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COMMERCE COMMISSION

Decision No. 417

Determination pursuant to the Commerce Act 1986 in the matter of an application for clearance of a business acquisition involving:

Zuellig Pharma Limited

and

Sigma NZ Limited

The Commission:	M J Belgrave (Chair) M N Berry E C A Harrison
Summary of Proposed Acquisition:	Zuellig Pharma Limited to acquire all of the assets of Sigma NZ Limited.
Determination:	Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition.
Date of Determination:	2 February 2001

CONFIDENTIAL MATERIAL IN THIS REPORT IS CONTAINED IN SQUARE BRACKETS [ ]

APPENDIX A

APPENDIX B

APPENDIX C

APPENDIX D

THE PROPOSAL

1. Pursuant to section 66(1) of the Commerce Act 1986 (the Act), Zuellig Pharma Limited ("Zuellig") gave notice to the Commission on 13 December 2000 ("the Application"), seeking clearance for the proposed acquisition by it, or any interconnected body corporate, of all of the assets of Sigma NZ Limited ("Sigma NZ"), and its subsidiary, Pharmacy Wholesalers Wellington Limited (PWL Wellington") as described in Schedule One to the Application. Attached as Appendix A is a copy of Schedule One to the Application.

THE PROCEDURES

2. Section 66(3) of the Act requires the Commission either to clear, or to decline to clear, a notice given under section 66(1) within 10 working days, unless the Commission and the person who gave the notice agree to a longer period. By agreement between the Commission and the Applicant, the date for the Commission's determination on the Application was extended twice: to 26 January and 2 February 2001.

3. The Applicant sought confidentiality for certain information contained in the Application and a confidentiality order has been made in respect of that information for a period of 20 working days from the Commission's determination of the Application. When the confidentiality order expires, the provisions of the Official Information Act 1982 will apply to the information.

4. The Commission's determination is based on an investigation conducted by its staff. In the course of their investigation of the proposed acquisition, Commission staff have discussed the Application with a number of parties. These parties included pharmaceutical suppliers and wholesalers, PHARMAC, the Ministry of Health, the Researched Medicines Industry Association, the Pharmaceutical Society of New Zealand, the Pharmacy Guild of New Zealand (Inc), and individual retail pharmacies. In addition, staff have sought and received comment and further information from the parties to the proposed acquisition.

THE PARTIES

Zuellig Pharma Limited ("Zuellig")

5. Zuellig, a wholly-owned subsidiary of the Bermuda–registered Interpacific Holding Limited, is engaged itself, or through its subsidiaries, in the following activities:

    - the wholesaling of prescription and over-the-counter (OTC) pharmaceutical products to retail pharmacies from nine branches throughout New Zealand;
    - the contract distribution of prescription and OTC pharmaceutical products on behalf of a number of pharmaceutical suppliers, to various customers throughout New Zealand;
    - the provision of specialist logistic services involving the supply of pharmaceuticals and consumables to two District Health Boards (Waikato and Otago); and

- the provision of marketing and logistics services to the *Vantage* buying group of retail pharmacies.

6. In addition, Zuellig has a 40% shareholding in Unichem Chemists Limited, which provides marketing and various other support services to the *Unichem* banner group of retail pharmacies, and in November 2000 it acquired a 25% shareholding in Procare Pharmacy Limited, which has opened three retail pharmacies in Auckland. The other shareholders in Procare Pharmacy are Procare Health Limited and Unichem Chemists Limited.

7. Zuellig has operated in New Zealand since 1988 when it acquired Stevens KMS Corporation Limited ("Stevens"). In 1993, Zuellig acquired Community Pharmacy Limited ("CPL"), following clearance from the Commerce Commission (AUT/BA S11/1).

8. Aside from its shareholding in Zuellig, Interpacific Holding Limited owns 100% of the shares in PSM Healthcare Limited, which is a contract manufacturer of basic pharmaceutical products (including paracetamol), and toiletry items in New Zealand.

9. Attached as Appendix B is a diagram showing the ownership and operating structure of Zuellig.

Sigma NZ Limited ("Sigma NZ")

10. Sigma NZ is a wholly-owned subsidiary of Sigma Company Limited ("Sigma Australia"), a long established company, which is listed on the Australian Stock Exchange Limited.

11. Sigma NZ has expanded rapidly in this country in recent years, principally through acquisitions. In 1998, the company acquired the *Pharmacycare* banner group, which had been established in 1994, and later in 1998 launched the *Guardian* banner group in New Zealand. Sigma NZ acquired a pharmaceutical wholesaler in Auckland (Russells Pharmaceuticals Limited) in August 1998, and another wholesaler (PWL Wellington) in February 1999. Last year, the company acquired 100% of the shares in Amcal Chemists Marketing Limited, following clearance from the Commerce Commission (Decision 350).

12. Sigma NZ is engaged itself, or through its subsidiary PWL Wellington, in the following activities.

    - the wholesaling of prescription and OTC pharmaceutical products to retail pharmacies in the North Island from warehouses in Auckland, Palmerston North and Wellington. The company also operates a sub-depot warehouse in Nelson which services [ ] retail pharmacies in the upper South Island;

    - the contract distribution of prescription and OTC pharmaceuticals to various customers in New Zealand; and

    - the provision of marketing and various other support services to the *Amcal*, *Guardian* and *Pharmacycare* retail banner groups and the *PPS* buying group (see paragraphs 46 and 47 for further details about these groups).

13. Sigma Australia is the proprietor of the *Amcal* brand in Australia and New Zealand.

14. Attached as Appendix C is a diagram showing the ownership and operating structure of Sigma NZ.

Other Relevant Parties

Other Pharmaceutical Wholesalers

15. There are a number of other pharmaceutical wholesalers operating in New Zealand, including the following co-operative companies, supplying a comprehensive range of prescription and OTC pharmaceuticals:

- Pharmacy Wholesalers (Bay of Plenty) Limited ("PWL BOP"), which supplies primarily to retail pharmacies in the upper North Island from its warehouse in Tauranga;

- Pharmacy Wholesalers (Central) Limited ("PWL Central"), which supplies primarily to retail pharmacies in the central North Island from warehouses in New Plymouth, Wanganui and Hastings; and

- CDC Pharmaceuticals Limited ("CDC"), which supplies retail pharmacies throughout the South Island from a warehouse in Christchurch.

16. In addition, the following pharmaceutical wholesalers currently supply a more limited range of pharmaceutical products:

- Health Support Limited (HSL), a company 50% owned by Ebos Group Limited ("Ebos"), and 50% by the Auckland and Waitemata District Health Boards, which is principally involved in the supply of pharmaceuticals and consumables to hospitals in the upper North Island from a warehouse in Auckland. The company also supplies prescription and OTC pharmaceuticals to retail pharmacies in Auckland. HSL has access to a warehouse in Christchurch, which it uses to supply some hospitals in the South Island;

- Mainland Medical Supplies Ltd, of Christchurch and Southern Medical Limited, of Dunedin, both supply to retail pharmacies in the South Island; and

- Orange Exchange Limited/orangex.net ("Orangex"), which last year established a wholesale business using the internet to obtain sales, supplies a limited range of prescription pharmaceuticals to retail pharmacies from a warehouse in Auckland.

Pharmaceutical Suppliers

17. There are many companies involved in the supply of prescription and OTC pharmaceuticals to customers in the hospital, retail pharmacy and grocery sectors throughout New Zealand. These include the following companies which supply direct to retail pharmacies and hospitals:

- Douglas Pharmaceuticals Limited ("Douglas");
- Pacific Pharmaceuticals Limited ("Pacific"); and

- Roche Pharmaceuticals (“Roche”).

Pharmaceutical Management Agency Limited (“PHARMAC”)

18. PHARMAC is a Crown agency, which was set up originally in 1993 as a limited liability not-for-profit company, owned by the Health Funding Authority (HFA). Last year, PHARMAC was converted into a Crown-owned entity. PHARMAC is responsible for managing the New Zealand Pharmaceutical Schedule, which lists the almost 3,000 subsidised prescription pharmaceuticals and related products available in New Zealand. The schedule records the price of each pharmaceutical item, the subsidy it receives from public funds, and the guidelines or conditions under which the pharmaceutical may be prescribed.

