

3.13 The Tribunal in *Re John Dee (Export) Pty Ltd & Ors* (1989) ATPR ¶40-938 citing *QCMA* stated as a guiding principle of the application of the authorisation test that:

... it is for the parties seeking authorisation to satisfy the Tribunal that benefit to the public is likely and that there will be sufficient public benefit to outweigh any likely anti-competitive detriment.¹⁵

Paragraph 6.11 of the Commission's Merger Guidelines also provides that the onus is on the applicant to satisfy the test. In order to discharge this onus, the Commission requires that the applicant fully substantiate any claims about the resulting public benefits and detriments made in the Application.

Conditional authorisation and enforceable undertakings

3.14 It is open to the Commission, in granting an authorisation, to do so on certain conditions. The Commission may consider it appropriate in particular cases to grant authorisation subject to conditions which ensure that the claimed public benefit is likely to eventuate or to lessen any detriment that might result from the acquisition. Such conditions could include a condition that certain relevant undertakings are provided to the Commission by the parties to the application.

3.15 Pursuant to s.87B of the Act, the Commission is able to accept written undertakings. Section 87B of the Act provides for enforcement in the Federal Court of written undertakings accepted by the Commission in connection with a matter in relation to which the Commission has a power or function under the Act. Where the Commission believes that a term of such an undertaking has been breached it may apply to the Court for:

- an order directing compliance; and/or
- an order to pay the Commonwealth up to the amount of any financial benefit that can be reasonably attributed, directly or indirectly, to the breach; and/or
- any order the Court considers appropriate to compensate a third party for loss or damage resulting from the breach; and/or
- any other order the Court considers appropriate.

¹⁵ *Re John Dee (Export) Pty Ltd & Ors* (1989) ATPR ¶40-938 at 50,206.

4. Commission's Assessment of Application

Relevant Market

4.1 For the purposes of determining an application for authorisation the Commission is not required to express an opinion as to whether the proposed acquisition would breach s.50 of the Act. However, in assessing the benefit to the public of the proposed acquisition it is appropriate to assess the competitive impact of the proposed acquisition. This assessment is conducted within the framework of analysis used for s.50 of the Act which requires the delineation of the relevant market(s).

4.2 Section 4E of the Act provides that the term market includes a market for those goods and services and other goods and services that are substitutable for, or otherwise competitive with, the first-mentioned goods or services. The Courts have established that both demand and supply side substitution is pertinent in determining the relevant market. The relevant market can be identified by determining the smallest area over which a profit maximising monopolist could impose a small but significant non-transitory increase in prices (SSNIP), or equivalent exercise of market power.

4.3 The Commission's market evaluation consists of four dimensions namely, product, geographic, functional and time.

Product Market

4.4 The Applicants suggest that the relevant product market is the market for the distribution of pharmaceuticals, including both ethical products and OTC products, to pharmacies.¹⁶ This market includes supply by full-line wholesalers, short-line wholesalers and manufacturers distributing direct to pharmacies.

For the purpose of assessing the Application, the Commission has accepted the Applicants' definition of the relevant product market.

4.5 The Commission also notes that two other markets will be affected by the merger, being:

- the market for the manufacture of pharmaceutical products; and
- the market for the provision of support services to retail pharmacies.

However, the Commission has no concerns that the merger will impact adversely on these markets, except to the extent that the Commission has concerns about vertical integration in these markets and its effect on wholesaling.

¹⁶ API/Sigma Submission, 26 July 2002, Page 40.

Geographic Market

4.6 API and Sigma submit that the pharmaceutical wholesaling market in which they operate is a national market because each full-line wholesaler maintains a national network and competes on a national basis.

4.7 The Commission disagrees that there is a national market for pharmaceutical wholesaling. While wholesalers obtain supply from manufacturers in a national market through centralised buying arrangements and national pricing structures, the demand side of the market is characterised by approximately 4,900 pharmacies requiring daily and short turnaround delivery. Therefore, in order to service any given pharmacist effectively, it is necessary to have warehouse facilities within a reasonable distance of each individual pharmacy. Sigma has 16 warehouses nationally, and API 15, and it is not feasible to service all pharmacists from one central warehouse. Short-line wholesalers generally are unable to operate outside the narrow geographic area surrounding their warehouse facilities. Further, direct supply manufacturers such as Arrow and Alphapharm each operate a number of warehouses nationally.

4.8 Significantly, no full-line wholesaler prices on a national basis. Each full-line wholesaler prices at a state level, and prices vary between states. This behaviour clearly indicates that there is no national market for pharmaceutical wholesaling on the demand side.

4.9 The Commission therefore considers that there are regional to state based markets in pharmaceutical wholesaling, rather than a single national market. For practical purposes¹⁷, the Commission will consider the impact of the merger in relation to state-based markets for pharmaceutical wholesaling. Support for this geographic market definition is given by Mayne:

There are factors which suggest that a state based market may be appropriate. These include:

(a) the ongoing requirement by pharmacists for just in time delivery in small lots necessitates locally based infrastructure for distribution. This customer demand has significant implications for infrastructure requirements and service capabilities of wholesalers and distributors.

(b) there is limited substitutability of interstate supply because of infrastructure requirements. An effective wholesaler needs to have distribution facilities in a state to develop significant market share in that state. This is a function of the just in time service which is demanded by pharmacies. Wholesalers who have centralised operations have limited success in penetrating interstate markets ...

(c) pharmaceutical manufacturers who have sought to expand into direct retailing have been limited in their ability to do so because of the need for a sales force and distribution infrastructure located in close proximity to pharmacists they wish to service;

(d) wholesaling services are provided on differing price bases in different states and this price difference is not related to differing costs of providing the service as a movement in prices in one state will not result in a corresponding price movement in another state.¹⁸

¹⁷ Most data relating to the wholesaling market is collated on a State basis (eg. IMS data and sales data provided by the Applicants).

¹⁸ Mayne Group Limited Submission, 13 August 2002. Pages 7-8

Functional Market

4.10 The Commission and API and Sigma agree that the functional market is wholesaling.

Conclusion on Market Definition

4.11 The Commission considers that the markets relevant to its assessment of this Application for authorisation are the various regional or state based markets for the distribution of pharmaceuticals, including both ethical products and OTC products, to retail pharmacies.

4.12 The Commission also notes that:

- the market for the manufacture of pharmaceutical products; and
- the market for the provision of support services to retail pharmacies;

are relevant to its assessment of this matter.

Future without the merger

4.13 As part of the with and without test that the Commission applies when considering applications for authorisations, the Commission must look into the future and assess the likely structure of the market if the merger does not proceed.

4.14 API and Sigma have stated to the Commission that, should they not be able to merge their operations, potentially one or both of them will be forced to cease operating as full-line wholesalers because such a business model is financially unsustainable in the current market. In order to remain financially viable in the absence of the merger, they may have to adopt a business model similar to that of existing short-line wholesalers.

4.15 If authorisation is denied, in the current environment, the Commission considers there are three possible outcomes:

1. The status quo will be maintained, with all three full-line wholesalers remaining in the market in approximately their present form¹⁹;
2. One full-line wholesaler will scale down its operations and adopt a business model more akin to that of a short-line wholesaler; or

¹⁹ The Commission accepts that there may be some rationalisation in the market if the merger doesn't proceed. The Commission asked API and Sigma to quantify their losses in relation to rural and regional, cold chain and dangerous good deliveries. Sigma was unable to identify such losses (because they do not account for such product lines and geographic areas separately), and API was able to identify only a small level of additional cost associated with such deliveries. Based on this information, the Commission does not consider that these losses are likely to be significant, and therefore considers that any rationalisation will be minimal and at the fringes of the market.

3. Two full-line wholesalers will scale down their operations and adopt a business model more akin to that of a short-line wholesaler.

4.16 In order to determine the probability of each of these scenarios occurring if the merger does not proceed, it is useful to consider the respective financial situations of API, Sigma and Mayne.

Sigma

4.17 Sigma operates two divisions - a manufacturing division and a healthcare division. The manufacturing division consists of Sigma's manufacturing operations, and has historically provided Sigma with a higher level of return (although it is a higher risk business). The healthcare division comprises its wholesaling and banner operations.

4.18 Below is a summary of Sigma's group financial performance. Historical division financial performance information is not available.

