

Competition Law

Antitrust law and policy in a global market *insight*

Protecting competition, not competitors – pharmaceuticals in South Africa

By Martin Howe and Pedro Fernandes
Europe Economics

published in the October 2003 issue of
Competition Law Insight

Published by

Informa Professional
30–32 Mortimer Street
London W1W 7RE
United Kingdom

Subscription Enquiries

Eleanor Slade
Tel: + 44 (0) 20 7017 4017
Fax: + 44 (0) 20 7017 5090
Email: eleanor.slade@informa.com

Editorial Contacts

Editor: Celia Hampton
Tel: + 44 (0) 20 7700 7387
Email: celia.hampton@publicinfo.net

Editorial coordinator: Eleanor Taylor
Tel: + 44 (0) 20 7017 5215
Fax: + 44 (0) 20 7017 5274
Email: eleanor.taylor@informa.com

Distribution

Protecting competition, not competitors – pharmaceuticals in South Africa

By *Martin Howe and Pedro Fernandes, Europe Economics**

Introduction

Competition law should be used to protect the competitive process and not to protect competitors. This may seem an obvious principle. But it is one that appears to be often overlooked by competition authorities. The recent decision by the South African Competition Tribunal in the *SAI/Kinesis* case on a complaint against an exclusive distribution arrangement reminds us of the principle, and indeed places it on centre stage.

Set against the backdrop of the Tribunal's decision, this brief article notes the importance for a competition authority to act, when necessary, as the guardian of the competitive process and the efficiencies that it generally promotes and not as the protector of competitors from the effects of that process.

That an authority should be clear about its role is particularly important when, as in the case facing the South African Tribunal, the competitive process is spurred on by the policies of larger, allegedly dominant, parties.

South African competition law

South African competition law is too complex to describe in detail here. Suffice it to say that, except for cartels that are prohibited *per se*, the Competition Act 1998 prohibits horizontal and vertical restrictions (restrictive practices) where they substantially lessen competition unless the anticompetitive effects can be shown by the parties to be outweighed by improvements in efficiency or by other procompetitive benefits.

The first responsibility for enforcing the Act falls on the Competition Commission, an independent administrative body headed by the Competition Commissioner. The Commission investigates possible infringements of the Act on its own initiative or on receipt of a complaint. If it concludes that there is an infringement, it must refer the case to the Tribunal. If no infringement is found, the case is closed but a dissatisfied complainant can then refer the matter to the Tribunal.

The Competition Tribunal is a quasi-judicial, collegiate body. It makes decisions in contested cases and it alone can impose penalties and determine remedies. The Tribunal also decides applications for interim relief.

Finally, decisions of the Commission and the Tribunal can be appealed to the specialist Competition Appeals Court.

Enforcement activity since the 1998 Act came into force in September 1999 has mainly concerned mergers. The fact that there have been few restrictive practices cases adds to the interest of *SAI/Kinesis*.

Background to SAI/Kinesis

The distribution of pharmaceutical products in the South African private sector has traditionally been carried out by pharmaceutical wholesalers who purchase pharmaceuticals from manufacturers at a traditional discount off the list price and resell them to retail pharmacists.

This mode of distribution came under pressure in the 1990s due to the entrance of mail order companies and the development of agency distributors. The case at hand concerns the creation of Kinesis, the second such agency to be formed in South Africa for the distribution of pharmaceuticals.

Kinesis was created in March 2000 following the purchase of Druggists Distributors (DD), an existing wholesale distributor, by five pharmaceutical manufacturers – subsequently, due to mergers, the five manufacturers became three.

In May 2000, DD, renamed Kinesis, began operating as an exclusive distribution agency (EDA) for its principals. Unlike wholesalers, Kinesis does not take ownership of the stock it distributes and has no say on the price list, discounts or other conditions attached to the sale of the pharmaceutical products. These are set by each of the principals. Kinesis receives a fee for its distribution services. Under the exclusivity agreement, all the principals' stock must flow through Kinesis. A wholesaler who wishes to purchase the products of one manufacturer must do so through Kinesis.

In May 2001, Kinesis was sold to Tibbett and Britten (T&B), a UK logistics service provider. T&B/Kinesis remains the exclusive distributing agent for the relevant manufacturers, each of the bilateral agreements being governed by separate five-year service level agreements.

In June 2000, a group of wholesale distributors (and others) lodged a complaint with the South African Competition Commission concerning the establishment of Kinesis as an exclusive distributor and, on the same matter, filed an application for interim relief with the Tribunal. The legal process has been a lengthy one and only in July 2003 has the Tribunal published its decision on the application for interim relief. The Commission has yet to decide on the founding case.

The complaint

The complaint lodged by the distributors in respect of both the founding case and the request for interim relief covers a raft of allegations. These included collusion by the manufacturers in setting up the new form of distribution and in the manner of its operation, discriminatory terms, exclusion of traditional wholesalers from the market and abuse of a

* *Martin Howe is a special adviser and Pedro Fernandes is a consultant at Europe Economics, London*

dominant position either by the manufacturers or their exclusive distributor. Many of these grounds received short shrift from the Tribunal.

