

RESPONSE TO STATEMENT OF ISSUES

1. Introduction and executive summary

- 1.1 This submission sets out Elanco Animal Health Inc.'s (**Elanco's**) response to the Commission's Statement of Issues dated 7 May 2020 (**SOI**), published in relation to the proposed acquisition of Bayer AG's (**Bayer's**) animal health business by Elanco (the **Proposed Transaction**).
- 1.2 The Commission is of the view that competition concerns cannot, at this stage, be ruled out in relation to the manufacture/importation and wholesale supply of products:
- (a) for the treatment of otitis in dogs;
 - (b) to veterinarians for the:
 - (i) treatment of external parasites on sheep; and
 - (ii) prevention of external parasites on sheep; and
 - (c) to rural supply merchant stores for the:
 - (i) treatment of external parasites on sheep; and
 - (ii) prevention of external parasites on sheep.
- 1.3 The Commission is also considering whether the Proposed Transaction would increase the potential for coordinated effects in the supply of sheep ectoparasiticide products to vets and rural supply stores, and conglomerate effects.
- 1.4 Elanco does not agree that the Proposed Transaction is likely to substantially lessen competition in any New Zealand market, for the following reasons in particular.
- (a) In respect of sheep ectoparasiticides:
 - (i) with the possible exception of Bayer's Maggo,¹ all fly/lice *treatment* products are also indicated for the *prevention* of flies/lice. The vast majority of sales of such products are to farmers seeking products to prevent flystrike. Farmers demanding prevention products have a large number of options – be they combination products or prevention only products. Accordingly, products used for *treatment* must be priced competitively with products *preventing* flies/lice on sheep, which means farmers purchasing solely for treatment purposes benefit from this wider constraint, *even if in a particular scenario they cannot switch to a prevention product from a demand perspective*.
 - (ii) sheep ectoparasiticide customers are price sensitive and readily switch between veterinarians and over-the-counter (**OTC**) suppliers (such as rural merchant stores). Similarly, suppliers can switch emphasis to supply more or less via a particular channel. The fact that not all suppliers or all customers may switch is not determinative – there is sufficient switching (and threat of switching) to impose a material and sufficient pricing constraint across channels;
 - (iii) generic sheep ectoparasiticide suppliers are a strong constraint on suppliers of branded products, and have the ability to enter/expand. That there may not have been large scale entry to date is not of itself indicative of barriers to entry – it may simply reflect competitively priced incumbent supply. The key issue is whether the

¹ Maggo can be used for short-term prevention against flystrike when used as a docking medication.

threat of such further entry/expansion constrains a hypothetical future price increase, and Elanco believes that it does;

- (iv) the segment is characterised by large customers with significant buyer power;
- (v) no conglomerate effects arise because neither of Elanco or Bayer (the **Parties**) supply a “must have” product, and could not profitably tie or bundle their products; and
- (vi) the Proposed Transaction does not increase the risk of coordination, including because price transparency is limited.

While Elanco believes the above arguments address the concerns set out in the SOI, any which remain are addressed by the proposed divestments of Maggo and Zapp Encore.

- (b) In respect of otitis treatments, Elanco believes there are a number of post-transaction constraints that preclude a substantial lessening of competition. However, in any event, any potential for competitive harm is eliminated by the divestment of Osurnia, e.g. to Dechra.

2. Sheep ectoparasiticides

Treatment and prevention products are in the same market and the pricing constraint flows across the market

- 2.1 Elanco disagrees with the Commission’s preliminary view that sheep ectoparasite prevention products may not sufficiently constrain treatment products, and has addressed this point in detail in relation to flystrike treatment in its submission on sheep external parasite treatments filed on 6 April 2020 (the **Sheep Ecto Submission**).² In summary, treatment products are constrained by prevention products because:
 - (a) with the possible exception of Bayer’s Maggo, all fly/lice treatment products are also indicated for the *prevention* of flies/lice, and thus the merged entity will be constrained by prevention products; as many of the products in this market are combination products (i.e. they can be used against flies and lice), flystrike-only products (whether treatment or prevention) must compete on price with combination products or farmers will switch. Given the regularity with which farmers treat their flocks to prevent flystrike and lice infestations (typically annually for both), and the relative rarity with which sheep are flystruck, the vast majority of the time (est. >95% for flies and >90% for lice) combination products are purchased for *prevention* – meaning the sales of *treatment* products are materially constrained by combination products; and
 - (b) accordingly, the profitability of combination products is contingent on ensuring that they continue to be sold, in substantial volumes, to farmers seeking to prevent flystrike. This is supported by industry evidence (which is set out in the Sheep Ecto Submission).
- 2.2 Elanco believes the Commission has placed undue weight on the fact a farmer with a treatment requirement can only choose a product indicated for treatment – which is true – but which ignores the fact the *price of those products is itself constrained by the price of combination and prevention products*, quite apart from the demand profile of a particular purchaser.
- 2.3 In any event, any concerns that the Commission continues to have will be addressed by the proposed divestment of Maggo and Zapp Encore. As Maggo is the sole treatment-only product in the Parties’ product portfolios, the divestment addresses the Commission’s concerns however markets are defined.