TABLE 6: FIVE YEAR SUMMARY OF SIGMA'S FINANCIAL PERFORMANCE (COMBINED OPERATIONS)

	2002	2001	2000	1999	1998
Sales (\$000)	1,663,970	1,522,130	1,308,212	1,200,999	1,133,556
EBITDA (\$000)	61,641	53,614	40,533	28,828	31,276
EBIT (before significant items) (\$000)	46,454	38,575	28,618	20,087	22,221
Return on shareholder equity	8.4%	3.6%	4.1%	5.5%	6.3%
EBIT margin	2.8%	2.5%	2.2%	1.7%	2.0%

Source: Sigma Annual Report 2001-02, Page 3

4.19 This clearly shows a trend that sales and profitability have increased over time. In addition, the Commission has been informed by a number of parties, and Sigma's financial performance confirms, that Sigma achieves lower EBIT margins than either API or Mayne in relation to its wholesaling operations. Based on the information in Sigma's 2001-2002 Annual Report, Sigma's EBIT margin in relation to its wholesaling business is approximately 1.8%, compared with API's at approximately 2.9%. Sigma's lower EBIT margins would appear to be the result of internal, rather than external, factors, and Sigma's management is attempting to improve Sigma's overall efficiency.²⁰

4.20 In Sigma's 2001-02 Annual Report, it reports that the Healthcare Division had pre-tax return on capital employed (ROCE) of 12.9% (approximately 9.5% after tax), up 31.6% on the corresponding 2000-01 figure.²¹ Pre-tax group ROCE was 14.2% in

²⁰ Confidential material see endnote i.

²¹ Sigma Annual Report 2001-02, Page 2. The Commission also notes that this is likely to understate the ROCE directly attributable to wholesale operations because the Healthcare Division includes Sigma's retail operations, which in 2000-01 (when segment figures were last provided) had a negative ROCE. Sigma's 2000-01 Annual Report claims that its wholesale division achieved ROCE of 17.8%.

2001-02, an increase of 32.6% over 2000-01. *Confidential material see endnote ii.*²²
*Confidential material see endnote iv.*²³

4.21 The Commission also notes the analysis presented in Confidential Attachment 1 to the NECG report relating to the ROCE earned by Sigma's individual warehouses. *Confidential material see endnote vi.*²⁴

4.22 Further, the Commission notes the comments made by Mr John Stocker, AO, Chairman of Sigma:

Last year I suggested that Sigma had emerged fundamentally stronger and that it had been a transition year as the Company re-focussed on its core strengths and improving performance.

...

This process is in many ways on-going, however, as a company we must always strive for further improvement and growth. For example, there remain further opportunities to improve margins in wholesaling operations and we have not yet seen the full benefit of some of our manufacturing acquisitions.

...²⁵

4.23 Similar comments were made by Mr Elmo de Alwis, Managing Director of Sigma:

... The wholesale component of the division introduced programs aimed at better managing working capital such as ongoing product range reviews and the introduction of the Sigma debtor management program (Sigma Rewards). These initiatives, combined with further rationalisation of warehousing and distribution infrastructure costs, have resulted in growth in profitability and improved returns on capital employed (ROCE).

...

This increased profitability comes through banner member support of Sigma's manufacturing and distribution facilities.

...

The Healthcare Division has delivered an EBIT improvement of 21.7% and a Profit before tax increase of 26.6% with increased sales of 7.6% to \$1.45 billion.²⁶

It is clear from these comments that Sigma's wholesaling performance is improving.

4.24 In its submission, Sigma argues that it is not meeting its cost of capital with respect to its wholesaling operations. The Commission questions whether this is historically the case. In its 2000-01 Annual Report, it was stated:

The Group EBIT to Capital Employed ratio increased by 31.5% over the prior year from 11.1% to 14.6%. Both the Pharmaceuticals Division and Healthcare Wholesaling comfortably exceeded the Company's weighted average cost of capital for the year ...²⁷

Therefore, as recently as 2000-01, Sigma considered that its wholesaling operations were making satisfactory returns. *Confidential material see endnote viii.* However, the Commission does note that historically Sigma accounted for its wholesale and retail

²² *Confidential material see endnote iii.*

²³ *Confidential material see endnote v.*

²⁴ *Confidential material see endnote vii.*

²⁵ Chairman's Review, Sigma Annual Report 2001-02, Page 5

²⁶ Managing Director's Report, Sigma Annual Report 2001-02, Pages 7-9

²⁷ Managing Director's Report, Sigma Annual Report 2000/2001, Page 8. The Healthcare Wholesaling section was the section responsible for distributing pharmaceuticals to pharmacies.

support operations separately, but that in 2001-02 these operations were accounted for together, and that historically Sigma's retail operations have suffered losses.

4.25 However, regardless of whether Sigma has historically met its cost of capital in relation to its wholesaling operations, the Commission believes that Sigma is generally in a solid financial position and that its EBIT is trending upwards. The information provided by the Applicants has not persuaded the Commission otherwise. The company's 2001-02 return on capital employed as calculated in its 2001-02 Annual Report, if not above its WACC, is not significantly lower than its WACC, and if it can realise the internal efficiencies it has highlighted in its Annual Reports, then the Commission believes that it should meet its cost of capital even if the merger does not proceed. *Confidential material see endnote ix.*

4.26 Finally, the Commission notes that most of the financial analysis provided to it by the Applicants, and the financial material prepared by NECG, is largely based on Sigma's financial situation. As noted above, it appears to the Commission that Sigma suffers from internal inefficiencies that do not accurately reflect the pharmaceutical wholesaling industry as a whole.

Australian Pharmaceutical Industries

4.27 The Commission considers that, from the available information, API is in a solid financial position. Evidence of this financial strength is clear from examination of API's most recent financial results, as well as the financial summary outlined above.

TABLE 7: FIVE YEAR SUMMARY OF API'S FINANCIAL PERFORMANCE

	2002	2001	2000	1999	1998
Sales (\$000)	1,881,406	1,645,457	1,237,141	1,132,806	1,001,209
Operating profit before tax (\$000)	50,006	44,538	41,301	37,530	29,465
Operating profit after tax (\$000)	34,657	28,586	26,578	25,970	18,645
Return on shareholders' equity (after tax)	13.01%	11.11%	17.18%	14.89%	11.65%
EBIT margin	2.95%	2.95%	3.47%	3.48%	3.04%

Source: API's Annual Report 2001, Page 15, API Financial Report to 30th April 2002.

API presently achieves an after tax return on shareholder equity of 13.01%. The Commission believes this to be above API's cost of equity, and is above the Applicants' estimate of API's cost of equity.²⁸ The Commission also believes that API is meeting its WACC.²⁹ *Confidential material see endnote xii.*

4.28 In addition, the Commission notes the comments in API's Directors' Report:

²⁸ API/Sigma Submission, 26 July 2002, Confidential Attachment 4. *Confidential material see endnote*

x.

²⁹ *Confidential material see endnote xi.*

The results achieved by the consolidated entity in the pharmaceutical distribution industry continues to be considered very satisfactory.

The Group's operations continued to gain market share in all states with improved trading profit performance recorded in each operation.³⁰

4.29 Based on the information available to the Commission, it considers that API is financially sound, and is making an adequate return on capital for it to continue to operate as a full-line wholesaler on a sustainable basis.

Mayne/Faulding

4.30 Mayne appears to be in a sound financial position. Both the Applicants and Mayne believe that Mayne is meeting its WACC in relation to its wholesaling business, and there is no suggestion that Mayne is earning supra-competitive profits.

4.31 Mayne submits that:

*Confidential material see endnote xiii.*³¹

4.32 It is however suggested by the Applicants that Mayne benefits from significant economies of scope as a result of its vertical integration strategy (including hospitals, medical and logistics operations). However, no evidence was presented to sustain such claims.

Other financial analysis

4.33 In the course of its inquiries, the Commission sought submissions from certain financial analysts specialising in the health sector. In particular, in its meeting with the Commission, Macquarie Research Equities commented that API is a better distributor than Sigma and has performed better in running its operations. It believed that API had the best returns in the market, followed by Mayne and then Sigma. In addition, Macquarie Equities indicated that Sigma's operations have not historically been run efficiently and that Sigma is struggling to meet its WACC.³² This is in accordance with the Commission's own analysis.

International comparison

4.34 Below is a summary of international returns on capital employed (after tax, pre-interest) that were achieved by international pharmaceutical wholesalers compared to Australian wholesalers. This information was obtained from the submission made by the NPSA, of which Mayne, Sigma and API are members, to the joint industry/Government review of wholesaling arrangements.

³⁰ API Annual Financial Report 30th April 2002, Page 3.

³¹ Mayne Group Limited Submission, 13 August 2002, Confidential Appendix 2.

³² Submission by Macquarie Research Equities, 1 August 2002.

