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Determination

Reckitt Benckiser Group Plc and Johnson and Johnson [2015] NZCC 12

The Commission:	Dr Mark Berry Sue Begg Dr Jill Walker
Summary of application:	An application from Reckitt Benckiser Group Plc seeking clearance to acquire from Johnson and Johnson through its subsidiary, McNEIL-PPC, Inc., insofar as they relate to New Zealand, the K-Y brand and product assets.
Determination:	Under s 66(3)(b) of the Commerce Act 1986 the Commerce Commission determines to decline to give clearance to the acquisition.
Date of determination:	24 April 2015

Confidential material in this report has been removed. Its location in the document is denoted by [ ].

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Acronyms and abbreviations

ACCC	Australian Competition and Consumer Commission
Ansell	Ansell Limited
Commission	Commerce Commission
EBOS	EBOS Group Limited
FlowMotion	FlowMotion Limited
Foodstuffs	Collective term for Foodstuffs (New Zealand) Limited, Foodstuffs Own Brands Limited, Foodstuffs North Island Limited and Foodstuffs South Island Limited
Foodstuffs NI	Foodstuffs North Island Limited
Foodstuffs SI	Foodstuffs South Island Limited
HMT	Hypothetical monopolist test
IP	Intellectual property
J&J	Johnson and Johnson
LET test	Test as to whether entry is likely in commercial terms, sufficient in extent to cause market participants to react in a significant manner; and timely, that is, feasible within two years from the point at which market power is first exercised
Progressive	Progressive Enterprises Limited
RB	Reckitt Benckiser Group Plc
s	Section
SKU	Stock keeping unit
SSNIP	Small, but significant, non-transitory increase in price
Supermarkets	Collective term for Foodstuffs and Progressive supermarket chains
Sylk	Brand name of the personal lubricant produced and supplied by Geneva Marketing (1998) Limited
the Act	Commerce Act 1986
UK	United Kingdom
USA	United States of America
Woolworths	Woolworths Limited, Australian parent company of Progressive

Executive summary

The acquisition

X1. The applicant, Reckitt Benckiser Group Plc (RB), seeks clearance to acquire from Johnson and Johnson (J&J) the K-Y brand and product assets. This is a global transaction that has already concluded in all other countries except the United Kingdom. The acquisition would combine the Durex and K-Y personal lubricant brands under RB's ownership.

The decision

X2. We are not satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market in New Zealand. We therefore decline to give clearance.

Without the acquisition

X3. Absent the sale of K-Y to RB, we consider there is a real chance that the K-Y brand would continue to be supplied in New Zealand either by J&J or through the sale of the brand to a third-party and K-Y would continue to provide a competitive constraint on RB in the supply of personal lubricant. The K-Y business is currently profitable and, absent the sale, J&J would have sufficient intellectual property rights needed to operate or divest the business.

Market definition

X4. Although we could consider a market that included both the supermarket and pharmacy channels, we consider that the market definition that best allows us to assess the competitive effects of the acquisition are markets in New Zealand for the wholesale supply of lubricant to supermarkets, and (separately) the wholesale supply of lubricant to pharmacy wholesalers.

X5. We have no competition concerns in markets for online sales or adult retailers as a wider variety of brands are available to consumers in those sales channels. We have, however, considered the constraint from all other sales channels when analysing the effect on competition in each of the supermarket and pharmacy channels.

X6. Even if we were to combine those channels and consider a market for the wholesale supply of lubricant to supermarkets and pharmacies that would not change our decision to decline clearance.

X7. RB and J&J supply lubricant to supermarkets and to pharmacy wholesalers. Pharmacy wholesalers in turn supply lubricant to pharmacies.

X8. On the demand-side, demand for lubricant from supermarkets or pharmacy wholesalers is derived from the demand from consumers. The price that is charged to either supermarkets or pharmacies could therefore be constrained by consumers switching between these two channels. In particular, a lubricant price increase in supermarkets could be constrained by consumers switching to the pharmacy channel where Sylk is a significant third supplier. However, the significantly and persistently higher price for lubricant at pharmacies suggests there would be limited switching in response to a small but significant price increase.

X9. While RB and J&J supply both supermarkets and pharmacies, some lubricant suppliers only supply pharmacies (even though suppliers do not appear to face capacity constraints). It is not straightforward for a supplier to pharmacies to expand into supplying supermarkets. While the products supplied are the same, suppliers cannot simply start supplying, or expanding their sales in, supermarkets. Instead they must convince supermarkets to put their products on the shelf (or increase product shelf space), which is likely to require an investment in promoting and selling their products to consumers. As such, we have considered this potential source of competition as entry and expansion.

X10. The lubricant suppliers that supply supermarkets are, for the most part, a subset of the suppliers to pharmacies. This means that pharmacies (and/or their wholesalers) cannot increase their competitive options by looking to stock lubricant brands sold in supermarkets.

X11. Products within these markets are differentiated along a spectrum that ranges from basic lubricant to enhanced products and as such different types of lubricant products may place differing constraints on each other. However, in light of evidence that different lubricant products perform similar functions and that consumers substitute between different products along the spectrum, we consider the above markets to include all personal lubricant types.

Supply of lubricant to supermarkets

X12. We are not satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the supply of lubricant to supermarkets.

Loss of competition

X13. RB, despite having submitted that the relevant market includes all personal lubricant, has argued that Durex and K-Y compete for different consumers.

X14. We consider the evidence indicates otherwise. We consider that Durex and K-Y impose a material degree of competitive constraint on each other. Together Durex and K-Y would account for [ ]% of supermarket sales. The two brands have products at both the basic and enhanced ends of the spectrum and they are the most well-known brands for a product where brand familiarity is important. While Durex has most of its sales at the enhanced end and K-Y at the basic end, they are each other's closest competitors along the spectrum. Market participants (including J&J) have consistently told us that Durex and K-Y compete against each other.

X15. RB submitted econometric analysis from Houston Kemp that it argued showed there was little competition between the two brands. We instructed Charles River Associates to review that report. Charles River Associates identified flaws in the model which meant it was unable to robustly identify the extent of competition between the parties. In addition, the results of the model were inconsistent with other evidence that we received. For these reasons we have placed very little weight on the results of the analysis.

Entry and expansion of rivals

X16. The merged entity's main existing rival would be Ansell, which currently has a market share of [ ]%. We are not convinced that Ansell would be able to replace the competition lost between Durex and K-Y.

X17. Ansell appears to have been well-placed to have significantly grown its share of supermarket sales over the past few years, but it has not done so. [ ] This is despite the fact it is a well-known brand in condoms, has existing relationships with supermarkets and has a full-range of lubricant products. Ansell entered two years ago and has captured a market share of [ ]%. Ansell is currently stocked in 37% of all supermarkets in New Zealand.

X18. Other brands that are in some supermarkets include FlowMotion and Sylk. FlowMotion and Sylk are premium natural products that have achieved ranging in only a few supermarkets. Sylk is a well-known brand in the pharmacy market. Each brand has [ ]% market share of supermarket sales and only supplies a single basic lubricant product.

X19. We are not satisfied that expansion by either Ansell, Sylk or FlowMotion (or entry by another lubricant supplier) would be likely to be sufficient in extent and occur in a timely fashion to constrain the merged entity and prevent a substantial lessening of competition.

X20. There are no significant capacity constraints or manufacturing barriers to expansion. However, evidence indicates that brand recognition and strong consumer loyalty to Durex and K-Y are conditions of entry and expansion that a supplier must navigate. In addition, lubricant suppliers must obtain access to supermarket shelves.

X21. We consider that Ansell is in a much better position than FlowMotion and Sylk to expand in the supermarket market. Given this, we consider that if Ansell is unable to expand, we cannot be satisfied that FlowMotion and Sylk (and other brands outside the market) would be able to expand either.

X22. We acknowledge that, in principle, Ansell could easily increase the range and volume it supplies to supermarkets. Supermarkets have the ability to choose which products to place on the shelves. Faced with a wholesale price increase, supermarkets in theory could easily swap the products of the merged entity with those of a rival.

X23. However, market participants indicated that brand loyalty to Durex and K-Y is strong. This creates a significant asymmetry between the incumbents and other suppliers seeking to enter or expand.

X24. For a supermarket to replace the products of the merged entity with those of another supplier, supermarkets indicated they would require the new product to be accompanied by significant investment in promotions by the supplier to ensure brand awareness and sales. Investment by a supplier in promotions is risky, both because there is no guarantee of success and because the investment would be sunk. Ansell has indicated that [ ].

X25. The evidence we have seen does not satisfy us that, faced with a price increase, supermarkets would have the incentive to exercise any countervailing power they have in support of the expansion of an existing supplier or a new entrant. The category is profitable for supermarkets and they are likely to be able to largely maintain this profitability if the wholesale prices of Durex and/or K-Y were to rise. This is because:

X25.1. any wholesale price increase is likely to be market wide (eg, apply to all supermarkets);

X25.2. the category is small and does not drive foot traffic so supermarkets are less likely to compete aggressively on price; and

X25.3. evidence shows that supermarkets have previously passed through wholesale price increases [ ].

X26. As such, the incentives of supermarkets are not necessarily aligned with those of consumers.

Supply of lubricant to pharmacies

X27. The main differences in the pharmacy market compared to the supermarket market are that:

X27.1. pharmacies may stock a narrower product range, with a focus on basic and functional products;

X27.2. there is a significant third player (Sylk) which has a [ ]% share by value;

X27.3. pharmacies may not have the same constraints on shelf space as supermarkets; and

X27.4. there is less countervailing power as pharmacy wholesalers purely perform a purchasing and distribution role for pharmacies and, except for Green Cross Health, pharmacies are small and disaggregated.

X28. We are also not satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening of competition in the pharmacy market. Although Sylk is a significant player, the merged entity would have a large share at [ ]%. Further, this share may underestimate the extent of the loss of competition. While Durex and K-Y supply a range of lubricant products, Sylk offers only a single premium natural product. As such, Sylk is not likely able to replace the competition lost with the acquisition.

X29. Faced with a price increase, pharmacies could in principle switch to Ansell for products that are more similar to Durex and K-Y. However, we cannot rely on Ansell to promote its product in pharmacies. It has had limited success in pharmacies so far ([ ]% share) and it would require time and investment to approach individual pharmacies to convince them to stock its products. As set out above, Ansell has stated that [ ].

X30. Consumers that purchase lubricant in pharmacies may switch to supermarkets if prices rise since prices are lower in supermarkets. However, as we consider a substantial lessening of competition would occur in the supermarket market, consumers would face a price increase there as well and the differential in pricing between pharmacies and supermarkets would remain unchanged.

The acquisition

1. On 16 May 2014, Reckitt Benckiser Group Plc (RB) applied for clearance to acquire from Johnson and Johnson (J&J) through its subsidiary, McNEIL-PPC, Inc., insofar as they relate to New Zealand, the K-Y brand and product assets comprising:

   1.1 all K-Y product-related intellectual property (IP), including domain names, toll free numbers, formulas, technical data and patents;

   1.2 regulatory information relating to the products;

   1.3 any existing promotional and marketing material;

   1.4 third-party supply and manufacturing rights and obligations; and

   1.5 existing finished goods inventory of the products.

2. The acquisition is a global transaction that has also been examined by agencies in other jurisdictions.

3. The acquisition would result in the aggregation of the Durex and K-Y personal lubricant brands under RB's ownership.

The decision

4. The Commission declines to give clearance to the acquisition as it is not satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market in New Zealand.

Our framework

5. Our approach to analysing the competition effects of the acquisition is based on the principles set out in our Mergers and Acquisitions Guidelines.[1]

The substantial lessening of competition test

6. As required by the Commerce Act 1986, we assess acquisitions using the substantial lessening of competition test.

7. We determine whether an acquisition is likely to substantially lessen competition in a market by comparing the likely state of competition if the acquisition proceeds (the scenario with the acquisition, often referred to as the factual), with the likely state of competition if the acquisition does not proceed (the scenario without the acquisition, often referred to as the counterfactual).[2]

8. We make a pragmatic and commercial assessment of what is likely to occur in the future with and without the acquisition based on the information we obtain through our investigation and taking into account factors including market growth and technological changes.

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1 Commerce Commission, *Mergers and Acquisitions Guidelines*, July 2013.

2 *Commerce Commission v Woolworths Limited* (2008) 12 TCLR 194 (CA) at [63].

9. A lessening of competition is generally the same as an increase in market power. Market power is the ability to raise price above the price that would exist in a competitive market (the 'competitive price'),[3] or reduce non-price factors such as quality or service below competitive levels.

10. Determining the scope of the relevant market or markets can be an important tool in determining whether a substantial lessening of competition is likely.

11. We define markets in the way that we consider best isolates the key competition issues that arise from the acquisition. In many cases this may not require us to precisely define the boundaries of a market. A relevant market is ultimately determined, in the words of the Act, as a matter of fact and commercial common sense.[4]

When a lessening of competition is substantial

12. Only a lessening of competition that is substantial is prohibited. A lessening of competition will be substantial if it is real, of substance, or more than nominal.[5] Some courts have used the word 'material' to describe a lessening of competition that is substantial.[6] A substantial lessening of competition in a significant section of a market, may, according to circumstances, be a substantial lessening of competition in a market.[7]

13. Consequently, there is no bright line that separates a lessening of competition that is substantial from one that is not. What is substantial is a matter of judgement and depends on the facts of each case. Ultimately, we assess whether competition will be substantially lessened by asking whether consumers in the relevant market(s) are likely to be adversely affected in a material way.

When a substantial lessening of competition is likely

14. A substantial lessening of competition is 'likely' if there is a real and substantial risk, or a real chance, that it will occur. This requires that a substantial lessening of competition is more than a possibility, but does not mean that the effect needs to be more likely than not to occur.[8]

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3 Or below competitive levels in a merger between buyers.

4 Section 3(1A). See also *Brambles v Commerce Commission* (2003) 10 TCLR 868 at [81].

5 *Woolworths & Ors v Commerce Commission* (2008) 8 NZBLC 102,128 (HC) at [127].

6 Ibid at [129].

7 As the Federal Court of Australia noted in *Dandy Power Equipment Pty Ltd & Anor v Mercury Marine Pty Ltd* (1982) 64 FLR 238, 260; 44 ALR 173, 192; ATPR 40-315, 43,888, cited with approval by McGechan J in *Commerce Commission v Port Nelson Ltd* (1995) 6 TCLR 406 at 435: "Although the words "substantially lessened in a market" refer generally to a market, it is the degree to which competition has been lessened which is critical, not the proportion of that lessening to the whole of the competition which exists in the total market. Thus a lessening in a significant section of the market, if a substantial lessening of otherwise active competition may, according to circumstances, be a substantial lessening of competition in a market".

8 *Woolworths & Ors v Commerce Commission* (HC) above n5 at [111].

The clearance test

15. We must clear an acquisition if we are satisfied that the acquisition would not be likely to substantially lessen competition in any market.[9] If we are not satisfied – including if we are left in doubt – we must decline to clear the acquisition.[10] It is open to us to say: "We are not sure and therefore we are not satisfied that there will be no substantial lessening of competition".[11]

16. The burden of proof lies with RB, as the applicant, to satisfy us on the balance of probabilities that the acquisition is not likely to have the effect of substantially lessening competition.[12] The decision to grant or refuse a clearance is necessarily to be made on the basis of all the evidence.[13] We will sometimes have before us conflicting evidence from different market participants and must determine what weight to give to the evidence of each party.[14]

Key parties

RB

17. RB is a global consumer goods company which manufactures and sells a range of health, hygiene, home food and pharmaceutical products. It is listed on the London Stock Exchange and is headquartered in the United Kingdom (UK).

18. Relevant to its application for clearance, RB's products include the Durex range of personal lubricant.

19. Durex lubricant products sold in New Zealand are manufactured under contract in Thailand.[15]

J&J

20. J&J is a global medical devices, pharmaceutical and consumer goods company. It is listed on the New York Stock Exchange and is headquartered in the United States of America (USA).

21. J&J produces consumer goods under 48 brands, including the K-Y brand of personal lubricant.

22. K-Y lubricant sold in New Zealand is also manufactured overseas. K-Y Jelly sold in New Zealand is manufactured in Australia, while other K-Y products are manufactured in the northern hemisphere.[16]

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9 Section 66(1) of the Commerce Act 1986.

10 In *Commerce Commission v Woolworths Limited* (CA), above n2 at [98], the Court held that "the existence of a 'doubt' corresponds to a failure to exclude a real chance of a substantial lessening of competition".

11 *Commerce Commission v Woolworths Ltd* (CA) above n2 at [207(a)].

12 *Commerce Commission v Southern Cross Medical Care Society* (2001) 10 TCLR 269 (CA) at [7] and *Commerce Commission v Woolworths Ltd* (CA) above n2 at [97].

13 *Commerce Commission v Woolworths Ltd* (CA) above n2 at [101].

14 *Brambles New Zealand Ltd v Commerce Commission* above n4 at [64].

