RBB | Economics

Mannheim, ACE 2006

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Local Market Analysis

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OVERVIEW

1. **Introduction: Boots/AU merger implications**

    1.1 Horizontal issues
    1.2 Vertical issues

2. **Local market analysis**

    2.1 Isochrones or radii centering and re-centering
    2.2 Market concentration and competitive outcomes
    2.3 Local competition
    2.4 Local markets and national competition

3. **Concluding points for discussion**

1. INTRODUCTION: MERGER IMPLICATIONS

Horizontal issues

- **Retail market**
  - Second and third largest pharmacy chains (post-merger Boots/AU 19% market share by outlets at national level)
  - Competition in local markets
    ➔Other competitors: Lloyds; Superdrug; supermarkets; regional chains and independents
- **Wholesale market**
  - AU wholesaler
  - Boots does not compete (limited self-supply)
    ➔no change

Vertical issues

- Potential change in Unichem's incentives
  ➔ possible (increased) incentive to foreclose

2.1 LOCAL MARKET ANALYSIS: CENTRING THE ANALYSIS

- **Identify catchment area of stores**
  - Scope of the area within which competition takes place
  - Geographic area from which firms draw their customers:
    - Distance: Geometric radius around a point (eg, outlet)
    - Time: Isochrone of travel time around the point (will reflect layout of local roads)
  - Choice depends on industry
    - Evidence suggests majority of customers travel to pharmacy by foot hence: radii
    - Choice of radius for pharmacy: area within which the majority of customers are drawn 1 mile
    - Sources: survey information; loyalty card data; etc.

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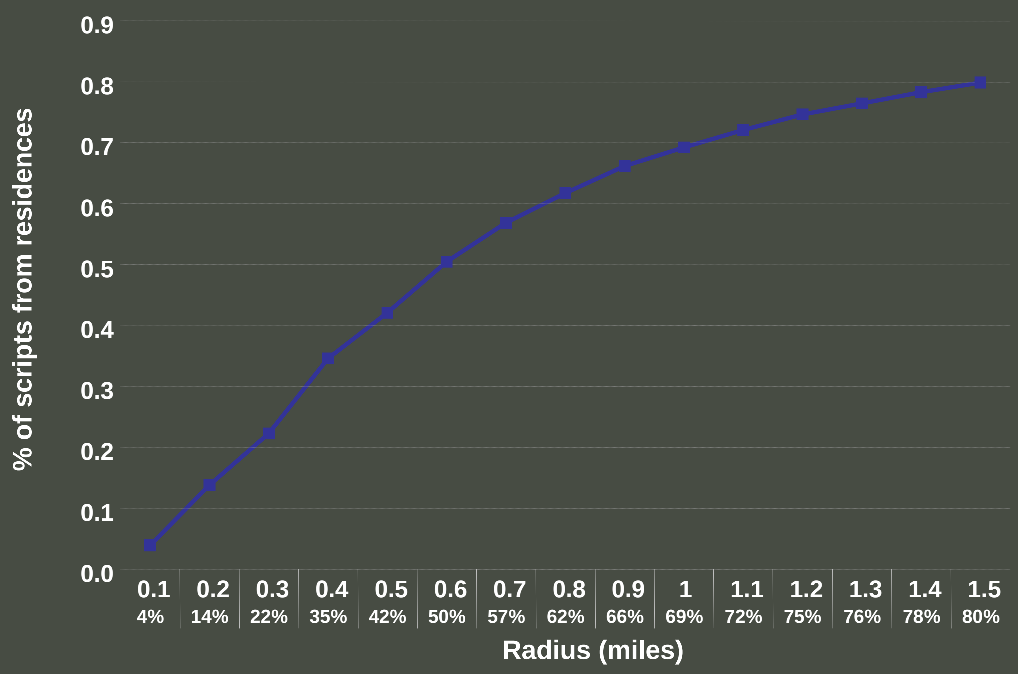
2.1 LOCAL MARKET ANALYSIS: CENTRING THE ANALYSIS

- **Size of catchment areas**
  - Consumer surveys (78% travel less than 1 mile)
  - For prescriptions AU data suggest about 70% travel less than 1 mile

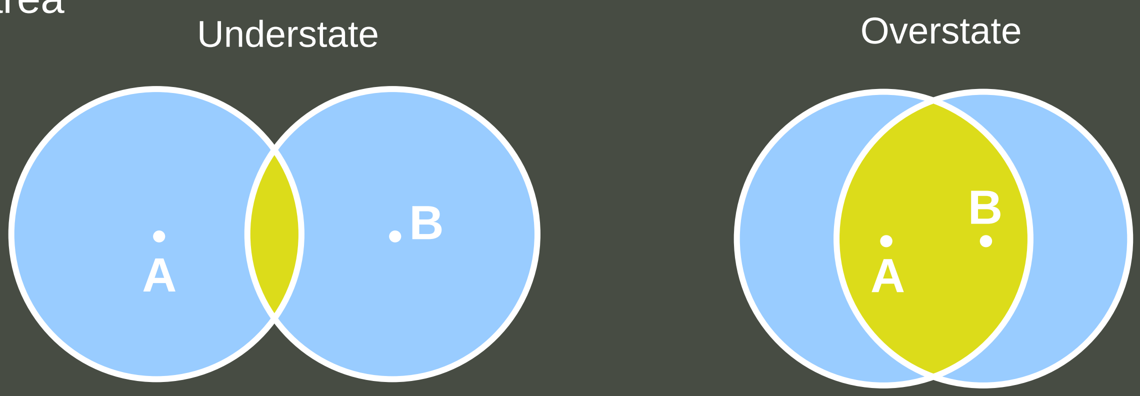


2.1 LOCAL MARKET ANALYSIS: CENTRING THE ANALYSIS

- **Where to centre the analysis**
  - Point of supply: outlet centred
    - ➔ Pharmacies
  - Consumers centred
    - ➔ eg, Households; GP surgeries
  - Potential problems with outlet centred radii: Understate or overstate degree of competition

