

## Statement of Preliminary Issues

### Dechra / Elanco

23 April 2020

### Introduction

1. On 26 March 2020, the Commerce Commission registered an application from Dechra Pharmaceuticals PLC, Dechra Limited and Dechra Veterinary Products LLC (together, Dechra or the Applicant) seeking clearance to acquire from Elanco Tiergesundheit AG (Elanco) its worldwide assets, rights and liabilities relating to the supply of Osurnia, a treatment for otitis in dogs (the Proposed Acquisition).<sup>1</sup>
2. The Commission will give clearance if it is satisfied that the Proposed Acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market in New Zealand.
3. This statement of preliminary issues sets out the issues we currently consider to be important in deciding whether or not to give clearance.<sup>2</sup>
4. We invite interested parties to provide comments on the likely competitive effects of the Proposed Acquisition. We request that submissions are received by close of business on **6 May 2020**.
5. The Commission acknowledges that some interested parties may face a range of challenges during particular COVID-19 alert levels and the variation of levels as and when they are altered. This may impact their ability to submit in a meaningful way within these timeframes. If you would like to make a submission but face difficulties in doing so within the timeframe, please ensure that you register your interest with the Commission at [registrar@comcom.govt.nz](mailto:registrar@comcom.govt.nz) so that we can work with you to accommodate your needs where possible.

### The parties

6. Dechra is a UK-based global animal healthcare company that develops, manufactures and distributes healthcare treatments for a range of companion animals (such as cats and dogs) and production animals (such as pigs, poultry and cattle).
7. Elanco and its related entities also develop, manufacture, and distribute healthcare treatments for a range of companion and production animals on a global basis.

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<sup>1</sup> A public version of the Applicant's clearance application is available on our website at: <https://comcom.govt.nz/case-register/case-register-entries/dechra-pharmaceuticals-elanco>

<sup>2</sup> The issues set out in this statement are based on the information available when it was published and may change as our investigation progresses. The issues in this statement are not binding on us.

8. While both Dechra and Elanco supply a broad portfolio of animal health products in New Zealand, they overlap only in the supply of products used in the treatment of otitis in dogs. Otitis is an inflammation of the external ear canal and it is a common affliction in dogs. For the treatment of otitis in New Zealand:
  - 8.1 Dechra supplies two daily dose otitis products under the brands PMP and Canaural;<sup>3</sup> and
  - 8.2 Elanco supplies a daily dose product under the brand Surolan and a long acting product under the brand Osurnia.<sup>4</sup>

### **Related application for clearance**

9. The Commission is also currently considering a clearance application from one of Elanco's related entities, Elanco Animal Health Inc., which is seeking clearance to acquire Bayer AG's (Bayer) animal health business (the Proposed Elanco/Bayer Acquisition). Bayer is in the process of introducing a product under the brand Neptra for the treatment of otitis in dogs and so, because Elanco currently supplies the brands Surolan and Osurnia, the Proposed Elanco/Bayer Acquisition would also result in the overlap of treatments for otitis in dogs.<sup>5</sup> As such, we are considering the two applications in tandem.

### **Our framework**

10. Our approach to analysing the competition effects of the proposed acquisition is based on the principles set out in our Mergers and Acquisitions Guidelines.<sup>6</sup> As required by the Commerce Act 1986 (the Act), we assess mergers and acquisitions using the substantial lessening of competition test.
11. We determine whether an acquisition is likely to substantially lessen competition in a market by comparing the likely state of competition if the acquisition proceeds (the scenario with the acquisition, often referred to as the factual), with the likely state of competition if the acquisition does not proceed (the scenario without the acquisition, often referred to as the counterfactual).<sup>7</sup> This allows us to assess the degree by which the Proposed Acquisition might lessen competition.
12. If the lessening of competition as a result of the Proposed Acquisition is likely to be substantial, we will not give clearance. When making that assessment, we consider, among other matters:
  - 12.1 constraint from existing competitors – the extent to which current competitors compete and the degree to which they would expand their sales if the merged firm's prices increased;

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<sup>3</sup> As per Dechra's application, we understand that Canaural is currently out of stock globally.

<sup>4</sup> For clarity, Surolan is not part of the Proposed Acquisition and the brand would be retained by Elanco.