15 Clearance Application from RB (16 May 2014) at [9.4].

Other industry participants

Competing lubricant brands

23. Ansell Limited (Ansell) describes itself as a global leader in protection solutions. It manufactures and supplies a range of protective gloves, clothing and safety devices for industrial and medical uses. In addition, Ansell has a sexual wellness business unit that manufactures and supplies condoms and personal lubricant. Ansell products are supplied in New Zealand through a distributor, EBOS Group Limited (EBOS).[17]

24. Geneva Marketing (1998) Limited manufactures and supplies Sylk, a New Zealand made premium natural lubricant produced from kiwifruit extract.

25. FlowMotion Limited manufactures and supplies FlowMotion, a New Zealand made premium organic lubricant.

Retailers and wholesalers

26. Progressive Enterprises Limited (Progressive) is a nationwide supermarket operator owned by Australian supermarket operator, Woolworths Limited. Progressive owns and operates over 170 Countdown supermarkets. Super Value and Fresh Choice supermarkets are also operated by Progressive on a franchise basis.

27. Foodstuffs is New Zealand's other nationwide supermarket operator and is operated as a co-operative. Foodstuffs grocery stores mainly trade under the New World, Pak'n'Save and Four Square brands. There are almost 190 New World and Pak'n'Save stores across New Zealand. Each store is independently owned and operated, with store owners being members of either Foodstuffs North Island Limited (Foodstuffs NI) or Foodstuffs South Island Limited (Foodstuffs SI), depending on the location of a store. Two national legal entities, Foodstuffs (New Zealand) Limited and Foodstuffs Own Brands Limited, serve to (amongst other things):[18]

    27.1 provide a means of co-ordinating policy and national activities;

    27.2 procure and market Foodstuffs private label products; and

    27.3 negotiate nationwide supplier trading terms and supplier price adjustments.

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16 E-mail from Kensington Swan (on behalf of J&J) to the Commerce Commission (5 August 2014).

17 In the remainder of this determination, we simply refer to Ansell as even though EBOS distributes Ansell products in New Zealand, [

].

18 http://www.foodstuffs.co.nz/about-foodstuffs/company-information/.

28. Green Cross Health is a primary healthcare provider involved in pharmacies, medical centres and community care. Green Cross Health has a network of around 300 Unichem and Life Pharmacy branded pharmacies across New Zealand.[19] The majority of the pharmacies are locally owned and operated by individual pharmacists, but Green Cross Health has an equity interest in 70 pharmacies which it operates on a corporate basis.[20]

29. Pharmacy wholesalers obtain personal lubricant from lubricant suppliers and on-supply it to pharmacies (such as Green Cross Health and small independently owned and operated pharmacies). The pharmacy wholesalers operating in New Zealand are CDC Pharmaceuticals Limited, Pharmacy Wholesalers (Bay of Plenty) Limited and Pharmacy Retailing (NZ) Limited, commonly referred to as ProPharma.

Industry background

Personal lubricant

30. The acquisition relates to personal lubricant. Personal lubricant is used for intimacy enhancement and sexual activity. It is a specialised lubricant used during human sexual activity to reduce friction between body parts, or between body parts and other objects. Personal lubricant is considered to be part of a wider sexual wellbeing category.[21]

31. A range of personal lubricant products are available in the market, differentiated by factors such as:[22]

    31.1 base ingredient (eg, water or silicone-based);

    31.2 functional attributes (eg, warming or tingling);

    31.3 end-use (eg, lubricant only or 2-in-1 massage product, vaginal or anal use, single use or couples product);

    31.4 flavour; and

    31.5 target consumer.

32. As submitted by RB, there is a spectrum of personal lubricant products with “basic reassurance”, “need-based” or “medical” positioning at one end to “playful”, “enhanced” or “adventurous” positioning at the other end.[23]

19 Some pharmacies within the Green Cross Health network operate under the other legacy brands such as Amcal or Radius Care, but many have been rebranded as a Unichem or Life Pharmacy.

20 Outside of Green Cross Health branded pharmacies, there are an additional 700 small independently owned and operated pharmacies. While Green Cross Health pharmacies represent one-third of all pharmacies by number, they account for a significantly higher proportion of pharmacy sales.

21 Application above n15 at [9.2] and [ ].

22 Application above n15 at [12.2].

23 Ibid at [13.1].

33. Table 1 lists the main lubricant products currently available in New Zealand supermarkets and pharmacies, separated into basic and enhanced products. Table 1 shows that Durex, K-Y and Ansell all supply basic lubricant and enhanced products.[24]

Table 1: Main basic and enhanced lubricant products

Product type	Durex, K-Y and Ansell products	Other brands
Basic	K-Y Jelly, K-Y Ultra Gel, K-Y Sensual Silk, Durex Play Feel, Ansell Lifestyles Natural	Sylk, FlowMotion
Enhanced[25]	K-Y Yours and Mine, Durex Perfect Glide, Durex Massage 2-in-1, Durex Embrace, Durex Play O, Ansell Warm Lovin	None

Source: Industry participants

34. Basic lubricant has been, and continues to be, a significant portion of the personal lubricant market.[26] However, according to RB, in recent years there has been growth in demand for more enhanced products.[27]

35. Sales data provided by RB shows that while [ ]% of total supermarket sales by value are what RB class as basic lubricant, [ ]% of sales are enhanced products.[28] However, equivalent sales data provided by RB for the pharmacy channel shows that basic lubricant represents a significantly higher proportion of pharmacy sales. In the pharmacy channel, [ ]% of total sales are what RB class as basic lubricant, with the other [ ]% of sales being enhanced products.[29]

Sales channels

36. Personal lubricant is sold to consumers primarily through grocery, adult retailer, pharmacy and online channels.[30] RB and J&J sell lubricant directly to supermarkets and to wholesalers (who then sell to pharmacies and other channels).[31]

24 As acknowledged by RB. Application above n15 at [16.37].

25 Enhanced products include silicone, warming/cooling, flavoured, massage, couples and orgasm enhancing products.

26 RB and J&J both stated that vaginal dryness is the core or key proposition for personal lubricant. Commerce Commission meeting with RB (9 June 2014) and Commerce Commission interview with J&J (1 July 2014). This is supported by documents provided by RB. [ ]

27 Application above n15 at [10].

28 Total supermarket sales of basic lubricant for the year ended 22 February 2015 were $[ ], compared to sales of enhanced products of $[ ]. E-mail from Bell Gully (on behalf of RB) to the Commerce Commission (10 April 2015).

29 Total pharmacy sales of basic lubricant for the year ended 25 February 2015 were $[ ], compared to sales of enhanced products of $[ ]. E-mail from RB above n28.

30 Application above n15 at [9.8].

31 RB and J&J supply lubricant directly to supermarket chains, but supply other, more fragmented, retailers through wholesalers. RB sells to adult retailers via wholesalers such as Universal Specialties Limited (a wholesaler on-selling to a range of customers including Prostitutes Collective, Condom World and others). Application above n15 at [9.6].

37. While RB supplies pharmacies through pharmacy wholesalers, pharmacy wholesalers merely order and stock products requested by pharmacies.[32] To get their lubricant stocked in pharmacies, RB and J&J (and other suppliers) need to engage directly with pharmacy chains and independent pharmacies, just as they do with supermarkets.[33]

38. The grocery (or supermarket) channel is the largest sales channel, accounting for the majority of RB's and J&J's lubricant sales[34] and with total annual retail sales (for all brands) of $[ ]. In comparison, total pharmacy sales of lubricant were $[ ] for the year ended 25 February 2015 (one-sixth the value of supermarket sales), having declined [ ]% between 2012 and 2015. Information gathered as part of our investigation indicated that supermarkets and pharmacies account for [ ]% of total lubricant sales in New Zealand, but a higher proportion of Durex and K-Y lubricant sales.[35] [36]

39. Durex and K-Y are major brands of personal lubricant sold in both supermarkets and pharmacies. Sylk is a third brand typically stocked in pharmacies. A number of supermarkets also stock Ansell as a third brand of lubricant.

40. In comparison to supermarkets and pharmacies, adult retailer and online channels are not significant sales channels for Durex and K-Y. Adult retailer and online channels tend to stock brands other than Durex and K-Y, and a greater range of brands and products. Brands stocked in adult or online retailers include Wet Stuff, Pjur, System JO, Gun Oil and Astroglide.[37]

With and without scenarios

41. To assess whether competition is likely to be substantially lessened in any market we compare the likely state of competition with the acquisition to the likely state of competition without the acquisition.[38]

With the acquisition

42. With the acquisition, RB would own both Durex and K-Y personal lubricant brands.

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32 [ ]

33 Green Cross Health stated that [ ]. Commerce Commission interview with Green Cross Health (27 June 2014).

34 Application above n15 at [9.9].

35 RB submitted that combined, supermarkets and pharmacies account for around [ ]% of Durex and K-Y lubricant sales in New Zealand. Application above n15 at [24.1].

36 The fact that [ ]% of all lubricant sales (or [ ]% of Durex and K-Y lubricant sales) are made through other sales channels (eg, adult retailers and online) is not, in and of itself, evidence that sales through such channels constrain the wholesale supply of personal lubricant to supermarkets or pharmacies. If consumers were to switch to adult retailers or online in response to an increase in the price of lubricant at supermarkets or pharmacies, then this would be evidence of those sales channels providing constraint.

37 For a full list of brands stocked in such retailers see Annex 8 to Application above n15.

38 *Mergers and Acquisitions Guidelines* above n1 at [2.29].

Without the acquisition

43. We have considered what is likely to happen to the K-Y brand in New Zealand absent its sale to RB.

44. Both RB and J&J submitted that, without the acquisition, [ ].[39]

45. [ ], we consider that it is likely (ie, there is a real chance) that the K-Y brand would continue to be sold in New Zealand whether by J&J or by a third-party.[40]

46. In accordance with the High Court in *Woolworths*,[41] we have considered whether competition is substantially lessened comparing the with-the-acquisition scenario to the without-the-acquisition scenario where the K-Y brand continues to be sold in New Zealand as this without-the-acquisition scenario gives rise to the most acute competition concerns.[42] In doing so, we note that irrespective of whether J&J retains the K-Y brand or sells the K-Y brand to a third-party, the essence of the competitive effect would be the same: K-Y would continue to be supplied independent of RB in competition with Durex.

K-Y brand likely to continue to be sold in New Zealand

47. [ ][43] J&J submitted that, were it to still supply K-Y without the acquisition, the K-Y brand would receive limited marketing support and there would be no product development.[44] However, J&J stated that [ ].[45]

48. On 23 December 2014, J&J [ ] indicated that without the acquisition [

[39] E-mail from Kensington Swan (on behalf of J&J) to the Commerce Commission (23 December 2014) and e-mail from Bell Gully (on behalf of RB) to the Commerce Commission (17 March 2015).

[40] Ultimately, there may be multiple scenarios that are likely without the acquisition. This is because something can be likely even when the chance of it occurring is less than 50%.

[41] *Woolworths & Ors v Commerce Commission* above n5 at [122].

[42] As the High Court in *Woolworths* noted, where there is more than one real and substantial without-the-acquisition scenario, it is not a case of choosing the one without-the-acquisition scenario that we think has the greatest prospects of occurring.

[43] E-mail from Kensington Swan (on behalf of J&J) to the Commerce Commission (25 June 2014), interview with J&J above n26 and e-mail from J&J above n16.

[44] Ibid.

[45] E-mail from J&J above n16.

].[46] [

]

48.1 by this time, J&J had completed the sale of the K-Y brand to RB in all markets except for the UK and New Zealand; and

48.2 given that K-Y had been sold to RB in Australia, J&J considered there were more complex logistical supply issues involved in continuing to supply K-Y in New Zealand [

].[47]

49. J&J also advised that [ ].[48] This is because in its view, [

].[49] While J&J advised that, [

].[50]

50. [ ], there is evidence which indicates that there is a real chance that the K-Y brand would continue to be supplied in New Zealand, whether by J&J or by a third-party after a sale.

50.1 J&J has access to all the IP rights to either continue the business in New Zealand or divest it to a third-party. J&J also retains an exclusive licence over the know-how if the sale of K-Y to RB does not close in a particular country.[51]

50.2 [

][52]

50.3 [

][53]

46 E-mail from J&J above n39.

47 Ibid.

48 E-mail from J&J above n39 and e-mail from Kensington Swan (on behalf of J&J) to the Commerce Commission (26 February 2015).

49 Ibid.

50 E-mail from J&J (26 February 2015) above n48.

51 E-mail from J&J above n16.

52 E-mail from Kensington Swan (on behalf of J&J) to the Commerce Commission (20 March 2015).

53 Ibid.

50.4 The sale of K-Y products in New Zealand is profitable. In recent years, J&J has made around [ ]% profit margin[54] on the sale of K-Y products in New Zealand (in dollar terms, a profit of around $[ ] on sales of around $[ ]) on the supply of K-Y in New Zealand.[55] While J&J said that the cost of manufacturing product for the New Zealand market would increase, it provided no indication of the extent to which these costs would affect profitability.[56]

51. The range of potential purchasers for the K-Y business includes trade buyers and private buyers. [ ]

52. We approached Ansell, Sylk and FlowMotion and [ ] and asked whether they would be interested in acquiring the K-Y brand in New Zealand. [ ] had no interest in acquiring K-Y solely in New Zealand.[57] In the absence of any information on what was for sale, the reactions of Ansell, Sylk and FlowMotion were understandably equivocal (at least in the case of [ ] and [ ]).[58] However, they [ ].We do not know whether there are other potential trade or private buyers.

53. In short, J&J has not discharged its onus of satisfying us that sale to another buyer is not likely particularly given that J&J has the necessary IP rights, and the sale of K-Y products in New Zealand is currently profitable. These two features imply that the K-Y business has a value.

Conclusion on the without scenario

54. In conclusion, we consider that if the acquisition does not proceed:

54.1 there is a real chance that the K-Y brand would continue to be supplied in the New Zealand market either by J&J or a third-party; and

54.2 [ ].

55. Accordingly, in the competition analysis section of this determination we focus on examining whether the acquisition substantially lessens competition compared to a without-the-acquisition scenario of the status quo or sale to a third-party. In our consideration of competition between Durex and K-Y, we consider whether K-Y

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54 This profit margin was calculated by deducting from K-Y's New Zealand annual net trade sales the cost of trade promotions, manufacturing/purchase costs and distribution costs.

55 E-mail from Kensington Swan (on behalf of J&J) to the Commerce Commission (23 October 2014).

56 E-mail from J&J above n39.

57 E-mail from [ ] to the Commerce Commission (21 April 2015).

58 [ ]

would be a stronger constraint were it owned by a third-party as opposed to J&J (which has not been investing in the brand).

How the acquisition could substantially lessen competition

56. As already described, the acquisition would bring together two suppliers of personal lubricant. Both RB and J&J have their lubricant products manufactured overseas and imported before supplying to retailers and wholesalers in New Zealand. Durex and K-Y personal lubricant is mainly sold in supermarkets and pharmacies.

57. RB and J&J earn profits from the difference between the production and distribution cost of the Durex and K-Y products (including the cost of promotional activity) and the price that is charged to their customers (mainly supermarkets and pharmacy wholesalers). RB and J&J would be able to increase their profits if they could raise prices to those supermarkets and pharmacy wholesalers. If the merged entity could profitably raise prices to those supermarkets and pharmacy wholesalers, this would likely indicate a substantial lessening of competition.

58. The ability for the merged entity to profitably raise prices to supermarkets and pharmacy wholesalers (and other customers) would in part depend on how supermarkets' and pharmacies' customers – the ultimate consumers of the product – view the different competing brands and products. Faced with a wholesale price increase, a supermarket or pharmacy wholesaler would not be able to switch to another supplier if that supermarket's or pharmacy's customers (ie, end consumers) would not purchase that alternative product. Alternatively, if consumers are willing to switch to an alternative lubricant brand, then a supermarket or pharmacy may have the confidence to stock that alternative brand rather than Durex or K-Y in response to a price increase.

59. Personal lubricant is a differentiated product. Each supplier of lubricant tends to offer a range of lubricant products with different characteristics (differentiated by the factors set out at paragraph 31 above). It is therefore important to assess how closely the products or brands of Durex and K-Y and other rivals compete. Competition concerns are more likely the closer the products of the merging parties compete and the more distant those of remaining competitors.

60. The merged entity would have a lower ability to profitably raise prices to retailers if remaining competitors have the ability and incentive to expand and/or reposition their products to be closer to those of the merged entity. Retailers may also be able to limit price increases if they have countervailing power.

Market definition

61. This section sets out our approach to market definition and the evidence to support the relevant markets we have defined.

62. RB submitted that the relevant market is the New Zealand market for the supply of personal lubricant.[59] However, we consider that the wholesale supply of personal lubricant to different retailers can be considered in separate markets. We have used the following markets in New Zealand to assess the acquisition:

62.1 the wholesale supply of personal lubricant to supermarkets; and

62.2 the wholesale supply of personal lubricant to pharmacy wholesalers.

63. We have not defined or analysed the effect of the acquisition on market(s) for the wholesale supply of personal lubricant to adult retailers or online channels because the aggregation in RB's market share in these sales channels as a result of the acquisition would be very small.

64. We note that the precise market definition is not critical to our determination in this case. Our determination to decline to give clearance would remain unchanged even if we adopted a wider market. We would still have not been satisfied that the acquisition would be unlikely to substantially lessen competition.