TABLE 8: INTERNATIONAL COMPARISON OF PHARMACEUTICAL WHOLESALER ROCE

Company	ROCE (after tax, pre-interest), 2000
API	
Sigma	
Mayne/Faulding	
Cardinal (USA)	<i>Confidential material see endnote xiv.</i>
McKesson (USA)	
Alliance (UK)	
GEHE (Germany)	

Source: Submission by the NPSA to the review of wholesaling margins.

Generally the returns achieved by Australian wholesalers compare favourably to those achieved by their international counterparts. However, the Commission notes that Sigma's performance is significantly lower than that of both API and Mayne. *Confidential material see endnote xv.*

Commission's view of the sustainability of API and Sigma's operations

4.35 Based on the information available to it and considering the probable future market environment, it is the Commission's view that should the merger not proceed:

- API will be able to continue to operate as a full-line pharmaceutical wholesaler on a sustainable basis based on its present performance;
- Mayne will be able to continue to operate as a full-line pharmaceutical wholesaler on a sustainable basis based on its present performance; and
- Sigma may not be able to continue to sustainably operate as a full-line pharmaceutical wholesaler in the long-term based on its present financial performance, but financial indicators suggest that there is significant scope for Sigma to realise internal efficiencies (bringing it in line with the other industry players) and that if this occurs, Sigma should be able to continue to operate as a full-line pharmaceutical wholesaler on a sustainable basis.

Therefore the Commission considers that, in the long term, all three full-line wholesalers are likely to remain in the market in approximately their present form. However, the Commission acknowledges that some rationalisation may occur in the market, but as noted earlier considers that such rationalisation would be minimal and at the fringes of the market.

Hypothetical effect of the merger

4.36 It is also useful to consider the likely profitability of the merged entity, and the change in profitability it will experience should it be successful in increasing wholesale margins following the merger.

4.37 The table below summarises the likely financial position of the merged entity in four separate situations:

- the simple combination of API and Sigma's existing operations without cost or other savings at present margins;

- the combination of API and Sigma's existing operations incorporating the likely cost savings of the merger and assuming that capital used by the merged entity decreases and average gross margins remain constant;
- the combination of API and Sigma's existing operations incorporating the likely cost savings of the merger and assuming that capital used by the merged entity decreases and average gross margins increase from 7% to 8%; and
- the combination of API and Sigma's existing operations incorporating the likely cost savings of the merger and assuming that capital used by the merged entity decreases and average gross margins increase from 7% to 9%.

TABLE 9: HYPOTHETICAL ROCE OF MERGED ENTITY

	Simple combination of existing operations	Merged entity		
Assumed gross margin	7%	7%	8%	9%
Sales (\$m)	3,454	3,454	3,486	3,518
Cost of sales (\$m)	3,228	3,228	3,228	3,228
Gross profit (\$m)	226	226	258	290
Operating costs (\$m) (a)	166	146	146	146
Profit before tax (\$m)	60	80	112	144
Profit after tax @ 30% tax rate	42	56	78	100
Capital employed (\$m) (b)				
Return on capital employed (%) pre-tax		<i>Confidential material see endnote xvi.</i>		
Return on capital employed (%) post tax				

(a) Assumes \$20 million pa saving in operational costs following merger as suggested by API and Sigma in their submission.

(b) API and Sigma estimate excluding financial guarantees in first column at Table 1, Confidential Attachment 4, and set at 75% of that in subsequent columns to reflect savings in plant and equipment, inventory and IT.

Sources: Sigma Annual Report 2001-02, API Annual Report to 30th April 2002, Submission by API and Sigma Confidential Attachment 4, ACCC estimates.

4.38 As is demonstrated above, the merged entity would, immediately after realising the cost savings associated with the merger, achieve a post-tax return on capital of *Confidential material see endnote xvii*. Further, it demonstrates that the merged entity will become increasingly profitable with only small increases in price.

5. Public Detriment

5.1 The Tribunal stated in *Re Queensland Co-operative Milling Association Ltd and Defiance Holdings Ltd* (1976) ATPR 40-012 (QCMA) that the relevant public benefit is a net or overall benefit after any detriment to the public resulting or likely to result from the proposed acquisition:

We accept that the statute calls upon us to adopt a balance-sheet approach: we must balance the likely benefits and detriments flowing from the acquisition.³³

5.2 The notion of public detriment falling for consideration under ‘all the circumstances’ is wider than the notion of anti-competitive effect, but the latter will be a primary consideration. The Tribunal stated in QCMA:

We accept that the notion of detriment falling for consideration under ‘all the circumstances’ is wider than the notion of anti-competitive effect. But at the same time, given the policy of the Act and the subject-matter under consideration, the most important of those potential detriments will normally be the anti-competitive effects.³⁴

5.3 The Trade Practices Tribunal concluded in QMCA that it is appropriate to commence the assessment of public benefit with an assessment of the competitive implications of the proposed merger, for the following reasons:

1. A merger may positively enhance the competitive process and thus give rise to a substantial benefit ...
2. ... the benefits claimed may not mention competition ... Nevertheless, our appraisal of all the listed claims must depend upon our appreciation of the competitive functioning of the industry, with and without merger ...
3. A claimed benefit may in fact be judged to be a detriment when viewed in terms of its contribution to a socially useful competitive process ...
4. ... the substantiality of benefits needs to be measured against likely anti-competitive effects (and other detriments).
5. Quite generally, the Tribunal’s role is seen as forming one of the means of achieving the policy objective of the Act, namely the preservation and promotion of useful competition.³⁵

This chapter explains the Commission’s views as to the likely effects of the proposed acquisition on competition.

5.4 The concept of competition under the Act is generally well understood and has been explained in decisions of the Courts and the Tribunal. The Tribunal said:

Competition is a process rather than a situation. Nevertheless, whether firms compete is very much a matter of the structure of the markets in which they operate. The elements of market structure which we would stress as needing to be scanned in any case are these:

- (1) the number and size distribution of independent sellers, especially the degree of market concentration;
- (2) the height of barriers to entry, that is the ease with which new firms may enter and secure a viable market;

³³ *Re Queensland Co-operative Milling Association Ltd and Defiance Holdings Ltd* (1976), ATPR 40-012, at 17,243.

³⁴ *Id.*

³⁵ *Ibid.*, pages 17,244 - 17,245

- (3) the extent to which the products of the industry are characterised by extreme product differentiation and sales promotion;
- (4) the character of “vertical relationships” with customers and suppliers and the extent of vertical integration; and
- (5) the nature of any formal, stable and fundamental arrangements between firms which restrict their ability to function as independent entities.

Of all these elements of market structure, no doubt the most important is (2), the condition of entry. For it is the ease with which firms may enter which establishes the possibilities of market concentration over time; and it is the threat of entry of a new firm or new plant into a market which operates as the ultimate regulator of competitive conduct.³⁶

Merger factors

5.5 In assessing whether a merger will substantially lessen competition in breach of s.50 of the Act, s.50(3) provides that the Court must have regard to a range of factors as listed in Chapter 3 above. While the Commission accepts that it is not necessary or appropriate for it to express a view as to whether the proposed acquisition would breach s.50 of the Act “the framework of analysis used for s. 50 is still an appropriate one for the evaluation of competitive effects in relation to applications for authorisation.”³⁷

5.6 These factors, derived from extensive judicial and academic reviews of mergers, form the basis of the Commission’s merger assessment procedures as set out in the Merger Guidelines. The analysis of the likely competitive detriment that will result from the merger below follows that approach.

Market concentration: s.50(3)(c)

5.7 Market concentration refers to the number and size of participants in the market. A concentrated market is a necessary but not sufficient condition to enable the exercise of market power. If the relevant market is properly defined, a firm or firms will not normally be able to exercise market power in the absence of a significant market share.

5.8 A merger which increases the level of concentration in a market may reduce competition by increasing the unilateral market power of the merged firm and/or increasing the scope for co-ordinated conduct among remaining competitors.

5.9 The unilateral exercise of market power requires that a firm has sufficient control of the market, such that it can profitably ‘give less and charge more’ without being threatened by competing suppliers. For undifferentiated products this normally requires that a firm control a substantial proportion of capacity. For differentiated products, brand loyalty and related factors may further inhibit smaller rivals from successfully preventing the unilateral exercise of market power. Market shares will generally be a good indicator of consumer preferences and brand loyalty for a firm’s products.

5.10 A reduction in the number of firms operating in a market increases the scope for coordinated conduct, including both overt and tacit collusion. It becomes easier to

³⁶ *Ibid*, page 17,246

³⁷ Merger Guidelines, Page 67.

reach agreement on the terms of coordination, to signal intentions to other market participants and to monitor behaviour. In other situations, the creation of one firm with a large market share may increase the likelihood of price leadership.

