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Statement of Issues

Elanco / Bayer

7 May 2020

Introduction

1. On 14 February 2020, the Commerce Commission registered an application from Elanco Animal Health Inc. (Elanco or the Applicant) seeking clearance to acquire Bayer AG's animal health business (Bayer)[1] (the Proposed Acquisition).[2]

2. This Statement of Issues (Statement) sets out our concerns about the potential competition issues we have identified following our initial investigation so that Elanco and interested parties can provide us with submissions relating to those concerns.

3. In reaching the preliminary views set out in this Statement, we have considered information provided to date by Elanco and other industry participants. We have not yet made any final decisions on the issues outlined below (or any other issues) and our views may change, and new competition issues may arise, as the investigation continues.

The concerns we are testing

4. We are still to conclude on the relevant markets. Our investigation is focusing on the product and wholesale customer dimensions of the markets. At this stage, we are testing whether the Proposed Acquisition would substantially lessen competition due to unilateral effects for manufacture/importation and wholesale supply of products:

   4.1 for the treatment of otitis in dogs;

   4.2 to veterinarians for the treatment of external parasites on sheep;

   4.3 to veterinarians for the prevention of external parasites on sheep;

   4.4 to rural supply merchant stores for the treatment of external parasites on sheep; and

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1 Specifically, Elanco is seeking to acquire up to 100% of the shares of four entities that comprise Bayer Animal Health (namely: Bayer Animal Health GmbH; KVP Pharma+Veterinär Produkte GmbH; Bayer (Sichuan) Animal Health Co., Ltd; and Bayer HealthCare Animal Health Inc.) and the business assets that form Bayer Animal Health.

2 A public version of the Applicant's clearance application is available on our website at: https://comcom.govt.nz/case-register/case-register-entries/elanco-animal-health-inc-bayer-ags-animal-health-business

4.5 to rural supply merchant stores for the prevention of external parasites on sheep.

5. In considering the potential unilateral effects of the Proposed Acquisition in these five markets, we are continuing to test whether the Proposed Acquisition could give the merged entity the ability to profitably raise prices and/or reduce service or quality in the supply of any of the relevant products.

6. In addition, we are still considering whether the Proposed Acquisition would increase the potential for:

6.1 coordinated effects, particularly in the manufacture/importation and wholesale supply of products to veterinarians, and to rural supply merchant stores, for the treatment of external parasites on sheep; and

6.2 conglomerate effects, given the large product portfolios that both Elanco and Bayer currently have across a number of markets.

7. If we identify any further issues during our analysis of the Proposed Acquisition that are not discussed in this Statement, we will update the Applicant and other interested parties through an updated Statement.

Areas of overlap that do not appear to raise competition concerns

8. There are a number of areas of overlap between Elanco and Bayer that do not appear to raise competition concerns because the evidence available to date indicates the merging parties are not close competitors and that the merged entity would be constrained by the presence of a number of existing competitors.

9. At this time, we are not investigating further and do not require any further information from the Applicant or interested parties in respect of the manufacture/importation and wholesale supply of products for the treatment of:

9.1 internal and external parasites in companion animals;

9.2 internal parasites in sheep;

9.3 liver fluke in cattle;

9.4 coccidial conditions in poultry; and

9.5 microbial conditions in ruminant animals.

Process and timeline

10. We have agreed with Elanco an extension of time until 3 June 2020 in which to make a decision.

11. The Commission would like to receive submissions and supporting evidence from the Applicant, Bayer and other interested parties on the issues raised in this Statement. We request responses by close of business on 21 May 2020, including a public

version of any submission. Where relevant, submissions should take into account the potential impact of COVID-19 and the extent to which there might be any immediate or medium-longer term effects on competition.

12. All submissions received will be published on our website with appropriate redactions.[3] All parties will have the opportunity to cross-submit on the public versions of submissions from other parties by close of business on 28 May 2020.

13. The Commission acknowledges that some interested parties may face a range of challenges due to COVID-19. This may impact their ability to submit in a meaningful way within these timeframes. If you would like to make a submission but face difficulties in doing so within the timeframe, please ensure that you register your interest with the Commission at registrar@comcom.govt.nz so that we can work with you to accommodate your needs where possible.

Industry background

14. Elanco and Bayer are two large suppliers of animal healthcare products in New Zealand. The two product areas that are most relevant to our assessment of the Proposed Acquisition are products for the treatment of otitis in dogs and products for the treatment and prevention of external parasites on sheep.

Treatments for otitis in dogs

15. A common condition in dogs is otitis externa (otitis) which is an inflammation of the external ear canal. It is not a disease in itself but rather a symptom of some other diseases, such as parasitic, bacterial or fungal infections. In New Zealand, products to treat otitis in dogs can only be provided with a veterinarian prescription.

16. Most products to treat otitis require an administration of a daily dose of treatment over a number of days. More recently, suppliers such as Elanco and Bayer have introduced (or are in the process of introducing) longer acting treatments that only require one or two applications over a period of days.

Products for the treatment and prevention of external parasites on sheep

17. The two main external parasites that affect sheep in New Zealand are flies (causing flystrike) and lice and there are a variety of animal healthcare products that are commonly used to treat these two parasites.

18. All industry participants interviewed by the Commission emphasised to us that end customers (namely sheep farmers) want to prevent flystrike and/or lice from

[3] Confidential information must be clearly marked (by highlighting the information and enclosing it in square brackets). Submitters must also provide a public version of their submission with confidential material redacted. At the same time, a schedule must be provided which sets out each of the pieces of information over which confidentiality is claimed and the reasons why the information is confidential (preferably with reference to the Official Information Act 1982).

emerging in the first place. To this extent, farmers apply prevention products to provide protection to sheep over a period of time.