Our general approach to market definition

65. Market definition is a tool that helps identify and assess the close competitive constraints the merged entity would face. Determining the relevant market requires us to judge whether, for example, two products are sufficiently close substitutes as a matter of fact and commercial common sense to fall within the same market.

66. In defining markets, we are conscious of the need to ensure that we define markets in the way that best isolates the key competition issues that arise from an acquisition.[60] 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, in our competition analysis we also consider the degree of competitive constraint imposed on the merged entity from the supply of personal lubricant outside the market (eg, the extent to which the supply of lubricant through online channels may constrain the merged entity in the wholesale supply of personal lubricant to supermarkets).

67. A conceptual tool to help define the market is the "hypothetical monopolist test" (HMT).[61] The HMT asks whether a hypothetical sole supplier of a group of products could profitably impose a small, yet significant, non-transitory increase in price (SSNIP) (often thought of as 5%). If it could impose a SSNIP, the HMT is satisfied and a market is defined. If it could not, then the market is widened to include the next best substitute and the process is repeated. The process continues until a group of products that satisfies the HMT is found.

68. Whether a SSNIP could be profitably imposed depends on the degree of demand and supply-side substitution that would occur. Demand-side substitution is where

[59] Application above n15 at [12.1].
[60] *Mergers and Acquisitions Guidelines* above n1 at [3.10-3.12].
[61] Ibid at [3.17-3.22].

customers switch to other products in response to a price increase. Supply-side substitution is where rival firms offering products outside the market could easily, profitably and quickly switch to supply products in the market. What matters is whether demand and supply-side substitution together are sufficient to defeat the SSNIP.

Approach to market definition in this case

69. RB and J&J both provide a range of different types of lubricant at the wholesale level to New Zealand supermarkets and pharmacy wholesalers. Supermarkets then retail the products to consumers, and pharmacy wholesalers supply lubricant to pharmacies that in turn retail the products to consumers.

70. Our assessment of market definition has focused on two main areas:

    70.1 whether different types of retailers (supermarkets, pharmacies, adult retailers and online) should be considered in the same wholesale market, or whether supermarkets and pharmacies (being the retailers through which Durex and K-Y personal lubricants are mainly sold) should be considered as being in separate wholesale markets, to best identify the competition issue arising from the acquisition; and

    70.2 whether different types of personal lubricant (based on characteristics or type of consumer) should be considered in the same market to best identify the competition issue arising from the acquisition.

Are there separate wholesale markets for different types of retailer customers?

71. Durex, K-Y and Ansell are the main suppliers to supermarkets, while in pharmacies Durex, K-Y and Sylk are the main suppliers. There are a wider range of lubricant suppliers to adult retailers; however, these suppliers do not typically include Durex and K-Y.

72. Despite this diversity of suppliers to the different retailers, RB submitted that the relevant wholesale market includes all retail sales channels in New Zealand as consumers are able to switch between retail channels.[62]

73. For the reasons set out below, we consider that the acquisition is best analysed by looking at the wholesale supply of personal lubricant to the different sales channels separately.

Is it appropriate to define a wholesale market for the supply of lubricant to supermarkets?

74. As Durex and K-Y make the majority of their sales in supermarkets, we have considered whether there would be sufficient demand-side and supply-side substitution to defeat a SSNIP at the wholesale level by a hypothetical sole supplier to supermarkets.

62 Application above n15 at [12.1], [17.1-17.3] and [18.1].

75. Importantly, the focus of this question is at the wholesale level, ie, what supermarkets would do in response to a price increase. Obviously, what supermarkets would do would be dependent on their own customers' preferences (ie, the preferences of end consumers). For example, if a supermarket faced a SSNIP at the wholesale level and passed that on to consumers and sufficient consumers then switched to buying lubricant in pharmacies so as to render the SSNIP unprofitable, this would suggest that wholesale supplies to supermarkets and pharmacies are in the same market.

<u>Substitution on the demand-side – ultimate consumers switching to other retailers in response to a SSNIP</u>

76. A hypothetical monopolist lubricant supplier to supermarkets could be constrained from imposing a SSNIP on supermarkets if a supermarket passed on that price increase and sufficient consumers switched to other retailers such as pharmacies, adult retailers, or online. If few consumers would switch to other retailers if prices went up in supermarkets, then it would be easier for a hypothetical sole lubricant supplier to impose a SSNIP. If instead a sufficient number of consumers would switch to other retailers, then a SSNIP to supermarkets may not be profitable.[63]

77. In terms of switching from supermarkets to pharmacies, RB submitted:[64]

> …consumers can and do substitute between supermarkets and pharmacies in making purchases in the medicinal or health and wellbeing category (including personal lubricants). Indeed most supermarkets are likely to have a pharmacy within a close proximity and both channels provide convenient alternatives for consumers.

78. We do not consider that a sufficient number of consumers would switch from supermarkets to pharmacies in response to a SSNIP in the order of 5% to make that unprofitable. This is for the following reasons.

    78.1 Evidence shows that prices in pharmacies are significantly higher for the same products. Data provided by RB and J&J indicated that the retail prices of lubricant are materially higher in pharmacies than in supermarkets.[65] [66] J&J confirmed this stating that pharmacies are generally more expensive than grocery for the same product.[67] An online check of supermarket and pharmacy retail prices further confirmed that prices are higher in pharmacies

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63 Even if there were sufficient switching of consumers across retail channels so as to render a price increase to them unprofitable, this does not necessarily mean that the merged entity could not increase wholesale prices. The inability to pass through would, however, increase the incentives of supermarkets to seek out alternative suppliers. Countervailing power is considered at paragraphs 178-223.

64 Submission from Bell Gully (on behalf of RB) (25 August 2014) at [6.28].

65 E-mail from Kensington Swan (on behalf of J&J) to the Commerce Commission (20 February 2015) and e-mail from Bell Gully (on behalf of RB) to the Commerce Commission (26 February 2015).

66 This is despite the fact that RB supplies personal lubricant to supermarkets and pharmacy wholesalers at the same wholesale price. E-mail from Bell Gully (on behalf of RB) to the Commerce Commission (25 February 2015). [ ]

67 Interview with J&J above n26.

for the same products at least at the time of testing.[68] A 5% (or even a 10%) increase in supermarket prices would still generally leave supermarket prices lower than those at pharmacies.

78.2 Consumers can pick up lubricant during their weekly shop at the supermarket so switching to pharmacies may be less convenient if they have to make a special trip.[69]

78.3 The range of lubricant products available in pharmacies may be more limited than in supermarkets, given that basic lubricant is [ ]% of pharmacy sales.

79. As RB submitted,[70] different prices for the same product do not necessarily imply different markets, since access to expert service could compensate for those price differences. However, once a consumer receives the advice, it is difficult to see how they would benefit from it again. As J&J stated, some consumers may initially buy personal lubricant at a pharmacy and get free advice, but subsequently buy at supermarkets where the prices are cheaper.[71] Moreover, a consumer who currently purchases from supermarkets is unlikely to be seeking such advice.

80. We consider that the persistent price differences across pharmacies and supermarkets suggests that there would be limited switching from supermarkets to pharmacies in response to a SSNIP at the wholesale level that is then at least partly passed through to consumers.

81. Nor do we consider that sufficient consumers would switch from supermarkets to adult retailers in response to a SSNIP in the order of 5% that is as at least partly passed through to consumers so as to render that SSNIP unprofitable. In addition to the convenience associated with purchasing at a supermarket:

81.1 there is the embarrassment of visiting an adult retailer;[72] [73]

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[68] On 29 January 2015, we checked lubricant prices online at three websites http://shop.countdown.co.nz/, https://shop.newworld.co.nz/store/6EE070045#/ and http://www.lifepharmacy.co.nz/. K-Y Jelly 100g was $11.99 in Countdown and $12.89 in New World compared to $19.99 at Life Pharmacy (part of Green Cross Health). Durex Play O 15ml was $23.99 in Countdown compared to $29.99 at Life Pharmacy. Durex Play Massage 2-In-1 200ml range was $13.99 in Countdown, $17.29 in New World compared to $17.99 at Life Pharmacy.

[69] A consumer survey conducted by FlowMotion prior to its entry found that [ ]% of people purchase lubricant at supermarkets and that lubricant is a normal part of everyday supermarket purchases. After supermarkets, the survey found that pharmacies are the next biggest sales channel ([ ]% of people). Adult and online retailers were found to be used by [ ]% and [ ]% of people, respectively (with 9% of people purchasing lubricant from other, unknown sources). [ ] attached to an e-mail from FlowMotion to the Commerce Commission (5 March 2015).

[70] Submission from Bell Gully (on behalf of RB) (23 December 2014) at [2.18].

[71] Interview with J&J above n26.

[72] [ ] stated that not everyone wants to walk into an adult retailer or buy online. Commerce Commission interview with [ ] (18 June 2014).

[73] [ ] stated that it did not know if consumers that normally buy lubricant through supermarkets or pharmacies would switch and buy through an adult or online retailer. It stated that a lot of the population would never go near an adult retailer. Commerce Commission interview with [ ] (18 June 2014).

81.2 consumers appear to be brand loyal and adult retailers do not tend to stock the brands grocery consumers purchase (in particular, Durex and K-Y); and

81.3 adult retailers appear to generally stock more expensive lubricant, when compared on a per ml basis to those in the supermarket.[74] [75] An online check of adult retailer prices confirmed this to be the case. [76] [77] Given this, consumers may not view these products as close substitutes to those available in supermarkets.

82. RB also submitted that online sales should be included as part of the market definition.[78] RB submitted that [ ].[79]

83. We do not consider that a large number of consumers would switch from supermarkets to online retailers in response to a SSNIP in the order of 5% that is at least partly passed through to consumers so as to render that SSNIP unprofitable.

84. Many supermarkets (eg, Countdown), pharmacies (eg, Life Pharmacy and Pharmacy Direct), adult retailers (eg, d.vice and Peaches and Cream), and other online sales channels (eg, Condoms Direct)[80] offer online sales of lubricant. However, it is unclear whether online sources are strong substitutes for consumers for the brands sold in supermarkets. First, prices do not necessarily appear to be cheaper online. For example, a spot check of K-Y Jelly 100g at Countdown found the price to be $11.99 compared to $15.99 on Pharmacy Direct and $15.95 on Condoms Direct.[81] Second, although online has the advantage of anonymity, this would not appear to be a major concern for supermarket customers who currently forgo that opportunity. Third, consumers can pick up lubricant during their weekly shop at the supermarket, rather than making a special purchase online.

<u>Substitution by lubricant suppliers in response to SSNIP</u>

85. The products that the parties supply to supermarkets and pharmacy wholesalers are the same. Despite this, it is not clear that suppliers which are not currently supplying supermarkets could "easily, profitably and quickly" expand into supplying supermarkets.[82] We consider that there are conditions that a supplier must

[74] [ ] stated that the prices of lubricant in adult retailers are much higher than in supermarkets. Commerce Commission interview with [ ] (17 June 2014).

[75] [ ] stated that if people are buying solely on price, then they will buy lubricant in supermarkets. Commerce Commission interview with [ ] (24 June 2014).

[76] On 29 January 2015, we checked lubricant prices online at http://www.dvice.co.nz/. This confirmed that the lowest priced lubricant sold at d.vice was Probe 75g and Lubexx 50g at $17.99 ($23.99 to $35.98 per 100g) , with prices going as high as $45.99 for Pjur 100ml.

[77] On 29 January 2015, we checked lubricant prices online at http://www.peachesandcream.co.nz/. This confirmed that the lowest priced lubricant was IT Original 60ml for $8.99 ($14.98 per100nl) and then System Jo 30ml for $11.99 ($39.97 per 100ml).

[78] Application above n15 at [9.15].

[79] Submission from RB above n70 at [2.22].

[80] Found through a google search of "lubricant online nz".

[81] Prices as at 29 January 2015.

[82] *Mergers and Acquisitions Guidelines* above n1 at [3.10-3.12].

overcome before it can supply supermarkets. Suppliers cannot simply start supplying supermarkets but instead must convince supermarkets to put their products on the shelf.[83] In large part a supplier is going to need to convince a supermarket that there will be buyers for its product and so supermarkets are likely to require the supplier to invest in advertising and promotions to support sales.

86. Given that a supplier needs to navigate these conditions before it can supply supermarkets, we do not consider that supply-side substitution justifies a wider market. Rather, we consider that these conditions of entry to supplying supermarkets are best considered as part of the ability of competitors to enter or expand, which we do in more detail at paragraphs 147-177.

Conclusion

87. We consider that defining a separate market for the wholesale supply of lubricant products to supermarkets best isolates the impact of the acquisition. Nevertheless, we take into account constraints from outside the market in the competition analysis.

Is it appropriate to define a wholesale market for the supply of personal lubricant to pharmacies?

88. For similar reasons to those explained for the wholesale supply of lubricant to supermarkets, we consider that defining a separate market for the wholesale supply of lubricant products to pharmacies best isolates the impact of the acquisition.

Substitution on the demand-side – ultimate consumers switching to other retailers in response to a SSNIP

89. As with supermarkets, the behaviour of end consumers affects the incentives of pharmacy wholesalers to switch to other products. For pharmacies it is less clear than for supermarkets whether or not consumers are likely to switch to other retailers if prices were to increase.

90. On the facts of this case, consumers have the ability to purchase the same Durex and K-Y products in the supermarket channel at a materially lower price. However, consumers switching from pharmacies to supermarkets may not be sufficient to defeat a SSNIP. Consumers switching from pharmacies to supermarkets would not materially increase the constraint on Durex/K-Y given that the merged entity would hold around [ ]% market share in the supermarket market, with Ansell only available in some supermarkets.

91. For similar reasons to that discussed above with respect to the supermarket channel, we do not consider that a sufficient number of consumers would switch from pharmacies to adult or online retailers in response to a SSNIP to defeat a price increase.

83 Suppliers need to engage with each supermarket chain and, depending on the ranging decisions made by the chains, may still need to convince individual supermarket stores to stock their product.

Substitution by lubricant suppliers in response to a SSNIP

92. In terms of a lubricant supplier's ability to expand into supplying pharmacies, as with supermarkets, a supplier would need to convince pharmacies to stock their product. In turn this would require investing in advertising and promotions. This would be more time consuming than for supermarkets as, aside from Green Cross Health, the pharmacy market is disaggregated.[84] In addition, since the suppliers that supply supermarkets are, for the most part, a subset of the suppliers to pharmacies, pharmacies (and/or their wholesalers) cannot increase their competitive options by looking to stock lubricant brands sold in supermarkets.

Conclusion

93. We consider that defining a separate market for the wholesale supply of lubricant products to pharmacies best isolates the impact of the acquisition. Nevertheless, we take into account constraints from outside the market in the competition analysis.

Are there separate product markets for different types of personal lubricant?

94. RB and J&J (like many other suppliers) supply a range of different types of lubricant to retailers,[85] which may target different types of consumers.[86] RB submitted that although there are a large range of different types of personal lubricant available (differentiated products), "there is substitutability along the spectrum of all products such that they should be considered to fall within one product market".[87] It further submitted:[88]

> The products supplied in this market require the same basic inputs, are manufactured using the same or similar production equipment and are sold to the same downstream consumers. Competing suppliers could quickly, and at limited cost, expand/switch as needed to supply demand side substitutes for the products supplied by the Parties (to the extent they were not already supplying such products). The prevalence of third party manufacturing makes such supply-side substitution easier still.

95. For the reasons set out below, we agree with RB that there is a single product market that includes all personal lubricant.[89]

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84 As noted above, depending on the ranging decisions made by a supermarket chain, a supplier may still need to convince individual supermarket stores to stock their product. However, the time that it would take a supplier to sell their product into individual supermarket stores would likely be considerably less than the time it would take to sell their product into independent pharmacies given that there are many more pharmacies than supermarkets.

85 As noted in Table 1, Durex and K-Y products both range from basic lubricant that is designed for consumers seeking lubricant for functional needs to more enhanced products.

86 Application above n15 at [13.1].

87 Ibid at [12.3].

88 Ibid at [12.5].

89 We note that lubricant products are also used for medical uses (eg, for inserting medical equipment such as catheters). While K-Y sells sterile lubricant suitable for medical uses, Durex does not sell personal lubricant for medical uses. RB submitted that [ ]. Application above n15 at [12.8]. Given that there is no overlap between RB and J&J in the supply of lubricant for medical uses, we do not consider this product further and it is excluded from the personal lubricant market we have defined.

96. Across the retail channels there is a range of brands and types of lubricant available. While there is evidence that suggests that there may be a distinction between basic and enhanced products, there is also evidence that different lubricant products perform similar functions and that consumers substitute between different products along the spectrum.

97. Evidence suggesting that there may be different segments to the market or discrete product markets for different types of lubricant includes:

97.1 basic lubricant designed for functional reasons being sold at a lower price point to products designed for enhancement reasons;[90] [91]

97.2 internal documents of RB and J&J indicating that they see two distinct types of lubricant consumers who have different reasons for using lubricant;[92] and

97.3 the existence of specialised lubricant products that target only specific segments (eg, lubricant that is marketed as being fertility friendly).