2.1 LOCAL MARKET ANALYSIS: CENTRING THE ANALYSIS

- **Centring of Catchment Areas**
  - Outlet centred – possible understatement or overstatement of competition depending on the distribution of consumers in the area



  - Demand centred – correctly identifies loss of competition for individual customer. Practical implications

➔An outlet centred approach was adopted, consistent with previous cases

2.2 LOCAL MARKET ANALYSIS: MARKET CONCENTRATION

- **Market concentration and competitive outcomes**
  - What is the current degree of competition and how will it be affected by the transaction?
    - ➔ Calculate number ('fascia') or market share of competitors within the catchment of each outlet
  - Compare number of competitors or market share to benchmark level of effective competition
    - ➔ Level of effective competition (eg. minimum number of fascia) can vary depending on industry
  - Approach to assess SLC
    - ➔ Can be determined by means of price-concentration studies
    - ➔ Caution if results of price concentration studies are inconclusive

2.3 LOCAL MARKET ANALYSIS : LOCAL COMPETITION

Closeness of competition

- Community vs. High street Pharmacies
  - Alliance Unichem: “Community pharmacy” (located in residential areas, close to GPs)
    - ➔ 85% T/O prescription medicines; 4% P; 2% GSL
  - Boots: “High Street” (located in central areas to maximise footfall)
    - ➔ 24% T/O prescription; 4% P; 9% GSL; 65% toiletries, photography, etc.
- Alliance Unichem Internal Study (effect of competitors within 0.5 mile on number of prescriptions)
  - ➔ Boots is not a close competitor
  - ➔ Different radii for different stores (Supermarkets exert a competitive constraint over a larger area- 3 miles)

2.3 LOCAL MARKET ANALYSIS: LOCAL COMPETITION

Closeness of competition

- Primary competitive variable: Location, ie, distance from GP (OFT, 2003)
  - Prescription medicines
    - ➔ No price competition; Quality of service? Service levels closely regulated
- Prices for OTC (P and GSL) set nationally by each chain
  - P medicines
    - ➔ GSL substitution to some extent
    - ➔ Supermarkets significant competitors
  - GSL
    - ➔ Broader array of suppliers
    - ➔ Largest competitors to Boots are Tesco and Superdrug (increment from merger with AU quite small)

2.3 LOCAL MARKET ANALYSIS: LOCAL COMPETITION

- **Closeness of competition**
  - Differentiation among competitors makes it difficult to interpret concentration measures to assess the degree of competition
  - Quality aspects to some extent
    - ➔ Waiting time
    - ➔ Opening hours
    - ➔ Range of stock
    - ➔ Range of services: eg, delivery or collection
- **Competitive benchmarking**
  - What is the number of fascias required to maintain adequate competition in a local area
  - Entry barriers due to regulation
- **OFT Decision**
  - 38 local areas of 2 to1 fascias in 1 mile radius (MMC 1996)
  - Further 61 areas 3 to 2
  - 4 to 3 no SLC
  - Divestments in lieu of referral to CC

2.4 LOCAL MARKET ANALYSIS: NATIONAL COMPETITION

- **National or local competition**
  - Retail pharmacy a highly fragmented market
    - ➔ Large number of independent pharmacies
  - Are the parties closer competitors than their market shares suggest?
  - Consumer behaviour
  - Price and quality setting
    - ➔ Local competition for prescriptions
    - ➔ Will post-merger incentives change for P and GSL?
    - ➔ Divestments address potential SLC
    - ➔ Current monopoly and duopoly areas do not defeat incentive for national pricing policy

3. CONCLUDING POINTS FOR DISCUSSION

- **Closeness of competition**
  - Use of internal documents and econometric analysis
- **Competitive benchmarking in the absence of price competition**
  - Empirical analysis of prescription volumes/service levels
- **Relevance of simple catchment area analysis**
  - Is a simple fascia count sufficient?

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KEY ISSUES: VERTICAL ISSUES (I)

- **Potentially increased incentive to foreclose independent pharmacies**
  - Poorer terms
  - Reduced service quality
  - Refusal to supply
- **RBB analysis**
  - Intensity of wholesale competition
  - Ability and incentive to foreclose

KEY ISSUES: VERTICAL ISSUES (II)

- **Effective wholesale competition**
  - "Taps"
    - ➔ 32% of stores involved
    - ➔ 26% of stores successful
    - ➔ Involvement of rivals
  - Churn
    - ➔ Evidence of switching

KEY ISSUES: VERTICAL ISSUES (III)

- **Ability to foreclose**
  - Evidence of strong competition
  - Absence of captive customers

- **Incentive to foreclose**
  - Lost wholesale margins vs. only partial retail recoupment
  - Deviation from optimised logistics
  - Reputational damage in the UK and in other countries.
  - Uncertainty