Anticipated acquisition by Convatec Limited of Acordis Speciality Fibres Limited

The OFT's decision on reference under section 33 of the Enterprise Act 2002 given on 12 February 2003

PARTIES

1. **Convatec Limited (CTL)** is a division of a wholly owned subsidiary of the Bristol-Myers Squibb Company. CTL manufactures ostomy care and modern (advanced) wound and skin care products. **Acordis Speciality Fibres Limited (ASF),** a subsidiary of Acordis International Holdings BV, develops and manufactures small volume, high value fibre products primarily used in the healthcare sector, in particular in the advanced wound care treatment sector. These include alginate fibre. ASF's UK turnover in 2002 was *(see note 1)*. In 1992, ASF collaborated with CTL to develop an advanced gel forming fibre called Hydrocel. The patent covering Hydrocel technology expires in *(see note 1)*. The fibres and fabrics are produced exclusively for CTL, which converts them into a wound care dressing called Aquacel. This manufacturing agreement expires at the same time as the patent. In 2002, ASF's UK sales of Hydrocel to CTL were approximately *(see note 1)*.

TRANSACTION

2. CTL has contracted to buy the entire issued share capital of ASF for a consideration of US$*(see note 1)* at closing *(see note 1)*.

3. The transaction was notified to the OFT on 15 December 2003 and the administrative deadline expires on 12 February 2004.

JURISDICTION

4. As a result of this transaction, CTL and ASF will cease to be distinct. The parties overlap in the UK in the supply of alginate fibre and the share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met. The OFT believes, therefore, that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, may be expected to result in the creation of a relevant merger situation.

RELEVANT MARKETS

5. Alginate is extracted from certain types of seaweed and converted into powder form. The majority of alginate powder is used as a thickening and stabilising agent in the food and brewing industries. Neither CTL nor ASF produces alginate powder. Only a small percentage of alginate powder is sold to alginate fibre manufacturers, which then process the powder into a fibrous material (alginate fibre). Both CTL and ASF are active in this conversion process. Alginate fibre is then converted into alginate wound care dressings (alginate dressings).

Product market

Alginate fibre

6. Manufacturers of alginate dressings can source alginate fibre from independent suppliers or produce the fibre in-house. CTL only produces alginate fibre for its own internal use and buys none from other sources. CTL carries out its own conversion of alginate fibre into alginate dressings, where it competes with ASF's customers. ASF sells all of its alginate fibre production to third parties doing no conversion work itself, although it does sub-contract the conversion of alginate fibre into dressings for two customers.

7. There are two types of alginate fibre, High G and High M. High G alginate fibres – based around guluronic acids – form strong but brittle gels, while High M alginate fibres – based around mannuronic acids – form weaker but more flexible gels. CTL submits that the two types are fully substitutable. However, on the demand side some third parties contend that they are not technically substitutes in all instances. Nevertheless on the supply side, third parties said that switching production between High G and High M can be achieved with ease and at minimal cost. Therefore, it seems reasonable to consider both types of alginate fibre within the same frame of reference for the purposes of the competition assessment.

8. CTL submits that the relevant product market should include all fabrics and materials used as constituent parts of advanced wound care dressings. As discussed below, alginate dressings are said to compete with film, foam, hydrocolloid and hydrogel dressings in the advanced wound care category. However, so far as alginate dressings are concerned, alginate fibre is an essential ingredient in their production, and manufacturers of alginate dressings have no substitute for alginate fibre. In the event of a small but significant non-transitory increase in the price of alginate fibre, third parties said that they might switch fibre supplier, but would not switch to make an alternative wound care dressing.[1] Therefore, other fabrics and materials used in other advanced wound care dressing production should not be considered under the same frame of reference as alginate fibre.

9. A key question is whether CTL and other internal manufacturers that do not currently supply externally to what could be termed a 'merchant sector' constrain

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[1] Any market power in the supply of alginate fibre might be constrained if there were effective substitutes for alginate dressings.

prices in that sector because they have the capacity to supply externally. As discussed below, evidence on this point is mixed but, at this stage of our analysis, we believe that the relevant frame of reference for assessing the competitive effects of the merger on alginate fibre might include both captive production, and merchant sales of fibre (i.e. to third parties).