98. Evidence suggesting that there is a single market for all lubricant includes:

98.1 some suppliers having different brands or products that are essentially the same formula, but are packaged or branded to target specific consumer segments (eg, basic lubricant marketed at heterosexual versus homosexual couples);[93] [94] and

98.2 comment that "lubricant is lubricant at the end of the day" and that different types of products compete against each other.[95] [96]

99. While we have defined a market that includes all personal lubricant, the products within this market are differentiated ranging from basic lubricant to enhanced

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90 J&J stated that innovative enhanced products command a price premium over more basic lubricant. Interview with J&J above n26.

91 For example, you can buy Durex's basic lubricant (50ml) for $9.99, Durex Play Massage 2-in-1 (200ml) for $13.99, Durex Play O (15ml) for $23.99 and Durex Embrace (120ml) for $26.99. Similar price differentials exist for K-Y and competing brands of lubricant. Even though the size of the bottles or tubes varies, basic lubricant is generally cheaper per ml. Prices taken on 29 January 2015 from http://shop.countdown.co.nz/.

92 [ ]

93 J&J stated that all lubricant products fundamentally do the same thing even though lubricant brands have a range of different SKUs and that different brands may target different consumer segments (have different product positioning). Interview with J&J above n26.

94 [ ] stated that some lubricant suppliers have different brands or products that essentially have the same ingredients, but are packaged or branded to target specific consumer segments. [ ]

95 Commerce Commission interview with Sylk (18 June 2014).

96 FlowMotion also stated that even though it produces an organic lubricant that is quite different to Durex and K-Y products, it is still up against Durex and K-Y on shelves. Commerce Commission interview with FlowMotion (16 June 2014).

products. We recognise that some suppliers focus on different areas.[97] As such, suppliers may impose a greater or lesser constraint on one another according to the specific lubricant products offered and/or type of consumer they target. The question of differentiation between Durex and K-Y, and its relevance to a possible substantial lessening of competition, is considered more fully as part of the competition analysis.

Competition analysis – wholesale supply of lubricant to supermarkets

100. As described earlier in these reasons, we consider that there is a real chance that K-Y would continue to be supplied in New Zealand. Given that conclusion, in this section we assess whether we are satisfied that there are sufficient constraints to prevent a substantial lessening of competition in the market for the wholesale supply of personal lubricant to supermarkets.

101. We are not satisfied that this is the case.

    101.1 Durex and K-Y are the two main lubricant brands currently sold in supermarkets and are the only lubricant brands stocked in some stores. The acquisition would give RB a [ ]% share of sales of personal lubricant through supermarkets.

    101.2 Durex and K-Y are each other's closest competitors. There is substantial overlap in the product range of the two brands, and Durex and K-Y are the most well-known brands.

    101.3 The remaining existing competitors (ie, Ansell and other lubricant brands such as Sylk) are not currently strong and effective constraints. Ansell is currently stocked as a third lubricant brand in 37% of New Zealand's supermarkets,[98] with a market share of [ ]%. The other two brands – Sylk and FlowMotion – have combined sold less than [ ] units across New Zealand in year ended 22 February 2015.

    101.4 We are not satisfied that existing competitors (or new entrants) would be likely to expand to a sufficient extent and in a timely enough way to constrain the merged entity. These competitors or entrants face significant conditions of entry and expansion due to consumers' strong brand loyalty to Durex and K-Y and the cost of promoting a new brand.

    101.5 We are not satisfied that, faced with a price increase, supermarkets have sufficient countervailing power or incentive to use what power they have in order to constrain the merged entity and offset a substantial loss of competition given that they would have few strong alternative options to a merged Durex/K-Y. Supermarkets have, in the past, generally passed on

[97] RB submitted that K-Y focuses on consumers seeking basic lubricant, while Durex focuses on enhanced products. Application above n15 at [13.1] and [16.31].

[98] Ansell advised that, as at 25 January 2015, its lubricant was stocked in 155 of the approximately 420 (or 37%) supermarkets in New Zealand. [ ]

wholesale price increases to consumers, and we are not convinced that they would not do so again post-acquisition.

Existing constraint provided by Durex and K-Y on one another

102. RB submitted that there is limited existing competition between Durex and K-Y.[99] This is because:

102.1 Durex and K-Y are not close competitors[100] as they "focus on different customer segments"[101] and compete for "white space" or new consumers;[102]

102.2 sales data "shows no meaningful evidence of substitution" between Durex and K-Y;[103] and

102.3 K-Y's competitive constraint is declining due to a lack of investment.[104]

Closeness of competition between Durex and K-Y

103. Even though Durex and K-Y both supply basic lubricant and enhanced products,[105] RB submitted there is only limited overlap between Durex and K-Y at the margin "due to their differentiated product offerings".[106] [107] While RB acknowledged that Durex takes competitors (including K-Y) into account in its decision making,[108] it submitted that its main driver is to gain sales from the "white space" in the market.[109] Overall, RB submitted that it does not see K-Y as providing significant constraint.[110] RB stated that Durex's closest competitor is Ansell, not K-Y (whose closest competitor is Sylk).[111]

104. Our investigation indicated, however, that there is competitive overlap between the parties and they are each other's closest competitors.[112]

104.1 Other industry participants we have spoken to (including J&J) consider that Durex and K-Y have the most well-known brands and are close competitors in the supply of personal lubricant. As acknowledged by RB itself, Durex has

99 Submission from RB above n70 at [3].
100 Submission from RB above n64 at [7.2].
101 Ibid at [7.6].
102 Ibid at [8.1].
103 Ibid at [3].
104 Application above n15 at [18.6-18.8].
105 As acknowledged by RB. Application above n15 at [16.37].
106 Application above n15 at [17.1].
107 Although, RB conceded that it does have a basic lubricant product, Durex Play Feel, "which is similar to K-Y's basic product". Application above n15 at [16.32].
108 Application above n15 at [18.11].
109 Submission from RB above n64 at [4] and [8.1].
110 Ibid at [8.1].
111 Commerce Commission meeting with RB (24 September 2014).
112 We note that Durex and K-Y need not be perfect substitutes for each other in order for them to provide a competitive constraint on each other. In particular, a supermarket does not have to be willing to give up Durex (or K-Y) entirely, but that it simply has to be willing to shift its purchases across the two in order to obtain better prices.

regard to K-Y when making business decisions.[113] This is despite the fact that Durex and K-Y to some extent may target different consumer segments and position themselves slightly differently to consumers.

104.2 The overlap between Durex and K-Y is across a range of lubricant products (both basic and enhanced). Durex and K-Y are the leading suppliers in each category in supermarkets and the only current suppliers of some types of lubricant in supermarkets (eg, couples lubricant), although we acknowledge that Durex and K-Y are each stronger in different product segments (basic lubricant for K-Y compared to enhanced products for Durex).

105. Table 2 sets out supermarket lubricant sales (by retail value) for the year ended 22 February 2015 broken down into sales of basic lubricant and enhanced products.[114] Table 2 shows that Durex and K-Y both supply lubricant products at both ends of the spectrum.

Table 2: Supermarket sales for basic lubricant and enhanced products

Brand	Basic		Enhanced products		Total[115]	
K-Y	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Durex	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Merged Entity	**[ ]**	[ ]%	**[ ]**	[ ]%	**[ ]**	[ ]%
Ansell	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Sylk	[ ]	[ ]%			[ ]	[ ]%
FlowMotion	[ ]	[ ]%			[ ]	[ ]%
Vagisil	[ ]	[ ]%			[ ]	[ ]%
TOTAL	**[ ]**	**100%**	**[ ]**	**100%**	**[ ]**	**100%**

Source: RB (based on supermarket scanner data)

106. Having said that, K-Y predominately sells basic lubricant and Durex predominately sells more enhanced products. Basic lubricant accounts for [ ]% of K-Y's total sales through supermarkets. Conversely, enhanced products are [ ]% of Durex's total sales through supermarkets. We also note that sales of K-Y enhanced products have declined in the last three years (see Figure 1), largely due to a lack of investment in and promotion of the products by J&J.[116] This is discussed further at paragraphs 122-129 in assessing the future constraint provided by K-Y.

107. Moreover, we have been told that the nature of personal lubricant means that brands are important. Consumers in supermarkets tend to choose brands they are familiar with. Durex and K-Y are the two most well-known brands in the market with the strongest brand recognition. This means that, even if Durex and K-Y target different types of consumers, many are likely to view Durex and K-Y as the next best alternative.

[113] Application above n15 at [18.11].

[114] In Table 2, enhanced products include silicone, warming/cooling, flavoured, massage, couples and orgasm enhancing products.

[115] Totals do not match 2015 figures in Table 3 due to differences in data provided.

[116] Interview with J&J above n26.

108. The views of market participants support this analysis. Market participants including J&J have consistently claimed that Durex and K-Y products compete against one another despite some differentiation.

108.1 J&J stated that Durex is K-Y's key competitor and that [ ] between Durex and K-Y; although it acknowledged that Durex and K-Y generally have different product positioning in terms of the consumers they target.[117]

108.2 [ ] submitted that Durex and K-Y are the closest competitors in supermarket channel and the most trusted entrenched brands in New Zealand.[118] [ ] stated that Durex and K-Y compete head-to-head and between them have all the top 10 lubricant SKUs.[119]

108.3 [ ] stated that there is a bit of market segmentation between lubricant brands.[120] However, [ ] stated that Durex and K-Y are "the major brands". Durex tends to be more at the enhanced end and K-Y more functional, but there is a lot of interplay between the brands and they're not that different.[121] [ ] commented that the amount of competitive tension between Durex, K-Y and Ansell is positive.[122]

108.4 [ ] stated that people buy Durex and K-Y because of the brand recognition and low pricing.[123]

Whether sales data indicates consumers switch between Durex and K-Y

109. We considered whether sales data tells us anything about the degree of competition between Durex and K-Y (in particular, whether consumers switch between Durex and K-Y). On this occasion, for the reasons described below, we do not consider that the analysis of sales data provides a reliable indicator of the closeness of competition between Durex and K-Y.

<u>Houston Kemp report</u>

110. Lubricant is often sold on special in supermarkets. However, while it was clear that lubricant sales increased when a product was on promotion, evidence from interviews was mixed as to whether this increase in sales was caused by switching away from another brand, consumers simply stocking up on their product of choice, or because of new consumer purchases.[124]

117 Ibid.
118 [ ]
119 [ ]
120 [ ]
121 [ ]
122 [ ]
123 [ ]
124 [ ]

111. RB provided a report analysing the effect of promotions on the sales of personal lubricant[125] [126] and submitted that the report was evidence that Durex and K-Y are not close competitors.[127]

112. The Houston Kemp report provided by RB used an econometric model to assess the effect that the promotion of a particular lubricant product had on the sales of other lubricant products in the supermarket sales channel.[128] The analysis was based on pairs of lubricant brands which were most similar and had high sales.[129] The analysis modelled the volumes of the first lubricant brand over time and then sought to identify whether certain events caused a statistically significant change in those volumes. The events studied were:

112.1 when the second lubricant brand (but not the first lubricant brand) was on promotion – a result consistent with strong competition would be a negative relationship between the first brand's volume and the second's brand promotion;

112.2 changes in the volume of the second lubricant brand – a result consistent with strong competition would be a negative relationship between the first and second brand's volume; and

112.3 the entry of Ansell – a result consistent with strong constraint from Ansell would be a negative relationship between the first brand's volume and Ansell's entry.

113. The Houston Kemp report carried out analysis for a wide range of lubricant pairs including combinations of the main brands of Durex, K-Y and Ansell. In most cases the analysis found no statistically significant relationship between the pairs.[130] This included the introduction of Ansell, which the report did not find affected the sales volumes of Durex or K-Y lubricant. The occasions where a statistically significant relationship was found were:

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125 Houston Kemp report, *Effect of Promotions of Personal Lubricants in New Zealand* (13 October 2014), attached to submission from Bell Gully (on behalf of RB) (14 October 2014).

126 Subsequently, RB provided further material from Houston Kemp (additional to the report provided on 14 October), being as follows: Houston Kemp memorandum to Bell Gully, *Response to NZCC's Letter of Unresolved Issues* (17 December 2014), attached to e-mail from Bell Gully (on behalf of RB) (12 January 2015); Houston Kemp memorandum to Bell Gully, *Explanatory information on use of R to assess the effect of promotions on personal lubricant* (20 January 2015), attached to e-mail from Bell Gully (on behalf of RB) (20 January 2015); Houston Kemp memorandum to Bell Gully, *Analysis of Increases in Retail Prices of KY and Durex Lubricants* (2 February 2015), attached to e-mail from Bell Gully (on behalf of RB) (4 February 2015); and Houston Kemp report, *Response to Report of Dr Tenn* (18 March 2015), attached to submission from Bell Gully (on behalf of RB) (18 March 2015).

127 Submission from Bell Gully (on behalf of RB) (14 October 2014) at [6.3].

128 Houston Kemp only conducted the analysis for Countdown supermarkets. It did not analyse New World or Pak'n'Save supermarkets because, as those stores had autonomy over their pricing, Houston Kemp was not able to identify specific periods of promotions. Houston Kemp report above n125 at 6.

129 Houston Kemp memorandum (17 December 2014) above n126 at 2.

130 Ibid at 17.

113.1 a negative relationship between the promotions of Durex Massage 2-in-1 and the sales of Durex Play Feel;

113.2 a negative relationship between the volumes of: Durex Massage 2-in-1 and Durex Play Feel, Ansell Natural and K-Y Jelly, and Ansell Natural and K-Y Sensual Silk; and

113.3 a positive relationship between the volumes of: Durex Massage 2-in-1 and K-Y Jelly, Durex Massage 2-in-1 and K-Y Sensual Silk, and K-Y Intense and Durex Play-O.

114. The authors further stated:[131]

> …the lack of any statistically significant negative relationship for all Durex and KY product pairs under the both the promotional and volume models suggest that there is no strong evidence of inter-brand competition between the 'like-for-like' or high selling products of these two brands of personal lubricant. That is, the models do not provide any support for the assertion that customers switch between 'like-for-like' Durex and KY products in response to product promotions.

<u>Review of the Houston Kemp results</u>

115. Our initial review of the Houston Kemp report led us to have concerns over the robustness of the model used. Given those concerns, we commissioned an independent expert in econometrics (Dr Steven A Tenn of Charles River Associates) to review the model.[132] [133] Based on our own analysis and that of Dr Tenn, we have concluded that the Houston Kemp report is flawed and therefore have placed very little weight on its results. We set out below some of the problems identified.

116. First, the model may underestimate the degree of constraint between Durex and K-Y. As the model analyses pairs of products, it does not reflect that the constraint between Durex and K-Y may come from each brand's portfolio of products. Houston Kemp recognises this problem.[134] Houston Kemp submitted that it is difficult to assess the constraint between groups of products given products are continually phased in and out, and its approach is therefore the best way to assess the constraint between Durex and K-Y.[135] Although this may be true, it does not change the fact that using pairs will underestimate the overall constraint.

117. Second, the model may have omitted variables. The effect of excluding important explanatory variables is that the model may under- or overestimate the effect of the variables included. In this case, each model only includes a single explanatory

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131 Ibid at 18.

132 Charles River Associates, *Expert Report of Steven A. Tenn, Ph.D. Pertaining to the proposed transaction between Reckitt Benckiser and certain assets of Johnson and Johnson* (3 March 2015).

133 Subsequently, Charles River Associates provided a further report responding to Houston Kemp's response to the initial CRA report. Charles River Associates, *Expert Report of Steven A Tenn, PhD, Pertaining to the proposed transaction between Reckitt Benckiser and certain assets of Johnson and Johnson* (20 April 2015).

134 Houston Kemp report above n125 at 2.

135 Houston Kemp memorandum (17 December 2014) above n126 at 20.

variable (ie, either whether a particular lubricant is on promotion or not, the volumes of a particular lubricant, or whether Ansell had entered the market or not). Dr Tenn's view is that the models do not include variables that are likely to affect volumes, including the price of the lubricant being modelled and those of its substitutes.[136] Evidence that there are omitted variables includes that the model finds a positive correlation between the volumes of K-Y Intense and Durex Play-O (which would suggest the two are complements rather than substitutes) and that the model does not include promotional effort as a variable, which RB implicitly suggests affects sales (see paragraph 120 for further explanation).

118. Third, the Houston Kemp material does not provide evidence of the degree of constraint between Durex and K-Y.[137] The Houston Kemp material assesses whether there is a statistically significant relationship between pairs of lubricant products and draws conclusions based on whether there is or is not. However, the lack of statistical significance could be because the model is not able to generate precise estimates. Therefore, the lack of statistical significance does not imply the products do not constrain one another. Houston Kemp claims it does not draw that conclusion but rather that "the absence of a statistically significant relationship … suggests that there is no strong evidence of competition".[138] This is not a claim that there is no competition between Durex and K-Y and, as such, the analysis provides little information in that regard.

119. As a result of these flaws (and others[139]), Dr Tenn concluded that the "Houston Kemp reports do not contain useful information regarding whether the merging parties are, or are not, in competition".[140]

120. In addition to the flaws in the model identified, there are some inconsistencies between the results of the model and other evidence which are hard to reconcile. This suggests the model does not accurately reflect how the market works. The inconsistencies that we have identified are described below.