² See in particular paragraphs 2.1 to 2.6 of the Sheep Ecto Submission.

Vet and OTC products (i.e. products supplied via rural supply merchant stores) are in the same market

- 2.4 Elanco does not agree with the Commission's view that wholesale supply of products to veterinarians might more appropriately be considered separately to OTC supply.
- 2.5 This is because end customers (farmers) are price sensitive and will switch between the two channels in response to price differentials, and suppliers can switch emphasis between channels in response to opportunities. The fact that some suppliers (or buyers) may not make a wholesale shift from one channel to another does not mean there are separate markets – the key point is that there is sufficient (demand and/or supply-side) substitutability to constrain any attempted price increase.
- 2.6 For further examples of this dynamic at play, please see **Confidential Appendix A**, which contains both Elanco and Bayer confidential information.

Generic competitors together are a further constraint

- 2.7 The constraint from local competitors focussed on generic supply was outlined in the Sheep Ecto Submission.³ The key points are summarised below.
- (a) A number of local suppliers compete aggressively in the sheep ectoparasiticide market and either supply, or are well placed to begin supply of, products substitutable for those supplied by the Parties. Jurox, PGG Wrightson (**PGGW**), Ravensdown, Jaychem (through Alleva), Animal Health Direct, and Donaghys each supply products in this market, and all are capable of expanding. Norbrook has previously supplied products in this market, the rights to which are now held by Abbey Laboratories. Accordingly, Abbey Laboratories could enter the market.
- (b) Although the local suppliers tend not to have revenue market shares as high as the major international players, in aggregate they account for a significant share of the market and, combined, have a significant impact on branded products. Branded products must compete with generic products on price or customers will switch. As noted, the fact particular suppliers may not have achieved substantial market share does not necessarily mean they face entry or expansion barriers – it could equally mean the market is being well served by incumbents supplying competitively priced products.
- (c) Further, low cost toll manufacturers are able to provide “own” label generic cyromazine products to generic companies based on existing registrations. For example, Nexan Corporation provides Cyromax SO and Liquid to PGGW, and Cyromazine SO and Liquid to Ravensdown. The threat of these generics is set to further increase [REDACTED]. This is a further constraint that the Parties must continue to have regard to. Obviously, a decision by the likes of a well-known name such as PGGW to roll out such a product has substantial ramifications for current suppliers (even more so given PGGW has its own retail presence). Moreover, once that decision is made it is not readily reversed, and thus incumbents will be careful not to price in such a way which risks incentivising such entry.

Potential entry / expansion

- 2.8 Each of the players listed at paragraph 2.7(a) above would have the ability to expand if the merged entity attempted to increase prices post-Transaction. In particular, PGGW and Ravensdown (with existing in-market products and extensive retail networks) and Jurox (as the supplier of an alternative dicyclanil-based product) are especially well-placed. The ease of ACVM registration for new products in New Zealand means that barriers to entry and expansion

³ See in particular paragraphs 4.1 to 4.5.

are relatively low, particularly where a product has been developed by a multi-national and is off-patent.

- 2.9 In addition, as set out in the Sheep Ecto Submission,⁴ MSD (as an established and well-resourced branded player) is well placed to expand into this market. It competes closely with the Parties and is particularly aggressive on price. [REDACTED].