5.11 These consequences were clearly recognised by Judge Posner in *Hospital Corp. of America v Federal Trade Commission*³⁸ when he stated:

The reduction in the number of competitors is significant in assessing the competitive vitality of the ... market. The fewer competitors there are in a market, the easier it is for them to coordinate their pricing without committing detectable violations of section 1 of the Sherman Act, which forbids price fixing. This would not be very important if the four competitors eliminated by acquisition in this case were insignificant, but in this case they were not; they accounted in aggregate for 12 percent of sales of the market. As a result of the acquisitions the four largest firms came to control virtually the whole market, and the problems of coordination was therefore reduced to one of coordination among these four.³⁹

5.12 As discussed above, the Commission considers that there are regional or state based markets for the distribution of pharmaceuticals to retail pharmacies. However, for practical reasons the Commission will consider the impact of the merger on state-based markets.

5.13 In addition, the Commission considers that turnover orders should not be considered as separate from the ordinary business of wholesalers as suggested by API and Sigma. From a commercial perspective, the role of the wholesaler is the same regardless of whether a turnover or ordinary order is placed, and wholesalers receive their ordinary payment. In relation to this issue, Mayne states in its submission:

... Turnover orders are, as noted in the Submission, orders generated by manufacturers through visits by the manufacturers sales representative to pharmacies in relation to particular products. The fulfilment of those orders, however, occurs through the pharmaceutical distributor. The distributors compete with one another for the right to fulfil those turnover orders in relation to a particular manufacturer and other full-line distributors compete for the placement of orders with the pharmacies. They are therefore properly a part of the business of the distributor.⁴⁰

5.14 In Confidential Attachment 5 to their submission, the Applicants provide state based market share information collated by IMS Health Australia, which is abstracted in the table below.

TABLE 10: MARKET SHARE BY STATE

	NSW	VIC	QLD	SA	WA	TAS
API						
Sigma						
Merged entity						
Manufacturers						
Other (including Mayne)						

Confidential material see endnote xviii.

Source: IMS Health, Applicants' submission, Confidential Attachment 5

³⁸ [1986-2] Trade Cases ¶67.377

³⁹ Ibid, page 61,990.

⁴⁰ Mayne Group Limited Submission, 13 August 2002, Page 8.

The Commission however notes that these figures may overstate the market share of 'other' wholesalers, as these market share figures include sales made by 'other' wholesalers of product they have purchased from API or Sigma.

5.15 Following the acquisition, API/Sigma would have significantly increased concentration in each state market, with particular concentration in NSW, Victoria and Queensland (approximately 60% for the merged entity). As discussed above, such a large market share tends to confer on a firm the potential for the exercise of unilateral market power. The merged entity's ability to raise prices independently of its competitors may be enhanced following the merger and it will be in a stronger position to protect its market position in the face of new entry. In addition, should the merger occur, Mayne would have the vast majority of the remaining market, and the likelihood of parallel conduct between the two major players remaining in the market is likely to increase.

5.16 The Commission notes that there is a great deal of concern expressed to it about the potential for price coordination between the merged entity and Mayne. For example, National Pharmacies considered that following the merger the potential for coordination was increased because there would only be two major players in each of the state based markets. In particular it expressed concern that this would result in less competition, and higher prices. It observed that competition was presently the driver of lower prices in the market.⁴¹

5.17 The Commission considers that the merger of API and Sigma would result in a significant increase in industry concentration. This increased level of concentration would significantly enhance the merged entity's ability to exercise unilateral market power or coordinate actions with the remaining full-line wholesaler in the market. In addition, while the Commission disagrees with the market definition proposed by API and Sigma, it considers that, even if the relevant market were a national pharmaceutical wholesaling market excluding turnover orders, the level of concentration in this market would be significantly increased by the merger and the merged entity's ability to exercise unilateral market power or coordinate actions with the remaining full-line wholesaler in that market would be enhanced.

Import competition: s.50(3)(a)

5.18 If import competition, or the potential for import competition, is an effective check on the exercise of domestic market power, it is unlikely that a merger will result in anti-competitive detriment.

5.19 There is no potential import competition in any of the pharmaceutical wholesaling markets. While there is potential and actual import competition in relation to pharmaceutical manufacturing, the Commission is not concerned about the impact the merger will have on competition in this market, except to the extent the Commission has concerns about vertical integration.

⁴¹ National Pharmacies Submission, 2 August 2002, Page 6.

Barriers to entry: s.50(3)(b)

5.20 Even if concentration is high and import competition is low, if the market is characterised by low barriers to entry, incumbent firms are likely to be constrained by the threat of potential competition to behave in a manner consistent with competitive market outcomes. However, if there are substantial barriers to entry faced by new suppliers into the market, or significant barriers to the expansion of smaller players in the market, a significant increase in concentration in the absence of significant import competition is likely to give rise to a substantial anti-competitive detriment.

5.21 Barriers to entry can be any feature of the market that places an efficient prospective entrant at a significant disadvantage compared with incumbent firms. They may consist of sunk costs; legal or regulatory barriers; access to scarce resources or cost advantages enjoyed by incumbent firms; economies of scale and scope; product differentiation; and the threat of retaliatory action by incumbents.

5.22 The 'height' of barriers to entry indicates the extent to which incumbents can raise the market price above its competitive level without attracting entry. It is not necessary for a merger to raise barriers to entry for it to be anti-competitive; only that significant barriers to entry exist, providing incumbents with significant discretion over pricing and other conduct. If the merger also increases barriers to entry, the anti-competitive effects are likely to be more severe.

5.23 The Commission considers that effective entry is that which is likely to have a market impact within a reasonably short period, either by deterring or defeating the attempted exercise of market power by the merged firm. In some markets the threat of entry is sufficient to constrain firm conduct. In others, actual entry will be required. The latter would require entry on a sufficient scale and which offered a product sufficiently attractive to consumers to be effective.

5.24 Based on the following assessment, the Commission considers that barriers to entry into the market are significant, and that the merger is likely to raise the height of barriers for new entrants and the expansion of existing market players.

Capital costs

5.25 The cost of new entry as a full-line wholesaler would be significant. It would require significant infrastructure in the form of warehousing, trucks and IT systems. It would also require a significant investment in inventory. Similarly, the cost for any existing short-line wholesaler to become a significant full-line wholesaler is also high.

5.26 The cost of entry for a new short-line wholesaler would be significantly less. It would require similar infrastructure to that required to enter as a full-line wholesaler, but on a lesser scale. The actual cost of entry for a short-line wholesaler would be lower, especially if such entry is confined to a narrow geographic area and product range.

Securing supply

5.27 Pharmaceutical wholesalers must be able to secure supply from pharmaceutical manufacturers in order to be effective competitors.

5.28 Smaller wholesalers and buying groups have indicated that some manufacturers are generally unwilling to supply many wholesalers. Unless they purchase a significant volume of product, manufacturers refuse to deal with them directly. Even groups the size of National Pharmacies are unable to source all their requirements direct from manufacturers. Manufacturers have confirmed their desire to deal with as few wholesalers as possible to minimise transaction costs.

5.29 As a result, short-line wholesalers are often forced to deal with at least one of the full-line wholesalers in order to obtain supplies of certain products. This may create a certain level of dependence from short-line wholesalers on full-line wholesalers and potentially discourages their expansion. The Commission sought information from API and Sigma in relation to sales made to short-line wholesalers. It was advised that *Confidential material see endnote xix*.⁴²

5.30 The Commission considers that this poses a significant barrier to entry in the market. For example, SWAPS stated:

I may add here that it is difficult for short-line wholesalers to compete with the nationals when major manufacturers (particularly those with PBS products e.g. Pfizer, MSD, AstraZeneca etc) refuse to open accounts with State based short-line wholesalers, even though their purchase criteria can be met ...⁴³

5.31 Further, in its submission Mayne expressed the view that, while securing supply from manufacturers is difficult now for many market participants, following the merger securing supply from manufacturers could become even more difficult:

The merged entity would have substantial economies of scale and market power. In those circumstances, there is the scope for the merged entity to negotiate preferred supplier arrangements with manufacturers for product distribution.⁴⁴

5.32 The Commission considers that difficulties in obtaining supply from manufacturers constitutes a barrier to entry to the pharmaceutical wholesaling market. Further, the merger may enhance the ability of the merged entity to create preferred supplier arrangements with manufacturers to the detriment of short-line wholesalers and potential new entrants following the merger.