Alginate dressings

10. A wound care dressing must satisfy a number of characteristics: e.g., it must be easy to apply, cover the wound and control odour. There are two broad categories of wound care dressings:

- *traditional* (dry wound environment); and
- *advanced* (advanced technology or moist wound environment)

11. Alginate dressings fall into the advanced category. Alginate dressings are made by processing the alginate fibre through cutting, packaging and sterilising, and are then sold under various brand names. Alginate dressings are considered particularly suited for absorbing liquids exuding from wounds and are also highly flexible. Other advanced wound care dressings include:

- *film dressings*, which create a moist environment that prevents scab formation, isolate the wound from contamination and allow more rapid healing. These are most often used in the treatment of lightly to moderately exuding, superficial clean wounds;
- *foam dressings*, which are often polyurethane based, are used on exuding wounds, e.g., burns and like other advanced wound dressings have absorbent qualities. Foam dressings appear to have captured sales from hydrocolloid dressings;
- *hydrocolloid dressings* are comfortable, easy to apply and remain intact as they absorb. They are generally used on exuding wounds; and
- *hydrogel dressings*, which absorb excess wound exudates, are used on dry or lightly exuding wounds.

12. The advanced wound care dressing manufacturers active in the UK provide most of this range of dressings and all have at least one alginate dressing. CTL is active in this downstream sector, converting alginate fibre into a dressing called Kaltostat. As noted above, ASF sells all of its alginate fibre production to third parties doing no conversion work itself, although it does sub-contract the conversion of alginate fibre into dressings for two customers: *(see note 1)*.

13. CTL contends that none of the advanced wound care dressings has special characteristics which would set it apart; therefore all advanced wound care products should be considered under the same frame of reference. The issue here is whether, on the demand side, a customer of alginate dressings could and would, in the event of a price stimulus, switch to another type of advanced wound care dressing - e.g., film, foam, hydrocolloid or hydrogel dressings.

14. Responses from third parties have been mixed. Supporting CTL's submission, some respondents commented that there is nothing unique to alginate dressings

and that alternative advanced wound care products are substitutable. However, other respondents contended that end-users choose a specific product based on clinical need. For example, third parties submit that alginate dressings have particular advantages at specific stages of the healing process, and have advantages over other dressings because the natural fibre prevents adverse reactions. Although third parties maintain that there may be some switching, this might not be of sufficient scale to impose a competitive constraint on producers of alginate dressings. Further, a number of third parties suggested that CTL's Aquacel product is directly comparable to alginate dressings in terms of usage.

15. Overall, on the basis of the evidence available to the OFT, the relevant frame of reference is considered to be the manufacture and supply of alginate dressings.

Geographic market

Alginate fibre

16. CTL maintains that the geographic scope of the supply of alginate fibre is global because the fibre is light, easy to transport and requires no special handling. In addition, transport costs appear to be small relative to the value of the product at between 1 per cent and 3 per cent of the resale value. Customers also appear to be widely spread: e.g., ASF exports alginate fibre from the UK to Germany, the US, Puerto Rico, Canada and Australia. Although evidence was mixed, the majority of third parties agreed that the geographic scope of the supply of fibre could be global, and some explicitly indicated that they would consider purchasing alginate fibre from international suppliers but were unclear about who they might be.

17. Even though third parties consider the geographic scope of supply to be global, there appears to be a limited number of international suppliers available (present and potential), which may limit the scope for geographical supply-side substitution. Almost all European production of alginate fibre (and most of the global production) takes place in the UK: CTL, ASF and the other main supplier Advanced Medical Solutions (AMS) all manufacture alginate fibre in the UK. The issue is whether an international manufacturer that currently produces alginate fibre could and would, in the event of a price stimulus, supply European customers. In this respect, the evidence is inconclusive. However, as the same issues appear to arise irrespective of the precise geographic scope of competition (either European or global), it has not been necessary to reach a firm conclusion on the relevant geographic frame of reference.