19. However, industry participants also advised that even the best prevention plans may not prevent outbreaks or infestations of flystrike or lice from developing. In circumstances where there are outbreaks, we understand that farmers will administer a treatment product (often called a knockdown product) that can treat the outbreak quickly by instantly killing the parasites.[4]

Regulatory requirements for animal health products in New Zealand

20. Prior to any animal healthcare product being distributed in New Zealand, the supplier of the product has to complete two main steps: the necessary research and development; and regulatory approval in accordance with the Agricultural Compounds and Veterinary Medicines Act 1997 (ACVM).[5] Developing and then registering new animal healthcare products can be both lengthy and costly, although the cost and time it takes depends on how novel the product is and the extent to which similar products are already registered in New Zealand.

21. Once a product is registered under the ACVM, it can be legally sold in New Zealand. How the product is sold to end customers depends on whether it can be purchased with or without a prescription.

    21.1 Products to treat otitis in dogs can only be purchased with a prescription and so they are typically purchased from a veterinary clinic under the guidance of the prescribing veterinarian.[6]

    21.2 Products to treat and prevent external parasites on sheep can be purchased over the counter without a prescription and so there are no regulatory limits on where the products can be purchased. End customers typically purchase such products from either a veterinarian or a rural supply merchant store such as PPG Wrightson or Farmlands.

22. When a product is sold, the relevant registrations under the ACVM for the product are included on the product label which also includes a list of indications that the product can be used for. For example, all registrations for products to treat and prevent external parasites on sheep include:

    22.1 the type of parasite it will deter;

    22.2 if it can be used to immediately treat the parasite and/or how long the prevention will typically last for; and

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4 For example, see "Managing flystrike and lice- a practical guide" Sheep and Beef Cattle Veterinarians Branch of the New Zealand Veterinary Association and Beef + Lamb New Zealand (August 2019).

5 See https://www.mpi.govt.nz/processing/agricultural-compounds-and-vet-medicines/acvm-overview/authorisation-of-acvm/

6 Although there may be cases where, once prescribed, an end-customer purchases the treatment from a different vet clinic.

22.3 the type of wool on which it can be used.

The relevant markets

23. We define markets in the way that we consider best isolates the key competition issues that arise from a merger. In many cases this may not require us to precisely define the boundaries of a market. What matters is that we consider all relevant competitive constraints, and the extent of those constraints. For that reason, we also consider products and services that fall outside the market, but which still impose some degree of competitive constraint on the merged entity.

24. Both Elanco and Bayer have large portfolios of animal healthcare products and, as a result, they currently overlap in a number of different product areas. As above, there are a number of areas that do not appear to raise any significant competition issues.

25. However, while we have yet to reach any final views on market definition, there are several areas of overlap that potentially raise competition issues requiring further investigation. There areas are products for:

    25.1 the treatment of otitis in dogs; and

    25.2 the treatment, and prevention, of external parasites on sheep.

Our preliminary assessment of the relevant product markets – otitis treatments for dogs

26. We are considering whether there might be separate product markets for daily dose otitis treatments and long acting otitis treatments.

27. Elanco considers there is a product market for all types of treatments for otitis in dogs, given the similar characteristics of the existing otitis products and their application methods.[7]

28. We understand that until last year, all products used for treating otitis were required to be administered daily (or multiple times per day). In 2019, Elanco introduced Osurnia, which is the first long acting treatment to be used for otitis in New Zealand. Our industry enquiries to date indicate that Osurnia's launch has been successful and it is currently one of the main products used to treat otitis.

29. In addition, Bayer supplies a long acting treatment called Neptra in the United States and Europe and is anticipating introducing the same product to New Zealand in the near future, once the required registrations have been obtained.[8]

30. Several veterinary clinics advised us that daily dose and long acting treatments are alternatives for one another because they have the same therapeutic indication, the

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7 Clearance application from Elanco (14 February 2020).

8 Clearance application from Elanco (14 February 2020).

treatment of otitis. In this respect, the choice of application (or application rate) depends on the symptoms and circumstances of the afflicted dog.[9]

31. There are currently a number of suppliers of daily dose treatments and there would be no aggregation between Elanco and Bayer for these treatments. However, the Proposed Acquisition would bring about aggregation in the supply of long acting products for otitis in New Zealand.

32. At this stage, while we have not reached any final view on the relevant product market, we are considering the application based on the Applicant's view that there is a product market that includes all products for the treatment of otitis in dogs.

33. However, we are also considering whether the likely competitive effects of the Proposed Acquisition may be different if we focused on the narrowest product market, which would be long acting otitis treatments for dogs. To this extent, we are continuing to assess the impact of Elanco's recent introduction of Osurnia on the demand for daily dose products and the impact that price and convenience have on the end-customer's choice of product.

Our preliminary assessment of the relevant product markets – products for external parasites on sheep

34. While we have yet to reach any final views on the relevant product markets, we consider it may be appropriate to assess external parasite treatment products used on sheep separately from prevention-only products, given the difference in indications and use and because only certain products are indicated for immediate treatment (or knockdown).

35. Elanco considers that products used on external parasites on sheep[10] are differentiated products, which means that there is no bright line that separates particular products from others.[11] We agree with the Applicant that many of the characteristics of these products are not sufficiently different to place them in discrete markets. However, we do not agree that this relates to all the different characteristics.

36. At this stage, based on information from the Applicant and some other industry participants, we do not consider it necessary to delineate products for use on external parasites on sheep by the following characteristics:

    36.1 pharmaceutical molecule or active ingredient – the products for use on external parasites on sheep currently supplied in New Zealand contain a number of different active ingredients that fall into different chemical groups and/or chemical classes but all have similar purposes from the perspective of

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9 Commerce Commission interview [ ] (22 April 2020); and email from [ ] to the Commerce Commission (4 May 2020).