Economies of scale

5.33 In their submission, the Applicants argue that the merger is necessary to allow them access to economies of scale. They argue that without access to economies of scale they are unable to meet their cost of capital, and are unable to effectively compete with Mayne.

⁴² API/Sigma Response to the Commission's Request for Further Information, API Confidential Attachment 5 and Sigma Confidential Attachment 5.

⁴³ SWAPS Submission, 29 July 2002, Page 2

⁴⁴ Mayne Group Limited Submission, 13 August 2002, Page 3.

5.34 The Commission accepts that there are significant economies of scale in pharmaceutical wholesaling. However, these economies of scale may also act as a barrier to future entry. Any new full-line wholesaler is likely to find it difficult to compete against a merged API and Sigma which would have economies of scale that no other market participant could match. Therefore, if the merger proceeds, the economies of scale obtained by API and Sigma are likely to entrench their position in the market, make new entry in either short or full-line wholesaling more difficult, and hinder possible expansion by existing market players.

5.35 This is recognised by a number of parties, including Exel:

In summary the downside to the merger is that two wholesalers will have over 90% market share, a large segment of their customers (pharmacy) would have no reasonable substitute to using the two firms. Barriers to entry in the market would increase with the huge scale advantages enjoyed by the two dominant entities allowing the two firms to have greater ability to engage in anti-competitive behaviour.⁴⁵

5.36 For these reasons the Commission believes that economies of scale are a large barrier to entry facing a potential new full-line wholesaler, or expansion by a short-line wholesaler, in each pharmaceutical wholesaling market, and the height of these barriers will be increased if the merger proceeds.

Financial Guarantees

5.37 Full-line wholesalers have traditionally provided pharmacists with financial guarantees. These guarantees allow pharmacists who would not otherwise meet normal bank lending criteria to purchase pharmacies and commercial premises, or allow pharmacists to access loans at lower interest rates than would otherwise be available to them. Between them, the three full-line wholesalers guarantee over a billion dollars of loans for pharmacists. While these financial relationships cannot be used to compel pharmacists to deal with a particular wholesaler, it seems that in practice these guarantees are given to pharmacists in expectation of them doing a significant amount of business with the wholesaler. If a pharmacist does not order enough stock from the wholesaler providing the guarantee, it is possible that the guarantee will be terminated by the wholesaler (because the wholesaler will receive no or little commercial benefit for the risk it assumes in guaranteeing the loan). *Confidential material see endnote xx.*

5.38 A number of submissions indicated that financial guarantees are indeed barriers to entry. For example, in its meeting with the Commission National Pharmacies noted that it believed financial guarantees constituted a significant barrier to entry in the market. In particular it commented that any new full-line wholesaler would have to have sufficient capital to guarantee loans for pharmacists because, without this linkage, they would be unable to effectively get sales volume.⁴⁶

5.39 These guarantees are, in the Commission's view, a significant barrier to new entry as a full-line wholesaler. They are less of a barrier to the establishment of short-line wholesalers, but act as a significant barrier to the expansion of short-line

⁴⁵ Exel Submission, undated, Page 3.

⁴⁶ National Pharmacies Submission, 2 August 2002, Page 6.

wholesaler operations and their ability to develop as major constraints on the competitive conduct of full-line wholesalers.

Business support

5.40 All full-line wholesalers provide pharmacists with a significant amount of business support. This support comes in many forms, including general management support, IT systems support and marketing support.

5.41 Primarily this support is provided by wholesalers through their banner groups. In return for an annual fee, and sometimes an additional fee for service, pharmacies are entitled to take advantage of this support. However, some business support is available to pharmacies outside of banner chains, either on a fee for service basis, or for free. Full-line wholesalers will also act as the agent (at no cost) for pharmacists wishing to sell their pharmacy, and there is anecdotal evidence to suggest that full-line wholesalers prefer to sell pharmacies to pharmacists wishing to stay in their banner group, or who will continue to deal with them as their primary wholesaler.

5.42 A number of submissions expressed concern about the effect these services had on competition. For example National Pharmacies indicated that full-line wholesalers provided business support to pharmacists in order to encourage reliance. It believed that this reliance was stifling other forms of distribution.⁴⁷

5.43 The Commission believes the effect of this business support is to create a strong tie between pharmacies and a particular wholesaler. As can be seen from the Table below, members of banner groups strongly favour the wholesaler owner of their banner group, even though there is no formal requirement to purchase a certain volume from them.

TABLE 11: BANNER GROUP PURCHASING CHARACTERISTICS

Wholesaler	Banner	% of product purchased from wholesaler owner
API	API Health Care Chemworld Pharmacist Advice Soul Pattinson Average per banner pharmacy	<i>Confidential material see endnote xxi.</i>
Sigma	Amcal Guardian	

Source: Confidential Attachment 1, Applicants' submission

5.44 In particular the Commission notes the comments of Sigma's Managing Director in its 2001-02 Annual Report:

Sigma's banners, Amcal and Guardian, have begun to demonstrate the potential they have both to deliver value to their members as well as to contribute to increased profitability to Sigma.

⁴⁷ National Pharmacies Submission, 2 August 2002, Page 6.

This increased profitability comes through banner member support of Sigma's manufacturing and distribution operations.⁴⁸

5.45 The Commission considers that this relationship of dependence or reliance constitutes a barrier to entry to the market. A new entrant or an existing player seeking expansion may be prevented from effectively competing for the business of a significant proportion of retail pharmacies as a result of these ties. This is particularly significant because, between them, API and Sigma have 1285 members in their banner groups (which comprise approximately 26% of total pharmacies).⁴⁹

Cross-subsidy

5.46 The parties argue that the merger is necessary because it will allow them to continue to subsidise deliveries to rural and regional areas, as well as deliveries of certain products, such as those requiring secure or cold chain delivery. The Applicants argue that without the merger, their ability to maintain this cross-subsidy is threatened.

5.47 Such a cross-subsidy, to the extent it exists, is a barrier to entry. It prevents new entry in relation to those geographic and product sub-markets that benefit from the cross-subsidy. It does so because any new efficient entrant is effectively prevented from entering those sub-markets unless they are also able to cross-subsidise their operations.

5.48 As Mayne points out in its submission:

Rather than delivering public benefits, the causal effect of the merger will be to permit Sigma and API to retain existing inefficiencies. The merger will not encourage an efficient approach to the achievement of the Government's policy objective of equity of access to pharmaceuticals.⁵⁰

Entry

5.49 Recent new entry into the market for pharmaceutical wholesaling has been limited. While there has been some new entry by short-line wholesalers and direct sale manufacturers, there has been no recent entry of any full-line or national wholesaler. In fact the wholesaling industry has experienced significant rationalisation so that only three full-line wholesalers remain in the marketplace. In addition, short-line wholesalers have not been successful in obtaining a large share of the markets for supply to retail pharmacies. However, the Commission notes the success of direct supply manufacturers such as Arrow in entering the market.

5.50 Further, no short-line wholesaler that has entered the market in recent times has done so nationally. Instead, new entry has been confined to certain geographic areas, predominantly large urban areas. However, there has not been any recent new entry into the full-line wholesaling market, or any short-line wholesaler that has successfully moved from a short-line to full-line wholesaling model in recent times.

⁴⁸ Sigma Annual Report 2001/02, Managing Director's Report, Page 7.

⁴⁹ API/Sigma Submission, 26 July 2002, Pages 66 and 68.

⁵⁰ Mayne Group Limited Submission, 13 August 2002, Page 1.

Countervailing power: s.50(3)(d)

5.51 Countervailing power exists where a supplier (buyer) faces a buyer (supplier) with market power or a credible threat of vertical integration or by-pass. In such cases the ability of the merged firm to increase (decrease) prices may be constrained and the likelihood of anti-competitive detriment occurring is diminished.

5.52 The vast majority of sales by pharmaceutical wholesalers are to pharmacies. Pharmacies are unable to pass on any price rise to consumers in relation to PBS products. These products are subsidised by the Federal Government and the maximum amount an end consumer will pay for a PBS medicine is the co-payment price. The payment a pharmacist receives for any given drug is set by the Federal Government, and includes a dispensing fee and the co-payment. This payment notionally includes a margin for wholesalers, but there is no legal impediment to prevent a wholesaler charging more or less than the notional 10% margin. Therefore any increase in wholesaling charges above their existing levels would impact directly on pharmacies.