Ministry of Health/Medsafe/HFA

19. Medsafe, a business unit of the Ministry of Health (“MOH”), is the authority responsible for the regulation of therapeutic products in New Zealand. Medsafe administers the Medicines Act 1981 and Medicines Regulations 1984, and parts of the Misuse of Drugs Act 1975 and Medicine Regulations 1977. Included among its statutory functions is the issuing of licences to those parties wishing to engage in the wholesaling of pharmaceutical products.

20. Until its disestablishment last year, the HFA was responsible for purchasing publicly-funded personal health, public health and disability support services from various healthcare service providers, on behalf of the New Zealand public. The HFA’s activities included contracting with retail pharmacies for the dispensing of prescription drugs.

21. On 1 December 2000, the HFA was disbanded, and under the New Zealand Public Health and Disability Act 2000, its functions were integrated into the MOH. In the longer term, it is expected that some of the functions undertaken previously by the HFA will be transferred to the newly established District Health Boards (DHBs).

Retail Pharmacies

22. There are currently around 950 retail pharmacies in New Zealand, the numbers having decreased over recent years. There are over 300 pharmacies belonging to banner groups, and at least another 200 who are members of buying groups.

23. The Pharmacy Guild of New Zealand (Inc) (“the Pharmacy Guild”) is the organisation which represents the interests of the retail pharmacy trade. It represents about 90% of retail pharmacies.

INDUSTRY BACKGROUND

Overview

24. Pharmaceutical products are generally divided into two categories: prescription and OTC. Most prescription pharmaceuticals in New Zealand are subsidised. The demand for such pharmaceuticals is driven by what general practitioners (“GPs”)

prescribe patients. Prescription-only pharmaceuticals can be supplied by retail pharmacies only to persons holding a prescription from an authorised medical practitioner.

25. Many OTC pharmaceuticals can be sold directly to consumers without the need for a prescription by retail pharmacies, supermarkets and some consumer goods stores. Some OTC pharmaceuticals are classified as “pharmacy only”, requiring them to be sold only by retailers holding a pharmacist’s licence. Most OTC products in New Zealand are not subsidised.

26. The majority of pharmaceutical products sold in New Zealand are sourced from pharmaceutical manufacturers/suppliers, usually large international companies. There are, however, some products that are manufactured in New Zealand by companies such as Douglas, Pacific and PSM Healthcare Limited. The supplier undertakes the distribution of pharmaceuticals itself, or in some instances it will appoint a company like Zuellig to distribute its products.

27. Wholesalers source pharmaceuticals from suppliers directly, or through a distributor, and resell the products, predominantly to retail pharmacies. For most pharmaceutical wholesalers, including Zuellig, around 85% of their business is generated from prescription pharmaceuticals, and the balance from OTC pharmaceuticals and other products.

28. Some wholesalers also supply pharmaceuticals to hospitals and various other customers. Wholesalers are frequently categorised as either full-line wholesalers, which offer at least 7-8,000 items, or part-line wholesalers, which sell around 4-6,000 lines.

29. The Applicant advises that all wholesalers use the services of third party trucking or courier companies to deliver pharmaceuticals to pharmacies.

30. Hospitals source the majority of their pharmaceuticals direct from suppliers, or from specialist logistics companies, such as HSL and Zuellig’s hospital division. Some hospitals purchase smaller quantities of pharmaceuticals from pharmaceutical wholesalers.

31. Pharmaceutical suppliers also sell direct to retail pharmacies, although this is generally confined to larger orders of OTC lines. Direct sales to retail pharmacies account for around 10-15% of total pharmaceutical sales on a national basis.

32. Historically, there was a requirement for same-day supply with retail pharmacies receiving multiple deliveries. However, over recent years, the trend has been towards overnight ordering for next–day delivery, although many retail pharmacists have commented that same-day delivery remains important, particularly for unanticipated and urgent situations. The demand for same-day delivery is also influenced by such factors as stock management practices, the availability of local warehouses, and patient expectations.

33. Zuellig carries out the wholesaling of prescription and OTC pharmaceuticals on a national basis through its wholesale division. It currently supplies customers from

nine warehouses situated throughout New Zealand (one each in Whangarei, Auckland, Hamilton, Napier, Palmerston North, Wellington, Nelson, Christchurch and Dunedin).

34. Sigma NZ operates its pharmaceutical wholesaling business through its Russells Pharmaceuticals Division, supplying customers in the upper North Island from a warehouse in Auckland. The company's wholly-owned-subsidiary, PWL Wellington, operates warehouses in Wellington and Palmerston North, supplying predominantly to customers in the lower North Island. In addition, PWL Wellington has a small warehouse in Nelson, which it uses to service retail pharmacies in the upper South Island.

35. The activities of the other parties involved in the wholesaling of prescription and OTC pharmaceuticals are described in paragraphs 15 and 16.

Pharmacy Retailing

35. The business of pharmacies may be viewed as falling into at least three categories. These would include the dispensing of pharmaceuticals prescribed by medical or other authorised practitioners, the sale of OTC pharmaceutical products, and the sale of a wide range of other goods and services (eg beauty and healthcare products).

36. In view of the statutory restrictions discussed below, pharmacies have a legal monopoly in respect of the retail supply of many pharmaceutical products .

37. Retail pharmacists are paid a fixed level reimbursement by the Government for the dispensing of prescriptions. These payments are made in terms of contracts between pharmacists and the MOH. The existing contracts are for three-year terms and are similar in scope. There are, however, some differences in payment amounts between the North and South Islands. This results from the operation of the Regional Health Authorities before the formation of the HFA. A description of the pricing of prescription pharmaceuticals is outlined below (see paragraphs 53-56).

38. In the case of restricted and pharmacy-only pharmaceuticals the pharmacist is responsible for setting the retail price.

39. For medical or health products which are not in the categories confined to pharmacies, the pharmacies face competition from other retailers, including supermarkets. In the case of other goods and services, which can be sold by non-pharmacists, such as OTC products, cosmetics, toiletries, photographic film and film processing, pharmacies face competition from a range of other retailers.

40. As noted previously, there are around 950 retail pharmacies in New Zealand. Of these, over 300 are currently affiliated to banner groups. However, it is estimated that banner groups account for a higher share based on revenue. This is due to the fact that many pharmacies belonging to banner groups are larger outlets situated in shopping malls or high street locations. The Applicant notes, however, that 13 of the top 28 customers of its wholesale division are not part of any banner group.

41. The Applicant advises that a group of independent retail pharmacies utilising the name Unichem Chemists started the concept of a banner group with the purpose of creating an

"image", and thereby differentiating the pharmacies affiliated to that group from other pharmacies. The *Amcal* and *Guardian* banner groups were launched subsequently along similar lines.

42. Differentiation is achieved through the provision of services to banner group members such as the benefits of group advertising, access to group purchasing, the acquisition of the banner group's "image", and access to support services such as training and development, information technology systems, standardised staff uniforms, store design and fit-out. Buying groups perform similar activities to banner groups, but are usually less structured in their marketing and advertising activities with the focus being on joint buying of products.

43. Pharmacies which are members of banner groups are not bound to buy exclusively from the wholesaler associated with their group. This applies to both Sigma NZ and its banner groups, and to Zeullig and the *Unichem* banner group. Sigma NZ noted that the exceptions to non-exclusivity are house brands (that is *Guardian* and *Amcal* house brand products), which comprise a small part of total sales, and purchases for organised promotions. Wholesalers endeavour to obtain orders from their banner group members and other pharmacies through their pricing policies, including discount structures.

44. Currently, Unichem Chemists services the largest banner group, with 130 members throughout New Zealand (*Unichem* [ ], *Unichem Life* [ ], and *Dispensary First* [ ]) . Unichem Chemists is controlled by its members. As noted above, Zeullig has a 40% shareholding in Unichem Chemists.

45. Aside from its interest in Unichem Chemists, Zuellig operates the *Vantage* buying group. The primary function of the *Vantage* group is the organisation of "letterbox drop" promotions, and the group purchasing of the products in these promotions. At any time, up to 80 pharmacies may participate in these promotions, which occur about five times per year.