Alginate Dressings

18. CTL maintains that competition in the manufacture and supply of advanced wound care products, including alginate dressings, takes place globally. Manufacturers of alginate dressings appear to supply their products widely.

19. On the demand side, the NHS Purchasing and Supply Agency (PASA), which purchases £1.3 million p.a. of alginate dressings in the UK, submits that it would consider purchasing from international suppliers. However, information on end-user purchasing decisions has been limited and third parties have maintained that wound care dressings require a European CE mark.

20. On the supply side, the extent to which international suppliers would start supplying alginate dressings to European customers following a price increase is unknown. Moreover, suppliers of dressings to the UK have those dressings produced and processed within the UK; there appear to be few examples of imports of dressings into the UK. Different brands of alginate dressings are prevalent in different European countries, implying that there may be some national preferences. Therefore, on the basis of the evidence available, the geographic frame of reference for the supply of alginate dressings is considered to be national.

Conclusion

21. In conclusion, the relevant frames of reference for considering the competitive effects of this transaction are the global or European supply of alginate fibre (including from captive production) (although it is not necessary to reach a conclusion on the geographic market) and the supply of alginate dressings in the UK.

HORIZONTAL COMPETITION ASSESSMENT

Alginate fibre

22. As noted above, CTL presently uses all of its alginate fibre production internally. In contrast, ASF uses none of its alginate fibre production internally, selling it all to third parties. Accordingly, CTL and ASF submit that they do not compete for alginate fibre sales and contend that the merger will not therefore substantially lessen competition in the supply of alginate fibre either globally or in Europe. However, CTL currently produces around *(10 -15)* tonnes (*see note 2*) of alginate fibre annually, and has the capacity (by increasing shift numbers) to produce up to *(20-25)* tonnes (annually; enough to satisfy *(70-90)* per cent of total global alginate fibre demand. We have therefore considered whether the loss of CTL as a potential merchant fibre supplier might be expected to give rise to a substantial lessening of competition.

Shares of supply

23. CTL submits that there are no publicly-available UK sales figures for alginate fibre and has thus provided alginate fibre production data. According to these data, the transaction would give the parties a combined share of alginate fibre production in the UK of *(70-90)* per cent with an increment of *(30-40)* per cent.[2] No production data have been provided for Europe, but they are unlikely to be materially different to the UK since almost all EU alginate fibre production takes place in the UK.

24. Total global alginate fibre production is estimated at 30-40 tonnes with an estimated resale value of £9-12 million. Based on these data, the transaction would result in a combined global share of production of 50-70 per cent (increment 20 - 30 per cent). The following chart provides more detail.

[2] Total UK production of alginate fibre is estimated by CTL at *(25-30)* tonnes and using CTL's estimate of *(£250-£350)* per kilo the resale value is estimated at £*(7-9)* million.

Table 1 Global share of total alginate fibre production

Firm	Production (tonnes)	Share of production	Capacity (tonnes)
CTL (UK)	*(10-14)*	*(30-40 per cent)*	*(20-30)*
ASF (UK)	*(7-11)*	*(25-35 per cent)*	*(5-10)*
Combined	*(17-25)*	*(60-80 per cent)*	*(30-40)*
AMS (UK)[1]	*(4-6)*	*(10-20 per cent)*	*(15-30)*
Others[2]	*(4-6)*	*(10-20 per cent)*	Unknown
Total[3]	*(30-40)*	100 per cent	Unknown

Source: CTL
[1] AMS produces *(see note 3)*
[2] *(see note 3)*.
[3] Total production estimated at 30 - 40 tonnes.

25. CTL contends that the above share data, which include alginate fibre production used internally and also fibre sold to third parties are not a true representation of the competitive constraints in this sector. This is because CTL states that it does not compete with ASF in the supply of alginate fibre as it consumes all the alginate fibre it produces in-house while ASF supplies only third parties. They thus never rival each other for custom.

26. We therefore need to consider whether CTL presently constrains pricing and, if so, whether the loss of any competitive constraint between CTL and ASF gives rise to a belief that there is a significant prospect that the merger would substantially lessen competition. The following considerations are relevant.