Large customers have significant buyer power

- 2.10 As set out in the clearance application, the Parties' production animal products are distributed through entities with significant distribution operations (such as Provect) and resellers with their own rural supplies stores (such as PGG Wrightson and Allied Farmers). Cooperatives, such as Farmlands, Ravensdown and Farm Source, also have retail arms that source products and sell to their customer shareholders (including, in the case of Ravensdown, under its own brand). The OTC channel is therefore categorised by large, sophisticated distributors with significant countervailing power.
- 2.11 The Commission has previously recognised that veterinarians exercise countervailing power over manufacturers of animal health products. In its decision in *ScheringPlough/Organon*, the Commission noted that many veterinarians are "relatively large and sophisticated buyers, due to a trend of rationalisation in the veterinary industry".⁵ In the time since the Commission's decision in this case there has been further consolidation of veterinary clinics, thereby increasing the buying power in particular of the large veterinary groups.⁶ Wholesalers in particular are also likely to exercise countervailing power given the position they hold in offering distribution cost savings to animal health suppliers, but also convenience to customers downstream (such as individual vets).
- 2.12 Information previously provided to the Commission on this point can be found at paragraphs 12.9 to 12.12 of the clearance application.

Conglomerate and coordinated effects

- 2.13 Elanco is of the view that the Proposed Transaction does not give rise to conglomerate or coordinated effects:
- (a) neither Party supplies a "must have" product – although Elanco disagrees with the Commission's proposed market definition, even in the narrowest plausible segment (sheep ectoparasiticide treatment products), neither of the Parties supply a 'must have' product, and all products in this segment are highly differentiated;
 - (b) as noted by the Commission at [124] of the SOI, many industry participants agree that the merged entity would be unlikely to have the ability to anti-competitively tie or bundle its products. Furthermore, to the extent that it were profitable to bundle or tie sets of products to exclude competitors, this should already occur to some degree today. It does not, and nothing about the Proposed Transaction would change the merged entity's ability or incentive to bundle or tie such products;
 - (c) most suppliers compete with a range of products across numerous animal health categories (i.e. treating different species) and many sheep ectoparasiticide products are already combination products. Accordingly, competitors are unlikely to be reliant on only one product to effectively compete in New Zealand, and in any event, it is likely to be impractical to bundle products across different species or within segments where

⁴ See in particular paragraphs 3.1 to 3.7.

⁵ *Schering-Plough Corporation/Organon Biosciences N.V.*, Commission Decision 621, 4 October 2007, (**Schering Plough/Organon**) at [303].

⁶ Examples of subsequent consolidation among veterinary practices include Quantum Vets, Vet Company South Island, Vetora and Vet Alliance.[REDACTED]

combination products already exist (as non-combination products must compete with combination products on price).

- 2.14 In relation to coordinated market power, the key factors currently precluding the exercise of such power are:
- (a) distribution takes place via contractual supply arrangements with customers, the terms of which are typically not known to competitors. Price transparency is therefore limited, making coordination difficult;
 - (b) the large number of competitors – global and local suppliers of both branded and generic products (in each segment, including sheep ectoparasiticides). Competitors are also of varying sizes and employ different cost structures; and
 - (c) sophisticated customers, who are well placed to detect and thwart any attempt to exercise coordinated market power.
- 2.15 None of these factors will change as a result of the Proposed Transaction. In addition, the Proposed Transaction does not remove a ‘maverick’ product – Maggo, Zapp Encore and Seraphos are not heavily promoted, so the Proposed Transaction does not change the status of an aggressively marketed or innovator product that is a key driver of competition or price in the rest of the segment. Accordingly, the Proposed Transaction cannot be said to facilitate tacit collusion.

The Proposed Divestment

- 2.16 Finally, any concerns the Commission may continue to have are addressed by the divestment of Maggo and Zapp Encore.
- 2.17 Given the Commission’s concerns relate primarily to products indicated for *treatment* of sheep ectoparasites, Elanco has proposed divesting Maggo and Zapp Encore in order to remove the majority of the overlap between the Parties arising from the Proposed Transaction.
- 2.18 Further detail can be found in documents provided to the Commission on 24 April 2020.

3. Otitis treatments

- 3.1 In relation to Otitis treatments, any potential for competitive harm is eliminated by the divestment of Osumnia. This is proposed to take the form of a sale to Dechra, which has been cleared by the ACCC and is currently under consideration by the Commission.
- 3.2 [REDACTED]

CONFIDENTIAL APPENDIX A

1. [REDACTED]

1.1 The progressive corporatisation of the New Zealand farming industry means that supply of production animal health products is becoming increasingly tender-based for larger customers. Smaller farms are also likely to shop around for the most competitive deals and will frequently switch between the vet and OTC channels, and dual source, if this is a cost-effective strategy.

1.2 Elanco has recently observed the following instances of customer switching / dual sourcing, on both large and moderate scale farming operations:

(a) REDACTED

(b) REDACTED]

2. [REDACTED]

2.1 REDACTED

(a) REDACTED

(b) REDACTED]