46. Sigma NZ is involved in three banner groups with a combined membership of 174 (*Amcal* [ ], *Guardian* [ ] and *Pharmacycare* [ ]). The *Amcal* and *Guardian* banner groups provide a comprehensive range of marketing and other support services to its members, while the *Pharmacycare* group offers a lesser range of services. The Commission has been advised that the *Pharmacycare* banner group is not currently active in promoting its brand, and that it has not carried out any major promotional activities in the last 12 months.

47. In addition, Sigma NZ has an interest in *PPS*, a buying group of about [ ] members, which arranges bulk purchases from individual wholesalers and organises promotional activities.

48. Other banner groups include Care Chemists Limited, which has about [ ] members (all in the North Island). Currently, The Warehouse holds 50% of the shares in Care Chemists, [

]

The Regulatory Environment

49. The importation, sale and distribution of pharmaceuticals are tightly controlled in New Zealand, principally through the Medicines Act 1981 and associated regulations. All new or altered medicines require the approval of the Minister of Health (or his/her delegate) before they can be marketed in New Zealand. Some pharmaceuticals, which have not been registered, may be supplied subject to a medical practitioner's prescription (section 29 of the Medicines Act). Wholesalers of pharmaceuticals require a licence to operate. Medsafe manages the approval system and the granting of wholesale licences.

50. Section 3 of the Medicines Act 1981 defines three categories of medicinal drugs which are declared by regulation or by a notice given under section 106 of the Medicines Act. These categories are prescription medicines, restricted medicines and pharmacy-only medicines. A prescription medicine can be supplied only pursuant to a prescription by an authorised person. Only a registered pharmacist can supply a restricted medicine, while only premises with a licence to sell medicinal drugs can supply a pharmacy-only medicine.

51. The Pharmacy Act 1970 requires a pharmacy to be at least 75% owned by a pharmacist, and to be under the supervision of a registered pharmacist. However, the Pharmacy Act allows up to 25% of a pharmacy to be held by another party (although, not by a wholesaler). Wholesalers are currently prevented from owning a pharmacy (section 44 of the Pharmacy Act), and from requiring a pharmacy to purchase from them, when providing services (section 2(3) of the Pharmacy Act).

The Pharmaceutical Schedule

52. Having received marketing approval, the manufacturer/supplier usually applies to PHARMAC to have a medicine included on the Pharmaceutical Schedule. Inclusion means patients can gain access to the medicine via a government subsidy towards the cost of the pharmaceuticals. The level of patient subsidy is decided through measures such as a "reference pricing" system, where the subsidy for all medicines in the same therapeutic subgroup is set at the level of the lowest priced pharmaceutical in that subgroup. This is applied where PHARMAC considers the medicines have the same or similar therapeutic effects in treating the same or similar condition.

The Pricing of Pharmaceuticals

53. The pricing of prescription pharmaceuticals is determined to a significant extent by the policies of PHARMAC and the MOH's contracts with retail pharmacies. The effect of these policies has been to squeeze margins at the wholesaling and retail levels of pharmaceutical distribution in New Zealand.

54. The retail price for prescription pharmaceuticals is made up of the following components:

- the manufacturers'/suppliers' selling prices, which are generally equal to the subsidies PHARMAC provides for pharmaceuticals listed in the Pharmaceutical Schedule. A premium may apply to some pharmaceuticals for which the consumer pays;

- a margin on PHARMAC's subsidy, which covers stock holding and procurement costs (currently 3.5% in the North Island and 5% in the South Island); and

- a dispensing fee which is reimbursed to retail pharmacies.

55. Given that the price ex-supplier is determined by the policies of PHARMAC, and the reimbursement to retail pharmacies is set under contract, the only scope available for a wholesaler to affect wholesale pricing is in terms of its margin. However, even that is limited. The wholesale margin is usually derived from a base margin of around 8%, which is then discounted back for prompt payment, and for the volume of business undertaken. For pharmacies placing the bulk of their orders through one wholesaler, the wholesale margin is approximately between 3.5% and 5%. The Applicant advises that the wholesalers' margin has declined from around 10% in 1993 to the current levels.

56. The wholesale pricing of most OTC pharmaceuticals is not subject to the regulatory constraints outlined above. Rather, it is influenced by competitive forces, including the availability of many OTC products from retail pharmacies, supermarkets and department stores. Typically, the wholesale margins for OTC pharmaceuticals are around 5-10%. This margin is usually derived from a 17.5% base minus discounts.

THE RELEVANT MARKETS

Introduction

57. The purpose of defining a market is to provide a framework within which the competition implications of a business acquisition can be analysed. The relevant markets are those in which competition may be affected by the acquisition being considered, and in which the application of section 47(1) of the Act can be examined.

58. Section 3(1A) of the Act provides that:

> ". . . the term 'market' is a reference to a market in New Zealand for goods and services as well as other goods and services that, as a matter of fact and commercial common sense, are substitutable for them."

59. Relevant principles relating to market definition are set out in *Telecom Corporation of New Zealand Ltd v Commerce Commission*,[1] and in the Commission's *Business Acquisition Guidelines* ("the Guidelines").[2] A brief outline of the principles follow.

60. Markets are defined in relation to three dimensions, namely product type, geographical extent, and functional level. A market encompasses products that are close substitutes in the eyes of buyers, and excludes all other products. The boundaries of the product and geographical markets are identified by considering the extent to which buyers are able to substitute other products, or across geographical regions, when they are given the incentive to do so by a change in the relative prices of the products concerned. A market is the smallest area of product and geographic space in which all such substitution possibilities are encompassed. It is in this space that a hypothetical, profit-maximising, monopoly supplier of the defined product could

[1] (1991) 4 TCLR 473.
[2] Commerce Commission, *Business Acquisition Guidelines*, 1999, pp. 11-16.

exert market power, because buyers, facing a rise in price, would have no close substitutes to which to turn.

61. A properly defined market includes products which are regarded by buyers or sellers as being not too different (‘product’ dimension), and not too far away (‘geographical’ dimension), and are therefore products over which the hypothetical monopolist would need to exercise control in order for it to be able to exert market power. A market defined in these terms is one within which a hypothetical monopolist would be in a position to impose, at the least, a “small yet significant and non-transitory increase in price” (the *“ssnip”* test), assuming that other terms of sale remain unchanged.

62. Markets are also defined by functional level. Typically, production, distribution, and sale occurs through a series of stages, with markets intervening between suppliers at one vertical stage and buyers at the next.

The Pharmaceutical Wholesaling Markets

Product Market

63. As noted above, pharmaceutical products are generally classified under two categories: prescription and OTC. Prescription pharmaceuticals account for around 85% of sales at the wholesale level, and OTC products make up about 15% of sales.

64. In its 1993 decision on the Stevens/CPL acquisition (“the Stevens/CPL decision”), the Commission defined prescription and OTC pharmaceuticals as falling into separate markets. However, the parties to the acquisition contend that in terms of wholesaling, there are no distinguishing characteristics between these products. Further, Zuellig states that it treats them in the same way in its wholesale business. Most other parties agreed that prescription and OTC pharmaceutical products should be treated together.

65. The Commission considers that, although there are some differentiating characteristics (eg the pricing of prescription pharmaceuticals is constrained by regulation, while OTC pharmaceuticals are generally not), prescription and OTC pharmaceuticals are stocked by all major wholesalers and are ordered, handled and delivered in the same manner. For these reasons, and for ease of analysis, the Commission proposes to include prescription and OTC pharmaceuticals in the same product market in this report.

Functional Markets

66. In the Stevens/CPL decision, the Commission concluded that the market was that for the wholesale and distribution of prescription and OTC pharmaceuticals. Zuellig, however, views wholesaling and distribution as separate functional activities, and operates them as discrete business units.

67. Wholesaling involves retail pharmacies and other purchasers placing an order with a company for prescription and OTC pharmaceuticals, and the company dispatching those products to purchasers, usually by a third party courier service (see Appendix D for details of the supply process). Title to the goods transfers from the wholesaler to the purchaser.