- First, CTL's unused production capacity (about *(10-14)* tonnes annually) is sufficient to meet around *(30-50)* per cent of total global alginate fibre demand. Although CTL has never supplied third parties with alginate fibre, it has a demonstrable ability to do so.

- Second, there is a small number of alternative post-merger suppliers of alginate fibre to third parties. Third parties and CTL maintain that ASF, AMS and Laboratoires Brothier (France) are the only producers currently supplying alginate fibre to third parties in Europe. *(see note 3)*.

- Third, the transaction might reduce CTL's incentives to supply externally in the event of a merchant price increase. At present, it appears that CTL has an incentive to begin supplying externally in the event of a price increase. This incentive might well be reduced post-merger as CTL would benefit from having internalised any additional profits gained from a merchant price increase.
- Fourth, to the extent that CTL has any incentive to begin supplying third parties, so too might several other vertically integrated producers that could easily divert or increase their alginate fibre production and sell externally *(see note 3)*. In principle, this appears plausible: we have not

been able to identify any obvious barriers to expansion. *(see note 3)* it has not been possible to obtain information about the capacity levels of other in-house producers. We do not therefore have sufficient evidence to assess whether companies with internal fibre production would have the ability to begin or expand third-party fibre sales.

Barriers to entry and expansion

27. CTL submits that barriers to entry in the alginate fibre sector are low and that margins are relatively good. (We note that good margins are not an indicator of low entry barriers.) CTL initially submitted that (although it does not supply to third parties) it considered that the margins on alginate fibre sales were *(over 70)* per cent. This figure was revised to an average of *(50-60)* per cent, range *(20-90)* per cent. According to CTL, equipment used in the production process is quite basic; the chemicals required are readily available and CTL contends there are no intellectual property rights issues. There appear to be no restrictions on imports and no regulatory or other restrictions on export (although FDA approval appears to be needed for export to the USA). ASF submits that to replace all plant and equipment at its sites would cost £0.5-1 million. One third party suggests that the cost of setting up a manufacturing plant is slightly higher than this, estimated at £1-2 million. The same third party believed that it would take 18 months to set up the plant, and that payback would take approximately five years. From this the company could expect turnover in the region of £5 million, but for this amount of turnover it would need to capture almost half of the global merchant fibre demand. There appears to be limited promotional activity within this sector: ASF's total annual marketing expenditure across its whole business activities does not exceed £*(50-200,000)*.

28. Comments from one third party, however, indicated that new entry was unlikely as the manufacturing process of alginate fibre was complex and required a degree of technical know-how. CTL and a competitor submitted that know-how could be achieved by head-hunting experienced staff. CTL provided details of seven potential entrants with the necessary know-how and technology to manufacture alginate fibre. Out of the three contacted, two did not have the facilities or capability to produce alginate fibre. The third manufactured alginate fibre for research needs only, but had the know-how to work with potential entrants and had worked with *(see note 3)* in the past.

29. Turning to different channels of entry, CTL contends that customers, i.e., manufacturers of alginate dressings, could vertically integrate backwards by taking production of alginate fibre in-house. Responses from third parties suggest that, even though this is theoretically feasible, it is unlikely given the need for a 'clean room' environment. One alginate fibre customer has indicated that it has undertaken some 'crude analysis' of the viability of setting up an in-house operation but did not consider the 'payback' would be satisfactory.

30. In terms of expansion, alginate fibre could be made available by vertically integrated competitors that currently produce for in-house supply. CTL maintains several in-house producers could easily increase their production and sell externally, and points to current over-capacity in the sector. As discussed above, there appear to be no barriers to expansion; however no information has been

provided on the capacity levels of third parties and one third party submitted that external supply would go against its business strategy.