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136 Charles River Associates report above n132 at [40].

137 Charles River Associates report above n132 at [42]-[48] and Charles River Associates report above n133 at [23]-[25].

138 Houston Kemp report (18 March 2015) above n126 at [12].

139 In addition to the flaws identified, Dr Tenn's concerns also included (Charles River Associates report above n133): Houston Kemp did not analyse whether Countdown customers are sufficiently similar to non-Countdown customers to enable the results to apply to the supermarket channel as a whole (at [14]); the analysis treats simultaneous pair-wise price reductions as being neutral even though they would likely lead to higher overall sales (at [21]); Houston Kemp have transformed the variables in a way that imposes a strong assumption on substitution patterns and which is not consistent with economic theory (at [27]); the lack of price variation in K-Y's main products means it is not possible to assess whether Durex is a substitute for those products (at [42]); the analysis treats price reductions as binary (on promotion or not on promotion) and does not take into account the size of the promotion (which is likely to affect the extent of the change in sales) (at [44]); the reports do not recognise that the lack of relationship in volume between two products does not necessarily imply that the two products are poor substitutes (at [50]); and Houston Kemp wrongly argue that the Ansell entry model can be used to assess whether Ansell is a substitute for Durex and K-Y, when instead it shows whether Durex and K-Y is a substitute for Ansell (at [53]).

140 Charles River Associates report above n132 at [59].

120.1 The model showed that the entry of Ansell had no impact on Durex's sales. [ ][141] If that is the reason no impact on volume is observed, then the model has omitted an explanatory variable (promotional effort).

120.2 The model showed no relationship between Durex Embrace and K-Y Yours and Mine. This contradicts a statement by J&J that sales of K-Y Yours and Mine have declined since the launch of Durex Embrace.[142]

120.3 The report found that Ansell has a statistically significant negative effect on K-Y volumes in the volume model but found no effect in the promotion and entry models. If Ansell provided a constraint on K-Y and the models were robust, then we would expect to see that effect in all three models.

121. To conclude, the analysis used to assess supermarket sales data does not provide reliable evidence that Durex and K-Y are not close competitors, or that any competition that would be lost by reason of the acquisition would not be substantial.

Future constraint from K-Y

122. Although K-Y has a high current market share, RB submitted that K-Y has weakened as a competitor in recent years – due to a lack of investment – and that trend would continue in the future.[143] J&J confirmed that around two years ago it decided to stop above-the-line advertising and only do limited promotions around K-Y.[144] [145] In addition, J&J stated that, without the acquisition, it would likely incur additional costs to have smaller quantities of K-Y products manufactured solely for the New Zealand market, implying that this would affect its margins).[146]

123. Given the above, we considered whether the current level of constraint provided by K-Y might exaggerate the loss of competition as a result of the acquisition.

124. Despite J&J's statement (noted above) that additional costs would be incurred to have K-Y manufactured solely for New Zealand,[147] it provided no information to suggest that it would make losses on the sale of K-Y in the future. J&J advised that [

141 Meeting with RB above n111 and submission from RB above n127 at [6.5].
142 Interview with J&J above n26.
143 Application above n15 at [18.7-18.10].
144 Interview with J&J above n26.
145 Above-the-line advertising or promotion uses media (eg, television, print, radio) that are broadcast and published to mass audiences to drive sales.
146 E-mail from J&J above n39 and e-mail from Kensington Swan (on behalf of J&J) to the Commerce Commission (12 February 2015).
147 E-mail from J&J above n39.

].[148] Based on this evidence, we are not satisfied that K-Y (whether owned by J&J or a third-party) would not remain price competitive.

125. In terms of K-Y declining in recent years, Table 3 shows that K-Y's sales (and share of sales) have declined between 2012 and 2015, while Durex's and Ansell's sales (and share of sales) have grown in nominal terms.

Table 3: Trend in supermarket sales by sales value

Brand	2012		2013		2014		2015	
K-Y	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Durex	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Ansell	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Sylk	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
FlowMotion							[ ]	[ ]%
Vagisil	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Marquis	[ ]	[ ]%						
TOTAL	**[ ]**	**100%**	**[ ]**	**100%**	**[ ]**	**100%**	**[ ]**	**100%**

Source: RB (based on supermarket scanner data)

126. A more detailed analysis of sales by individual SKU indicates that, at the basic end of the spectrum, K-Y Jelly continues to have steady sales despite a lack of investment by J&J.[149] However, sales of K-Y enhanced products have declined [ ] in recent years (as shown in Figure 1).[150]

Figure 1: Performance of K-Y enhanced products 2012-2015

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Source: RB (based on supermarket scanner data)

[148] E-mail from J&J (12 February 2015) above n146.

[149] J&J stated that K-Y Jelly has a lot of consumer loyalty such that consumers continue to use K-Y Jelly despite J&J doing no above-the-line advertising. Interview with J&J above n26.

[150] E-mail from Bell Gully (on behalf of RB) to the Commerce Commission (17 April 2015).

127. [ ] In addition, as Figure 1 shows, some of K-Y’s other enhanced products have not proved successful and have been withdrawn from the New Zealand market. J&J expressed the view that [ ].[151]

128. K-Y’s sales and its competitive constraint may decline in the future, particularly if it is still owned by J&J. J&J submitted that, were it to still supply K-Y without the acquisition, the K-Y brand in New Zealand would continue to receive limited market support.[152] [153] If no investment was made in the K-Y brand without the acquisition (including in product development), then sales of K-Y enhanced products may continue to decline, making them less of a constraint on comparable Durex products. However, if the K-Y brand was sold to another party, that party might decide to undertake above-the-line advertising and promote K-Y products, and the downward trend may not continue.

129. Even if K-Y’s sales of enhanced products were to continue to decline to the extent that it ended up only selling lubricant at the basic end of the market, K-Y would nonetheless continue to provide a competitive constraint on Durex for basic products. In this scenario, we would still have concerns about the loss of competition between Durex and K-Y in terms of basic lubricant.

Conclusion on competition between Durex and K-Y

130. Based on the evidence provided to us, we consider that Durex and K-Y provide a material competitive constraint on each other. The acquisition would result in a substantial loss of existing competition in the wholesale supply of personal lubricant to supermarkets. In subsequent sections, we consider whether constraint from existing competition, potential competition and/or the countervailing power of supermarkets would be sufficient to offset this loss of competition.

Existing constraint provided by other competitors

131. RB submitted that post-acquisition there would “remain many strong and effective competitors across the spectrum of personal lubricant products”.[154] RB identified four other brands as existing competitors in the wholesale supply of personal lubricant to supermarkets (namely Ansell, Sylk, FlowMotion and Vagisil). We have considered the constraint these parties currently provide and whether it would be sufficient to prevent a substantial lessening of competition.

132. For the reasons set out below, we are not satisfied that these existing competitors are currently a strong and effective constraint. We consider later, as part of potential competition, whether the potential for these existing competitors to grow is

151 Interview with J&J above n26.
152 E-mail from J&J (25 June 2014) above n43.
153 J&J also stated that without the acquisition future product innovation would be impacted as new K-Y products would not be developed in the Northern Hemisphere. Interview with J&J above n26.
154 Application above n15 at [17.1-17.2].

sufficient to replace the competition that would be lost with the acquisition and would be sufficient to prevent a substantial lessening of competition.

Ansell

133. Ansell is Durex's and K-Y's main existing competitor with a market share of [ ]% in supermarkets.

134. Two years ago, only very small volumes of Ansell lubricant were sold in New Zealand supermarkets. However, since April 2013, Ansell has achieved ranging in more stores and grown its sales. Ansell lubricant has gone from being stocked in only around 10 stores,[155] to being stocked in 155 (or 37)% of stores.[156]

135. RB submitted that Ansell's New Zealand lubricant sales have grown significantly.[157] Figure 2 shows annual supermarket sales (by value) for Ansell lubricant for the last four years.[158]

Figure 2: Trend in Ansell lubricant sales 2012-2015

[

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Source: RB (based on supermarket scanner data)

136. Figure 2 shows [ ] growth in Ansell's sales (by volume) since 2013, with Ansell's sales having increased [ ]% between 2013 and 2014 (from $[ ] to $[ ]). Between 2014 and 2015, Ansell's sales have continued to increase (with sales of $[ ] in 2015, an increase of [ ]% on 2014).

137. RB noted that Ansell had achieved the market share that it had in a relatively short space of time and with little "above the line" promotional activity.[159] RB further

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155 Submission from RB above n64 at [5.15].

156 Ansell advised that, Countdown has the highest distribution of Ansell lubricant, followed by Foodstuffs NI. Ansell stated that there is only minimal distribution of Ansell lubricant in Foodstuffs SI. [ ]

157 Application above n15 at [18.3].

158 The data on which Figure 2 is based is for the years end February 2012, 2013, 2014 and 2015 (ie, the year ended February 2015 comprises sales from March 2014 to February 2015.

159 Submission from RB above n70 at [4.7(a)].

submitted that Ansell's current relatively small market share "simply reflects the fact that it is a relatively new entrant".[160]

138. Although Ansell's market share has grown materially in the last two years, this growth has been from a very low base. Ansell is still currently a minor player in New Zealand compared to Durex and K-Y. Ansell is currently present in just over one in three stores and has fewer lubricant SKUs on the shelves than Durex and K-Y.[161] Brand loyalty to Durex and K-Y is something that Ansell has had to confront in trying to expand its market share. At a market share of [ ]%, we are not satisfied that Ansell would sufficiently constrain the merged entity.[162]

Sylk

139. Sylk is currently not present in supermarkets to any noticeable degree. Sylk is only stocked by a small number of stores (none being Countdown supermarkets) whose owners have approached it seeking to stock its product (following requests from consumers).[163] Sylk sold only [ ] units in the year ended 22 February 2015. Sylk stated that it currently does not do much advertising or promotion, other than to provide free samples to consumers through medical professionals.[164]

140. On this basis, we are not satisfied that Sylk would sufficiently constrain the merged entity.

FlowMotion

141. Launched in June 2014, FlowMotion is an organic personal lubricant made in New Zealand by a newly established company.[165] Like Sylk, FlowMotion is currently not present in supermarkets to any noticeable degree. FlowMotion is currently only stocked in 17 stores in the South Island.[166] Between June 2014 and 22 February 2015, FlowMotion sold only [ ] units in supermarkets.

142. On this basis, we are not satisfied that FlowMotion would sufficiently constrain the merged entity.

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160 Ibid at [4.4].

161 While Ansell produces a range of different lubricant products from basic lubricant to enhanced products, only two Ansell SKUs are currently stocked by New Zealand supermarkets (being its basic natural lubricant and more enhanced warm lovin' lubricant), such that Ansell has a more limited range of lubricant products on the shelves than Durex or K-Y.

162 While we considered whether sales data tells us anything about competition between Ansell and Durex or K-Y, for reasons already discussed at paragraphs 109-121 we have concluded that we can place very little weight on the results of that analysis.

163 Commerce Commission interview with Sylk (12 September 2014).

164 Interview with Sylk above n95.

165 FlowMotion is manufactured on contract by [ ] above n69.

166 Count of stores stocking FlowMotion taken on 10 April 2015. At the time of its launch in June 2014, FlowMotion was only stocked in three stores in Nelson and Takaka. FlowMotion has got into more stores since January 2015 after being ranged by Foodstuffs SI [ ]. A full list of FlowMotion stockists is available at http://flowmotion.co.nz/.

Vagisil

143. Vagisil has been identified as a fourth competitor to Durex and K-Y. RB submitted that Vagisil is a popular basic personal lubricant product.[167]

144. Vagisil's product range includes Vagisil Intimate Moisturising Lubricant as well as feminine wash products. While Vagisil Intimate Moisturising Lubricant can be used as a personal lubricant during sexual activity, it is promoted as a product that can be used on a daily basis to help prevent vaginal dryness. No interested parties identified Vagisil as being a competitor to Durex and K-Y. [ ] stated that Vagisil is quite a different product to other personal lubricant.[168]

145. Vagisil is not present in supermarkets to any noticeable degree and currently has a [ ]% share of lubricant sales in the supermarket market.

146. Given this, we consider that Vagisil may be more appropriately classified as a vaginal moisturiser rather than a personal lubricant. We do not consider the constraint provided by Vagisil any further in this determination.

Potential competition

147. In this section we consider whether existing competitors would expand or new competitors would enter and effectively compete with the merged entity if prices increased.[169] The threat of entry or expansion must be sufficient to constrain market power. This requires entry or expansion to be likely, sufficient in extent, and timely (referred to as the 'LET test').[170]

148. Because there are a number of small existing competitors already supplying supermarkets on a limited scale, we have first focused on the ability of these competitors to expand post-acquisition. The ability of these competitors to expand is, in our view, a good marker as to the likelihood of new entry constraining the merged entity more generally, particularly given the importance of brand to consumers. Because supermarket customers are already at least partially familiar with these brands, these competitors are the ones most likely to satisfy the LET test.

149. RB submitted that "competitors have the capability to expand sales quickly".[171] RB further submitted that:

149.1 Ansell is a strong rival that has the range of products and ability to swiftly expand in the supermarket market;[172]

149.2 Sylk is a strong rival in the pharmacy market that could easily enter and expand in the supermarket market;[173] and

[167] Application above n15 at [16.6].
[168] [ ]
[169] *Mergers and Acquisitions Guidelines* above n1 at [3.91].
[170] Ibid at [3.96].
[171] Application above n15 at [17.1-17.2].
[172] Ibid at [16.16] and [18.4].

149.3 FlowMotion (a new personal lubricant brand) has recently achieved ranging in a number of stores and would no doubt seek to extend its ranging.[174]

150. For the reasons set out below, we are not satisfied that expansion by Ansell, Sylk or FlowMotion would be likely, sufficient in extent, and timely.

150.1 Ansell starts from a low market share and would require considerable investment in its products to become a competitor sufficient to offset the loss of competition between Durex and K-Y. The importance of brand is a condition of expansion that Ansell would have to navigate. Ansell would have to make substantial and sustained sunk cost investment in advertising and promotion in order to try to overcome the entrenched brand loyalty to incumbents, with no guarantee of success. Ansell has had limited success in its expansion in New Zealand so far and there is no evidence that it would be more successful in the face of a price rise by the merged entity.

150.2 Sylk is not present in supermarkets to any noticeable degree. It, like Ansell and any other entrant or competitor, would have to overcome significant conditions of expansion to become a material participant in the supermarket market. [ ][175]

150.3 Like Sylk, FlowMotion is currently not present in supermarkets to any noticeable degree. While FlowMotion wants to be stocked in supermarkets around New Zealand, it is early days and it would have to overcome similar significant conditions of expansion in the supermarket market to become a material participant.

151. We discuss conditions of entry and expansion before going on to analyse whether any of Ansell, Sylk and FlowMotion are prepared to promote their products to the necessary extent to meet the LET test.

152. In the countervailing power section, we discuss the extent to which supermarkets could sponsor new entry or expansion.

Conditions of entry and expansion

153. The likely effectiveness of entry and expansion is determined by the nature and effect of the aggregate conditions of entry and expansion into the relevant market. The conditions of entry and expansion can take a variety of forms, including structural, regulatory and strategic conditions.[176]

154. RB submitted that there are no significant barriers to entry and expansion because:

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173 Ibid at [18.5].

174 Submission RB above n127 at [2.5].

175 Interview with Sylk above n95 and interview with Sylk above n163.

176 *Mergers and Acquisitions Guidelines* above n1 at [3.108].

154.1 there are no manufacturing barriers to entry or significant import barriers;[177]

154.2 in RB's experience convincing retailers to stock new lubricant SKUs is not sufficiently difficult so as to constitute a barrier to entry or expansion;[178] and

154.3 while an attractively branded product is important, brand reputation is not as important in lubricant as it is with contraceptives.[179]

155. There are no significant manufacturing barriers to entry or import barriers. Most personal lubricant brands sold in New Zealand are manufactured overseas (on contract by third-party manufacturers).[180] [181] In addition, existing lubricant suppliers do not appear to have any capacity constraints that would prevent them expanding.[182]

156. However, we consider that brand recognition and consumer loyalty are conditions of entry and expansion that a supplier must navigate. In addition and as a corollary of this, lubricant suppliers must obtain access to supermarket shelves.

<u>The importance of brand</u>

157. The recent entry of FlowMotion may be consistent with RB's submission that brand recognition does not constitute a substantial barrier to entry in the wholesale supply of personal lubricant to supermarkets. However, while fringe entry may be relatively easy, this does not necessarily translate into entry that would effectively constrain the merged entity. The fact that FlowMotion has only achieved ranging in 17 supermarket stores in the South Island since its entry in June 2014 and other evidence indicates that brand recognition and strong consumer loyalty are conditions of entry and expansion in the wholesale supply of personal lubricant to supermarkets.

158. Durex and K-Y both have strong brand recognition and are trusted brands.[183] Lubricant appears to be a product for which consumers require a level of trust and, therefore, consumers tend to be loyal to one or two brands.