68. As noted above, retail pharmacies (including hospital-operated pharmacies) account for the major share of wholesalers' revenue. Other purchasers include hospitals, rest homes and various other parties. Those purchasers can also be supplied in some circumstances by direct supply from pharmaceutical suppliers. Hospitals often require very large orders, and can generally order the bulk of their pharmaceuticals in advance, along with other consumable products. Such purchasing behaviour generally lends itself towards supply by distributors, specialist suppliers, or direct by manufacturers/suppliers. In contrast, retail pharmacies generally have a more urgent need for pharmaceuticals, especially prescription pharmaceuticals, and therefore tend to source most of their requirements through a wholesaler.

69. Distribution (or pre-wholesaling) of pharmaceuticals involves a company acting as a contract warehouse for international pharmaceutical suppliers, usually on an exclusive basis, for payment of a fee. This includes receiving bulk product into warehouse facilities and arranging delivery to customers, who predominantly comprise wholesalers or hospitals (see Appendix D for details of the supply process). The distributor does not market or sell these goods, but may provide support services (eg debt collection and 0800 number services). Title to the goods is generally retained by the supplier throughout the distribution process. The distributor is, therefore, acting on behalf of the supplier.

70. Having regard to the above factors, the Commission considers that it is appropriate for the purpose of this report to define wholesaling and distribution under separate functional markets. Wholesaling is confined largely to the supply of pharmaceuticals to retail pharmacies (including hospital-operated pharmacies). Direct sales of pharmaceuticals from manufacturers/suppliers to retail pharmacies are included in the wholesaling market because they provide some supply-side alternatives. However, the relevant market does not extend to the bulk supply of pharmaceuticals to hospitals, or direct sales made by suppliers to those institutions.

Geographic Markets

71. In the Stevens/CPL decision, the Commission identified three separate regional markets for the purpose of analysing the likely competitive impact in the wholesale market: upper North Island (ie Taupo north); lower North Island (ie south of Taupo); and South Island. The reasons for such an approach relied on the requirement by retail pharmacies for "same day" supply.

72. In the 1999 decision on Sigma/Amcal, the Commission adopted a national market for the wholesaling of pharmaceuticals.

73. In its application, and in further submissions, Zuellig considers that the wholesaling of pharmaceuticals now constitutes a national market. To support this argument, Zuellig contends that:

- the importance of "same-day" supply has virtually disappeared since the Commission's decision in 1993. Zuellig estimates that around 90% of its sales are currently for overnight delivery, and that only a small percentage of customers would require twice-daily deliveries. Advances in computer systems and improved stock management practices by pharmacies have contributed to a reduction in the need for same-day deliveries;

- transport costs are not such as to impede market participants from competing in either the North or South Islands. Nor are freight costs between the North and South Islands onerous for bulk orders;

- its local warehouses can generally source out-of-stock lines from one of its other warehouses overnight for next-day delivery, to meet customer needs as required;

- there is evidence of traditionally local or regional wholesalers expanding outside their immediate geographic area(s). For example, PWL BOP is supplying retail pharmacies in Auckland and Northland from Tauranga, while CDC is supplying pharmacies in Auckland from the South Island; and

- it operates a national pricing policy despite the fact that reimbursement levels under the MOH pharmacy contracts differ between the North and South Islands.

74. In the Sigma/Amcal Application, Sigma Australia claimed that the wholesaling of prescription and OTC pharmaceuticals could be viewed as two separate North and South Island geographic markets. In reaching that view, the company attached weight to the importance of same-day service from wholesalers. However, after developing a more detailed understanding of the New Zealand market place, Sigma NZ now believes that the geographic market is national in its scope. In support of this conclusion, Sigma NZ refers to the trend towards overnight delivery, the large number of suppliers and acquirers of pharmaceuticals operating across traditional geographic boundaries, the presence of direct supply (which is conducted nationally), and wholesalers competing outside their traditional boundaries.

75. Some parties consulted by the Commission disagree with Zuellig's (and Sigma NZ's) contention that the wholesaling of pharmaceuticals is a national market. Although they acknowledge that most retail pharmacies now order the bulk of their stock overnight for delivery next-day, they contend that it is not practical to stock the full range, and that there is a requirement for timely delivery, such as in urgent situations, or in emergencies. One party suggested that it was necessary to have access to a wholesaler within two hours of the pharmacy.

76. Factors which influence such service requirements include:

- retail pharmacies seek to minimise their stock holding costs, especially in an environment of low retail margins. They also seek to avoid being left with stock removed from the Pharmaceutical Schedule (which pharmacists suggest occurs regularly), or which passes the product's "used by date";

- specific supply requirements which are set under contracts between the MOH and retail pharmacies. These contracts require that 90% of prescriptions must be filled within an hour, and 100% within 24 hours;

- retail pharmacies are unable to fully anticipate consumer demand in terms of the type and quantities of pharmaceuticals; and

- the public generally expect prescriptions to be filled in a timely manner. Without access to a wholesaler within close proximity to the pharmacy, service levels are unlikely to be maintained.

77. In light of the above factors, several pharmacies, and [ ], consider that the relevant regional markets are more narrowly defined than those employed in the Stevens/CPL decision. Under their definition, the markets would be based on narrowly defined regions (eg Auckland, Waikato, Manawatu, Wellington, etc).

78. The Commission has considered the views expressed above. It also carried out a limited survey of pharmacies in the greater Wellington region, in part to assist in determining the relevant geographic markets. On the basis of the information collected, the Commission found that:

- the majority of pharmacies order the bulk of their orders for prescription pharmaceuticals overnight for next day delivery. For some, this is because of the practicality of administering a single delivery a day, while in the case of Zuellig's customers, they also face financial incentives which encourage them to employ such buying practices;

- the indications are that many pharmacies could operate on one overnight delivery and one same-day delivery, although customer expectations in the metropolitan areas may lead to a higher demand for same-day deliveries;

- there are no major impediments (including freight costs), to limit the movement of pharmaceuticals within the North and South Islands, and in the case of overnight deliveries, between the North and South Islands;

- pharmacies can achieve compliance with the specifications in the pharmacy contracts without difficulty, generally from their own stocks; and

- while pharmacists are unable to anticipate demand fully, and it is impractical for them to carry the full range of stock, efficient inventory management practices appear to mitigate the effects. In those situations where the pharmacist runs out of stock, and there is an urgent demand for that item, an alternative source of supply can generally be found (eg obtaining the item from a nearby pharmacy).

79. The Commission concludes that, if it were not for the requirement for same-day delivery services to meet urgent situations, it may have defined the markets more broadly than those adopted in the Stevens/CPL decision. However, having regard to the factors identified above, and the current supply patterns of wholesalers, the Commission proposes for the purpose of this report to adopt the same geographic markets as it employed in the Stevens/CPL decision, ie upper North Island, lower North Island and the South Island. While it is difficult to divide the North Island into two geographic markets, the Commission proposes to use Taupo as the demarcation point.

The Pharmaceutical Distribution Market

80. For the reasons explained above, the distribution of prescription and OTC pharmaceuticals is considered by the Commission to fall into a separate functional market to that of wholesaling.

81. The various market participants undertake the distribution of pharmaceuticals on a New Zealand–wide basis. Accordingly, the Commission considers that a national market is appropriate to analyse the consequences of the proposed acquisition.

The Market for Organisational Services to Banner Groups

82. The provision of organisational services to retail pharmacies was considered by the Commission in its Sigma/Amcal decision (Decision 350). The Commission noted in Decision 350 that the exact services, which are available, would depend on the rules of the group. The services which may be provided to banner group members include the benefits of group marketing, access to more favourable buying terms than those available to independent firms, the acquisition of the banner group's "image", and access to support services such as training, information technology systems, design and store fit-out.

83. Banner groups may operate nationally, as *Amcal* and *Unichem* do, or they could operate in a more limited geographic region. However, even if a banner group chose the latter course, there would be no reason why it could not later extend its coverage. A New Zealand-wide geographic market therefore appears appropriate.