31. Customers' switching costs might also deter new entrants or expansion by existing alginate fibre producers. Switching costs are difficult to quantify, but evidence indicates that there are costs associated with the time and effort in re-sourcing, validation, changes to packaging, changes to documentation and the verification that products would be acceptable to existing customers. In addition, switching to a different source of alginate fibre may result in a change in product quality, which may have a knock on effect downstream in terms of alginate dressing sales revenue. On the other hand, there was some agreement with CTL that the costs associated with switching between alginate fibre suppliers is minimal since this involves only a change in technical detail (cost estimated to be tens of thousands of pounds rather than hundreds of thousands). *(see note 1)*.

32. Overall, even though margins appear high and entry may be possible, entry might be considered unlikely due to the small size of the sector, costs of switching and current levels of over-capacity. In terms of expansion, as noted above, no information has been provided on the capacity levels of third parties and those contacted by the OFT appeared unwilling to supply externally.

Buyer power

33. There are relatively few customers that purchase alginate fibre. ASF has *(see note 1)* major customers: *(see note 1)*. Other purchasers of alginate fibre include customers of AMS, *(see note 3)*. CTL maintains that customers have, and will continue to have, negotiating strength. Customer responses, however, were mixed with the small quantities purchased being cited as a reason for lack of buyer power and a concern expressed by a customer that the merger would reduce any negotiating strength that they currently held.

34. While the merger does not reduce the number of current suppliers of alginate fibre to the merchant sector, it does remove the only non-integrated supplier[3] in the UK and will reduce the number of potential suppliers of alginate fibre. CTL submit that is possible for in-house suppliers to supply the open market. We note that, to the extent that this is true of CTL itself, the merger may raise horizontal competition concerns. However, due to lack of information on capacity levels and potential incentives it is unclear to what extent CTL and other in-house suppliers could and would supply external customers in the future. Overall, it appears that the threat of 'switching' by customers might be less significant post merger and that buyer power will not necessarily be an effective constraint.

Alginate dressings

35. As described above, alginate fibre is converted into alginate dressings by a number of vertically integrated companies (such as CTL) and by dressing manufacturers (such as S&N and J&J). ASF does not itself carry out any conversion of fibre into dressings. Nor does it sell dressings. It does on behalf of two customers organise sub-contracting of the conversion process. However, this

[3] AMS has recently announced that it is to enter the alginate dressings sector with its own products.

sub-contracting is *(see note 1)*. Hence, the parties do not explicitly overlap downstream in the supply of alginate dressings.

36. On the other hand, there would not appear to be any reason why ASF could not engage with the same sub-contractor to manufacture dressings on ASF's behalf. It is therefore possible to see ASF as a potential entrant to alginate dressing supply in the UK and the merger may remove that potential. Even so, this would only give rise to a significant prospect of a substantial lessening of competition if the competitive constraint represented by ASF's potential entry were sufficiently important.

37. Post-merger, it appears that there will continue to be a number of other potential suppliers of dressings besides ASF. CTL estimates total UK alginate dressing sales at £8.6 million and its UK turnover as £*(2.5-3.5)* million. The following table shows 2002 UK shares of alginate dressing sales.

Table 2 UK 2002 shares of supply (not including Aquacel)

Manufacturer	**Total Sales £m**	**Share**
Convatec (CTL)	*(2.5-3.5)*m	*(30-40)* per cent
Maersk Medical (MM)*	*(3.5-4.5)*m	*(40-50)* per cent
Others	*(1-2)*m	*(10-20)* per cent
Total	*(7-10)*	100 per cent

Source: CTL
* MM is a customer of ASF. No figures for *(see note 1)* (also customers of ASF) have been submitted.

38. No sales have been attributed to ASF as its role in organizing conversion of fibre for *(see note 1)* is limited: the identity of the sub-contractor, the product's technical specifications and price are all controlled by the end-customer, not ASF. These data show that, with a share of supply of *(30-40)* per cent, CTL is the second largest supplier of alginate dressings behind MM (which currently buys alginate fibre from ASF).

39. Post-merger, *(ASF's customers) (see note 4)* may be expected to continue competing vigorously for business (subject to the vertical competition issues discussed below). Moreover, as noted above, AMS has recently announced that it is to enter the alginate dressings sector with its own products. Together with the fact that we have not identified any special factor relevant to ASF to suggest that the loss of its threat of potential entry would have adverse competitive effects, and leaving aside vertical considerations (see paragraph 41 below), the above evidence does not suggest that the merger gives rise to a significant prospect of a substantial lessening of competition in alginate dressings.

