COMPETITION TRIBUNAL OF SOUTH AFRICA

Case No: 127/LM/Dec08

In the matter between:

ASPEN PHARMACARE HOLDINGS LIMITED	Acquiring Firm
and	
FINE CHEMICALS CORPORATION (PTY) LTD	Target Firm

Panel	:	D Lewis (Presiding Member), N Manoim (Tribunal Member) and Y Carrim (Tribunal Member)
Heard on	:	8 April 2009
Order issued on	:	8 April 2009
Reasons issued on	:	12 May 2009

Reasons for Decision

Introduction

[1] On 8 April 2009 the Tribunal approved the acquisition by Aspen Pharmacare Holdings Limited ("Aspen") of Fine Chemicals Corporation (Pty) Ltd ("Fine Chemicals"). The reasons follow below.

The transaction and parties

[2] The target firm Fine Chemicals, is a manufacturer and supplier of narcotic and non-narcotic active pharmaceutical ingredients ("APIs"), which are inputs in the manufacturing of a variety of pharmaceutical products. Fine Chemicals is jointly controlled by Aspen and Matrix Laboratories ("Matrix"), an international pharmaceutical manufacturer. Aspen, a manufacturer and distributor of pharmaceutical products intends to acquire the remaining 50%

shares in Fine Chemicals from Matrix. Thus the proposed transaction is a move from joint to sole control.

Background to the transaction

[3] In 2004 Aspen acquired sole control of Fine Chemicals. This was notified to the Commission as an intermediate merger. The Commission imposed certain behavioural conditions[1] which were in force for three years, and which expired in 2007. It is not clear why the conditions imposed were limited to a period of 3 years. When asked to clarify this point at the hearing, the present staff at the Commission dealing with this matter said that they were not involved in the previous evaluation and could not explain why those conditions were imposed for only three years. All they could confirm was that the behavioural conditions had indeed lapsed when they expired in 2007.

[4] Subsequent to the expiry of the conditions, in 2006, Aspen sold 50% of its shares in Fine Chemicals to Matrix. This transaction was not notified to the Commission as it constituted a small merger and small mergers are not subject to compulsory pre-merger notification. The proposed transaction in this matter thus restores the previous situation in 2004, where Aspen acquired sole control of Fine Chemicals.

Rationale for the transaction

[5] According to Aspen, Matrix's strategic interests in Fine Chemicals changed since 2007, when Matrix became a subsidiary of Mylan Inc., a US pharmaceutical company, which made Matrix less valuable to the joint venture with Aspen. For this reason Aspen proposed to buy back the remaining shareholding of Fine Chemicals from Matrix. By the same token Matrix avers that Fine Chemicals no longer fits into its broader portfolio, and for this reason, opts to dispose of its interests in Fine Chemicals.

[1] The conditions were put in place to allay concerns regarding discriminatory practice in relation to supply and price for customers. .

The relevant market and competition effects

[6] Aspen manufactures and suppliers various pharmaceutical products. Fine Chemicals is the only supplier of narcotic APIs in South Africa, which include; codeine phosphate, codeine hydrochloride, morphine sulphate, morphine hydrochloride, pholcodine and fentanyl, which are used as inputs in the manufacturing of pharmaceutical products. Fine Chemicals also supplies non-narcotic APIs which include; paracetamol powder, scopolamine N butyl bromide and azathioprine.

[7] The proposed transaction does not result in any horizontal overlap between the merging parties, and will not directly change the concentration of the markets in which they operate. However, there is vertical integration in that Aspen manufacturers pharmaceutical products which uses some of Fine Chemical's narcotic APIs as inputs. Currently Aspen buys two narcotic API products from Fine Chemicals which are; Codeine phosphate and pholcodine.[2]

[8] The distinction between narcotic and non-narcotic APIs is important. Due to the potential for abuse of narcotic substances, it is international practice for the United Nations as well as national governments to put in place controls to impose limits on the number of firms in a country that are permitted to manufacture these substances and to restrict their import. Hence, the South African Department of Health ("DOH") requires manufacturers of narcotic API's to apply for a licence, and it has restricted the importation of certain categories of narcotic API's.

[9] From a demand side APIs have distinct characteristics and usage which limit the possibilities for substitution between them. Furthermore it is difficult to switch to other APIs once a drug is developed because approval must be obtained from the Medical Controls Council of South Africa. On the supply side, as mentioned earlier, there are regulatory restrictions on imports of some of the narcotic APIs such as codeine phosphate and pholcodine which are prohibited from being imported into South Africa by the DOH. FCC holds the only licence in South Africa to manufacture certain of these controlled

[2] Aspen is said to contribute approximately 34% and 28% of Fine Chemical's sales of Codeine Phosphate and Pholcodine.

narcotic API substances.[3] In addition FCC is the only South African manufacturer of paracetamol, though the scale of import in the paracetamol product is significant.