<sup>5</sup> See: <https://comcom.govt.nz/case-register/case-register-entries/elanco-animal-health-inc-bayer-ags-animal-health-business>

<sup>6</sup> Commerce Commission, *Mergers and Acquisitions Guidelines*, July 2019. Available on our website at [www.comcom.govt.nz](http://www.comcom.govt.nz)

<sup>7</sup> *Commerce Commission v Woolworths Limited* (2008) 12 TCLR 194 (CA) at [63].

- 12.2 constraint from potential new entry – the extent to which new competitors would enter the market and compete if prices increased; and
- 12.3 the countervailing market power of buyers – the potential constraint on a business from the purchaser’s ability to exert substantial influence on negotiations.

## **Preliminary issues**

### **Market definition**

- 13. Market definition is a tool that provides a framework to help identify and assess the close competitive constraints the merged firm would likely face. We define markets in the way that we consider best isolates the key competition issues that arise from the proposed acquisition. In many cases this may not require us to precisely define the boundaries of a market. A relevant market is ultimately determined, in the words of the Act, as a matter of fact and commercial common sense.<sup>8</sup>
- 14. Both Dechra and Elanco supply products used in the treatment of otitis in dogs. Treatments for otitis can only be supplied with a prescription so the products are supplied to the end customer by a prescribing veterinarian.
- 15. Dechra and Elanco both consider there is a discrete market for the supply of treatments for otitis in dogs. We will consider whether the supply of products for the treatment of otitis in dogs is an appropriate market for our assessment of the Proposed Acquisition. This will involve testing whether it would be appropriate to define product markets that are narrower or broader in scope.
  - 15.1 Narrower markets – we will test the extent to which otitis treatments for dogs that are required to be administered daily (or multiple times per day) are substitutes for longer acting products that are only required to be administered on one or two occasions.
  - 15.2 Broader markets – we will test the extent to which treatments with a different therapeutic indication are substitutes for treatments that are indicated for treating otitis in dogs. We understand that otitis is not a disease in itself but rather a symptom of conditions such as parasitic, bacterial or fungal infections. As otitis treatments tend to be a combination of treatments for those individual conditions, we will assess the extent to which the individual treatment products might be direct substitutes for treatments of otitis in dogs.
- 16. Both Elanco and Dechra develop and manufacture their products overseas and import them into New Zealand for supply. At this stage, we consider that the geographic and functional dimensions are likely to be the national market for the manufacture/importation and wholesale supply of the relevant product/s.

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<sup>8</sup> Section 3(1A) of the Act. See also *Brambles v Commerce Commission* (2003) 10 TCLR 868 at [81].

### Without the acquisition

17. We will consider what the merging parties would do if the Proposed Acquisition does not proceed. We will consider the evidence on whether the without-the-acquisition scenario is best characterised by the status quo or whether there are other likely counterfactual scenarios. This assessment will include considering the potential implications that our assessment of the Proposed Elanco/Bayer Acquisition would have on the with and without scenarios for Dechra's application.
18. Dechra considers that, in the with the acquisition scenario, it would acquire Elanco's long acting treatment (Osurnia) as well as continuing to supply its two existing daily dose treatments (PMP and Canaural). In addition:
  - 18.1 Elanco would continue to supply a daily dose treatment (Surolan); and
  - 18.2 a supplier independent of Dechra would introduce a long acting treatment called Neptra which would closely compete with Osurnia (this would be either Bayer or Elanco depending on the outcome of the Proposed Elanco/Bayer Acquisition).
19. Elanco anticipates that competition jurisdictions in Europe and the United States may require the divestment of Osurnia to remedy competition concerns arising in their respective reviews of the Proposed Elanco/Bayer Acquisition. To this extent, Dechra considers that, in the without the acquisition scenario, it is possible that Elanco would need to find an alternative purchaser for Osurnia in order to obtain the necessary approvals from competition jurisdictions to enable it to complete the Proposed Elanco/Bayer Acquisition.

### Competition analysis

#### *Horizontal unilateral effects*

20. We will investigate whether the Proposed Acquisition would be likely to substantially lessen competition in any relevant market by assessing whether unilateral effects might result from the Proposed Acquisition. The question that we will focus on is whether the loss of competition between Dechra and Elanco would enable the merged entity to profitably raise prices or reduce quality or innovation.
21. Dechra considers that the Proposed Acquisition would not be likely to substantially lessen competition in the supply of treatments for otitis in dogs because:
  - 21.1 the merged entity would face strong competition from existing daily dose suppliers including Virbac New Zealand Limited (with Easotic), Vetroquinol New Zealand Limited (with Aurizon) and Merck Sharp & Dohme (New Zealand) Limited (with Otomax) as well as Elanco (with its remaining product Surolan);<sup>9</sup>

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<sup>9</sup> Dechra advised that this is because the Proposed Acquisition does not involve any assets relating to the supply of Surolan.