Conclusion on horizontal competition assessment

40. The parties both manufacture alginate fibre. The transaction would result in a combined global share of manufacture based upon CTL's figures of up to *(60-80)* per cent (increment *(20-40)* per cent). Even though entry may be possible it appears unlikely, the extent of switching costs is unclear, and it does not appear that buyer power post merger can be relied upon to constrain the merged entity. The transaction may raise horizontal competition concerns by removing a potential

supplier of alginate fibre to the merchant sector and so gives rise to the belief that there is a significant prospect that the merger would substantially lessen competition in the supply of alginate fibre.

41. As mentioned earlier, CTL and ASF do not explicitly overlap in the supply of alginate dressings, although ASF does arrange for the processing of alginate fibre by nominated sub-contractors for *(see note 1)*. The merger might therefore remove a competitive constraint by reducing the incentives for ASF to enter dressing conversion/manufacture. On balance, however, and leaving aside the vertical considerations, we do not consider that the loss of ASF's threat of potential entry gives rise to the belief that there is a significant prospect that the merger would substantially lessen competition in the supply of alginate dressings.

VERTICAL COMPETITION ASSESSMENT

42. CTL is active at both levels of the supply chain; the production of alginate fibre and the production of alginate dressings. The merger will result in CTL gaining control over ASF, a merchant supplier of alginate fibre to third parties. Following the transaction CTL will therefore control the supply of alginate fibre to a number of companies (*(see note 1)*) that compete with CTL downstream in the supply of alginate dressings. This raises a vertical competition concern in that the merger might alter CTL's future incentives to continue supplying alginate fibre to third parties or the terms on which it does so.

Alginate dressings

43. Shares of 2002 global alginate fibre production and 2002 overall UK alginate dressing sales are set out above. As regards UK alginate dressing sales, these sales may be further divided between the NHS hospital sector and the NHS community sector. The NHS Purchasing and Supply Agency (PASA) submits that the value of UK sales of advanced wound care products is around £80 million p.a., of which around £60 million is supplied to the NHS community sector via the Drug Tariff and around £20 million is sold to hospitals via PASA.

- Within the hospital sector, NHS Trusts can obtain advanced wound care products through the NHS Logistics Authority at prices which have been negotiated by PASA or can themselves seek tenders for direct supplies. If a supplier is not on the PASA framework agreement then access to the advanced wound care dressings sector is difficult.

- Within the community sector, the Drug Tariff sets the maximum price of the product (agreed with the Department of Health) which also determines the level at which pharmacies and other healthcare providers are reimbursed by the NHS.

44. PASA submits that there are eight alginate dressing products available in the UK and that the merged entity would have manufacturing influence over five. PASA estimated that the transaction would result in CTL gaining manufacturing control over *(90)* per cent of the NHS alginate dressings sector *(see note 3)*. The value of alginate dressings on the PASA agreement is £1.3 million p.a *(see note 3).*

45. Another third party estimated that the transaction would result in CTL controlling approximately *(over 90)* per cent of sales of alginate (and Hydrofibre / Aquacel) dressings for the UK community sector. Other third parties estimate the merged entity's share of alginate dressing sales to be lower, in the region of 60-65 per cent.

Vertical issues

46. As noted above, CTL has both a high share of current alginate fibre production and unused production capacity. It has been argued that, post-merger, CTL could and would use its enhanced position in the supply of alginate fibre to disadvantage its rivals or consumers. These strategies might take one of a number of forms, which are described below. More generally, as to CTL's ability to engage in these kinds of strategic behaviour, ASF's contracts with its existing *(see note 1)* customers *(see note 1)*. Accordingly, notwithstanding CTL's submission that its current intention is to supply ASF's existing customers *(see note 1)*, it would therefore be possible for CTL to change the terms of existing alginate fibre supply contracts or even terminate them altogether. The following discussion therefore focuses on CTL's incentives to engage in each of the vertical strategies.