[10] No competition implications arise in regard to the non-narcotic APIs as no legislative restrictions to their imports exist. The Commission found that the scale of imports in the non-narcotic products is significant, therefore there are competitors to Fine Chemicals with regard to the final products containing non-narcotic APIs, and customers of these products have alternatives to purchase these products from international sources and import them into South Africa.[4] It would seem that transport costs do not give importers a competitive disadvantage as given the small size of the product, transport costs can be spread across large volumes, and hence are not a material part of the cost.

Issues raised in the proposed transaction

[11] The issue raised in the merger is whether the increase in Aspen's share from 50% to 100% and the concomitant change in control from joint to sole control changes the incentives of Fine Chemicals from what they were pre-merger, given that Aspen is a purchaser of inputs from Fine Chemicals. The fact that Aspen has joint control and owns equity in the target firm is a given pre-merger, and whatever the merits of the Commission's decision in 2004 not to impose conditions on the firm on a long term basis – this scenario cannot be undone.

[12] At present before the merger takes place Fine Chemicals has Aspen as its joint shareholder and controller and is not subject to any regulatory restrictions as to how it exercises that control. Nevertheless, as we have previously held, a move from joint to sole control has competition implications, because the incentives of a target firm may change post merger. What we have to consider is whether the presence of Matrix acted as a constraint on Aspen, a constraint that may be absent post merger?

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[3] The DOH had also indicated that there was unlikely to be another supplier who would be given license to supply Narcotic APIs into South Africa.
[4] During the Commission's investigations DOH submitted that currently other players in the market currently import close to about 50% of paracetomol from international players.

[13] In considering this, we examined a number of competitive concerns which are raised in the proposed merger: the first theory of harm concerns potential foreclosure of rivals to Aspen in the upstream market who buy narcotic API's from Fine Chemicals; secondly, whether the merger will lead to monopoly pricing by Fine Chemicals in the upstream market, and thirdly whether barriers to entry in the downstream market will increase? We further considered the public sector implications that arise due to the proposed merger. All of these concerns are dealt with in some detail below:

Foreclosure concerns

[14] The concern is that the merged entity could foreclose its downstream rivals with inputs and possibly raise their costs by charging higher input prices given that Fine Chemicals is the sole supplier of narcotic APIs in South Africa. It is noteworthy to mention that narcotic API products are subject to a single exit price regime, and price changes must be approved by the DOH. The input products are not subject to regulation. It is thus possible that foreclosure could be partial in that the merged firm could raise prices for the API input to rivals who faced with the ceiling of the regulated price downstream, but increased costs, might experience a margin squeeze.

[15] Adcock Ingram which is a customer of Fine Chemicals and a competitor of Aspen in the manufacture and marketing of pharmaceutical products, made written submissions to the Commission where it raised concerns that the proposed merger would enable Fine Chemicals to unilaterally increase prices, especially because upon expiry of the conditions imposed in the 2004 merger, Fine Chemicals increased the price of paracetamol by approximately 28%. Adcock expressed the view that the current transaction would also further Fine Chemicals ability to unilaterally increase API prices, and increase Aspen's competitive advantage in that Fine Chemicals may favour Aspen over Aspen's competitors, through preferential pricing and supply.[5]

[16] Be-Tabs Pharmaceuticals, also a customer of Fine Chemicals and competitor of Aspen, also raised concerns on the grounds that the market for narcotic

[5] It was also submitted that there has been recent increases in the Codeine price. However, at the hearing the parties submitted that this was motivated principally by raw material costs and exchange rate considerations given that Fine Chemicals sources its Codeine from Australia. See transcript, pg. 29.

APIs is already strictly regulated, and that the proposed merger would give Aspen competitive advantage as it would be able to control the inputs required in the manufacture of the pharmaceutical products, driving Aspen's competitors to be price takers of APIs.

[17] Resmed which is also a customer of Fine Chemicals for many years, as well as Aspen's competitor, particularly in the tender market, raised concerns that the proposed merger would negatively affect its tender business as Aspen would effectively control the prices of APIs and thereby Resmed's tender prices as well.

[18] The DOH similarly raised concerns that the proposed transaction would potentially result in increased API cost/prices, which could be felt not only in the private sector, but also in the public sector tender market.