10 The products for use on external parasites on sheep supplied by Elanco and Bayer (and all the other existing suppliers) are only registered and indicated for use on sheep and so cannot be used on other animals.

11 Clearance application from Elanco (14 February 2020).

the end user (ie, sheep farmers) and we understand that farmers can and do switch between different chemical groups and active ingredients;

36.2 parasite(s) that the products are used to target – the products for use on external parasites on sheep are used to treat, prevent and control flystrike and lice and narrowing our assessment to focus on products targeting one specific parasite does not appear to impact on our competition assessment. Most suppliers currently supply a range of narrow (ie, flystrike only) and broad spectrum (ie, combination flystrike and lice) products and the competitive constraints on the merged entity would be the same whether we look separately at combination products, fly-only products or lice-only products.

36.3 application method – there are two common application methods for products for use on external parasites on sheep with each method having certain advantages and disadvantages. These are the jetting or saturation method (which involves saturating the sheep in a shower or bath with a dip wash), or the pour-on/spray-on method (which involves a low volume of product being applied by a hand-held applicator). Most suppliers supply their products in both application methods.

Products used and indicated for treatment appear to be separate from those for prevention

37. On the information available to us to date, it appears that we should define separate product markets depending on whether a product is used to either treat or prevent external parasites on sheep.

38. The Applicant submitted that treatment products are combination products (with indications for prevention) and so there are no pure treatment products.[12] Because they are combination products, the Applicant considers that treatment products should be assessed together with prevention products as the pricing of treatment products would be constrained by prevention products. In particular, the Applicant noted that:

38.1 there are significantly more prevention-only products than combination treatment/prevention products and Elanco's combination products predominantly compete with prevention products;

38.2 sales of treatment products are dependent on ensuring they are priced competitively compared with numerous prevention products; and

38.3 the profitability of combination products is contingent on ensuring that they continue to be sold in substantial volumes to farmers seeking to prevent external parasites.

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12 Submission from Elanco to the Commerce Commission (31 March 2020).

39. All external parasite products are indicated for prevention. However, we understand that, as per the ACVM indications, there are only a few external parasite products that can be used for the immediate treatment (or knockdown) of flystrike or a lice infestation.[13]

40. In differentiated markets, as appears to be the case with external parasite products on sheep, some products will be closer substitutes and compete more vigorously with each other than with other products. In these types of markets, what matters is that we consider all relevant competitive constraints, and the extent of those constraints.

41. Industry participants advised that treatment (or knockdown) products are used in a very different manner and have a different purpose than those products used as part of a prevention plan.[14] In general, treatment products will only be required when a farmer needs to urgently treat sheep that already have external parasites.

42. With different uses and purposes, it appears that it may be appropriate to assess external parasite treatment products separately from prevention products. For example, it appears that a product only indicated for prevention would not be a close substitute when a farmer is requiring a treatment product. As such, if the price of treatment products increased then a farmer will not switch to a prevention-only product.

43. In addition, a number of industry participants advised us the range of product options available for farmers is also different, with there being a larger number of prevention products (and suppliers).[15] One of the reasons for this is that some active ingredients used in prevention products are designed to regulate the growth of the parasite over its life cycle rather than to kill it immediately.[16] This suggests that, in the face of a price increase for treatment products, some suppliers producing certain prevention products may have a limited ability to easily switch to producing a treatment product using their existing resources.

44. We are continuing to assess the extent to which the product indication, and potential use, impacts on a farmer's alternatives and any related competitive constraints. While we have yet to reach any final views on the relevant product markets, we consider it may be appropriate to assess external parasite treatment products separately from prevention-only products, given the difference in indications and use and because only certain products are indicated for immediate treatment (or knockdown).

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13 "Managing flystrike and lice- a practical guide" Sheep and Beef Cattle Veterinarians Branch of the New Zealand Veterinary Association and Beef + Lamb New Zealand (August 2019).

14 Commerce Commission interview with [ ] (28 February 2020); and Commerce Commission interview with [ ] (2 March 2020)

15 Commerce Commission interview with [ ] (20 February 2020); Commerce Commission interview with [ ] (10 March 2020); Commerce Commission interview with [ ] (12 March 2020); and Commerce Commission interview with [ ] (13 March 2020)

16 "Managing flystrike and lice- a practical guide" Sheep and Beef Cattle Veterinarians Branch of the New Zealand Veterinary Association and Beef + Lamb New Zealand (August 2019).

Preliminary assessment on the product markets for external parasite products for sheep

45. While we have yet to reach any final views on the relevant product markets, on the information available to date we are proposing to assess separate product markets for animal healthcare products indicated for:

    45.1 the treatment of external parasites on sheep; and

    45.2 the prevention of external parasites on sheep.

46. We invite submissions on the extent to which products indicated for treatment of external parasites on sheep compare and/or contrast, on both the demand-side and supply-side, with those products indicated for prevention.

Our preliminary assessment of the relevant functional and customer markets

47. While we have yet to reach any final views on the relevant markets, we are considering if it may be appropriate to delineate the wholesale supply of any relevant products by the relevant wholesale customer group.

48. Elanco considers there is a market for the manufacture/importation and wholesale supply of any relevant product and there is no reason to delineate by any particular customer group and/or distribution channel.[17]

Treatments for otitis in dogs

49. We understand that all existing treatments for otitis in dogs are prescription-only products that can only be supplied to end customers by a veterinarian. As such, at the wholesale supply level (and retail level), otitis treatments are supplied through one customer group (or distribution channel), namely through veterinarians.

Treatment and prevention of external parasite products for sheep

50. On the information available to us to date, our preliminary view is that it may be appropriate to take a narrow approach and assess the supply of treatment and prevention external parasite product markets to veterinarians separately from the supply of the same products to rural supply merchant stores. The main reason for taking this approach at this stage is that it appears that the likely competitive effects of the Proposed Acquisition may be different depending on the wholesale customer.

