

Statement of Preliminary Issues

CDC Pharmaceuticals / Pharmacy Wholesalers (Central) Limited

11 July 2014

Introduction

1. On 19 June 2014, the Commerce Commission received a joint application from CDC Pharmaceuticals Limited (CDC) and Pharmacy Wholesalers (Central) Limited (PWL) seeking clearance to merge their businesses through an amalgamation.
2. The public version of the application is available on our website at: <http://www.comcom.govt.nz/business-competition/mergers-and-acquisitions/clearances/clearances-register/detail/827>
3. This Statement of Preliminary Issues outlines the key competition issues we currently consider will be important in deciding whether or not to grant clearance. The issues highlighted in this statement are based on the information available at the time of publication, and may change as our assessment of the application for clearance progresses. Therefore, the issues highlighted in this statement are not binding on us.
4. We invite interested parties to make comment on the likely competitive effects of the proposed merger and request that parties who wish to make a submission do so by **Friday 18 July 2014**.

The transaction

5. CDC and PWL intend to merge their respective pharmaceutical wholesale businesses through an amalgamation. CDC would be the surviving company if the merger is cleared.

Relevant parties

CDC Pharmaceuticals Limited

6. CDC is an incorporated and co-operative company engaged in the wholesaling of prescription, specialist hospital only (specialist) and over-the-counter (OTC) pharmaceutical products. As a co-operative company, CDC is wholly owned by its members, the pharmacies it supplies.
7. CDC supplies retail pharmacies, private hospitals, and public hospitals. Currently, CDC supplies customers in the South Island, the lower North Island and Auckland regions of New Zealand. CDC, in conjunction with PWL and Pharmacy Wholesalers (Bay of Plenty) Limited (PWL Bay of Plenty), also provides marketing and logistics services to the ACCESS Buying Group of Retail Pharmacies.

Pharmacy Wholesalers (Central) Limited

8. PWL is an incorporated and co-operative company. Unlike CDC, PWL is substantially but not wholly owned by the pharmacies it supplies.

9. PWL also supplies prescription, specialist and OTC pharmaceuticals to retail pharmacies and public hospitals in the Central North Island and Auckland regions. As noted above, PWL along with CDC and PWL Bay of Plenty also provide marketing and logistics services to the ACCESS Buying Group of Retail Pharmacies.

Our framework

10. As required by the Commerce Act 1986, we assess whether a merger is likely to result in a substantial lessening of competition. How we assess this is set out in our Mergers and Acquisitions Guidelines.¹
11. We ask whether a merger is likely to substantially lessen competition in a market by comparing the likely state of competition if the merger proceeds (the scenario with the merger, often referred to as the factual), with the likely state of competition if the merger does not proceed (the scenario without the merger, often referred to as the counterfactual).²
12. A tool used to assess competitive effects is market definition. Market definition provides a framework to help identify and assess the close competitive constraints the merged firm would likely face.³ A market is defined in the Commerce Act as a market in New Zealand for goods or services as well as other goods or services that are substitutable for them as a matter of “fact and commercial common sense”.⁴
13. We define markets in the way that we consider best isolates the key competitive constraints on the merging parties. In many cases this may not require us to precisely define the boundaries of a market.
14. We analyse the extent of competition in each relevant market both with and without the merger to determine whether the merger would be likely to substantially lessen competition.
15. We assess the following three factors when considering whether this is likely to be the case.
- 15.1 Existing competition – the degree to which existing competitors compete.
- 15.2 Potential competition – the extent to which existing competitors would expand their sales or new competitors would enter and compete effectively if prices were increased.

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

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

³ *Commerce Commission v New Zealand Bus Limited* (2006) 11 TCLR 679 (HC), at [123]. *Brambles New Zealand Ltd v Commerce Commission* (2003) TCLR 868 (HC) at [137].

⁴ Similarly, the courts have said that “[t]he boundaries of the market are defined by substitution between one product and another and between one source of supply and another, in response to changing prices”. See *Commerce Commission v New Zealand Bus Limited* (HC), above n 3 at [123] citing *Re Queensland Co-operative Milling Association Ltd* (1976) ATPR 40-012 at 17,247.

- 15.3 The countervailing market power of buyers – the potential for a business to be sufficiently constrained by a purchaser’s ability to exert substantial influence on negotiations.
16. A comparison of the extent of competition both with and without the merger enables us to assess the degree by which the proposed merger might lessen competition. If the lessening is likely to be substantial, we may not give clearance to the proposed merger.