Conclusion on Market Definition

84. The Commission considers that the following markets are relevant for the purpose of analysing the competition implications of the proposed acquisition:

- the market for the wholesaling of prescription and OTC pharmaceutical products in the upper North Island ("the upper North Island pharmaceutical wholesaling market");

- the market for the wholesaling of prescription and OTC pharmaceutical products in the lower North Island ("the lower North Island pharmaceutical wholesaling market");

- the market for the wholesaling of prescription and OTC pharmaceutical products in the South Island ("the South Island pharmaceutical wholesaling market");

- the national market for the distribution of prescription and OTC pharmaceutical products ("the national pharmaceutical distribution market"); and

- the national market for the provision of organisational services to retail pharmacies ("the national organisational services market").

COMPETITION ANALYSIS

Introduction

85. Section 47(1) of the Commerce Act prohibits certain business acquisitions:

> "No person shall acquire assets of a business or shares if, as a result of the acquisition, -
>
> That person or another person would be, or would be likely to be, in a dominant position in a market; or
>
> That person's or another person's dominant position in a market would be, or would be likely to be, strengthened."

86. Section 3(9) of the Commerce Act states:

> "For the purposes of sections 47 and 48 of this Act, a person has … a dominant position in a market if that person as a supplier … of goods and services, is or are in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in that market and for the purposes of determining whether a person is … in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in a market regard shall be had to-
>
> (a) The share of the market, the technical knowledge, the access to materials or capital of that person or those persons:
>
> (b) The extent to which that person is … constrained by the conduct of competitors or potential competitors in that market:
>
> (c) The extent to which that person is … constrained by the conduct of suppliers or acquirers of goods or services in that market."

87. The test for dominance has been considered by the High Court. McGechan J stated:[3]

> "The test for 'dominance' is not a matter of prevailing economic theory, to be identified outside the statute."
>
> …
>
> "Dominance includes a qualitative assessment of market power. It involves more than 'high' market power; more than mere ability to behave 'largely' independently of competitors; and more than power to effect 'appreciable' changes in terms of trading. It involves a *high degree of market control*."

88. Both McGechan J and the Court of Appeal, which approved this test,[4] stated that a lower standard than "a high degree of market control" was unacceptable.[5] The Commission has acknowledged this test:[6]

> "A person is in a dominant position in a market when it is in a position to exercise a high degree of market control. A person in a dominant position will be able to set prices or conditions without significant constraint by competitor or customer reaction."

89. The Commission's *Business Acquisitions Guidelines* state:

> "A person is in a dominant position in a market when it is in a position to exercise a high degree of market control. A person in a dominant position will be able to set prices or conditions without significant constraint by competitor {or} customer reaction."
>
> …

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[3] *Commerce Commission v Port Nelson Ltd* (1995) 5 NZBLC 103,762 103,787 (HC)
[4] *Commerce Commission v Port Nelson Ltd* (1996) 5 NZBLC 104,142 104,161 (CA)
[5] *Commerce Commission v Port Nelson Ltd* (1995) 5 NZBLC 103,762 103,787 (HC)
and *Commerce Commission v Port Nelson Ltd* (1996) 5 NZBLC 104,142 104,161 (CA)
[6] *Business Acquisition Guidelines*, Section 7

> "A person in a dominant position will be able to initiate and maintain an appreciable increase in price or reduction in supply, quality or degree of innovation, without suffering an adverse impact on profitability in the short term or long term. The Commission notes that it is not necessary to believe that a person will act in such a manner to establish that it is in a dominant position, it is sufficient for it to have that ability." (p21)

90. The role of the Commission in respect of an application for clearance of a business acquisition is prescribed by the Commerce Act. Where the Commission is satisfied that the proposed acquisition would not result, or would not be likely to result, in an acquisition or strengthening of a dominant position in a market, the Commission must give a clearance. Where the Commission is not satisfied, clearance is declined.

91. In the following sections, the Commission analyses the competition issues relevant to the proposed acquisition. Although the proposal involves the amalgamation of two existing vertically integrated operations, the principal concerns relate to the horizontal aggregation resulting from the merger of the wholesaling operations of the parties.

Dominance Assessment in the Upper North Island Pharmaceutical Wholesaling Market

Market Concentration

92. An examination of concentration in a market often provides a useful starting point of whether a merged firm may or may not be constrained by others participating in the market, and thus the extent to which it may be able to exercise market power.

93. The *Business Acquisitions Guidelines* specify certain "safe harbours" which can be used to assess the likely impact of a merger in terms of s 47 of the Act-

> "In the Commission's view, a dominant position in a market is generally unlikely to be created or strengthened where, after the proposed acquisition, either of the following situations exist:
>
> - the merged entity (including any interconnected or associated persons) has less than in the order of a 40% share of the relevant market;
> - the merged entity (including any interconnected or associated persons) has less than in the order of a 60% share of the relevant market and faces competition from at least one other market participant having no less than in the order of a 15% market share." (p 17)

94. These safe harbours recognise that both absolute levels of market share, and the distribution of market shares between the merged firm and its rivals, is relevant in considering the extent to which the rivals are able to provide a constraint over the merged firm. The Commission went on to state (at page 17) that:

> "Except in unusual circumstances, the Commission will not seek to intervene in business acquisitions which, given appropriate delineation of the relevant market and measurement of shares, fall within these safe harbours."

95. Although, in general, the higher the market share held by the merged firm, the greater the probability that dominance will be acquired or strengthened (as proscribed by section 47 of the Act), market share alone is not sufficient to establish a dominant position in a market. Other factors intrinsic to the market structure, such as the extent of rivalry within the market and constraints provided through market entry, also typically need to be considered and assessed.

96. The applicant has provided national market share based on data from IMS Health (NZ) Limited ("IMS Health"). IMS collates independent market share data for the pharmaceutical industry worldwide, including wholesale pharmaceutical sales in New Zealand. On the basis of IMS Health market share information (including IMS Health's regional sales data), together with that provided by the market participants themselves, the Commission has determined the respective market shares of participants involved in the upper North Island pharmaceutical wholesaling market. Because most wholesalers operate across different regions in the North Island, it has been difficult to provide any precise market share information. For the purpose of the analysis, all of PWL BOP's sales have been included in the upper North Island market.

97. The market share figures identified in this market are provided in Table 1 below:

Table 1
Market Shares in the Upper North Island Pharmaceutical Wholesaling Market

	Estimated Revenue ($m) Year ended 31/10/00)	Market Share (%)
Zuellig	[ ]	[ ]
Sigma NZ	[ ]	[ ]
Combined Entity	[ ]	[ ]
PWL BOP	[ ]	[ ]
HSL	[ ]	[ ]
Direct Sales	[ ]	[ ]
Total	[ ]	100

98. The figures provided above indicate that the combined Zuellig/Sigma NZ would have a market share of around [ ]. PWL BOP, with a market share of around [ ], and HSL, with a market share of around [ ], would be the other significant market participants. Direct sales from various pharmaceutical suppliers would account for the remaining [ ] of sales. In addition, CDC and PWL Central supply some pharmaceuticals into Auckland, but the amounts are only relatively minor.

99. On the basis of the above figures, the market share of the combined entity would fall [ ] within the Commission's "safe harbours". However, additional factors must also be considered before a conclusion on dominance is reached. These other factors are discussed below.

Constraint from Existing Competitors

100. The Commission notes that, aside from the parties to the acquisition, there are two wholesalers currently participating in the relevant market.

101. PWL BOP currently supplies a full range of prescription and OTC pharmaceuticals, primarily to retail pharmacies in the Waikato/Bay of Plenty regions. Also, the company currently supplies [ ] retail pharmacies in the greater Auckland area, and has customers in Whangarei, Gisborne, and the Thames/Coromandel Peninsula area. The company can generally provide overnight and same-day deliveries into Auckland.

PWL BOP can only service areas such as Northland, which are distant from its warehouse, on an overnight basis.

102. [ ]

103. Some parties have questioned the ability of co-operative wholesalers, such as PWL BOP, to expand because of their ownership structure. In particular, those parties claim that co-operative companies lack the capital to readily or rapidly expand their operations. However, the Commission has been advised that co-operatives could secure finance by borrowing, and while their ownership structure might limit, to some degree, the rate at which they could expand, the Commission does not view that as a major deterrent. Indeed, the presence of scale economies in the wholesaling of pharmaceuticals and the relatively low wholesale margins may encourage such companies to further develop their customer base, thereby improving their overall financial performance, and realising benefits to both new and existing members. The Commission notes that PWL BOP has developed from a small base of 20 members at its formation in 1978, to become the fourth largest pharmaceutical wholesaler nationally, with over [ ] members, and with a projected turnover of more than $[ ]m in the 2000/2001 year. So far, a lack of capital does not appear to have constrained its growth.