51. The Applicant considers there is no basis to delineate any products supplied to any one particular wholesale customer group (or one particular distribution channel) because all products for use on external parasites on sheep can be purchased from any retailer without a prescription and neither Elanco nor Bayer favours any one retailer or distribution channel over another.[18]

52. If there are differences in the conditions of wholesale supply to particular customer groups, then this could result in different prices and offerings across the different

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17 Clearance application from Elanco (14 February 2020).

18 Clearance application from Elanco (14 February 2020).

groups, either at the wholesale or retail level. If this was the case, then it would be appropriate to define separate markets for the supply to different wholesale customers groups, particularly if farmers cannot switch between the different retailers.

53. At present, treatment and prevention products are supplied to end-customers at the wholesale level through two customer groups and these groups are the immediate customers of Elanco and Bayer. These two groups are:

    53.1 veterinarians; and

    53.2 rural supply merchant stores including firms such as Farmlands and PPG Wrightson.

54. On the demand side, to date we have received mixed evidence on the extent to which farmers switch their purchases of their preferred treatment and prevention products between veterinarians and the rural supply merchant stores and we are continuing to test the level and frequency of switching with industry participants.

55. On the supply side, we understand that, while Elanco and Bayer (and some other suppliers) distribute to both veterinarians and rural supply merchant stores, there are some suppliers who only distribute their products to veterinarians and some others only distribute to the rural supply merchant stores.

56. We are continuing to explore any differences in the conditions of wholesale supply to any particular customer group.

    56.1 The Applicant considers that a supplier's choice of wholesale customer group comes down to the individual preferences of each supplier and there is nothing stopping any supplier from distributing to any customer group.[19]

    56.2 However, a number of industry participants indicated to us that, in addition to a supplier's preference on who it prefers to distribute through, the role of veterinarians in recommending a particular product and the related rebate schemes means there are differences in the conditions for supplying external parasite products for sheep to veterinarians compared to the rural merchant stores.[20]

57. Several industry participants advised that these differences are the reason why there are fewer suppliers distributing to veterinarians and there are more barriers to establishing a market presence with veterinarians than with any rural supply merchant store.[21]

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19 Clearance application from Elanco (14 February 2020).

20 Commerce Commission interview with [ ] (10 March 2020); and Commerce Commission interview with [ ] (12 March 2020);

21 Commerce Commission interview [ ] (17 March 2020); and Commerce Commission interview with [ ] (12 March 2020).

58. However, some suppliers advised us that there are some advantages to supplying through veterinarians because, when their products are used under the supervision of the veterinarian, they tend to be used more effectively and this helps maintain the product's reputation.[22]

59. On the information available to us to date, our preliminary view is that it is appropriate at this stage to take the narrowest approach (as this best identifies the competition concerns), and assess the wholesale supply of treatment and external parasite prevention products for sheep to veterinarians separately from the wholesale supply of the same products to the rural supply merchant stores.

60. We invite submissions on the extent to which there are different customer groups (or distribution channels) for the wholesale supply of products for the treatment and prevention of external parasites for sheep, including any additional information on the extent to which suppliers and farmers can and do switch between the two wholesale customer groups.

Our preliminary assessment of the relevant geographic markets

61. Elanco considers there is a national market for the manufacture/importation and wholesale supply of all the relevant products.[23]

62. We consider that the relevant geographic markets of products for the treatment of otitis in dogs, for the treatment of external parasites on sheep and for the prevention of external parasites on sheep are national in scope, given that all these animal healthcare products are manufactured/imported and then distributed nationwide and competitive conditions at the wholesale level do not seem to differ regionally.

Preliminary assessment on the relevant markets

63. While we have yet to reach any final views on market definition at this stage of our investigation:

    63.1 in relation to products for dogs, we consider there is likely to be a national market for the manufacture/importation and wholesale supply of products for the treatment for otitis in dogs (the otitis treatment market); and

    63.2 in relation to products for sheep, at this stage, our preliminary investigation indicates that we should focus on the national markets for the manufacture/importation and wholesale supply of products:

        63.3 to veterinarians for the treatment of external parasites on sheep (the vet external parasite treatment market);

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22 Commerce Commission interview with [ ] (17 March 2020); and Commerce Commission interview with [ ] (12 March 2020).

23 Clearance application from Elanco (14 February 2020).

63.4 to veterinarians for the prevention of external parasites on sheep (the vet external parasite prevention market);

63.5 to rural supply merchants for the treatment of external parasites on sheep (the rural merchant external parasite treatment market); and

63.6 to rural supply merchants for the prevention of external parasites on sheep (rural merchant external parasite prevention market).

64. We invite submissions on these proposed market definitions.

With and without scenarios

65. Assessing whether a substantial lessening of competition is likely requires us to compare the likely state of competition if the Proposed Acquisition proceeds (the scenario with the merger, often referred to as the factual) with the likely state of competition if it does not (the scenario without the merger, often referred to as the counterfactual) and to determine whether competition is likely to be substantially lessened by comparing those scenarios.

With the acquisition

66. With the acquisition, Elanco would acquire Bayer AG's animal health business. However, Elanco considers that the with-the-acquisition scenario does not include Elanco owning the assets, rights and liabilities relating to the supply of Osurnia, a treatment for otitis in dogs. This is because Elanco is in the process of selling Osurnia to Dechra Pharmaceuticals PLC, Dechra Limited and Dechra Veterinary Products LLC (together Dechra).

67. The Commission is currently considering an application from Dechra seeking clearance to acquire the worldwide assets, rights and liabilities relating to the supply of Osurnia from Elanco[24] and we are investigating the two clearance applications in tandem.

68. However, as Elanco has not yet sold the Osurnia brand to Dechra, we consider that there is a real chance that Elanco would continue to own the Osurnia brand and so we are assessing the with-the-acquisition scenario on this basis.