[19] The Commission in its investigations considered all of the above concerns and found that due to the existence of import competition of final pharmaceutical products, the merged entity would not be able to significantly influence the downstream prices, particularly since the merged entity is not dominant in any of the downstream markets, and therefore does not have any incentives to raise costs since it might lose customers and profits in the upstream.[6] In addition, the Commission held that there are price regulations which restrain the merged entity from monopolising prices downstream so there would be no effect on the prices to final consumers.

[20] Although the tribunal invited some of the concerned customers to participate in our hearings through oral submissions none of them took up the opportunity to do so.

Upstream Monopoly concerns

[21] At the hearing the Tribunal also raised concerns that Aspen could potentially monopolise prices in the upstream market for narcotic APIs, particularly in absence of price regulation at this level. This might be because Matrix had an interest in maximising sales of the input since it was not engaged in the sale

[6] Some of Aspen's competitors downstream include firms like; Pharmachem, Adcock Ingram, and Johnson and Johnson.

of the downstream product in South Africa. However, the Commission found that even in the upstream market, the merged entity does not have the incentive to raise prices, and that currently it has the ability to do so, but does not. The reason the Commission submitted is that there are local manufacturers of pharmaceutical products who are able to manufacture products elsewhere and import these products as finished products to compete with Aspen's products locally, which exerts some constraint's on local prices, hence serving as a discipline to Aspen's pricing strategy.[7]

[22] The parties also submitted that a lot of the major generic international manufacturers of APIs, such as in India and China, are much more cost effective than Fine Chemicals as their volume of production is so much larger.

Barriers to entry

[23] It is common cause that barriers to entry in the market for narcotic APIs are absolute given the licence and other policy restrictions characteristic in this market which is significantly made up of import products. The challenges are more in respect to imports of liquid products, which due to their nature, are problematic to transport. The Commission indicated that in light of this problem, liquid products often have to be manufactured domestically, but that these do not make a substantial portion of the overall market given that most of the international players import a final narcotic product into the market.

Supply concerns

[24] The Tribunal considered the question whether Aspen has sufficient capacity, or would have the capacity to increase its own production to supply the final products to the domestic market, particularly in the event that Adcock or some other domestic producer, exit the market. The Commission submitted that Aspen is currently considering expanding its operations, and asserted that even with its current facilities; there are no foreseeable reasons why it would not be able to provide sufficient supply to the domestic market.

[7] For example; Adcock moved its operations to India where it manufactures most of its products and imports those into South Africa.

Impact on the public sector

[25] Finally, the Tribunal raised concerns regarding the impact of the proposed merger on the public sector. The merging parties submitted that the proposed merger does not have public sector implications because firstly there is a tender system in place by the state which has significant countervailing power, which is why generally the prices supplied to the state are significantly cheaper than the ones in the private sector. Secondly, that the proposed merger will not impact on the supply of ARVs by the state because the APIs produced by Fine Chemicals are not for ARVs, instead Aspen sources its APIs for ARVs from offshore producers such as Matrix. Similarly, other competitors in the ARV market such as Adcock, also source their APIs for ARVs from other international producers, and not from Fine Chemicals.

Conclusion

[26] Although it is a matter of concern that Aspen will enjoy sole control of a firm that supplies a key input to its downstream rivals, this is mitigated by a number of factors. Firstly, imports from firms that make the final product more cheaply at present than would Aspen, would inhibit its incentives to foreclose rivals or to consider such a strategy profitable. Profits foregone upstream in such a strategy would not be recouped downstream given the strength of this competition and the fact that the downstream price is regulated. Secondly, the monopoly enjoyed by FCC is a creation of regulation, and whoever owns this firm would, as a result of public policy, be the recipient of a domestic manufacturing monopoly; the merger does not change this.

[27] To the extent that Fine Chemicals might now be more likely to exploit this monopoly than pre-merger is difficult to determine, but the fact that the final product can be imported competitively, suggests that this strategy would have its limitations and even if it leads to the demise of domestic rivals, it is by no means clear that the market downstream would be there for Aspen to command. Thus an upstream monopolist strategy, (assuming that it is not already maximising its pricing power pre-merger, which we do not know for certain) could prove counter-productive.[8]

[8] If the firm is already profit maximizing upstream then the merger makes no difference.

[28] Based on the above, the Tribunal finds that the proposed transaction is unlikely to substantially prevent or lessen competition in any of the relevant markets. Further, no public interest issues are raised.

____________________ **12 May 2009**

N Manoim Date

D Lewis and Y Carrim concurring.

Tribunal Researcher:	L Xaba
For the merging parties:	Antony Norton
For the Commission:	Sibusiso Madonsela, Edwina Ramohlola and Sung Fung