104. HSL, which is currently 50% owned each by Ebos, and a company representing the Auckland and Waitemata DHBs, is currently supplying about [ ] lines of prescription and OTC pharmaceutical products to about [ ] retail pharmacies (including a hospital-operated pharmacy) in the Auckland area. The company operates one warehouse in Auckland, and so far its activities have focused primarily on supplying hospital contracts in the North Island.

105. [ ]

106. Some parties spoken to by the Commission questioned the effectiveness of HSL because of its ownership structure, the fact that it only supplies a relatively limited range of products, and because its computer systems may not be as efficient as the other major wholesalers. However, HSL contends that it has undertaken a gradual growth path, which has involved targeting specific customers, and that its systems are adequate. As noted above, this strategy has led to the company securing about [ ] retail pharmacy clients.

107. In addition to the above market participants, the Commission notes that pharmacies are supplied directly by suppliers, including Douglas, Pacific and Roche. Delivery is

organised either through a distributor, a wholesaler, or through a retail pharmacy holding a wholesale licence. This method of supply is normally restricted to minimum purchase levels, and is generally confined to OTC lines, as suppliers are neither equipped nor interested in handling numerous accounts. For these reasons, the Commission considers that direct supply would provide only a limited constraint on the combined entity.

Conclusion on Constraint from Existing Competitors

108. The Commission considers that were the combined entity to raise its prices, or reduce its output or service quality, then PWL BOP and HSL could readily expand their existing market position, thereby providing an effective constraint on the combined entity. PWL BOP is capable of offering overnight services, and in some cases, a same-day service, in the upper North Island, while HSL currently offers same–day delivery in the Auckland area, and overnight delivery outside Auckland. The Commission also considers that various pharmaceutical companies supplying pharmacies on a direct basis would provide some additional constraint on the combined entity.

Constraint by Potential Competitors

109. In the Commission’s view, a business acquisition is unlikely to result in a dominant position in a market if the threat of new entrants acts as a significant constraint on behaviour in that market. An assessment of the nature and extent of that constraint represents a key element of the Commission’s assessment of competition and market dominance. Evaluation of the weight to be given to the possibility of new entry requires assessing the conditions of entry, and identifying any barriers to entry. If these barriers are high in aggregate, the likelihood of new entry is diminished.

110. The Applicant contends that there are no barriers to entry or expansion into the wholesale market. While it accepts that there are some costs in setting up a wholesale facility, it submits that these are not greater and are no different to costs and licensing obligations that fall on incumbents.

111. An assessment of the relevant entry conditions is provided below.

Conditions of Entry

Regulatory

112. As noted above, pharmaceutical wholesalers must obtain a licence from the MOH pursuant to the Medicines Act 1981 (sections 50-55 refer), and the associated regulations. This requires the payment of a $300 fee and the satisfaction of certain qualitative criteria such as the standard and security of premises, the qualifications of staff, recording and documentation procedures. The procedure is very straightforward and can be achieved relatively quickly.

Access to Suitable Premises and Delivery Systems

113. A new entrant would require access to a secure warehouse or appropriate storage facility, which are available for lease. Also, it would be necessary to have access to a delivery system, but that can be carried out by employing a courier company or other logistical company.

Capital Costs

114. The costs involved in establishing a wholesale business are not necessarily high, although such costs are dependent on the nature and range of products that are stocked. For example, the Commission has received information from Orangex that the cost of starting its short-line wholesaling operation was about [ ]. The set up costs for a full-line wholesaler would be substantially greater. In particular, substantial costs are likely to be incurred in the establishment phase, such as purchasing stock and developing the necessary infrastructure (eg computer systems to manage stock and refrigeration plant).

Access to Product

115. In the notice, the Applicant states that in terms of access to supply agreements, exclusive dealing arrangements are prohibited for pharmaceutical wholesalers in terms of the Pharmacy Act. Accordingly, it argues that access to suppliers is not an issue, as it is available on equal terms to all entrants. However, comments received from a number of parties, including [ ], indicate that a new entrant may experience difficulties in securing supplies because of the lack of a track record (including credit) and reputation. So far, [ ] has only been able to secure supply arrangements from [ ] smaller suppliers, and it has experienced difficulties in securing supplies which are not cash on delivery from the major pharmaceutical companies.

Economies of Scale

116. The Applicant (and other parties) has noted that the wholesaling of pharmaceuticals is characterised by scale economies and relatively low margins. Thus, maximising sales revenue is important as it enables the company's fixed costs to be spread more thinly, resulting in average cost falling. The requirement for economies of scale are not as significant for short-line wholesalers, who carry a smaller and less diverse range of pharmaceuticals, and who do not require the same initial outlay as full-line wholesalers.

History of New Entry

117. The Commission notes that there are few examples of new entry into pharmaceutical wholesaling over recent years. The major form of entry has been by acquisition as illustrated by Sigma NZ. Low margins have been identified as a major contributory factor. Recently, Orangex has opened a small wholesaling operation in Auckland, but it carries only a limited range of pharmaceutical lines.

Assessment of Constraint from Potential Competitors

118. The Commission's approach to the evaluation of the potential threat of market entry as a constraint on the exercise of market power is based on the "*lets*" test, in conjunction with the preceding assessment of entry conditions. Under this test, to constitute a

sufficient constraint such that the acquisition or strengthening of dominance would be unlikely, entry must satisfy all four of the following criteria: it must be *l*ikely, sufficient in *e*xtent, *t*imely and *s*ustainable.[7] Each of these criteria is assessed below.

Likelihood of Entry

119. In order to be an effective constraint on incumbent market operators, entry must be likely in commercial terms. That is, there has to be a "reasonable prospect of achieving a satisfactory return on … investment".[8]

120. The Commission considers that entry as a full-line wholesaler is unlikely to be feasible in commercial terms, at least in the short term. The low wholesale margins in the current regulatory environment, high infrastructure costs and a requirement for scale economies, are likely to provide a major disincentive to entry. This is reflected in the absence of any significant new entrants into pharmaceutical wholesaling over the last decade.

121. The Commission considers that entry into the relevant market is more likely to occur on a relatively small scale. For example, a new entrant might set up initially as a short-line wholesaler, and once it was established, steadily expand to become a full-line wholesaler.

122. For these reasons, the Commission concludes that the likelihood criterion in the "lets" test is unlikely to be satisfied, in the event that the combined entity were to attempt to raise prices.

Extent of Entry

123. If entry is to constrain an otherwise dominant firm, then entry must potentially be at a scale and spread of operations as to impact significantly on its behaviour.

124. The Commission considers that entry, if it were to occur, may only be feasible initially only on a relatively limited scale. Once a new wholesaler became established, and its reputation developed, it could then expand its business for only a relatively low additional outlay. The Commission, therefore, concludes that the "extent" criterion may be satisfied, depending on the expansion of any new entrant.

Timeliness of Entry

125. To constrain effectively the exercise of market power to the extent necessary to alleviate concerns about market dominance, entry must be likely to occur before consumers in the relevant market are detrimentally affected to a significant extent.[9] The Commission has said that the relevant time frame has to be considered on a case-by-case basis, but that "for most markets, entry which cannot be achieved within two years from initial planning is unlikely to be sufficiently timely to alleviate concerns about market dominance".[10]

126. On the basis of the available information, the Commission considers that entry could be effected on a modest scale within about six months. That represents the

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[7] *Ibid,* pp. 19-20.
[8] *Ibid,* p. 19.
[9] *Ibid.* p.19.
[10] *Ibid.* p.20.

approximate time period in which [ ] set up its operations. Although, entry on a larger scale may require extra time, this is likely to be achieved within the Commission's two-year time frame for consideration of timeliness. The Commission concludes, therefore, that the "timeliness" criterion is likely to be met.