Without the acquisition

69. At this stage, it appears likely that the status quo would be the relevant counterfactual. As discussed above, the without-the-acquisition scenario would see Bayer introduce a new otitis treatment for dogs in New Zealand and Elanco and Bayer would continue to operate independently (albeit that Bayer AG would likely continue to seek an alternative purchaser of Bayer).

[24] Clearance application from Dechra (26 March 2020).

Competition assessment: unilateral effects – the otitis treatment market

70. We are continuing to investigate whether the Proposed Acquisition would substantially lessen competition due to unilateral effects in the otitis treatment market, as the Proposed Acquisition would combine the only existing and potential suppliers of long acting otitis products in this market.

71. Unilateral effects arise when a firm merges with or acquires a competitor that would otherwise provide a significant competitive constraint (particularly relative to remaining competitors) such that a market participant can profitably increase prices above the level that would prevail without the merger (and/or reduce quality).

72. Elanco considers that the Proposed Acquisition is unlikely to create any significant competition issues in the otitis treatment market, given the number of other existing suppliers. Further, Elanco does not consider its long acting treatment (Osurnia) and Bayer's long acting treatment (Neptra) are likely to be close competitors as they have different application methods, application frequencies and formulations.[25]

73. The Proposed Acquisition would combine the only two existing and potential suppliers with long acting otitis treatments. Our investigation to date indicates that, with Bayer's forthcoming entry into the market, Elanco and Bayer would be each other's closest competitors and this competition would be lost as a result of the Proposed Acquisition.

74. To this extent, given our current view on the factual, it appears that the Proposed Acquisition has the potential to raise competition concerns in the otitis treatment market because the merged entity would be the only supplier of long acting otitis treatments in New Zealand.

75. Until 2019, all available treatments were daily doses products. However, in some other jurisdictions, long acting treatments have been available for some time. Several parties provided us with information such as sales data and business plans that suggest that, when there are two long acting treatments available, they tend to compete more closely with one another than with other otitis related products.[26]

76. As noted above, Elanco's launch of Osurnia in 2019 appears to have been relatively successful and several parties consider that Bayer would also expect to have a similar impact in New Zealand when its launches Neptra.[27]

77. However, several veterinary clinics advised us that daily dose and long acting treatments are to some extent alternatives for one another because they have the

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25 Clearance application from Elanco (14 February 2020).

26 [ ] attached to an email from Simpson Grierson (acting for Bayer Animal Health) to the Commerce Commission (9 March 2020). Clearance application from Dechra (26 March 2020).

27 Commerce Commission interview with [ ] (22 April 2020); and Commerce Commission interview with [ ] (2 March 2020).

same therapeutic indication and the choice of product comes down to the symptoms and condition of the dog.[28]

78. To this extent, we are continuing to investigate the constraints on the merged entity from existing suppliers with daily doses products such as Virbac New Zealand Limited (with Easotic), Vetroquinol New Zealand Limited (with Aurizon) and Merck Sharp & Dohme (New Zealand) Limited (with Otomax). To date, our investigation indicates there may be limited barriers to these suppliers expanding the amount of daily dose treatments they currently supply, but we have received no evidence that entry with a new long acting treatment is likely.

79. We invite submissions on the extent to which long acting treatments compete with daily dose treatments (and vice versa) and hence the extent to which daily dose treatments would constrain the merged entity.

80. We are also continuing to consider the potential for new entry with either a daily dose or long acting treatment. In addition, we are also considering the level of constraint that products from outside the otitis treatment market would have on the merged entity. We understand that otitis is not a disease in itself but rather a symptom of conditions such as parasitic, bacterial or fungal infections. As otitis treatments tend to be a combination of treatments for those individual conditions, we are considering whether there are situations where individual treatment products might be an alternative to products specifically indicated for otitis in dogs.

Competition assessment: unilateral effects –products for external parasites on sheep

81. We are continuing to investigate whether the Proposed Acquisition would substantially lessen competition due to unilateral effects, given the Proposed Acquisition would combine two of the largest suppliers in each of the four likely markets for the manufacture/importation and wholesale supply of products for use on external parasites on sheep in New Zealand. In each market, Elanco and Bayer appear to be close competitors and this competition would be lost as a result of the Proposed Acquisition.

82. We are continuing to consider whether, by removing the existing rivalry between Elanco and Bayer, the Proposed Acquisition would be likely to give the merged entity the ability and/or incentive to:

    82.1 raise the wholesale and/or retail price of its treatment and prevention external parasite products for sheep; and/or

    82.2 reduce the quality or innovation of its treatment and prevention external parasite products for sheep.

[28] Commerce Commission interview with [ ] (22 April 2020); and email from [ ] to the Commerce Commission (4 May 2020).

83. As above, our investigation indicates that we should focus on the supply to the different wholesale customer groups for products for treatment of, and separately prevention of, external parasites on sheep. However, we are continuing to consider the level of constraint on the merged entity from products that might fall outside the markets.

What the Applicant submitted – the products for external parasites on sheep

84. Elanco considers that the Proposed Acquisition would not raise any competition issues for any wholesale customer and/or distribution channel for any external parasite products used on sheep because Elanco's and Bayer's product ranges are largely complementary and do not compete closely with one another.[29] This is because:

84.1 Elanco's and Bayer's products have different chemical properties;

84.2 end customers need to regularly switch suppliers due to the need to prevent bacterial resistance developing; and

84.3 given the need for continued switching, the merged entity would face competition from big brand competitors such as Boehringer Ingelheim Animal Health New Zealand Limited (Boehringer Ingelheim) and MSD Animal Health, which is a division of Merck Sharp & Dohme (New Zealand) Limited (MSD), as well as generic suppliers such as Ravensdown Limited (Ravensdown), Donaghys Limited (Donaghys) and Alleva Animal Health Limited (Alleva).