5.53 If the merger were to proceed, the amount of countervailing power wielded by pharmacists would decrease significantly. Most pharmacists require the use of two wholesalers – a primary and a secondary wholesaler.⁵¹ Most pharmacists use two full-line wholesalers to fulfil these roles. If the merger were to proceed, most pharmacists would require the services of both the merged entity and Mayne, thereby losing any credible threat of bypass. For example:

Around 5,000 pharmacies operate in Australia and the majority have more than one account with a good number having at least three accounts, one with each wholesaler. This is done for a number of reasons, being if stock is out of supply with one then the pharmacy can obtain product from another and the second is not tie themselves to one wholesaler and be at the mercy of this wholesaler. The actual numbers are 27% have an account with one wholesaler, 52% have an account with two wholesalers and the balance of 21% have accounts with all three wholesalers. Of the 52% of pharmacies that have two accounts, almost half (43%) have both accounts with API and Sigma.⁵²

5.54 The ability of pharmacists to bypass wholesaling appears limited. An individual pharmacist does not have the ability to vertically integrate back to create his/her own wholesaling operation. Similarly, an individual pharmacist's ability to sponsor entry of a new entrant (or expansion of an existing short-line wholesaler) is limited. No individual pharmacist has the buying power to do so.

5.55 It is likely that the merger will significantly diminish the countervailing power held by individual pharmacists.

5.56 Conversely it is likely that a proportion of pharmaceutical manufacturers will retain countervailing power when dealing with wholesalers. This is especially true of large manufacturers, such as Pfizer and AstraZeneca, which believe they will not be harmed by the merger. If the merged entity were to attempt to extract unfavourable terms, they could potentially create alternative distribution channels. However, smaller

⁵¹ In addition, pharmacists will also often receive a delivery (usually monthly) from direct supply manufacturers and/or short line wholesalers.

⁵² Submission by Meredith Baker, 19 August 2002, Page 1.

manufacturers – those with a reliance on the distribution channel provided by the parties, and particularly those supplying OTC products – have expressed concern that they will not have sufficient power to counteract the market power API and Sigma will obtain through the merger.

5.57 It is unlikely that the merger will diminish the countervailing power held by pharmaceutical manufacturers generally. However, small manufacturers and manufacturers of OTC and generic products are more likely to be adversely effected by the merger.

5.58 The issue of whether the Commonwealth Government possesses countervailing power with respect to wholesalers is considered below.

Availability of substitutes: s.50(3)(f)

5.59 The elasticity of supply, either in terms of alternative products that may be used or the capacity of existing suppliers to quickly expand output, will have a material impact on the extent to which prices may be raised post-merger if the merged entity seeks to exercise market power.

5.60 There are three possible substitutes for the services of the merged entity – non-pharmaceutical wholesalers and logistics providers, direct supply by manufacturers and short-line wholesalers.

5.61 Wholesaling services provided by non-pharmaceutical wholesalers and other logistics providers are, to some extent, substitutable for pharmaceutical wholesaling services. However, pharmaceutical wholesalers are a special category of wholesalers in that they specialise in single unit delivery, as opposed to other wholesalers that deliver in pallets or boxes. Also, given that most pharmacists who provided submissions to the Commission have indicated that frequent (daily or twice daily) delivery is essential (because of health, inventory and storage considerations), these alternative forms of delivery are therefore in their current form largely unsuitable and unsubstitutable for pharmaceutical wholesaling.

5.62 In *FTC v Cardinal Health Inc. and Bergen-Brunswick Corp.*; *FTC v McKesson Corp. and Amerisource Health Corp.*, Judge Sporkin indicated:

The business of wholesale drug delivery is considerably more sophisticated than merely “picking and packing” as suggested by the Defendants throughout the trial. The evidence presented by the FTC clearly demonstrates that wholesalers provide customers with an efficient way to obtain prescription drugs through centralized warehousing, delivery, and billing services that enable the customers to avoid carrying large inventories, dealing with a large number of vendors, and negotiating numerous transactions. The value of this service is underscored by the additional services offered by the Defendants, which the evidence overwhelmingly shows are provided only by certain wholesalers. According to the FTC, if the Defendants were to merge and engage in anti-competitive practices, a large segment of Defendants’ customers – namely hospitals and independent pharmacies – would have no reasonable substitutes.

...

The Court is persuaded that within the overall industry, different classes of customers have varied ability to substitute the services currently provided by wholesalers ... the Court also finds merit to the Defendant’s position that a certain, yet significant, portion of the large retail chains can themselves reasonably provide a substitute for Defendants’ services ...

However, with regard to hospitals, independent pharmacies, and non-warehousing retail chains, the Court finds that the alternatives suggested by the Defendants' such as captive production cannot be included within the relevant product market ...⁵³

5.63 Similarly, some pharmaceutical manufacturers are unable and unwilling to supply pharmacies directly. The vast majority of manufacturers who provided the Commission with submissions indicated that direct supply would be impractical and inefficient, and would only be contemplated in circumstances where there was a significant breakdown or impediment in the supply chain. While there are some manufacturers that supply pharmaceuticals directly to pharmacies, these tend to be manufacturers of generic products, and it is impossible for a pharmacist to obtain all necessary drugs from the current direct supply manufacturers. Similarly, some manufacturers who offer direct supply use the full-line wholesalers as logistics providers – for example, GlaxoSmithKline has contracted Fauldings to undertake its delivery function with respect to direct sales.

5.64 In relation to the possibility of setting up its own distribution channel, AstraZeneca commented that it could not set up an alternative wholesale distribution in the short-run and could not feasibly deal with pharmacists directly. However it did note that in the long term it may be able to establish an alternative distribution network, but only if full-line wholesalers tried to significantly change the present system.⁵⁴ This was consistent with the response of other major pharmaceutical manufacturers.

5.65 Finally, the Commission considers that short-line wholesalers are not perfect substitutes for full-line wholesalers. This is because short-line wholesalers generally do not carry the full line of products required by pharmacists and are unable to obtain some products from manufacturers. Additionally, short-line wholesalers tend to confine themselves to certain, usually urban, geographic areas. The Commission does however consider that short-line wholesalers provide some constraint to full-line wholesalers in those areas, and in relation to those product lines, they serve. However, pharmacists are unable to obtain supply from short-line wholesalers for a large number of products and in significant geographic areas. Finally, the fact that short-line wholesalers have been unsuccessful in obtaining significant market share is further evidence that they are not complete substitutes for full-line wholesalers.

5.66 In addition, the Commission understands that several short-line wholesalers are either owned by a full-line wholesaler or have close working associations⁵⁵.

5.67 As considered above, most, if not all, pharmacists acknowledge that it is necessary for them to deal with at least one, and usually two, full-line wholesalers, and that it would be impossible for them to operate effectively using only short-line wholesalers or direct manufacturers. Following the merger, most pharmacists will have to deal with both the merged entity and Mayne.

⁵³ *FTC v Cardinal Health Inc. and Bergen-Brunswig Corp.*; *FTC v McKesson Corp. and Amerisource Health Corp.* DC DoC, 12 Fsupp2d 546; [1998-2] Trade Cases ¶72,226.

⁵⁴ AstraZeneca Submission, 31 July 2002, Page 2.

⁵⁵ For example, IPS is part of the Mayne Group and Dean Garbutt has a commercial association with the Mayne Group.

5.68 The Commission therefore considers that there are some services that are partially substitutable for the pharmaceutical wholesaling function that would be performed by the merged entity. However, these substitutes are of varying degrees of effectiveness and are unlikely to act as an effective constraint on the merged entity.

Dynamic characteristics: s.50(3)(g)

5.69 The pharmaceutical wholesale market is growing. This growth, at least in relation to PBS items, is driven by two factors:

- an increase in the number of prescriptions being written by doctors; and
- an increase in the average price of prescription medications.

Other factors that are likely to impact on the market include Australia's ageing population and pressure on Government to constrain PBS expenditure in the future.

Removal of a vigorous and effective competitor: s.50(3)(h)

5.70 Both API and Sigma are vigorous and effective competitors in the market place. The vast majority of submissions received by the Commission recognise this fact. Further, API presently operates with the lowest gross margins in the market and the Commission believes this encourages competition between market players:

API is the price leader. In addition API has a monthly bulk order known as "Slasha", which is priced about 4% below Sigma's best price.⁵⁶

5.71 Therefore the merger will result in the removal of a vigorous and effective competitor and consequently has the potential to substantially lessen competition in the market and result in associated public detriments.

Vertical integration: s.50(3)(i)

5.72 Vertical integration can act as a barrier to entry if it hinders new entry or hinders the expansion of existing players. If the merger were to proceed, the parties argue that their manufacturing and wholesaling businesses will be strengthened. In addition, as noted above, the merged entity will have effective ties, whether formal or informal, to a significant number of pharmacies.⁵⁷

5.73 The parties argue that the merger will enhance the strength of their manufacturing operations, and allow downstream services to be provided on a sustainable basis. Therefore, the merger will enhance the merged entity's upstream integration and entrench its downstream integration with pharmacists.