Sustainability of Entry

127. Entry is likely only if there is likely to be a lasting economic incentive to enter the market.[11]

128. In the absence of successful entry over the last 10 years, it is difficult to ascertain whether or not entry would be sustainable. The available information suggests that entry is unlikely to be sustainable over the longer term. For these reasons, the Commission concludes that the "sustainability" criterion is unlikely to be satisfied.

Conclusion on Constraint from Potential Competitors

129. The Commission concludes that entry into the relevant market is likely to satisfy the "timeliness" criterion, and may satisfy the "extent" criterion, but not the "likely", and "sustainability" criteria. Accordingly, entry is considered unlikely to effectively constrain the combined entity. The Commission is satisfied, however, that the combined entity would face effective constraint from parties such as PWL BOP and HSL.

Countervailing Power

130. As noted previously, the pricing of pharmaceuticals is determined largely by Government policies, and those policies ultimately impact on pharmaceutical wholesalers when setting their prices. The retail price of prescription pharmaceuticals is based on the fixed level reimbursement levels, which are set in terms of the contracts between the MOH and retail pharmacies. The payment is based on a dispensing fee, and a margin over manufacturers' costs to cover the cost of procuring and holding stock. In the North Island, this margin is 3.5%, while in the South Island the figure is 5%.

131. The overall effect of the practices of the MOH has been to set a benchmark for Zuellig and other wholesalers. However, some parties note that the terms and conditions of trade, the volumes purchased, and various other commercial factors influence the wholesale margin. A wholesale margin in excess of 3.5% for a North Island pharmacy has to be met out of the dispensing fee, or from profits on OTC items.

132. The pricing behaviour of wholesalers is also affected by the policies of PHARMAC. These policies effectively constrain the price manufacturers/suppliers can charge on their products, and has had a major impact on driving down the cost of prescription pharmaceuticals, in some cases by 60-70%. This in turn has had a major impact on pricing behaviour at the wholesale level, which has seen discounts based on volume of business and other terms of trade.

133. The wholesale margin for OTC products is not constrained to any significant extent by regulatory agencies, as only a very small number of OTC products are subsidised. The pricing of OTC lines is, however, constrained by competitive forces, including the

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[11] *Ibid.* p.20

availability of many OTC products from a range of suppliers and through various retail outlets.

134. The Commission concludes that the Government's regulatory policies would provide a significant constraint on the pricing behaviour of the combined entity. Any scope the combined entity would have to raise its wholesale margins post–acquisition would be sufficiently constrained by other market participants.

Conclusion on Dominance

135. The acquisition would result in aggregation of market share with Zuellig increasing its market share to [ ] inside the Commission's second "safe harbour". However, the Commission considers that the combined entity is likely to continue to face effective competition from other existing operators. Further, the constraints from regulatory agencies are also likely to exercise an effective discipline on the combined entity, while some degree of constraint would be provided by direct sales, and from competitors expanding into the relevant market.

136. For these reasons, the Commission is satisfied that implementation of the proposed acquisition would not result, and would not be likely to result in any person acquiring or strengthening a dominant position in the upper North Island pharmaceutical wholesaling market.

Dominance Assessment in the Lower North Island Pharmaceutical Wholesaling Market

Market Concentration

137. The Commission has estimated market shares based on data provided by IMS Health (including IMS Health's regional market share data), together with information provided by market participants. For the purpose of the analysis, all of PWL Central's wholesale revenue has been attributed to the lower North Island.

138. The market shares identified in this market are provided in Table 2.

Table 2
Market Shares in the Lower North Island Wholesaling Market

Operator	Estimated Revenue ($m) (Year ended 31/10/00)	Market Share (%)
Zuellig	[ ]	[ ]
Sigma NZ	[ ]	[ ]
Combined Entity	[ ]	[ ]
PWL Central	[ ]	[ ]
Direct Sales	[ ]	[ ]
Total	[ ]	100

139. On the basis of the above estimates, the combined Zuellig/Sigma NZ would hold a market share of about [ ]. PWL Central, with a market share of around [ ], would be the only other significant participant. Direct sales from pharmaceutical suppliers would account for around a [ ] market share.

140. From this data, the combined entity's market share falls outside the Commission's "safe harbours" (refer paragraph 93). However, the fact that a proposed acquisition may lead to a market share falling outside these "safe harbours" does not necessarily mean that it will be likely to result in the acquisition or strengthening of a dominant position in a market. Additional factors must also be considered before a conclusion on dominance is reached. These other factors are discussed below.

Constraint from Existing Competitors

141. As indicated in Table 2, apart from the parties to the proposal, the only other company currently participating in the relevant market to any significant degree is PWL Central. PWL Central is a co-operative company, which has been operating since 1978. Last year, it acquired the Wanganui-based Medi-Group Wholesalers. PWL Central currently supplies a comprehensive range of prescription and OTC products to retail pharmacies and hospitals throughout the central North Island from warehouses in New Plymouth, Wanganui and Hastings. Currently, it does not supply any customers in the greater Wellington area.

142. [

]

143. [

]

144. To join PWL Central would involve a new member paying a deposit of [ ], and subscribing up to [ ] of shares. New members could pay for their shares over a three-year period by a deduction from their annual rebates. Membership of the company would entitle a pharmacist to a dividend, to a residual rebate, and to the full benefits of the company's terms of trade. To resign from PWL Central would require formal notice. PWL Central advised that, under normal circumstances, the process could be completed within six months. It would involve PWL Central buying back a member's shares in accordance with the provisions of the Companies Act 1993 and the Co-operative Companies Act 1996. The relevant legislation allows the company to buy back up to 20% of its share capital.

145. As noted above, some parties have questioned the capacity of co-operatives, such as PWL Central to expand rapidly, and to provide effective competition due to their co-operative ownership structure. However, for the reasons outlined above, the Commission does not consider that co-operative ownership would necessarily provide a major impediment to growth, although it might affect the rate of expansion. [ ]

146. Several pharmacists in the Wellington area, and particularly those with past experience as co-operative members, advised the Commission that they would be prepared to join a co-operative, although they added that they would evaluate the decision to join with the total package offered by the co-operative, including the terms and conditions of trade. Some pharmacists, however, expressed a reluctance to join a co-operative because it would involve investing in a pharmaceutical wholesaler from whom they purchase the product, while a few expressed concern about the ease with which shares in a co-operative could be sold, if they decided to exit.

147. The Commission has also received indications that, were the combined entity to raise its prices, or reduce its discounts, even marginally, retail pharmacies would begin looking for an alternative source of supply. In many instances, pharmacies were able to identify the supplier to whom they might switch. The Commission notes that following implementation of the Stevens/CPL acquisition in 1993, many of the customers of the merged company switched to an alternative supplier, resulting in a significant reduction in the company's national market share.

148. Apart from PWL Central, other potential suppliers into the relevant market include PWL BOP (Tauranga) and CDC (Christchurch), both of which could supply retail pharmacies in the lower North Island with deliveries overnight. As noted above, transport costs are not considered significant for overnight deliveries. Most wholesalers charge a small handling fee for small orders, but freight costs are often absorbed for large orders. Some Wellington-based pharmacists told the Commission that they had considered sourcing from PWL BOP or CDC in the past, [ ]

149. The Commission notes that the direct supply of pharmaceuticals occurs in the relevant market, although on a much smaller scale to that of the upper North Island. The Commission, therefore, considers direct sales would provide only a limited constraint on the combined entity in this market.

Conclusion on Constraint from Existing Competitors

150. The Commission considers that the combined entity would be constrained by the ability of the existing competitor, PWL Central, to increase its share in this market. PWL Central could provide overnight and same-day deliveries throughout the lower North Island, and the Commission considers that it could expand quite rapidly [ ]

Constraint from Potential Competitors

151. The review of entry/expansion conditions, and the “lets” test contained in paragraphs 112-129, is relevant to the consideration of this market.

152. Entry, or expansion into the lower North Island market is likely to be achieved in a similar manner to that described in the upper North Island market. Entry on a modest scale is likely through the establishment of a short-line wholesaling operation. Entry as a full line wholesaler appears less likely. The Commission considers that an existing wholesaler, such as PWL Central could expand its existing market presence, thereby providing a constraint on the combined entity. Alternatively, entry could be achieved by a party such as PWL BOP or CDC expanding into this market.