- 21.2 the merged entity would face strong competition from an upcoming product, Neptra. Bayer is in the process of introducing Neptra, a long acting treatment which would compete with the existing daily dose and long acting otitis treatments supplied in New Zealand (and as noted either Bayer or Elanco would be supplying Neptra); and
  - 21.3 the barriers to entry and expansion for otitis treatments are low and there are a number of products available overseas that are not currently available in New Zealand which could easily enter the market.
22. To assess whether the merged entity would be able to profitably raise prices or reduce quality or innovation we will consider:
- 22.1 the closeness of competition between Dechra's products PMP and Canaural, and Elanco's product Osurnia. To the extent that they compete closely and therefore that the constraint that they impose on one another is material, we will assess whether the competition lost between the merging parties could be replaced by rival competitors;
  - 22.2 entry and expansion: the conditions for entry, how easily firms could enter and/or expand in response to an increase in price or reduction in quality or innovation by the merging parties; and
  - 22.3 countervailing power: the extent to which the key customers of these treatments, prescribing veterinarians, have special characteristics that would enable them to resist a price increase by the merged entity.

#### *Coordinated effects*

- 23. An acquisition can substantially lessen competition if it increases the potential for the merged entity and all or some of its remaining competitors to coordinate their behaviour and collectively exercise market power or divide up the market such that prices increase across the market.
- 24. Dechra considers that the Proposed Acquisition would not be likely to substantially lessen competition due to coordinated effects. This is because the market is currently competitive, there are no current indications of coordination occurring in the market and the Proposed Acquisition will not substantially change the competitive conditions in the market nor change any of the factors (such as a lack of price transparency, product differentiation, etc) that currently prevent coordinated effects in the industry.
- 25. We will assess whether the Proposed Acquisition would make coordination more likely, more complete or more sustainable. As part of this assessment we will consider whether any relevant market is vulnerable to coordination and whether the Proposed Acquisition would change the conditions to make coordination more likely. In particular, we will assess whether the Proposed Acquisition would make it easier for Dechra to monitor and punish the behaviour of rivals and hence make coordination more likely.

### *Conglomerate effects*

26. A conglomerate merger is a merger between firms that supply products that may relate to each other (for example, complementary products). A conglomerate merger may increase a merged firms' ability and/or incentive to foreclose competitors, particularly if the merged entity would have any must have products and the Proposed Acquisition would enable the merged entity to bundle or tie its products.
27. We will test whether the Proposed Acquisition would increase the potential for conglomerate effects as a result of Dechra adding a long acting otitis treatment to its existing portfolio of products. In particular, we will assess whether Dechra would have any must have products that would enable it to bundle its products together.

### **Next steps in our investigation**

28. The Commission is currently scheduled to make a decision on whether or not to give clearance to the Proposed Acquisition by **26 May 2020**. However, this date may change as our investigation progresses.<sup>10</sup> In particular, if we need to test and consider the issues identified above further, the decision date is likely to extend.
29. As part of our investigation, we will identify and contact parties that we consider will be able to help us assess the preliminary issues identified above.

### **Making a submission**

30. If you wish to make a submission, please send it to us at [registrar@comcom.govt.nz](mailto:registrar@comcom.govt.nz) with the reference 'Dechra/Elanco' in the subject line of your email. Please do so by close of business on **6 May 2020**. Normally we also accept submissions via post. However, currently the Commission cannot receive postal deliveries due to COVID-19, so submissions can only be accepted via email until further notice.
31. As above, if in the current COVID-19 environment this deadline will be difficult for you to meet, please register your interest with the Registrar so that we can work with you to accommodate your needs where possible.
32. Please clearly identify any confidential information contained in your submission and provide both a confidential and a public version. We will be publishing the public versions of all submissions on the Commission's website.
33. All information we receive is subject to the Official Information Act 1982 (OIA), under which there is a principle of availability. We recognise, however, that there may be good reason to withhold certain information contained in a submission under the OIA, for example in circumstances where disclosure would unreasonably prejudice the supplier or subject of the information.

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<sup>10</sup> The Commission maintains a clearance register on our website at <https://comcom.govt.nz/case-register> where we update any changes to our deadlines and provide relevant documents.