⁵⁶ Submission by Southern Hospital Supplies.

⁵⁷ Although the Commission notes that regulation largely prevents persons other than pharmacists from owning pharmacies.

5.74 A number of industry participants are concerned by this trend, for example, Medicines Australia:

(O)ur members hold grave concerns over the increased capacity for vertical integration that this merger would permit and the impact that this might have on the market and consumer choice. The ability for the merged organisation to manufacture medicines, promote them through commercial arrangements with pharmacists and for pharmacists to substitute these products for other non-wholesaler manufactured products, is increased by the merger ...⁵⁸

5.75 Similarly 3M Pharmaceutical considers:

(A) significant threat to the OTC, ethical and generic businesses of 3M and other Australian pharmaceuticals manufacturers is posed by the proposed vertical integration in this supply chain, and the dominant position that would result from this merger. This would be highly likely to negatively impact the Australian manufacturing industry.⁵⁹

5.76 The Commission considers that the merger will increase the level of vertical integration in the marketplace, and that this will in turn raise the barriers to entry in the market.

Impact on prices and profit margins: s.50(3)(e)

5.77 Flowing on from the factors discussed above, the Commission is concerned that the merger would create a situation where the merged entity would be able to raise prices and/or decrease service levels and increase profit margins. While wholesale margins are notionally set at 10% for PBS products, no full-line wholesaler obtains this margin. Following the merger, there is a real possibility that wholesale margins will increase up towards this notional 10% and, in theory, it is possible that margins greater than 10% could be achieved. In relation to pharmacy only products there is no regulation that would prevent, or constrain, increases in prices following the merger, and these products account for approximately \$500 million per annum of sales by API and Sigma. *Confidential material see endnote xxii.*⁶⁰ Finally the Commission notes OTC products comprise a significant proportion of wholesaler sales. However the Commission notes that these products are supplied through a number of retail channels, and are therefore likely to be subject to greater price constraint than ethical or pharmacy only products following the merger.

5.78 The Commission considers that the merger would impact significantly on market concentration and on the level of competition in the market. These altered market conditions are likely to enhance the merged entity's ability to raise prices and/or decrease service levels following the merger. On the analysis below, the Commission believes that there already exists a correlation between market share and gross margin in the market. However, the Commission bases its conclusion - that the ability of the merged entity to increase prices or decrease service levels will be enhanced - on the likely competitive effect of the merger, rather than any characteristics existing in the market at present. The following analysis only serves to reinforce the Commission's view on this issue.

⁵⁸ Medicines Australia Submission, 12 August 2002, Page 4.

⁵⁹ 3M Pharmaceuticals Pty Ltd Submission, 8 August 2002, Page 2.

⁶⁰ API and Sigma response to the Commission's request for further information, API Confidential Attachment 10 and Sigma Confidential Attachment 12.

5.79 Outlined below are API and Sigma's gross wholesale margins in each state, compared with the market share of each company in that state.

TABLE 12: COMPARISON OF GROSS MARGINS AND MARKET SHARE

State	API				Sigma			
	Market share (%)	Rank	Gross margin (%)	Rank	Market share (%)	Rank	Gross margin (%)	Rank
NSW	<i>Confidential material see endnote xxiii.</i>							
VIC								
QLD								
SA								
WA								
TAS								

Sources: Market share data from IMS, Gross margin information supplied by API and Sigma⁶¹

5.80 When comparing this data with that supplied by the parties in relation to their state market shares, a strong correlation can be seen.⁶² In those state markets where API and Sigma have high market shares (around 40%), they have gross margins higher than in markets where they have lower market share. *Confidential material see endnote xxiv.*

5.81 *Confidential material see endnote xxv.* Therefore, it is possible, and the Commission considers it likely, there is a relationship between market share and gross margins, and that increased market share enhances the ability of a market participant to sustainably increase prices in order to increase profitability.

5.82 It is also relevant that competition in regulated markets is often based on service levels and wholesaling appears no different. Wholesalers compete on service levels (such as frequency of delivery, range of product offered, financial assistance and marketing) and in doing so compete away part of the theoretical 10% gross margin allowed to them. Post-merger the Commission considers the ability of the merged entity to decrease service levels to increase profit levels would be enhanced.

5.83 The Commission therefore considers that the merger will increase the ability of the merged entity to increase prices and decrease levels of service in each regional to state based market following the merger. This is a concern expressed by a number of parties who made submissions to the Commission.

5.84 In relation to this issue the Applicants commissioned a report by NECG. This report undertakes a critical loss analysis using the framework set out by Harris and

⁶¹ API/Sigma Submission, 26 July 2002, Confidential Attachments 2, 3 and 5.

⁶² When regression analysis (using t and F stat analysis) is performed on this market share and gross margin data, it is clear that there is a statistically significant relationship between market share and gross margin. While the Commission acknowledges that factors other than market share also effect gross margins, market share is likely to be a factor that impacts on prices in the market.

Simons⁶³. The conclusion of that analysis is that, if wholesalers were to increase their margin by 10% (for example, from 7% to 7.7%), this increase in price would only be viable if the corresponding decrease in sales volume is less than 11.8%.⁶⁴ Simply put, if sales volume were to fall by more than 11.8%, then the extra profit made from increasing prices by 10% would be outweighed by the profit lost from decreased sales. NECG concludes that, based on the present market dynamic, short-line wholesalers could easily obtain the 11.8% market share necessary to make a 10% increase in price unprofitable, and thereby act as an effective constraint on the merged entity. The Commission agrees with the theory of critical loss analysis. However, as discussed above, it views the competitive dynamics of the market differently to those expressed in the Application by NECG.

5.85 The Commission does not believe that short-line wholesalers would be able to obtain the 11.8% of the market necessary to make a price rise of 10% unprofitable. According to API and Sigma's own submission, short-line wholesalers presently make up only 5% of the marketplace and direct supply manufacturers approximately 7%. As acknowledged by API and Sigma, short-line wholesalers operate in limited areas and product lines – those areas and product lines that are most profitable. They are also dependent, in some instances, on full-line wholesalers for the provision of certain products as manufacturers will not deal with them. Therefore there are large geographic areas and a significant number of products over which the parties could profitably increase their prices because short-line wholesalers and direct manufacturers would provide minimal competitive constraint. Further, for the reasons outlined in this Chapter, the Commission believes that following the merger it will become even more difficult for short line wholesalers and direct supply manufacturers to compete in the market, making it less likely that they will be able to effectively constrain the merged entity.

5.86 As pharmacists will be largely unable to substitute the services provided by full-line wholesalers following the merger, the Commission considers that an increase in price or decrease in service by the merged entity is unlikely to result in a critical loss. Further, the view that there will not be a critical loss in response to an increase in price or decrease in service has been demonstrated in practice by the Applicants. API and Sigma state in their submission:

In response to these pressures, the parties have already reduced service levels and introduced new charges for support services. These service reductions and increased charges are the only way API and Sigma have been able to maintain reasonable returns, and ... are responsible for the growth reported in the parties' recent results ...⁶⁵

5.87 This statement makes it clear that API and Sigma believe that increases in price or decreases in service contribute positively to profitability. In 2001-02 Sigma reported EBIT in its healthcare division of \$26.7 million, up 21.7% on 2000-01⁶⁶ and API

⁶³ Harris and Simons, *Focussing market definition: how much substitution is necessary?* Research in Law and Economics, Volume 12, 1989.

⁶⁴ However, the Commission notes that while wholesalers will increase their margin by 10%, from the pharmacist's perspective the actual price will increase only marginally because the bulk of the actual price incurred relates to the physical cost of the drug. Therefore, a decrease in demand of 11.8% would be required to make an increase in price of less than 1% (from the pharmacists perspective) unprofitable.

⁶⁵ API/Sigma Submission, 26 July 2002, Page 9.

⁶⁶ Sigma Annual Report 2001-02, Page 2.

reported earnings before tax of \$50.006 million, up 12% from the previous year.⁶⁷ If, as API and Sigma claim, these service reductions and price increases have been the only drivers of its profit growth, then these recent gains clearly demonstrate that API and Sigma (and presumably the merged entity) can increase prices and decrease service levels without suffering a critical loss.

5.88 Therefore, the Commission believes that the merged entity will not suffer a critical loss as a result of an increase in price. Consequently, the Commission believes that the merger will enhance the merged entity's ability to increase prices or decrease service levels following the merger.