47. First, the transaction might give CTL an incentive fully or partially to foreclose the supply of alginate dressings downstream, either through raising downstream rivals' costs or, in the extreme case, refusing to supply and diverting all its production in-house. This is a plausible argument: CTL accounts for a significant proportion of global fibre production so a foreclosure strategy might in principle be profitable. (One third party suggested that CTL could use the acquisition strategically to promote its Aquacel brand and foreclose the market via pricing strategies and withholding supplies of alginate fibre to competitors.) The reasons CTL has suggested for this not being a viable strategy are discussed below:

- Alginate fibre is only a small part of the overall cost of alginate dressings: hence, any attempt to raise rivals' costs is unlikely to result in any significant increase in the prices charged to end customers. However, the evidence provided by the parties on this point has been inconclusive and has been contradicted by some third parties.

- CTL would have no incentive to engage in a foreclosure strategy if fibre customers had alternative alginate fibre suppliers to which they could turn in order to defeat a price increase. However, for the reasons discussed above, it is not clear whether such choices exist.

48. Second, CTL may have a greater incentive to increase the price of its alginate dressings to end-users such as PASA and Department of Health (DoH). Although CTL may lose sales of alginate dressings to alternative suppliers through such a strategy, it may still be profitable as the increased demand faced by the alternative suppliers of dressings might lead to increased sales of alginate fibre for CTL. CTL's incentives for engaging in such a strategy are discussed below:

- The success of such a strategy is obviously dependent upon the scale of the additional profits earned on fibre as compared to the profit foregone on lost sales of CTL dressings. No evidence has been provided to enable the OFT to assess satisfactorily whether the lost profits on dressings would offset the additional profits on fibre.

- The incentive for CTL to engage in any such price-raising strategy seems unlikely to be diminished by end-user customers switching to alternative advanced wound care dressings (which as noted above appear to be limited). The scope for new fibre and/or dressing entry is also uncertain and the capability and capacity of producers to divert (or expand) captive production so as to supply externally is unknown.

- End-user buyer power may constrain the merged entity, either through PASA (or the individual NHS Trusts) or the operation of the Drug Tariff. In the hospital sector, although PASA may have negotiating strength at present, post-merger this may be reduced due to CTL's control of the upstream sector and its potential ability to influence the input costs of its competitors. Any buyer power that remains in the sector is not considered sufficient to represent countervailing buyer power.

- The risk of losing sales of alginate dressings may be low if the merger enables all suppliers of fibre to set prices higher than they otherwise would have been.

Conclusion on vertical competition assessment

49. The merger may alter CTL's incentives to supply alginate fibre to its downstream competitors. A number of possible foreclosure and price raising strategies have been suggested and there is evidence to suggest that these strategies might be profitable for the merged entity. If any such strategy was viable, it is not clear that the remaining factors of competition (switching, buyer power and barriers to entry) would be sufficient to constrain the behaviour of CTL. On balance, after considering the evidence available to OFT, these vertical concerns give rise to a belief that there is a significant prospect that the merger would substantially lessen competition.

THIRD PARTY VIEWS

50. Overall, third party views were mixed, with some respondents at all stages of the supply chain having no objections to the merger. However, concern was expressed by a number of manufacturers of alginate dressings that following the transaction the merged entity will control much of the supply of alginate fibre in the UK and that an independent supplier would be removed as a result of the transaction. Some nursing staff expressed preference for using alginate dressings to treat certain wounds and PASA who set prices for the hospital sector[4] expressed concern that the merged entity will have 'manufacturing control' over a high proportion of the alginate dressing sector. Other third party views are reflected elsewhere in this decision.

[4] PASA has stated that it should be more correctly defined as 'PASA, who negotiate contracts on behalf of the NHS'.

CONCLUSION

51. CTL and ASF are the two leading producers and suppliers of alginate fibre in the UK. CTL is also a leading producer and supplier of alginate dressings. ASF sells all of its alginate fibre production to third parties. We have therefore considered both horizontal and vertical competition issues.