158.1 J&J stated that personal lubricant is a high trust category. It stated that if a supplier builds trust in a lubricant brand, it can be sustainable long-term. But if a supplier does not invest to build trust in consumers, then it will not be successful. However, it takes time to build trust. A supplier needs to market their product to consumers and highlight the point of difference they offer.[184]

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177 Application above n15 at [19.1(a)-(e)].
178 Submission RB above n64 at [5.14].
179 Application above n15 at [19.1(f)].
180 Application above n15 at [9.3].
181 [ ]
182 Sylk stated that it had capacity available to significantly increase supply. Interview with Sylk above n163.
183 A global consumer survey conducted by RB found that [ ]% of New Zealand respondents identified Durex or K-Y as brands they were aware of. [ ] above n26.
184 Interview with J&J above n26.

158.2 [ ] stated that consumer focus groups suggest that consumers require a level of trust in a lubricant brand. A strong brand is needed for a supplier to gain traction with retailers (and also with consumers).[185] [ ] submitted that "brand trust is very important in the sexual wellness category".[186]

158.3 [ ] stated that there is strong brand loyalty in personal lubricant. People tend to make a fast decision at the shelf in the supermarket about the lubricant they will purchase. The standard consumer tends to repurchase the same product that they are familiar with.[187]

158.4 [ ] stated that to introduce and stock another lubricant brand, it would need to be a known brand that consumers trust. It stated that consumers know Durex and K-Y and there are no other lubricant brands with the same level of recognition. [ ] stated that you would not, relatively quickly, turn around a supplier that was relatively non-existent in a category to a 50% share. To do so would be a remarkable success story in any category, not just lubricant.[188]

159. Negotiating this condition – and in particular the asymmetry between Durex/K-Y's existing brand loyalty and the competitor's – requires considerable sunk investment in promotion and advertising, with no guarantee of success. As noted below, existing competitors [

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Access to supermarkets

160. FlowMotion's entry may also be consistent with RB's submission that access to supermarkets does not constitute a barrier to entry. However, while fringe entry may be relatively easy, this does not necessarily translate into entry that would effectively constrain the merged entity. The fact that FlowMotion has only achieved ranging in 17 supermarket stores in the South Island, along with other evidence from other lubricant suppliers and supermarkets, indicates that this is a condition of entry a supplier must navigate, and one which is interdependent with consumers' loyalty to incumbent brands and knowledge of a supplier's brand.

161. Evidence from supermarkets indicates that the process of getting a product on supermarket shelves is the same for an existing supplier (who may be seeking to get an additional SKU on the shelves or get its product into more stores) and a new entrant, although an existing supplier's relationship with a supermarket is likely to give it some advantage over a new supplier. We note that Ansell advised that it got its lubricant onto New Zealand supermarket shelves largely because of its pre-existing relationships with supermarket category managers.[189] In either case, a supplier needs to present its product to supermarkets and convince them that there

185 [ ]
186 [ ]
187 [ ]
188 [ ]
189 [ ]

is value in putting it on the shelves. A product could add value because it has a point of difference, is a product that consumers want (and will increase sales), or because it would provide supermarkets with higher profits. Supermarkets indicated that suppliers need to commit to investment in promotions to ensure brand awareness and sales of any new product. Evidence indicates that supermarkets are open to stocking new lubricant products that meet the above criteria, but that any new SKU would compete with existing SKUs for shelf space.[190]

162. Evidence from lubricant suppliers indicates that they see getting product stocked on supermarket shelves as being a significant issue.

162.1 J&J stated that retailers are interested in category margins and the incremental sales and value that a new SKU would provide to a category.[191]

162.2 [ ] stated that barriers to entry and expansion are strong for small players. It commented if it was easy, other lubricant brands would be on the shelves already.[192] [ ] further stated that as a small supplier, it is difficult to even get an appointment with supermarket chains.[193]

162.3 [ ] stated that supermarkets are quite particular about who they see and require suppliers to spend a lot on advertising, which is not practical for small players or necessarily justifiable given the size of the lubricant market.[194]

Whether the LET test is met

163. The entry and expansion of Ansell and FlowMotion in recent years suggests that further entry or expansion in the wholesale supply of personal lubricant to supermarkets is possible. However, the possibility of entry or expansion in itself is insufficient to constrain the merged entity. Entry or expansion must be likely, sufficient in extent, and timely before it could constrain the merged entity and prevent a substantial lessening of competition.[195]

164. We are not satisfied that, if the merged entity increased prices, expansion by Ansell, Sylk or FlowMotion would meet the LET test.

190 [ ]

191 Interview with J&J above n26.

192 [ ]

193 [ ]

194 [ ]

195 *Mergers and Acquisitions Guidelines* above n1 at [3.96].

Likely

165. The experiences of Ansell, Sylk and FlowMotion to date provide insight as to whether they are likely to expand with the acquisition in response to a price increase.

166. As noted earlier, in the two years since its entry, Ansell has only been able to get its lubricant stocked in 155 (or 37)% of stores and achieve a market share of [ ]%. The reasons underlying Ansell's limited success since entry make it relevant to both the likelihood of Ansell expanding further if prices increased, as well as the likelihood of other brands expanding or entering the market.

167. Evidence from Ansell indicates that it has found it hard work to achieve a [ ]% market share. [

][196] [197] This suggests that it is possible, but not necessarily likely that Ansell would expand. We consider further below whether, even if Ansell did expand, that expansion would be sufficient in extent and timely.

168. Nor are we satisfied that Sylk is likely to expand in the supermarket market such that it would meet the likely part of the LET test. Evidence from Sylk indicates that [

].[198] As Sylk does not meet the "likely" strand of the LET test we do not consider it further under "extent" or "timely".

169. In the ten months since its entry, FlowMotion has only got its lubricant stocked in 17 supermarket stores in the South Island and sold [ ] units. FlowMotion has publicly stated its desire to be stocked in supermarkets around New Zealand so as "to give the big boys a run for their money".[199] [

][200] On this basis, it appears likely that FlowMotion would seek to expand with the acquisition.

170. We next turn to the questions of whether expansion by rivals would be sufficient in extent and timely. While fringe or niche entry and/or expansion may, in theory, be

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198 Interview with Sylk above n95 and interview with Sylk above n163.

199 http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11399007.

200 Commerce Commission interview with FlowMotion (16 February 2015).

relatively easy, Sylk and FlowMotion are the only examples of such type of entry to date and they have very small market shares. Ansell is the only brand to have attempted large scale entry and, while Ansell has made some gains, it still has limited market share, [ ].

171. As Ansell, Sylk and FlowMotion are already present in supermarkets they appear to be best-placed to expand. We have not identified any other major suppliers in New Zealand or Australia that are likely to attempt large scale entry. Furthermore, Sylk does not appear likely to expand. As such we only consider Ansell and FlowMotion in the sections below.

<u>Sufficient in extent</u>

172. Notwithstanding our view that it is not necessarily likely that Ansell would expand, we have considered whether any expansion by Ansell (were it likely) would be sufficient in extent. From the evidence before us, we are not satisfied that any expansion by Ansell would be sufficient in extent to replace the competition that would be lost with the acquisition and would be sufficient to prevent a substantial lessening of competition. Ansell stated that it currently has a goal of growing its sales to have a [ ]% share of New Zealand supermarket sales.[201] However, Ansell has found it hard work to get to its current [ ]% share of supermarket sales [ ].[202] Based on this, and our conclusions about the importance of brand and support from supermarkets (discussed in the next section), we are not satisfied that Ansell's sales would grow to a level where it becomes a significant competitor to the merged entity.

173. We are also not satisfied that any expansion by FlowMotion would be sufficient in extent to replace the competition that would be lost with the acquisition and would be sufficient to prevent a substantial lessening of competition. FlowMotion is currently only stocked in 17 supermarket stores in the South Island ([ ]% of stores nationally). FlowMotion needs to get its lubricant stocked in supermarkets on a larger scale and significantly grow its sales before it would pose a sufficient competitive constraint on the merged entity. FlowMotion is targeting to achieve sales of $[ ], which it estimates would give it a [ ]% share of supermarket sales of personal lubricant.[203] Even if it achieves this, it is unclear what level of competitive constraint FlowMotion would provide on Durex and K-Y since it is positioned as a premium, organic product at the basic end of the spectrum.

174. We are not satisfied that entry or expansion by Ansell or FlowMotion, were it to occur, would be sufficient in extent to constrain the merged entity.

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[201] [ ]

[202] [ ]

[203] [ ] above n69.

Timely

175. Given the small market shares that Ansell and FlowMotion have achieved since entry and their aspirations around expansion (noted above), we are not satisfied that any expansion by Ansell or FlowMotion, were it to occur, would occur within a reasonably short time period so as to constrain the merged entity.

Conclusion on the LET Test

176. We are not satisfied that the LET test is met. None of Ansell, Sylk or FlowMotion are likely to grow big enough and quickly enough in response to a price increase to meet the LET test requirements of sufficient in extent and timely expansion. Nor do we consider that there are other potential competitors that could do so.

177. Ansell, Sylk and FlowMotion could grow with the support of supermarket chains. We consider the question of countervailing power in the next section, in particular whether, in response to an increase in price and/or decrease in quality by the merged entity post-acquisition, supermarkets are likely to be incentivised to stock other lubricant brands and/or support existing competitors to grow.

Countervailing power

178. A merged entity's ability to increase prices profitably may be constrained by countervailing power of buyers.[204] Countervailing power goes beyond the ability of a customer to switch to other suppliers. A customer's size and importance is not sufficient in itself to amount to countervailing power. Countervailing power exists when a customer possesses a special ability to substantially influence the price the merged entity charges.[205] It must be sufficient to prevent a substantial lessening of competition.

179. RB submitted that Foodstuffs and Progressive hold strong significant countervailing power[206] and that [ ].[207] RB further submitted that any action taken by it post-acquisition to degrade the competitive offering of Durex or K-Y personal lubricant would be met by any one of a number of responses (or threatened responses) by supermarkets, including:[208]

179.1 reducing shelf space or promotional slots for Durex and K-Y lubricant while increasing the same for a third competitor (eg, Ansell);

179.2 listing additional brands and offering preferential treatment to assist those competing brands to quickly become established (potentially including a house brand); and/or

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204 *Mergers and Acquisitions Guidelines* above n1 at [3.113].

205 For examples of the types of characteristics that may give rise to countervailing power see *Mergers and Acquisitions Guidelines* above n1 at [3.115].

206 Application above n15 at [9.9] and [24.1].

207 Submission from Bell Gully (on behalf of RB) (24 October 2014) at [2.1].

208 Application above n15 at [24.1].

179.3 retaliating against RB in respect of other products that it supplies through supermarkets ([ ]).

180. RB submitted that the threat of supermarkets exercising countervailing power "is both credible and likely".[209]

181. We recognise supermarkets can choose the suppliers they purchase from and the individual SKUs that they stock on their shelves. However, the acquisition would combine the two leading suppliers of lubricant in supermarkets resulting in a market share of [ ]%.

182. We are not satisfied that the countervailing power of supermarkets would be sufficient to offset that loss in competition and subsequent shift in bargaining power.

Our approach to assessing countervailing power in this case

183. Supermarkets would account for a large share of the merged entity's sales. However, the acquisition would lead to the aggregation of sales and brands of the two leading lubricant suppliers, which would shift the bargaining power towards the merged entity. We have therefore considered whether supermarkets have the means to impose sufficient countervailing power to offset that shift in bargaining power.

184. While we accept that Foodstuffs and Progressive are likely to have some degree of countervailing power, they could be expected to be using that countervailing power now to the extent they can so as to constrain any existing market power. The question is what further actions a supermarket could take to constrain the merged entity if it sought to increase price and/or decrease quality, and whether supermarkets are incentivised to take those actions.

185. Supermarkets could:

185.1 sponsor the growth of a current rival such as Ansell or sponsor entry into the supermarket market of a new competitor (eg, by allocating them shelf space and/or promotional slots);

185.2 introduce a house brand personal lubricant; or

185.3 exert countervailing power in one market by punishing RB in other more competitive markets for different products.

186. Although supermarkets could undertake these actions if the merged entity increased wholesale prices, there is a question as to whether they would be likely to do so. Taking the actions listed above would not be without risk or cost. For example, allocating slots to another lubricant supplier might reduce sales or lead to consumer disappointment (and consumers switching to another supermarket). To devise and monitor the strategy would also impose an opportunity cost of management time.

209 Submission from RB above n70 at [1.1(g)].

Ability to exercise countervailing power

187. Before considering the incentives of supermarkets to take action, we consider the evidence around supermarkets' ability to exercise countervailing power through sponsoring the entry or expansion of other lubricant brands, introducing house brand lubricant and the use of RB's products in other categories to wield competitive pressure.

Ability to sponsor the growth of a current rival or entry of another brand

188. RB submitted that "sponsoring" entry, merely requires supermarkets to provide access to shelf space and some basic promotional support[210] and there exists a credible threat that supermarkets would take such action because they have credible alternatives to Durex and K-Y.[211]

189. Progressive and Foodstuffs each account for a large proportion of lubricant sales in New Zealand. This means they would, in principle, be in a position to support the growth of a current rival or entry of a new brand. Evidence from supermarkets suggests that they are, in principle, open to stocking other brands and it is possible that they could sponsor the growth of an existing competitor or a new entrant.

189.1 [ ] stated that if circumstances arose where it made commercial sense for it to promote a less popular brand over another more popular brand then it may pursue that.[212] If RB raised prices by 5-10%, [ ] stated that it could look to go to another lubricant supplier and do something (eg, give them more ranging on shelf, stock more of their SKUs and less Durex/K-Y SKUs) if it made commercial sense. [ ][213] However, for [ ] to assist another lubricant supplier to grow, that supplier would have to also invest itself.[214]

189.2 [ ][215] [ ] indicated that if pricing increased by 5-10% or retail margins decreased, this [ ].[216]

189.3 For its part [ ] stated that supermarkets could assist it to grow, but considers it extraordinarily unlikely and cannot see it being in their interests to do so given the small size of the category.[217]

190. RB provided examples purportedly showing supermarkets exercising countervailing power by sponsoring entry in products other than lubricant and suggested there was

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210 Submission from RB above n64 at [5.32].
211 Ibid at [6.6] and [6.13].
212 [ ]
213 [ ]
214 [ ]
215 [ ]
216 [ ]
217 [ ]

no reason why supermarkets would not take similar action in personal lubricant post-acquisition.[218] Because of requests for confidentiality made by RB, we have been unable to test the examples with supermarkets, so we do not know the reasons for a supermarket's actions and cannot be certain that they would behave the same in terms of personal lubricant. This, in turn, affected the weight that we placed on this evidence.

191. Although we accept sponsoring entry is possible in theory, we have to consider whether supermarkets would actually be prepared to do this for lubricant if prices were to increase post-acquisition. This requires taking into account the likely costs and benefits of taking such action. We consider this in the sections below.

Ability to introduce a house brand lubricant

192. In some countries overseas (eg, the USA and the UK), supermarkets sell private label lubricant products in competition with RB. RB submitted that, should it attempt a price rise post-acquisition, New Zealand supermarkets could launch their own private label personal lubricant products (or at least credibly threaten to do so).[219]

193. Supermarkets currently sell private label products in a number of product categories. In principle, Progressive and Foodstuffs are in a position to introduce private label lubricant. Although we consider this is possible in theory, we have to consider whether supermarkets would actually be prepared to do this for lubricant if prices were to increase post-acquisition. This requires taking into account the likely costs and benefits of taking such action. We consider this in the sections below.

Ability to use RB's wider portfolio

194. RB submitted that if it put prices up, supermarkets could leverage RB's wider portfolio.[220] It submitted that doing so would not require the availability of credible alternative lubricant suppliers.[221] RB further submitted that the cost of the action (in terms of lost profit) to a supermarket would be negligible,[222] but such action could seriously affect RB's revenues.[223]

195. In principle, supermarkets could use RB's wider portfolio to constrain it post-acquisition. For example, [ ].[224]

196. Although we consider that the use of RB's wider portfolio is possible in theory, we have to consider whether supermarkets would actually be prepared to do this for lubricant if prices were to increase post-acquisition. This requires taking into account the likely costs and benefits of taking such action. We consider this in the sections below.

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218 Submission from RB above n64 at [6.10] and submission from RB above n207 at [2.1].
219 Application above n15 at footnote 45.
220 Ibid at [24.9] and [24.13].
221 Submission from RB above n70 at [6.16].
222 Submission from RB above n64 at [6.25].
223 Application above n15 at [24.10].
224 [ ]

197. We also note that RB did not provide any examples of supermarkets disciplining RB in one market in order to achieve a better outcome in another market.[225]

Would supermarkets have the incentive to exercise countervailing power?

198. We do not consider that supermarkets would have the incentive to take the actions highlighted above in response to the merged entity increasing prices. It would not make commercial sense for a supermarket to incur the risks and costs to do so if it can simply pass through the wholesale price increases to its consumers without materially affecting its profits. The factors that influence whether supermarkets could pass-through wholesale price increases are the following.

    198.1 The size of the category: if the category is small and does not drive foot traffic, the ability to pass through a price increase is enhanced because supermarkets are less likely to use the product to compete against one another and are likely to be less aggressive with their retail prices.

    198.2 Whether supermarkets earn relatively high profits on the sale of existing lubricant brands and will continue to do so post-acquisition, such that they are less likely to assume the risk of low sales and low profitability by stocking other lubricant brands.