Countervailing Power

153. The Commission analysed the countervailing power of Government regulatory agencies in paragraphs 130-134. The Commission concludes that, for the same reasons given in the earlier section, that the countervailing power from the relevant regulatory agencies would provide a significant constraint on the combined entity in the lower North Island pharmaceutical wholesaling market.

Conclusion on Dominance in the Lower North Island Pharmaceutical Wholesaling Market

154. Implementation of the proposed acquisition would result in the combined entity increasing its market share to a level which places it outside the Commission’s “safe harbours”. However, the Commission concludes that effective competition is likely to be provided by PWL Central, which has a market share of around [ ]. In addition, there is scope for PWL Central to readily expand its market share, while the barriers to expansion do not appear such as to prevent parties such as PWL BOP and CDC, from extending their existing operations into the market. In addition, the Commission considers that the countervailing power of Government agencies would sufficiently constrain the pricing behaviour of the combined entity.

155. For these reasons, the Commission is satisfied that implementation of the proposed acquisition would not result, or would not be likely to result in any person acquiring or strengthening a dominant position in the lower North Island pharmaceutical wholesaling market.

Dominance Assessment in the South Island Pharmaceutical Wholesaling Market

156. The proposed acquisition would result in some aggregation of market share in the South Island pharmaceutical wholesaling market, with the combined entity increasing

its market share to around [ ]. That figure falls within the Commission's "safe harbours" (refer paragraph 93).

157. The combined Zuellig/Sigma NZ would face effective competition in this market from one other significant participant, CDC, which has a market share of about [ ]. In addition, the scope for expansion and the countervailing power provided by Government regulatory agencies is likely to effectively constrain the conduct of the combined entity.

Conclusion on Dominance

158. Having regard to the above factors, the Commission is satisfied that the acquisition would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position in the South Island pharmaceutical wholesaling market.

Dominance Assessment in the National Pharmaceutical Distribution Market

159. Zuellig and Sigma NZ are both involved in the distribution of prescription and OTC pharmaceutical products on a national basis. On the basis of available information, the Commission estimates that the combined entity would account for around a [ ] share of the relevant market. It would face significant competition from other logistics businesses, including Total Logistics Company Limited (TLC), which is the largest distributor in this market with an estimated share of around [ ].

160. The distribution of pharmaceuticals is a logistics/supplies business, which is generally undertaken on an exclusive basis, usually for a period of up to three years. Distributors act on behalf of suppliers, and have limited discretion in terms of the marketing and selling of the products. A significant term of these agreements is that distributors must make the products available to all wholesalers and other customers.

Conclusion on Dominance

161. The Commission concludes that the acquisition would result in some aggregation of market share, but the market shares would fall within the Commission's "safe harbours". Further, the combined entity would face sufficient constraint from other participants, including TLC. Accordingly, the Commission is satisfied that no dominance concerns arise in the national pharmaceutical distribution market.

Dominance Assessment in the National Organisational Services Market

Overview

162. As noted above, Zuellig has a 40% interest in Unichem Chemists, which in turn operates the *Unichem/Dispensary First* banner groups. The company also has an interest in Procare Pharmacy Ltd, and owns a 100% interest in the *Vantage* buying group. Sigma NZ is involved in the *Amcal, Guardian,* and *Pharmacycare* banner groups, and the *PPS* buying group. All banner and buying groups provide various marketing and other support services to their members, who comprise individual retail pharmacies.

163. Neither Zuellig nor Sigma NZ is involved in the ownership of any retail pharmacy businesses, which is prohibited under the Pharmacy Act. The Applicant advises that its interests in banner groups entitle it to hold intellectual property in the name, and to assist in the co-ordination of the banner groups' activities.

164. The Applicant states that its interest in the banner groups is a form of relationship building with retail pharmacies. On the basis of enquiries carried out by the Commission, the major advantages of banner groups as perceived by pharmacies are to obtain access to marketing services and a brand image. In addition, obtaining collective buying strength, access to information technology systems, and various other support services have been identified as reasons for joining a banner group.

165. There are generally no major restrictions to pharmacies joining any of the major banner groups. Most groups, however, apply territorial restrictions. This means that new members cannot have premises in close proximity to those of an existing member, or alternatively, there may be limits on the number of premises trading under the banner group in a specific area, based on population numbers.

166. The major financial expenditure incurred by pharmacies when joining a banner group involve the fit-out costs (including signage, uniforms etc), and subscription fees. The fit-out costs depend on the nature of the banner group, but it has been indicated that these may vary between about $100,000 and $500,000.

167. The ongoing costs of belonging to a banner group vary depending on the range of services provided. The fees for belonging to a retail banner group consist largely of an annual subscription. This varies depending on the range of services that are undertaken. For example, *Pharmacycare* members pay [ ] annually, *Guardian* members pay [ ] annually, and *Amcal* members pay on average [ ] annually. *Unichem* members pay a joining fee of [ ], and an annual subscription of [ ], while members of *Dispensary First* pay a joining fee of [ ], and an annual subscription of [ ]. *Unichem Life* members pay a joining fee of [ ] and an annual subscription based on their sales turnover.

168. There are no major restraints on pharmacies leaving banner groups. For those *Amcal* members who have not signed a contract, which is the situation with around [ ] of members, there is a period of notice on intention to exit, but this is normally waived. The Commission has been advised that there are no major obstacles for those members of the *Unichem* banner group who wish to withdraw.

169. However, in the case of the major banner groups, such as *Unichem* and *Amcal*, which charge higher up-front fees and subscriptions and provide a more comprehensive range of services, the costs of entry and exit may encourage members to take a longer term view before deciding to withdraw from the group.

170. As noted previously, banner group members are not obliged to buy exclusively from the wholesaler affiliated with the group. There is, however, a requirement from some banner groups, including *Amcal* and *Guardian*, to purchase house brands and to participate in a specified number of promotions, but these account only for a minor percentage of sales.

171. The costs of establishing a banner group would vary according to the size and range of services provided. [ ] However, the costs of setting up a smaller banner group or a buying group are likely to be significantly less.

Competition Assessment

172. The acquisition would result in aggregation of market share in the market for the provision of organisational services to retail pharmacies. The services provided by banner groups can be, and are provided by a variety of other organisations, including companies providing general marketing services. There are no major impediments to pharmacies establishing their own banner group. On the basis of available information, it appears that around 75-100 members are needed to develop a "first-tier" banner group such as *Amcal* or *Unichem*. Sigma NZ told Commission staff that, when it set up the *Guardian* banner group, which is a "second–tier" group, it signed on [ ] members after a period of four months.

173. Alternatively, pharmacies may choose to undertake individually the marketing and other services otherwise provided by a banner group themselves. Several larger pharmacies have indicated their preference to undertake their own marketing and other activities carried out by a banner group. Additionally, the membership subscriptions, particularly for the major banner groups, may deter those retail pharmacies from joining unless they have a reasonable-sized turnover (over $1m). The Commission estimates that there are some 600 retail pharmacies that do not currently belong to a retail banner group.

Conclusion on Dominance

174. For the reasons outlined above, the Commission is satisfied that the horizontal aggregation resulting from the acquisition would not give rise to dominance concerns in this market.

OVERALL CONCLUSION

175. The Commission has considered the impact of the proposed acquisition in the following markets:

- the market for the wholesaling of prescription and OTC pharmaceutical products in the upper North Island;
- the market for the wholesaling of prescription and OTC pharmaceutical products in the lower North Island;
- the market for the wholesaling of prescription and OTC pharmaceutical products in the South Island;
- the national market for the distribution of prescription and OTC pharmaceutical products; and

- the national market for the provision of organisational services to retail pharmacies.

176. Having regard to the factors set out in section 3(9) of the Act, and all other relevant factors, the Commission is satisfied that implementation of the proposed acquisition would not result, or would not be likely to result in any person acquiring or strengthening a dominant position in the relevant markets.

DETERMINATION ON NOTICE OF CLEARANCE

177. Accordingly, pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance to Zuellig Pharma Limited, or any interconnected body corporate, to acquire all of the assets of Sigma NZ Limited.

Dated this day of February 2001

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M J Belgrave
Chair