Specific additional issues raised by the Applicants in relation to anti-competitive detriment

5.89 In addition to the specific consideration of the merger factors above, the Commission will also address a number of issues raised by the Applicants which they argue will effectively prevent any anti-competitive detriment resulting from the merger.

5.90 Specifically, it is suggested that:

- the Commonwealth Government is the monopsony purchaser of all PBS pharmaceuticals and this effectively constrains the merged entity's pricing behaviour; and
- if wholesalers increased their margins to extract monopoly rents, then the Commonwealth government would impose further regulation to remove this rent.

The Commission disagrees with these arguments.

5.91 First, while the Commonwealth Government directly regulates PBS pricing at the manufacturer and retail levels, it does not directly regulate actual margins at the wholesale level. The DHA acknowledges that there is no legal impediment to wholesalers charging more than the theoretical 10% margin. While the Commonwealth is the monopsony purchaser of pharmaceuticals at a retail level, it is individual pharmacists who purchase, and are responsible for negotiating prices, at the wholesale level.

5.92 Second, it is theoretically possible that the Commonwealth Government would reduce wholesale margins available to wholesalers if they attempted to extract monopoly rents. However, as noted above, under the present system of regulation, the Commonwealth does not regulate wholesale margins directly, and acknowledges that there is no legal impediment to wholesalers charging pharmacists a margin higher than 10% in relation to PBS items. In any case, in relation to non-PBS items there exists no such constraint. Further, it is possible to argue that in relation to any acquisition that results in market power, the government may regulate to stop any possible extraction of monopoly rents following the merger. However, the Commission does not consider it appropriate for it to pre-empt future government policy in the absence of clear statement by the government as to what its policy will be.

⁶⁷ API Annual Financial Report 30th April 2002, Page 3.

Submissions by those in support of the merger

5.93 The Commission has considered all of the submissions it has received that contend that the merger will not result in anti-competitive detriment.

5.94 The majority of non-pharmacist industry participants were against, or had reservations about, the merger. However, Arrow Pharmaceuticals was one of the few non-pharmacist supporters of the proposed merger:

If the merger were to proceed we do not believe there would be any changes to wholesaler prices or margins. This is because the real competitor in this market is Mayne. A merged business could not afford to increase its prices as this would lead to increased market share and reduced profits. We do not foresee that the merger would alter our margins in any way. Once again, the presence of Mayne guarantees that there will be no change to structure of the business of full-line wholesaling. The same reasoning applies to service levels ...

On the other hand, if the merger does not proceed there seems to be considerable doubt over whether one or both will withdraw from full-line wholesaling to pursue other business models ... The increased financial pressure on both companies could force increased prices or reduced services and service levels.⁶⁸

5.95 This was the most common argument raised by supporters of the merger. However, based on the financial assessment above, the Commission considers such arguments unsustainable.

5.96 The Commission also acknowledges that the majority of submissions received from pharmacists have been in support of the merger, although a significant proportion of pharmacists expressed concern about the impact of the merger on competition. Those submissions by pharmacists in favour of the merger tend to focus on the historical actions of API and Sigma, and their origins as cooperatives. Evidence that this strong feeling amongst pharmacists that API and Sigma will continue to act in the interests of pharmacists is clear from the submission of the Pharmacy Guild:

(T)he Guild is confident that, given their long and honourable history of social obligations relating to the environment in which pharmacists operate, both Sigma and API will not betray that trust with pharmacists.⁶⁹

5.97 However, the Commission's role is to undertake an objective analysis of the effect the acquisition is likely to have on the structural and dynamic features of the market. It is not the Commission's role to assess the honour or trustworthiness of API and Sigma. It does note, however, that since the Applicants became public companies the financial imperatives upon them are significantly different to when they were cooperatives.

Potential anti-competitive outcomes

5.98 The Commission has outlined above the competitive conditions it believes will prevail in the market should the merger proceed. The Commission believes that the

⁶⁸ Arrow Pharmaceuticals Submission, 31 July 2002, Page 2.

⁶⁹ Pharmacy Guild of Australia National Secretariat Submission, 6 August 2002, Page 3.

existence of these conditions will present the merged entity with the opportunity to pursue a wide range of strategic activity.

5.99 In particular, the Commission is concerned that the merged entity will have increased ability to:

- substantially and sustainably increase prices charged to pharmacies for wholesaling services generally and particularly in relation to pharmacies located in regional areas and in relation to specific pharmaceutical product groups being areas or products which are not serviced by short-line wholesalers (including pharmacy only products not covered by the PBS);
- substantially and sustainably decrease service levels to pharmacies;
- enter into strategic distribution arrangements with pharmaceutical manufacturers, potentially to the detriment of short-line wholesalers;
- engage in strategic price behaviour, such as price signalling, tacit or overt price collusion with the remaining market participants; and
- obtain increased levels of vertical integration, that could be used to the detriment of upstream and downstream market players.

5.100 This is consistent with the views of many market participants. For example, Exel believes:

If the merger proceeds the new entity will extract greater profits simply as a result of distribution economies of scale. The new entity's market power will also give it the potential over time to extract even greater profits by nature of its industry dominant status (derived both horizontally and vertically) within the pharmacy channel. Potential leverage opportunities include:

- the potential to charge pharmacies dues to belong to a given network;
- charge contract administration fees ...;
- charge transaction costs to pharmacy or manufacturers ...;
- leverage growth in generic drug distribution through leveraging its monopoly distribution status and influence over pharmacy ...;
- arbitrage manufacturer price increases ...;
- reduce service levels to maximise profits.⁷⁰

5.101 This view is confirmed by Mayne:

It seems inherently unlikely that Sigma and API would continue to provide that level of service when, as they acknowledge, the price of those services does not reflect the cost of providing them. A lower level of overall costs does not provide an incentive for the merged entity to continue to provide specific services that are high cost; recognising that the current level of service provision is already reduced from that which has previously existed. Given that historical behaviour pattern, it would be expected that Sigma/API would behave in a profit maximising way and seek to reduce service levels to the extent necessary to maximise returns. There is nothing in the proposed undertakings which would constrain the merged entity from acting in this way.⁷¹

5.102 For the reasons outlined above, the Commission considers that the merger is likely to have a significant and sustained anti-competitive effect on each

⁷⁰ Exel Logistics Australia and New Zealand Submission, undated, Page 3.

⁷¹ Mayne Group Limited Submission, 13 August 2002, Page 6.

pharmaceutical wholesale market, and that this anti-competitive effect constitutes a significant public detriment.

5.103 The Commission notes that it has fewer concerns in relation to OTC products where other distribution channels and competitors exist in the market. However, the Commission is particularly concerned about the merger's impact in relation to PBS and pharmacy only products, and these products comprise approximately 85% of API and Sigma's total sales.

Competitive outcome without the merger

5.104 As indicated above, the Commission believes that if the merger does not proceed, there are three possible outcomes:

1. The status quo will be maintained, with all three full-line wholesalers remaining in the market in approximately their present form;
2. One full-line wholesaler will scale down its operations and adopt a model more akin to that of a short-line wholesaler; or
3. Two full-line wholesalers will scale down their operations and adopt a model more akin to that of a short-line wholesaler.

Status quo

5.105 The Commission considers that if the merger does not proceed, the most likely outcome is that the status quo will be maintained – API, Sigma and Mayne will remain in the market as full-line wholesalers.

5.106 If the status quo is maintained, the Commission does not consider that there will be any adverse effect on competition. The level of competition in the market is presently high. There is evidence that there will be some rationalisation of service levels if the merger does not proceed, but such rationalisation is likely to occur even if the merger does proceed for the reasons outlined above and below. In addition, because the market will remain competitive, the Commission believes that any such rationalisation would be fairly minor and at the fringes of the market.⁷²

5.107 In support of this view, Mayne notes:

Sigma and API argue that they cannot maintain the current levels of services and, if the merger does not proceed, they will become short-line suppliers. Again, such an outcome is inherently unlikely. The most likely response if the merger does not proceed is that all of the existing full-line distributors will make some modifications to the way in which they currently conduct their operations. This is the way in which API and Sigma have responded to date and there is nothing to suggest that going forward they would adopt some radically different approach.

If the Review does not provide an outcome which addresses at least some of the industry issues, then it is likely that Mayne would need to consider appropriate modifications to the way in which it provides those services. Mayne would not see this as leading to any need for dramatic

⁷² As noted earlier, the applicants have been unable to quantify the likely extent of rationalisation, nor the loss they incur by providing uneconomic services. While it is of the view that some rationalisation may occur, the Commission does not consider that such rationalisation would be significant.