    198.3 Whether the wholesale price increase is industry-wide: supermarkets would be more likely to pass through industry-wide cost increases than firm-specific cost increases. This follows because if only one supermarket faces the cost increase, then it would risk losing consumers to other rivals in the market if it alone raises its price.[226]

    198.4 Whether past price increases for lubricant have been passed through to consumers: When consumers are price inelastic supermarkets are more likely to be able to pass-through price increases because there will only be a small reduction in demand, resulting in only a small impact on profitability.

199. We address these factors now.

<u>Are wholesale price increases likely to be passed through?</u>

Lubricant is a small category

200. Personal lubricant is only a small portion of total supermarket sales. Sales of personal lubricant through supermarkets last year totalled $[ ], compared to total sales of $[ ] (lubricant sales being [ ]% of total).[227]

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225 [

] Submission from RB above n207.

226 See for example RBB "Cost pass-through: theory, measurement and potential policy implications: A report prepared for the Office of Fair Trading" (February 2014) at [1.5.2].

227 [

]

201. RB itself acknowledged that no personal lubricant brands are "must stock" in the sense that they drive foot traffic.[228]

202. Evidence from supermarkets indicates that the small size of the category would likely impact on their incentives to take action in response to a price rise post-acquisition. [ ][229] [ ] stated that because lubricant is a small category, it is unlikely to introduce private label lubricant.[230]

Whether profits are high

203. There is evidence to indicate that supermarkets earn [ ] profits from the sale of personal lubricant.

    203.1 [ ] commented that the lubricant category is [ ].[231]

    203.2 RB stated that [ ].[232]

204. RB submitted that supermarkets would be motivated "to promote less popular brands if they provide higher margins and/or provide shoppers with low price products".[233]

205. Table 4 summarises the gross margins (in percentage terms) that supermarkets earn on the supply of major Durex and K-Y lubricant SKUs, alongside supermarket sales for those SKUs for the year ended 22 February 2015.

Table 4 Supermarket gross retail margins

Product	Sales	Margin[234]
Durex Play Feel	$[ ]	[ ]%
Durex Massage 2-in-1	$[ ]	[ ]%
Durex Embrace	$[ ]	[ ]%
Durex Play O	$[ ]	[ ]%
K-Y basic lubricant[235]	$[ ]	[ ]%
K-Y Yours and Mine	$[ ]	[ ]%

Source: RB and J&J

228 Submission from RB above n64 at [2(b)].
229 [ ]
230 [ ]
231 [ ]
232 Submission from RB above n70 at [5.2(f)].
233 Submission from RB above n207 at [2.4].
234 Supermarket margins shown are retail margin (or mark-up) between wholesale prices and Countdown retail prices (excluding GST). They are not adjusted for the impact of any specials or price discounts.
235 Sales figures and margin data shown are for both of K-Y's basic lubricant products, being K-Y Jelly and K-Y Ultra Gel (or K-Y Sensual Silk).

206. Despite requests, Ansell provided no information on retail margins. [ ][236] [237]

207. Due to limits on supermarket shelf space, supermarkets stocking more of Ansell or other suppliers' products would likely come at the opportunity cost of stocking less Durex/K-Y. Therefore, in order to convince a supermarket to replace an existing product, the new product would have to be at least as profitable. If the new product is not as well-known as the existing product, it would achieve lower overall sales and so the supermarket would require a relatively larger retail percentage margin. This may make it difficult for less-known brands to replace incumbent products.

Competing supermarkets are likely to face the same wholesale price increases

208. There is no difference in the lubricant SKUs that Durex and K-Y offer to supply to each supermarket. RB sells Durex to supermarkets and pharmacies at the same wholesale price, and wholesale price increases in the last three years have been the same for all retailers.[238] [ ] commented that it considers it important that RB treats Progressive and Foodstuffs the same, such that they are competing on a level playing field.[239]

209. There is no evidence to think that this would change; competing supermarkets are likely to face the same wholesale price increases on any given lubricant SKU. Although, we note that competing supermarkets may pay different effective prices where they negotiate different rebates off wholesale prices.

Whether past price increases for lubricant have been passed through to consumers

210. Information on past wholesale price increases suggests that supermarkets have generally passed on wholesale price increases to consumers.

211. Table 5 summarises the price increases in the last three years for major Durex and K-Y SKUs.[240] The table also shows the change in Countdown's retail prices.[241]

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236 [ ]

237 [ ]

238 E-mail RB above n66. [ ]

239 [ ]

240 E-mail from Bell Gully (on behalf of RB) to the Commerce Commission (4 February 2015) and e-mail from Kensington Swan (on behalf of J&J) to the Commerce Commission (29 January 2015).

241 We refer to Countdown rather than Progressive here because RB and J&J provided us with trend information on Countdown stores only. They were unable to provide information for Super Value and Fresh Choice supermarkets operated by Progressive on a franchise basis. Given the structure of Foodstuffs (where stores are individually owned by co-operative members who, with the exception of specials in circulars, can set their own retail prices), RB and J&J were also unable to provide us accurate information on the trend in retail prices for Foodstuffs supermarkets. [ ]

Table 5: Past price increases

Product	Wholesale price increase	Increase in Countdown retail price
Durex Play Feel	[ ]	[ ]
K-Y Jelly 100g[242]	[ ]	[ ]
Durex Massage 2-in-1	[ ]	[ ]
Durex Embrace	[ ]	[ ]
K-Y Yours and Mine	[ ]	[ ]
Durex Play O	[ ]	[ ][243]

Source: RB and J&J

212. Table 5 shows that [ ].[244]

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242 [ ]

243 [ ]

244 [.]

213. RB did not provide any evidence to suggest that supermarkets had pushed back on lubricant price increases in recent years.[245] J&J advised that supermarkets and pharmacies had accepted past changes in wholesale prices.[246]

214. However, RB submitted that while supermarkets have in the past accepted price increases justified by reference to inflationary pressure on costs, they would not simply accept price increases resulting from an attempted exercise of market power.[247] RB further submitted that if it were to raise prices post-acquisition, supermarkets would likely react rather than simply passing through price increases.[248] However, it may be difficult for supermarkets to distinguish between price increases based on an increase in costs and price increases based on an exercise of market power. In addition, reacting to a price increase, whatever the cause, would require supermarkets to have options which they are incentivised to take. Post-acquisition, the main option available to supermarkets (eg, K-Y where RB seeks a price increase for Durex) would have disappeared and other options involve supermarkets sponsoring entry or investing in house brands, both of which are unlikely.

215. [ ][249] [ ][250]

216. The above evidence is consistent with evidence from market participants (other than RB) that the lubricant category is price inelastic.[251] This is because when consumers are price inelastic supermarkets are more likely to be able to pass-through price increases.

    216.1 J&J stated that the lubricant category is very inelastic.[252]

    216.2 [ ] noted that lubricant purchases are more considered and the category is not as price elastic as other categories (consumers are still likely to buy lubricant if price was higher).[253]

    216.3 [ ] noted that the lubricant category is [ ] (given nature of product) and consumers [ ] unless

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245 Although, RB submitted that [ ]. E-mail from RB above n240.

246 E-mail from Kensington Swan (on behalf of J&J) to the Commerce Commission (12 November 2014).

247 E-mail from RB above n240.

248 Submission from RB above n70 at [6.14].

249 [ ]

250 [ ]

251 We note that the fact that market participants consider the lubricant category to be inelastic is not necessarily inconsistent with the fact that lubricant is often on special in supermarkets and that sales increase when a product is on promotion (discussed earlier) if sales simply increase because consumers are stocking up.

252 Interview with J&J above n26.

253 [ ]

they are prepared to ask questions or shop around.[254] It commented that there had [ ] in sales volume after past price increases.[255]

Whether there is a cost to supermarkets exercising countervailing power

217. RB submitted that "taking a promotional slot away from one supplier and giving it to another will not necessarily result in a cost to the supermarket".[256]

218. Although reallocating promotional slots (or shelf space) may have a small direct cost (eg, in terms of the cost of supermarket management time), we consider that it may involve significant opportunity cost. The risks might include that the new product listed does not produce as much profit as the previous product and that delisting products leads to consumer disappointment.[257] We are not satisfied that supermarkets would turn over shelf space to brands which have no significant established customer base (and have either themselves and/or the supplier make substantial investment in promotion), when they could simply pass price rises onto brand loyal Durex and K-Y consumers.

Conclusion on whether supermarkets are likely to exercise countervailing power

219. Based on the above discussion around the ability and incentive of supermarkets, as well as other evidence from supermarkets noted below, we are not satisfied that supermarkets are likely to exercise countervailing power in response to price increases post-acquisition (thereby constraining RB).

220. Evidence from supermarkets indicates that they are unlikely to:

220.1 sponsor entry or expansion themselves;[258]

220.2 introduce private label lubricant given that the category is so small and there is high brand loyalty;[259] and/or

220.3 use RB's wider portfolio because they make decisions on products primarily based on the needs of each category.[260] [261]

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254 [ ]

255 [ ]

256 Submission from RB above n207 at [4.6].

257 [ ] stated that if it removed a product from shelf that consumers wanted to buy, this would only punish consumers. [ ]

258 [ ]

259 [ ]

260 [ ]

221. The past behaviour of supermarkets has been to follow wholesale price increases with price increases of their own. We consider that this evidence supports the notion that faced with a general price increase – whether driven by market power or cost increases – supermarkets are likely to simply pass that price increase on to consumers rather than exercise countervailing power to constrain it.

222. RB submitted that in a number of previous decisions we had found that supermarkets “wield substantial countervailing power”.[262] RB further submitted:[263]

> …given the relative size of the category, and its position within the wider health and wellbeing category (in which RB supplies a number of other products, e.g. Nurofen), if anything, retailers’ power in this respect is greater than that for other products (e.g. milk, bread, etc where the Commission has previously found this ability exists).

223. We make decisions based on the facts of each case. We are not departing from previous reasoning in reaching our decision in this case. Simply, this case is factually distinct from earlier cases in which the countervailing power of supermarkets was relied upon.

Coordinated effects

224. 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 across the market.[264]

225. In terms of coordinated effects, RB submitted:[265]

> The relevant market does not currently show signs of co-ordinated conduct. More importantly, the acquisition does not remove any unique factors preventing co-ordination today, nor would it lead to the emergence of a new factor which would provide an incentive for co-ordination in the future.
>
> Indeed, the market is highly fragmented and in the grocery channel, Ansell will be incentivised to vigorously expand its presence and take advantage of its current market position. Any attempt at coordination with the merged entity would increase the risk of the introduction of further brands.

226. The investigation has not provided any indication that the acquisition is likely to enhance the possibility of coordination in the supermarket market. There would be a high degree of asymmetry between suppliers. In the supermarket market the merged entity would have a [ ]% share of sales by value. There are also likely to be some differences in costs between the firms since the merged entity has its products

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261 [ ]

262 Submission from RB above n64 at [6.1].

263 Ibid at [6.21].

264 *Mergers and Acquisitions Guidelines* above n1 at [3.84].

265 Application above n15 at [26.1-26.2].

produced overseas in large manufacturing plants whereas some smaller competitors (eg, Sylk) produce lubricant locally. This asymmetry makes it less likely that the firms would find it mutually beneficial to coordinate their behaviour.

Constraint from outside the market

227. While we consider other sales channels (pharmacy, adult retailers and online) to be outside the relevant market, we have also considered the extent to which the merged entity would be indirectly constrained by the supply of lubricant to and through such sales channels. This constraint would result from consumers faced with a price increase of Durex and K-Y in supermarkets, switching to buying products at these other retailers.

228. We acknowledge the existence of at least some degree of constraint from the supply of personal lubricant to and through other sales channels. For example, some consumers may switch to a pharmacy, some may switch to adult retailers and some may switch to online retailers. We further recognise there may be a general trend towards consumers shopping online.[266] However, we consider that this constraint is not currently sufficient to offset the loss of competition as a result of the acquisition. It remains the case at this point in time that the majority of consumers prefer to purchase personal lubricant at the supermarket.[267]

229. Further, the fact that supermarkets have, in the past, generally passed on wholesale price increases to consumers and that the lubricant category is price inelastic, does not suggest that there is a material level of constraint from any sources (or all sources combined) outside the market. Pharmacy and adult retailer prices also tend to be higher than prices at supermarkets.

230. Given this, we are not satisfied that sufficient consumers would switch to buying lubricant from sources outside the market in response to an increase in supermarket prices post-acquisition.

The constraints taken together

231. We have considered whether all constraints taken together are sufficient to prevent a substantial lessening of competition in the wholesale supply of personal lubricant to supermarkets. For the reasons set out below, we are not satisfied that is the case.

232. As noted earlier, we are not satisfied that:

    232.1 existing competitors are currently a strong and effective constraint;

    232.2 expansion by existing competitors (or new entry) would be likely, sufficient in extent, and timely; and/or

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266 Ibid at [9.18].

267 As noted earlier, a consumer survey conducted by FlowMotion prior to its entry found that 64% of people purchase lubricant at supermarkets. In comparison, only [ ]% of people purchase lubricant from online retailers. [ ] above n69.

232.3 supermarkets are likely to exercise countervailing power in response to price increases post-acquisition.

233. There is no reason to think that adding these unlikely constraints together would collectively prevent a substantial lessening of competition. We are also not satisfied that constraints from outside the market are sufficient to allay our concerns about a likely substantial lessening of competition.

234. At the heart of this case is the brand loyalty that consumers have to the Durex and K-Y brands. This is not easily replicated without substantial sunk investment and we consider that it is unlikely that competitors would expand or enter on that basis. The same barriers that make entry, and more particularly expansion, unlikely to be an effective competitive constraint, also make it unlikely that supermarkets would sponsor entry. While supermarkets could sponsor new entry or potentially take other steps to discipline a price increase, history shows that this is not what they have done. Moreover, we can infer from the fact that retail price increases have persisted that when faced with price increases at the retail level, sufficient consumers have not switched to other sales channels.

Competition analysis – wholesale supply to pharmacy wholesalers

235. Given we consider that there is a real chance that K-Y would continue to be supplied in New Zealand, in this section we assess whether we are satisfied that there are sufficient constraints to prevent a substantial lessening of competition in the market for the wholesale supply of personal lubricant to pharmacy wholesalers. Where appropriate this analysis draws on our competition analysis with respect to the supermarket market.

236. We are not satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the New Zealand for the wholesale supply of personal lubricant to pharmacy wholesalers.

236.1 As in supermarkets, Durex and K-Y are close competitors; there is substantial overlap in the range of the two brands and represent a significant portion of pharmacy sales of lubricant.

236.2 Sylk supplies only a single premium natural lubricant product. Being limited to the basic end of the spectrum and, at that end, being priced at a premium, Sylk is not likely to be a sufficient constraint on the merged entity.

236.3 Pharmacy wholesalers and/or major pharmacy retailers may not have sufficient countervailing power to constrain RB post-acquisition and offset the loss of competition.

237. As noted earlier, the retail prices of lubricant are materially higher in pharmacies than in supermarkets. This could mean that, in response to a price rise in pharmacies post-acquisition, consumers may be more likely to switch to buying lubricant in supermarkets (than consumers would be to switch from supermarkets to pharmacies). However, given our concern that the acquisition would substantially

lessen competition in the supermarket market, we consider that the price differential between supermarkets and pharmacies would likely be maintained post-acquisition such that there would not be a greater incentive on end-consumers to switch to supermarkets. In addition, since the suppliers that supply supermarkets are, for the most part, a subset of the suppliers to pharmacies, pharmacies (and/or their wholesalers) cannot increase their competitive options by looking to stock lubricant brands sold in supermarkets.

Existing competition

238. There are some key differences between the supermarket and pharmacy market in terms of existing competition. While Durex and K-Y are key brands of personal lubricant sold in both, Sylk also exists as a key supplier to and through pharmacies.

239. This difference in existing competition is reflected in the market shares for the pharmacy market, with Sylk having a market share of [ ]% by sales value (or [ ]% by sales volume). Table 6 sets out data on pharmacy sales of personal lubricant for the year ended 25 February 2015 by retail value and sales units.[268]

Table 6: Pharmacy sales of personal lubricant

Brand	Retail value		Sales units	
K-Y	[ ]	[ ]%	[ ]	[ ]%
Durex	[ ]	[ ]%	[ ]	[ ]%
Merged Entity	**[ ]**	[ ]%	**[ ]**	[ ]%
Ansell	[ ]	[ ]%	[ ]	[ ]%
Sylk	[ ]	[ ]%	[ ]	[ ]%
Other	[ ]	[ ]%	[ ]	[ ]%
TOTAL	**[ ]**	**100%**	**[ ]**	**100%**

Source: RB (based on pharmacy scanner data)

240. Another difference in competition between the supermarket and pharmacy market is the presence of RB. In the supermarket market, Durex and K-Y are the top two brands, with Ansell being a distant third competitor. In comparison, as indicated by Table 6, Sylk is a significant competitor in the pharmacy market. This difference is reflected in the market shares of the merged entity, with it having a [ ]% share of sales by value through pharmacies, compared to a [ ]% share of sales in the supermarket market.