85. While accepting that the merged entity would have a high market share (in a market that includes all external parasite products for sheep), Elanco considers that the smaller existing suppliers are all well placed to be able to expand to constrain the merged entity.[30] For example, Elanco considers that:

85.1 MSD would be a significant constraint on the merged entity's ability to materially increase prices because all its products offer comparable protection against flystrike and lice when compared to the products currently supplied by Elanco and Bayer and it currently has a large presence in Australia, which it could use to grow its New Zealand presence;

85.2 Jurox New Zealand Limited (Jurox) is ideally placed to expand, if incentivised by the actions of the merged entity. This is because Elanco's most popular product is based on dicyclanil and Elanco and Jurox are the only two existing suppliers with dicyclanil-based products in New Zealand; and

85.3 local suppliers, although tending not to supply the same volumes as Elanco, Bayer or Boehringer Ingelheim, in aggregate would account for a significant share of sales and, combined, would have a significant impact on the merged

[29] Clearance application from Elanco (14 February 2020).

[30] Submission from Elanco to the Commerce Commission (31 March 2020).

entity. This is because they have the ability to produce low cost own label generic cyromazine products relatively easily.

Existing competition in the supply of products for external parasites on sheep

86. Table 1 sets out our current understanding of the main suppliers in each of the four likely markets post-acquisition. This table indicates that there are fewer existing suppliers in the two treatment markets than in the two prevention markets.

Table 1: Suppliers in the four likely product markets for external parasites on sheep

Likely markets	Existing suppliers, post acquisition
Vet external parasite treatment market	Merged entity, Boehringer Ingelheim
Vet external parasite prevention market	Merged entity, Boehringer Ingelheim, MSD, Alleva, Jurox
Rural merchant external parasite treatment market	Merged entity
Rural merchant external parasite prevention market	Merged entity, MSD, Animal Health Direct Limited, Ravensdown, Donaghys, Nexan (via PPG Wrightson)

Source: Industry participants

Existing competition

87. We are continuing to investigate the closeness of competition between Elanco and Bayer as well as the level of constraint from existing competitors in all four markets.

88. All industry participants noted that, regardless of market definition, the Proposed Acquisition would combine two of the largest suppliers of products for external parasites on sheep and that, currently, Elanco and Bayer are each other's closest competitors.[31] This competition would be lost as a result of the Proposed Acquisition.

89. In terms of the products that the merging parties currently compete with one another with:

89.1 Elanco's prevention-only products are sold under the brands CLiK and Expo and its prevention/treatment combination products are sold under the brands Cyrex and Extinosad (Elanco recently withdrew one prevention-only product called Vetrazin); and

89.2 Bayer's prevention/treatment combination products are sold under the brands Seraphos, Zapp Encore and Maggo, although Bayer considers that Maggo is used almost exclusively as a treatment product (Bayer recently withdrew one prevention-only product called Zapp).

[31] Commerce Commission interview with [ ] (20 February 2020); Commerce Commission interview with [ ] (21 February 2020); and Commerce Commission interview with [ ] (17 March 2020).

90. In terms of the market share data we have collected to date, it appears that:

90.1 in each of the four markets, the merged entity would have a significant market share, especially in the two treatment markets where there are fewer existing competitors than in the two prevention markets; and

90.2 other than Boehringer Ingelheim, many of the other existing suppliers in each market would have a small market share when compared to the merged entity.

91. We are continuing to assess the level of constraint that each supplier listed in the above table would impose on the merged entity. In particular, we are continuing to assess, in each market:

91.1 how the different suppliers' products compare in terms of their efficacy;

91.2 the level of switching between the different brands and different suppliers; and

91.3 the impact that rotation between different products by farmers has on competition between the different suppliers.

92. While price is an important aspect of competition between the different suppliers, many industry participants emphasised that efficacy is perhaps a more important consideration and it is the key determinant behind a farmer's choice of brand.[32]

93. For example, several industry participants noted that Elanco and Bayer have many of most effective products and, as a result, they have the most prominent and respected brands such as CLiK, Cyrex, Extinosad and Zapp Encore.[33] Each of these brands has significant market share on their own. In comparison, we understand that there is only one other comparably prominent brand, Boehringer Ingelheim's Cyrazin, which currently has a similar presence as each of the main brands supplied by Elanco and Bayer.

94. We are continuing to assess the extent to which farmers are brand loyal and the level of switching between the different brands and different suppliers. We understand that many farmers are reluctant to switch away from their existing product, given the potential implications for animal welfare of making the wrong choice of product. In this respect, many farmers stay with the brands they know and trust, which may be one of the reasons why both Elanco and Bayer have a significant market presence.

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[32] Commerce Commission interview with [ ] (28 February 2020); Commerce Commission interview with [ ] (2 March 2020); and Commerce Commission interview with [ ] (27 February 2020).

[33] Commerce Commission interview with [ ] (20 February 2020); Commerce Commission interview with [ ] (17 March 2020); Commerce Commission interview with [ ] (28 February 2020); and Commerce Commission interview with [ ] (2 March 2020).

95. The Applicant emphasised that all products are susceptible to resistance, which can reduce a product's efficacy (and therefore its market presence). To reduce the potential for resistance to develop, farmers are advised to rotate the products they used between the different active ingredients contained in the different products.[34]

96. We are continuing to assess the impact of rotation on how the different suppliers compete with one another and whether this creates more, or less, opportunities for existing suppliers to compete with the merged entity.

