap is considered to arise in wholesaling. A number of potential vertical concerns were considered during the assessment but they were not backed up by the evidence.
85. Given the conclusions at paragraph 82 above, the OFT believes 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.

UNDERTAKINGS IN LIEU

86. Where the duty to make a reference under section 33(1) of the Act is met, pursuant to section 73(2) of the Act the OFT may, instead of making such a reference, accept from such of the parties concerned undertakings as it considers appropriate for the purpose of remedying, mitigating or preventing the SLC concerned or any adverse effect which has or may be expected result from it.
87. The OFT has therefore considered whether there might be undertakings in lieu of reference which would address the competition concerns outlined above. The OFT's guidance on undertakings in lieu of reference states that, 'undertakings in lieu of reference are appropriate only where the competition concerns raised by the merger and the remedies proposed to address them are clear cut' (see Mergers – Substantive Assessment guidance para 8.3).
88. Boots and UniChem indicated to the OFT that that they would be prepared to consider divesting pharmacies where the OFT found there to be a substantial lessening of competition in the following circumstances:
- (i) where there is a two to one or three to two overlap on the basis of a one-mile [] overlap [] they would divest one pharmacy; and
 - (ii) []

The parties have also indicated that they would be prepared to arrange for any divestments to be made in 'packages' to address the OFT's concerns about the practicability of considering and consenting to a large number of individual disposals.

89. The areas where the OFT considers divestments are necessary to fully address the OFT's competition concerns are those described at paragraphs 43 - 46 above (i.e. those areas (including relevant consortia pharmacies) which fall within the one-mile radius referred to in (a)). It appears to the OFT that such an undertaking would address all of the potential adverse effects arising from the merger.
90. Accordingly, on the information currently available, the OFT has decided to exercise its discretion under section 73(2) of the Act to negotiate undertakings in lieu of reference.

DECISION

91. The merger will therefore be referred to the Competition Commission under section 33(1) of the Act, unless Boots gives suitable undertakings pursuant to section 73 of the Act to address the potential competition concerns outlined above.