52. The transaction would result in a relatively high combined global share of supply of alginate fibre of up to *(60-80)* per cent (increment *(20-40)* per cent) (see note 2). Although ASF sells all of its alginate fibre production to third parties and CTL uses all of its alginate fibre production internally, the merger would appear to eliminate the possibility that CTL would supply third parties in the event of a price stimulus from the merchant sector. On balance, there is reason to believe that CTL currently constrains to some degree prices in the merchant sector, especially given its substantial over-capacity. Absent a constraint from CTL, it is not clear that sufficient alternative supply choices exist for non-vertically integrated third parties to discipline prices charged by ASF and other suppliers. The evidence does not suggest that there is a significant number of alternative fibre suppliers to which customers could turn. Nor does new entry into or expansion of alginate fibre production seem likely to arise as a disciplining factor. Furthermore, buyer power appears limited and will be further reduced by this transaction.

53. As to the vertical competition issues, following the transaction, the merged entity will control the supply of alginate fibre to a number of competing suppliers of alginate dressings downstream. In such a position, the merged entity could pursue a number of strategies that would be detrimental to competition. There are plausible arguments that such strategies would be profitable for CTL, although evidence as to CTL's incentives is mixed. It is also unclear to what extent factors such as substitution by end-users to alternative advanced wound care dressings; end-user buyer power; substitution by manufacturers of alginate dressings to alternative advanced wound care dressings; and the possible entry of alternative alginate fibre suppliers would constrain the merged entity.

54. In light of the above, the OFT believes that there is a significant prospect that the merger would substantially lessen competition within a market or markets in the United Kingdom for goods or services. That is a sufficient condition for the OFT to refer the merger to the Competition Commission. To reach a reference decision in this case, therefore, it has not been necessary to assess the merger further in relation to the interpretation of the test for reference given in the recent judgment of the Competition Appeal Tribunal in *IBA Health Limited v OFT* [2003] CAT 27.

UNDERTAKINGS IN LIEU OF REFERENCE

55. Where the duty to make a reference under section 33(1) of the Act is met, pursuant to section 73(2) of the Act the OFT may, instead of making such a reference, accept undertakings for the purposes of remedying, mitigating or preventing the substantial lessening of competition concerned or any adverse effect which may be expected to result from it. Having reached a reference conclusion, the OFT has considered whether there might be undertakings in lieu of reference which would address the competition issues outlined above. The OFT's guidelines on undertakings in lieu of reference state that, 'undertakings in lieu of

reference are appropriate only where the competition concerns raised by the merger and the remedies proposed to address them are clear cut.'[5]

56. CTL has offered to undertake to: (a) confirm CTL/ASF's commitment to supply, at current levels, ASF's external customers of alginate fibre for a defined period; and (b) set a price (subject to review) at which supply of fibre would be maintained.

57. The OFT has considered carefully whether these undertakings would address the issues outlined above, but is not confident that the proposed undertakings would address the identified competition concern in a clear-cut way. First, the proposed undertakings would maintain a static market situation and would not therefore adequately replace the conditions of competition which exist at present. For instance, evidence has been provided of customers negotiating significant price reductions with alginate fibre suppliers on the basis of existing competition and their ability to switch suppliers. Second, there are considerable difficulties in using the proposed pricing mechanism to replicate the current competitive incentives. Third, the undertakings would not replicate the current incentives to innovate: downstream competitors of CTL would be unlikely to combine with ASF to develop new alginate dressing products when ASF is owned by CTL.

58. In light of these concerns, the OFT has decided not to exercise its discretion to seek undertakings in lieu of reference.

DECISION

59. This merger will therefore **be referred** to the Competition Commission under section 33(1) of the Act.

NOTES

1. Details excised at the request of the parties for reasons of commercial confidentiality

2. Where figures appear in italics in the text this is to replace actual figures that have been excised at the request of the parties.

3. Details excised either at request of third parties or for reasons of commercial confidentiality

4. Text replaced at request of parties

[5] Mergers, ' Substantive assessment guidance', May 2003 at paragraph 8.3