    96.1 The Applicant considers that rotation encourages regular switching between different suppliers because suppliers tend to supply products containing different active ingredients.[35]

    96.2 However, we understand that many of the products supplied by some of the other existing competitors are less effective because they contain active ingredients that are older and so have more resistance issues than the products supplied by either Elanco or Bayer.[36] In this respect, we are continuing to investigate whether, if a farmer was to switch products for rotation purposes, they are more likely to switch to the brands that would be supplied by the merged entity (such as to CLik, Cyrex and Zapp Encore) than they would switch away from the merged entity.

97. We invite submissions on the closeness of competition between Elanco and Bayer as well as the level of constraint for existing competitors in all four markets. In particular, we welcome any further information on:

    97.1 the closeness of competition between the different treatment products supplied by Elanco, Bayer and Boehringer Ingelheim; and

    97.2 the constraint that combination products that are used for both treatment and prevention would have on external parasite products that are used only for treatment and used only for prevention.

Potential entry and expansion in the supply of external parasite products for sheep

98. We are continuing to assess the extent to which entry and expansion would constrain the merged entity in any of the four markets and we welcome feedback on the constraint from potential entry in each market.

Potential expansion from existing suppliers of external parasite products for sheep

99. We are continuing to assess the ability, and incentive, of existing suppliers to expand their presence in each of the four markets. Our investigation to date indicates that a number of existing suppliers would, individually, need to expand significantly for each of them to be able to impose a meaningful constraint on the merged entity.

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34 "Ectoparasiticides in NZ and their control" (Section 5.5) provided in Attachment 4, Clearance application from Elanco (14 February 2020).

35 Clearance application from Elanco (14 February 2020).

36 Commerce Commission interview with [ ] (17 March 2020).

100. The Applicant considers there are no barriers to expansion in any relevant market. For example, Elanco advised us that generic equivalent suppliers such as Ravensdown, Donaghys and Animal Health Direct Limited have been increasing their presence in the industry and they are well-placed to expand. The Applicant considers that, combined, these suppliers can have a significant impact on the branded products it supplies as well as the products distributed by other branded suppliers such as Bayer and Boehringer Ingelheim.[37]

101. We welcome feedback on whether the loss of competition between Elanco and Bayer could be offset by rival suppliers entering or expanding in any relevant market. This includes submissions on the extent to which reputation, brand loyalty and efficacy impacts on the choice of product made by farmers and the ability of existing suppliers to expand. In this respect, we are still considering:

101.1 the extent to which brand loyalty may impact the ability of existing suppliers to expand, given a number of industry participants noted that many farmers are very brand loyal and will stick with the brands they know and trust; and

101.2 the extent to which generic equivalent products are direct substitutes for branded products. Several parties noted that some generic products can vary in their formulations compared to the brand equivalent formulation, which can impact on the perception of the effectiveness of the particular 'equivalent' product. If a product is perceived to be not as efficient as another product, then this may make farmers reluctant to switch to this product, even if there are no limits on the ability of the supplier to supply the product.

Potential entry in the supply of external parasite products for sheep

102. We are continuing to consider the degree of constraint that potential entry would have on the merged entity in all four of the likely markets as well as the likelihood that any existing supplier would be able to extend their range of existing treatment and/or prevention products.

103. In animal healthcare markets, we understand that there are a number of ways that new entry can occur, although all of these can be quite costly and timely. Typical methods of entry include:

103.1 the development of a new pharmaceutical molecule or active ingredient;

103.2 new formulations based on novel combinations of existing active ingredients used by other suppliers;

103.3 range extension, such as using an existing product or active ingredient/s formulated for one animal species and developing it for use on another animal species; or

[37] Submission from Elanco to the Commerce Commission (31 March 2020).

103.4 the introduction of a generic equivalent product using an existing active ingredient and/or formulation that is no longer patent protected.

104. We have no evidence to suggest it is likely that the merged entity would be constrained by new entry in any of the four likely markets with a product containing a new or novel pharmaceutical molecule or active ingredient. Industry participants that we spoke with considered that the cost and time required to enter with a novel product mean that entry is unlikely.[38]

105. We are continuing to assess the extent to which existing suppliers would enter and expand through:

105.1 range or product extension/s based on the existing active ingredient/s they have patented;

105.2 a new combination product based on currently used active ingredients; or

105.3 the introduction of a new product based on a generic active ingredient (or one that is soon to be off-patent).

106. The Applicant considers that there is nothing preventing existing suppliers from developing new products in a timely manner to extend their existing ranges of products for the treatment and prevention of external parasites on sheep.[39]

107. We understand that a number of existing suppliers have research and development programs that are focused on developing animal healthcare products for New Zealand-based customers.[40] In the recent past, these programmes have resulted in some suppliers introducing prevention products for external parasites on sheep to both veterinarian customers and to rural supply merchant stores.

108. However, it appears that the examples of recent entry for which we have data suggest that these products have only been able to achieve relatively modest market shares, particularly when compared to the main brands supplied by Elanco and Bayer. In addition, we are not aware of any recent entry of a treatment product.

109. Accordingly, we are continuing to assess the likelihood of entry in all four of the relevant markets. We have received some evidence that suggests that there may be impediments to supplying veterinarian customers with new products compared to rural supply merchant stores. To this extent, we are continuing to consider:

109.1 the extent to which suppliers need the support of veterinarians to introduce a new product, given that many veterinarians both recommend and supply

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38 Commerce Commission interview with [ ] (20 February 2020); Commerce Commission interview with [ ] (21 February 2020); and Commerce Commission interview with [ ] (17 March 2020).

39 Clearance application from Elanco (14 February 2020).

40 Commerce Commission interview with [ ] (10 March 2020); Commerce Commission interview with [ ] (12 March 2020); and Commerce Commission interview with [ ] (13 March 2020).

treatment and prevention external parasite products to the end-customer; and

109.2 the extent to which veterinarians and rural supply merchant stores purchase the same range of products from the same suppliers and whether the scale and scope of purchases might impact on any potential rebate the wholesale customer might receive. For example, we are considering whether a wholesale customer might not want to support a new product from one supplier, if the support was to impact on a rebate from a competing supplier.