241. Table 7 shows the trend in sales by lubricant supplier and total pharmacy sales of lubricant between 2012 and 2015. Table 7 shows that total pharmacy sales have declined significantly in nominal terms, [

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268 We note that the pharmacy data is sourced from IRI-Aztec. The Aztec data is not complete scanner data for all pharmacies, but is considered to represent the total pharmacy channel. Aztec collects scanner data from Green Cross Health and supplements this with scan data from a sample of independent pharmacies.

Table 7: Trend in pharmacy sales by sales value

Brand	2012		2013		2014		2015	
K-Y	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Durex	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Ansell	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Sylk	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Other	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
TOTAL	**[ ]**	**100%**	**[ ]**	**100%**	**[ ]**	**100%**	**[ ]**	**100%**

Source: RB (based on pharmacy scanner data)

Existing constraint provided by Durex and K-Y on one another

242. The sales data in Tables 6 and 7 shows that Durex and K-Y products ([ ]) account for a significant portion of sales in the pharmacy market.

243. Even though Durex and K-Y have a lower combined share of the pharmacy market (compared to the supermarket market), we consider that Durex and K-Y are still likely to be close competitors. Sylk only has one product, at the basic end of the spectrum. Durex and K-Y have a full range of products. As such, pharmacies that seek to stock enhanced products (that Sylk does not offer) are likely to view Durex and K-Y as the closest substitutes at that end of the spectrum. In addition, Sylk is priced at a premium to Durex and K-Y basic lubricant products.[269] With the acquisition, that existing competition between Durex and K-Y would be lost.

Existing constraint from other competitors

244. RB submitted that post-acquisition there would "remain many strong and effective competitors across the spectrum of personal lubricant products" and the pharmacy market would remain "highly competitive".[270] [271] Green Cross Health (whose pharmacies account for just under $[ ]m, or [ ]%, of pharmacy market sales) [ ]. Green Cross Health commented that [ ].[272]

245. We are not satisfied that the constraint from existing competitors alone would be sufficient to prevent a substantial lessening of competition across the spectrum of personal lubricant despite Sylk's presence as a significant rival.

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269 Analysis provided by RB on the comparative prices for basic lubricant SKUs on a per 100ml or 100g basis reveals that Sylk (at $22.25 per 100g) is more expensive than each of Durex Play Feel ($19.98 per 100ml), K-Y Jelly ($11.99 per 100g) and Ansell natural lubricant $11.99 per 100ml). Annex 3 to submission from RB above n64.

270 Application above n15 at [17.1-17.2].

271 RB submitted that New Zealand pharmacies stock a wide range of personal lubricant products including the majority of the top brands and lesser known products. Application above n15 at [19.3-19.4]. Each of these lesser known lubricant brands represents only a small portion of pharmacy sales. Given this, our analysis has focussed on Sylk and other brands sold in supermarkets.

272 Interview with Green Cross Health above n33.

Sylk

246. Sylk is Durex's and K-Y's main existing competitor in the supply of personal lubricant to pharmacies with a market share of at least [ ]%. Based on market share, it appears that Sylk is positioned to provide greater constraint on the merged entity in the wholesale supply of personal lubricant to pharmacy wholesalers than Ansell currently does in the supermarket market. However, we are not satisfied that Sylk presents a sufficient constraint.

247. RB stated that in the pharmacy channel you see more focus on basic lubricant products (compared to supermarkets).[273] Sales data confirms this, with [ ]% of total pharmacy sales being what RB class as basic lubricant and [ ]% of sales being enhanced products.[274] However, RB submitted:[275]

> …given the Commission's view on the future of K-Y's playful skus, the fact that Sylk only offers a basic product is likely to be irrelevant to the state of competition as it will provide a competitive constraint on RB at the basic end of the spectrum (where the limited competitive constraint currently provided by K-Y will be lost).

248. Although Sylk is a basic lubricant that does not mean that it would be a close substitute for the basic products of Durex and K-Y. Durex and K-Y. Compared to Durex and K-Y, which supply a range of lubricant products, Sylk offers a more expensive premium natural product. In addition, enhanced products make up a material part of the market, which Durex and K-Y supply but Sylk does not. Sylk would need to broaden its product range (or reposition its existing product) to compete directly with Durex and K-Y.

Ansell

249. Ansell lubricant is stocked by some pharmacies, but currently has only a [ ]% share of lubricant sales in the pharmacy market. Ansell currently provides little constraint in the wholesale supply of personal lubricant to pharmacy wholesalers.

Potential competition

250. As with our analysis of potential competition in the supermarket market, because Sylk and other small existing competitors are already present in the pharmacy market, we have focused on the ability of these competitors to expand. Because pharmacy customers are already at least partially familiar with these brands, they are most likely to satisfy the LET test.

251. For similar reasons to that discussed above with respect to the wholesale market for the sale of personal lubricant to supermarkets, we are not satisfied that expansion by Ansell, Sylk or FlowMotion (or any other participant) would be likely, sufficient in extent, and timely.

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273 Meeting with RB above n26.
274 E-mail from RB above n28.
275 Submission from RB above n70 at [6.20].

Conditions of entry and expansion

252. For the same reasons as discussed above with respect to the supermarket market, we consider that brand recognition and consumer loyalty are conditions of entry and expansion that a supplier must navigate when expanding or entering the pharmacy market. However, there is mixed evidence as to how difficult it is to obtain access to pharmacy shelves.

253. There are many more pharmacies than there are supermarkets. To get product stocked in supermarkets, suppliers need to negotiate with supermarket chains (ie, Progressive and Foodstuffs) to have their product ranged and, in the case of Foodstuffs, potentially sell it into individual stores. For pharmacies, while suppliers can negotiate with Green Cross Health (in terms of the pharmacies that fall under its banner), considerably more time could be involved in negotiating to get their product into the 700 small independently owned and operated pharmacies across New Zealand.

254. Pharmacies consider similar criteria to supermarkets when deciding whether to give a product shelf space, although pharmacies do not appear to have the same constraints on shelf space as supermarkets. Green Cross Health stated that, in considering whether to stock a new lubricant brand in its pharmacies, it would [ ].[276]

255. Evidence from lubricant suppliers suggests that it is not necessarily easier to get into pharmacies than supermarkets.[277] [278] [279] Other evidence also indicates that brand recognition is just as important in pharmacies as it is in supermarkets. [ ] stated that it was able to get [ ] lubricant stocked in [ ] pharmacies for a period, but the brand was removed as a product line because of low sales.[280]

Whether the LET test is met

256. For similar reasons to that discussed above with respect to the supermarket market, we are not satisfied that the threat of Ansell, Sylk or FlowMotion (or any other participant or new entrant) growing in the pharmacy market is sufficiently strong to offset the loss of competition from the acquisition. We are not satisfied that the LET test is met.

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276 Interview with Green Cross Health above n33.

277 [ ] stated that there is quite a lot of complexity involved in getting a brand or SKU into pharmacies. [ ]

278 [ ] stated that, as with supermarkets, it is similarly quite a process to get into pharmacies because they are largely individually owned. [ ]

279 [ ] stated that it is easier to get products into independent pharmacies than into pharmacy chains, but noted that Green Cross Health is hard to supply as it only likes to deal with big players. [ ]

280 [ ]

257. Ansell advised that [ ]. It commented that the pharmacy channel is very small, with sales of personal lubricant products shifting to the supermarket channel over time.[281] [ ], we do not consider it likely that Ansell would expand.

258. Sylk focuses on supplying the pharmacy market[282] and has capacity available to significantly increase supply.[283] Within the pharmacy market, Sylk also appears to have a degree of consumer loyalty.[284] On this basis, Sylk is likely to be able to expand pharmacy sales of its premium natural lubricant post-acquisition. However, we are not satisfied that the expansion of that product would be sufficient to offset a loss of competition between Durex and K-Y. As noted earlier, compared to Durex and K-Y, which supply a range of lubricant products, Sylk offers a more expensive premium natural product. It is unclear that Sylk would be in a position to replace the lost competition unless it expanded its range or significantly lowered its price. There is no evidence to suggest that Sylk would do so.[285] As such, we are not satisfied that any expansion by Sylk would be sufficient in extent to replace the competition lost with the acquisition.

259. Since its launch in June 2014, FlowMotion has not entered the pharmacy market on a large scale. FlowMotion lubricant is only stocked in seven independent pharmacies around New Zealand.[286] While FlowMotion may seek to expand with the acquisition, for the reasons noted earlier with respect to supermarkets, we are not satisfied that expansion by FlowMotion would be sufficient in extent and timely.

Countervailing power

260. RB submitted that pharmacy wholesalers, which purchase on behalf of pharmacies, hold strong countervailing power.[287] As already noted (and discussed further below), because pharmacy wholesalers merely order and stock products demanded by pharmacies, we have considered the countervailing power of pharmacies themselves as well as pharmacy wholesalers.

261. The acquisition would combine two important suppliers of lubricant to pharmacies resulting in a market share of around [ ]%. For similar reasons to that discussed above with respect to the supermarket market, we are not satisfied that the countervailing power of pharmacy wholesalers and/or pharmacies would be sufficient to offset that loss in competition and subsequent shift in bargaining power.

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281 [ ]
282 Interview with Sylk above n95.
283 Interview with Sylk above n163.
284 Sylk stated that it does not do much advertising and most of its sales are repeat sales. Interview with Sylk above n95.
285 As noted earlier, Sylk currently does not do much advertising or promotion and [ ]. Interview with Sylk above n95 and interview with Sylk above n163.
286 Count of pharmacies stocking FlowMotion taken on 10 April 2015. A full list of FlowMotion stockists is available at http://flowmotion.co.nz/.
287 Application above n15 at [24.1].

262. As with supermarkets, the sale of personal lubricant is a small category within pharmacies.[288]

263. Evidence indicates that pharmacies may also earn [ ] profits from the sale of personal lubricant. Table 8 summarises the gross margins (in percentage terms) that pharmacies earn on the supply of popular Durex and K-Y lubricant SKUs, alongside pharmacy sales for those SKUs for the year ended 25 February 2015.

Table 8: Pharmacy gross retail margins

Product	Sales	Margin[289]
Durex Play Feel	$[ ]	[ ]%
Durex Massage 2-in-1	$[ ]	[ ]%
Durex Embrace	$[ ]	[ ]%
Durex Play O	$[ ]	[ ]%
K-Y basic lubricant[290]	$[ ]	[ ]%
K-Y Yours and Mine	$[ ]	[ ]%

Source: RB and J&J

264. In addition to the information in Table 8, Sylk advised that retailers earn margins of [ ]% on the sale of Sylk.[291] [292] This indicates that [

].

265. If pharmacies had limits on shelf space (on which there is mixed evidence as noted above), pharmacies stocking more of Sylk or other suppliers' products may come at the opportunity cost of stocking less Durex/K-Y. Therefore, in order to convince a pharmacy to replace an existing product, the new product may have to be at least as profitable. If the new product is not as well-known as the existing product, it may achieve lower overall sales and so the pharmacy may require a relatively larger retail percentage margin. This may make it difficult for less-known brands to replace incumbent products.

266. The pharmacy market is smaller and more fragmented than the supermarket market. RB submitted that just a few pharmacy banner groups[293] and wholesalers account for all of the pharmacy channel's purchases.[294] However, pharmacy wholesalers purely perform a purchasing role for their members (ordering products demanded by their

288 Green Cross Health stated that [ ]. Interview with Green Cross Health above n33.

289 Pharmacy margins shown are retail margin (or mark-up) between wholesale prices and pharmacy retail prices (excluding GST). Pharmacy retail prices for K-Y used to compute margins are average actual prices after specials and price discounts, so margin reflects any such discounts.

290 Sales figures and margin data shown are for both of K-Y's basic lubricant products, being K-Y Jelly and K-Y Ultra Gel (or K-Y Sensual Silk).

291 [ ]

292 Sylk provided no detail as to how this margin is calculated, so we do not know whether it is comparable to the gross margin data for Durex and K-Y in Table 8.

293 For example, Green Cross Health, whose pharmacy banner groups include Life Pharmacy and Unichem.

294 Application above n15 at [24.13].

members) and do not involve themselves in promotions.[295] Wholesalers are not in a position themselves to support the growth of existing competitors or promote new entrants. Instead suppliers must approach pharmacy banner groups or individual pharmacies directly. As the pharmacy market is much smaller it seems less likely that pharmacies (including the banner groups) would be large enough to support a new entrant. Even if pharmacy banner groups had countervailing power and used it to extract lower wholesale prices, whether they would pass those savings on to consumers may depend on what independent pharmacies are paying and charging consumers for the same products.

267. RB has not provided examples of countervailing power in the pharmacy market. Green Cross Health stated that if RB looked to engage in restrictive practices post-acquisition (eg, raise prices or reduce service), it would [ ].[296]

268. For similar reasons to that discussed above regarding the supermarket market, we consider that an individual pharmacy would be able to pass through an increase in wholesale price without losing much profitability (other than profits lost from consumers potentially shifting to supermarkets). Information suggests that pharmacies have, in the last three years, passed through wholesale price increases on some products.

Coordinated effects

269. For similar reasons as stated above with respect to the supermarket market, the investigation has not provided any indication that the acquisition is likely to enhance the possibility of coordination in the pharmacy market.

Constraint from outside the market

270. While we consider other sales channels (supermarkets, adult retailers and online) to be outside the relevant market, we have also considered the extent to which the merged entity would be indirectly constrained by the supply of lubricant to and through such sales channels. This constraint would result from consumers faced with a price increase of Durex and K-Y in pharmacies, switching to buying products at these other retailers.

271. Some consumers facing a price increase in the pharmacy channel may consider switching to supermarkets to buy lubricant. However, as noted above, we are not satisfied that the acquisition would not lead to a substantial lessening of competition in the supermarket market. If prices rise in supermarkets, pharmacy customers will be in the same position as prior to the acquisition. As with the supermarket market, we are not satisfied that significant consumers would switch to online and adult retailers.

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295 This is true for all pharmacy wholesalers. [ ]

296 Interview with Green Cross Health above n33.

Competition analysis – combined supermarket and pharmacy market

272. Notwithstanding our view that there are separate markets for the wholesale supply of personal lubricant to different retailers, we set out below competition analysis for the supermarket and pharmacy sales channels combined. The analyses below shows that our determination to decline clearance for the acquisition would be the same even if we were to define a wider market for the wholesale supply of personal lubricant to supermarkets and pharmacies.

273. Table 9 sets out data on the combined supermarket and pharmacy sales of personal lubricant for the year ended 22 February 2015 by retail value and sales units. The acquisition would give RB a [ ]% share of sales of personal lubricant through supermarkets and pharmacies combined. Post-acquisition, Sylk would have a market share of [ ]% and Ansell would have a market share of [ ]%.

Table 9: Combined supermarket and pharmacy sales of personal lubricant

Brand	Retail value		Sales units	
K-Y	[ ]	[ ]%	[ ]	[ ]%
Durex	[ ]	[ ]%	[ ]	[ ]%
Merged Entity	**[ ]**	[ ]%	**[ ]**	[ ]%
Ansell	[ ]	[ ]%	[ ]	[ ]%
Sylk	[ ]	[ ]%	[ ]	[ ]%
Other	[ ]	[ ]%	[ ]	[ ]%
TOTAL	**[ ]**	**100%**	**[ ]**	**100%**

Source: RB (based on supermarket and pharmacy scanner data)

274. While Sylk is a key rival in the wholesale supply of personal lubricant to pharmacy wholesalers, with (as noted earlier) a market share of [ ]% by sales value (or [ ]% by sales volume), Table 9 shows that Sylk has a substantially smaller market share in a combined market for the wholesale supply of personal lubricant to supermarkets and pharmacies. This is because total pharmacy sales of lubricant are one-sixth the value of supermarket sales (or, alternatively, supermarket sales are six times the value pharmacy sales).[297] Furthermore, in the wider market there is a greater range of products. As Sylk has only a single basic, premium priced lubricant product, this limits the degree of constraint it can impose on Durex and K-Y.

275. For the same reasons discussed above in our competition analyses for the wholesale supply of personal lubricant to supermarkets and the wholesale supply of personal lubricant to pharmacy wholesalers, we would not be satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a wider market in New Zealand for the wholesale supply of personal lubricant to supermarkets and pharmacies.

297 Because of the size of the supermarket channel, Ansell's market share in a combined market for the wholesale supply of personal lubricant to supermarkets and pharmacies is the same as its market share in a narrower market for the wholesale supply of personal lubricant to supermarkets.

Determination on notice of clearance

276. The Commission is not satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market in New Zealand.

277. Under s 66(3)(b) of the Commerce Act 1986, the Commission declines to give clearance to Reckitt Benckiser Group Plc to acquire from Johnson & Johnson through its subsidiary, McNEIL-PPC, Inc., insofar as they relate to New Zealand, the K-Y brand and product assets comprising:

277.1 all K-Y product-related IP, including domain names, toll free numbers, formulas, technical data and patents;

277.2 regulatory information relating to the products;

277.3 any existing promotional and marketing material;

277.4 third-party supply and manufacturing rights and obligations; and

277.5 existing finished goods inventory of the products.

Dated this 24th day of April 2015

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Dr Mark Berry
Chairman