Preliminary issues

17. The Commission will assess the following matters that might arise as a result of this merger.

Market Definition

18. We understand that both CDC and PWL Central supply prescription, specialist and OTC pharmaceuticals to retail pharmacies and public hospitals. CDC also supplies private hospitals.
19. CDC primarily supplies the South Island and lower North Island, from warehouses located in Wellington, Christchurch and Dunedin. Currently, PWL primarily supplies products in the central North Island from warehouses in New Plymouth, Wanganui and Napier. Both parties also operate to some extent in Auckland.
20. The applicants submit that wholesaling of prescription, specialist and OTC pharmaceuticals are treated the same in terms of ordering, stocking, picking, packing and delivery. We will consider if distinctions between wholesaling pharmaceutical products, whether prescription, specialist or OTC, exist.
21. The applicants submit that the market for wholesaling of pharmaceuticals is national. Pharmacies are contractually required to fill 99% of prescriptions on the same day, and 100% within 48 hours and pharmacies require timely and reliable supply of products. However, the applicants submit that they are able to deliver products from one central location to another within the stipulated timeframes, such that there is a single national market.
22. We will consider whether separate markets exist for the wholesale supply of pharmaceuticals to private hospitals, public hospitals and pharmacies, and whether the related geographic markets are national or regional. We note that wholesalers have a number of warehouses throughout the country.
23. Both CDC and PWL, along with PWL Bay of Plenty provide marketing and logistics services, and support to retail pharmacies through the ACCESS Buying Group. We will also consider whether there is likely to be a lessening of competition in this area of overlap.

Existing competition

24. The applicants submit that the merged entity will be significantly constrained by existing wholesalers and the ability of these wholesalers to expand their operations.
25. As CDC and PWL are both co-operative companies, they are wholly or substantially owned by the pharmacies they supply. We will consider if this customer-shareholder dynamic has any effect on the level of competition in any of the relevant markets. This will include assessing if membership of a co-operative affects a pharmacy's ability and incentive to select or switch between wholesalers, and if applicants will have any incentive to raise price given that they primarily sell to their own members. Sales to non-co-operative members will be separately considered.
26. Both CDC and PWL submit that the merged entity would face strong competition from existing pharmaceutical wholesalers such as EBOS Group Limited (through its subsidiaries ProPharma, Pharmacy Wholesalers Russell (PWR) and OneLink Limited) and PWL Bay of Plenty.
27. The applicants submit that as pharmacies and hospitals can easily switch wholesalers, the threat of losing existing customers to other participants in the market will act as a constraint on the merged entity.
28. We will consider the ease of switching, taking into account whether being a member of a co-operative or not, affects a pharmacy's ability and incentive to do so, and other factors such as the geographic proximity of likely alternative suppliers.
29. We will also consider the option for retail pharmacies, whether they are co-operative members or not, of switching from a wholesaler to directly sourcing from a manufacturer. The applicants note that some hospitals already source directly and increasing numbers are choosing to do so. However, the Commission found in a past Decision that direct supply often requires minimum quantity purchases and may not be available for all product lines. We will consider whether this is still the case.

Potential competition

30. We will consider the entry and expansion conditions and whether entry or expansion is likely, timely and sufficient in extent to prevent a substantial lessening of competition.
31. The applicants submit that there are no significant barriers to new entry or expansion in the relevant pharmaceutical wholesale markets. The applicants note that initial set up costs are standard to establishing any business including leasing premises, purchasing technology and hiring staff. They add that the costs associated with obtaining the necessary licensing and regulatory compliance are not overly burdensome.
32. However, the applicants note the need for scale given the low margins on wholesaling of pharmaceuticals. We will assess the scale new entrants would need to

achieve in order to compete effectively, and any conditions that may impact the likelihood and timeliness of doing so.

33. The applicants identify a number of sources of potential competition.
 - 33.1 Manufacturers could expand their direct supply activities to a greater number of hospitals, and begin to direct supply to retail pharmacies.
 - 33.2 Pharmaceutical wholesalers who currently only supply OTC products due to regulatory constraints could acquire the necessary licensing requirement and expand to also supply prescription pharmaceuticals.
 - 33.3 An overseas pharmaceutical wholesaler, likely an Australian firm, could enter the New Zealand market.
 - 33.4 New Zealand supermarkets (which currently supply their in-house pharmacies), could expand their wholesaling to other pharmacies.

Other competition issues

34. The applicants submit that the ability of PHARMAC to set subsidy prices significantly limits the ability of wholesalers to influence pricing on prescription pharmaceuticals. We will assess the extent to which this constraint on wholesaler's pricing ability is applicable.

Next steps

35. We are currently aiming to make our decision by **Friday 12 September 2014**. However, this date may change as the investigation progresses.
36. To keep up to date with any changes to our deadline and to find relevant documents, visit our clearance register on our website at <http://www.comcom.govt.nz/clearances-register/>
37. As part of our investigation, we will identify the parties we believe will provide the best information to help us assess the preliminary issues identified above.
38. We also invite submissions from any other parties who consider they have information relevant to our consideration of this matter. If you wish to make a submission, please send it to us at registrar@comcom.govt.nz with the reference CDC/PWL Central in the subject line of your email, or The Registrar, PO Box 2351, Wellington 6140 by close of business **Friday 18 July 2014**. Please clearly identify any confidential information contained in the submission and provide contact details.