110. We welcome feedback on the extent to which entry and expansion would constrain the merged entity in any of the four markets. This includes submissions on the extent to which existing suppliers, that are only supplying rural supply merchant stores, would have an ability and incentive to enter and expand their wholesale supply to veterinarians.

Countervailing power in any market for products for external parasites on sheep

111. We are continuing to assess whether any wholesale customers might have any countervailing power to constrain a price increase, including the ability of any wholesale customer to sponsor entry or punish the merged entity in another market.

112. The Applicant submitted that key customers such as veterinarians and rural merchant stores all make high volume purchases and all have the ability to switch between suppliers if they are unhappy with the price or service offering made available to them.[41]

113. However, the ability to switch suppliers is not typically countervailing power, rather it is a dynamic of existing competition. On the information available to us to date, it appears that an ability to switch between the different suppliers, by itself, is unlikely to give any customers the ability to substantially influence the price the merged entity might charge.

114. Further, even if a large customer, or a wholesale buying group, had a degree of buyer power over the merged entity, its unlikely that this would be available to other wholesale customers or retailers. For example, we understand that there are a large number of small vet clinics and these clinics, individually, are unlikely to have any countervailing buyer power.

115. We invite submissions on the extent to which any customers might have a degree of countervailing power with which to constrain the merged entity.

Other competition issues

Coordinated effects

116. We continue to consider the potential for coordinated effects in the relevant markets. At this stage, our main focus in on whether the Proposed Acquisition

[41] Clearance application from Elanco (14 February 2020).

changes the conditions in any relevant market for the supply of products for external parasites on sheep so that any coordination is more likely, more complete or more sustainable.

117. An acquisition can substantially lessen competition if it increases the potential for the merged entity and all, or some of its remaining competitors to coordinate their behaviour and collectively exercise market power such that output reduces and/or prices increase in the relevant market. Unlike a substantial lessening of competition which can arise from the merged entity acting on its own, coordinated effects require some or all of the firms in the market to be acting in a coordinated way.

118. Market features that may facilitate coordinate conduct can include:

118.1 a small number of competitors and an absence of a particular vigorous competitor;

118.2 firms repeatedly interacting through, for example, industry organisations or meetings;

118.3 firms of similar size and cost structure; and

118.4 little innovation, stable demand and lack of supply shocks/volatility.

119. The Applicant does not consider there is any potential for coordinated effects as a result of the Proposed Acquisition, given the number of existing suppliers of products for external parasites on sheep in New Zealand and the differentiated nature of the products.[42]

120. We understand that products for the treatment and prevention of external parasites on sheep appear to be somewhat differentiated (given the different active ingredients within each product) and there are a mix of local and global firms, which could mitigate any potential for coordination.

121. However, if the markets are narrower than those submitted by the Applicant, as our current thinking suggests, the Proposed Acquisition may have the potential to give rise to coordinated effects in a relevant market. For example, we understand that in the vet external parasite treatment market and the rural merchant external parasite treatment market:

121.1 there are very few existing suppliers;

121.2 the barriers to entry for novel products appear to be high; and

121.3 currently there appears to be limited innovation.

122. We invite submissions on the potential for the Proposed Acquisition to give rise to coordinated effects in any relevant market and whether the Proposed Acquisition

[42] Clearance application from Elanco (14 February 2020).

changes the condition in any of the markets we have identified so the coordination is more likely, more complete or more sustainable

Conglomerate effects

123. A conglomerate merger is a merger between firms that supply products that may relate to each other (for example, complementary products). A conglomerate merger may increase a merged firms' ability and/or incentive to foreclose competitors, particularly if the merged entity would have any must have products and whether the Proposed Acquisition would enable the merged entity to bundle or tie its products.

124. We are continuing to test whether the Proposed Acquisition would increase the potential for conglomerate effects, given the large product portfolios that both Elanco and Bayer have. However, many industry participants agree with the Applicant's submission that, absent the areas of overlap highlighted above, Elanco and Bayer's portfolios are largely complementary and that the merged entity is unlikely to have any must have products that would enable it to bundle or tie its products anticompetitively.

125. We invite submissions on the potential for the Proposed Acquisition to give rise to conglomerate effects in any relevant market.

Next steps in our investigation

126. The Commission is currently scheduled to decide whether or not to give clearance to the Proposed Acquisition by 3 June 2020. However, this date may change as our investigation progresses.[43] In particular, if we need to test and consider further the issues identified above, the decision date may extend.

127. As part of our investigation, we will continue to identify and contact parties that we consider will be able to help us assess the issues identified above.

Making a submission

128. We are continuing to undertake inquiries and seek information from industry participants about the impact of the Proposed Acquisition. We welcome any further evidence and other relevant information and documents that Elanco or any interested parties are able to provide regarding the issues identified in this Statement.

129. If you wish to make a submission, please send it to us at registrar@comcom.govt.nz with the reference 'Elanco/Bayer' in the subject line of your email. Please do so by close of business on 21 May 2020. Normally we also accept submissions via post. However, currently the Commission cannot receive postal deliveries due to COVID-19, so submissions can only be accepted via email until further notice.

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[43] The Commission maintains a clearance register on our website at http://www.comcom.govt.nz/clearances-register/ where we update any changes to our deadlines and provide relevant documents.

130. As above, if in the current COVID-19 environment this deadline will be difficult for you to meet, please register your interest with the Registrar so that we can work with you to accommodate your needs where possible.

131. All information we receive is subject to the Official Information Act 1982 (OIA), under which there is a principle of availability. We recognise, however, that there may be good reason to withhold certain information contained in a submission under the OIA, for example in circumstances where disclosure would be likely to unreasonably prejudice the commercial position of the supplier or subject of the information.