At its heart, however, is the complaint that the arrangements between the manufacturers and T&B/Kinesis are such that competition is distorted, namely competition in the distribution of pharmaceuticals as wholesale distributors who wish to trade in the principals' products must purchase them via T&B/Kinesis.

Wholesale distributors are presented with the same price and discount list as all other purchasers, including retail pharmacies themselves. Wholesale distributors claim that, given this arrangement, and particularly their inability to obtain more advantageous terms and conditions than are available to pharmacies, they do not have a margin on which they can profitably operate. The result, they claim, is that they are foreclosed from the market to the detriment of competition.

In fact, the evidence does not support the case put forward by the complainants. The Tribunal finds that wholesalers can, and do, continue to trade profitably in the distribution of the principals' products, namely by taking advantage of bulk discounts.

Safeguarding competition, not competitors

There is, however, a higher-level point to be made that goes beyond an analysis of what bulk discounts are available to distributors. In particular, it should be recognised that competition in distribution can be thought of as taking place at two levels.

First, different models of distribution compete, with manufacturers choosing between different models depending on their relative efficiencies and costs. A variety of models are currently seen in South Africa: traditional wholesale distribution, self-distribution and agency distribution.

Second, within a particular distribution model, firms will compete for business. In the case of traditional wholesaler distribution, competition should take the form of wholesalers competing for sales to retailers. Under the agency distribution model, agency distributors compete against each other to supply distribution services to manufacturers.

Historically, wholesalers developed to take advantage of the economies of scale that could not be realised under self-distribution. But wholesaling can have no perpetual claim to be the most efficient distribution model, and the replacement of wholesale distributors by agency distributors suggests that manufacturers believe that, in the current context, the latter can better meet their needs.

The arrangement between SAI/Kinesis and its principals gave the former the incentives to invest in modern IT equipment and in enhanced warehousing and distribution facilities. These investments, which wholesaler distributors had seemed reluctant to undertake, are expected to improve the service provided, namely the quality of the information flow and stock management and the handling and security of the pharmaceutical products.

This is precisely the view taken by the Tribunal. The Tribunal's decision notes how the pressures being put on manufacturers by large purchasers (the state, large pharmacy chains)

have led the former to search for those areas where costs can be further reduced and quality improved. The principals of T&B/Kinesis have identified the scope for improvement in the distribution chain by undertaking this function in a different way from the traditional wholesaler model.

The Tribunal found that "[t]here is, however, nothing necessarily sinister about this albeit that it may reverberate to the detriment of established pharmaceutical wholesalers – it is simply part of the competitive process" (*para 43*).

And it is the competitive process, and not competitors, that competition policy in general, and the South Africa 1998 Competition Act in this case, should protect and promote. As noted by former European Commissioner Karel Van Miert, "competition forces companies to run themselves efficiently. It forces them to adjust to changes and it forces them to innovate. Competition leads to lower prices and to higher quality for consumers" (*speech on 6 May 1998*). This view is fully embraced in the Tribunal's decision:

Great companies have frequently been victims of this, the competitive process. Still greater companies, spurred by the competitive process, have repositioned themselves – they have found new value-adding services to offer their customers, they have developed new products and, at times, they have entered new markets. However, the matter before us represents an effort by a group of companies which, when confronted by market dynamics, turn to regulation, rather than innovation, to rescue them (*para 44*).

Despite the seemingly obvious line of reasoning taken by the Tribunal, the temptation for it to have taken an opposite view is clear. When the rhythm of change taking place in the market is being set by a firm, or group of firms, large in size and financial resources at the expense of competitors with an overall smaller business, it would be all too easy to interpret these changes as attempts to exploit the larger firms' position. This is particularly so when the changes will undeniably put at risk the mode of business of those smaller competitors.

We believe that the Tribunal was right to resist the temptation in this case and to recognise the movement away from wholesale distribution to EDAs in pharmaceuticals as an embodiment of the operation of the competitive process itself.

Conclusion

The Tribunal's decision is refreshing and should encourage firms not to fear that every innovation that appears to disadvantage competitors would be dogged by regulatory risk. Whether the Tribunal's lead will be followed generally, in South Africa or elsewhere, we will have to wait and see.

References

South African Competition Tribunal's decision and order in *Pharmaceutical Wholesalers and Glaxo Wellcome*, Case 68/IR/Jun00, 18 June 2003
<http://www.comtrib.co.za/decidedcases/pdf/68IRJUN00kinesis.pdf>

For a comprehensive survey of South Africa's competition law, see *Competition Law and Policy in South Africa*, a peer review report to the OECD Global Forum on Competition, Paris, 11 February 2003
<http://www.oecd.org/dataoecd/11/61/2498908.pdf>

EDAs have also been formed by International Healthcare Distributors (IHD), for a group of pharmaceutical manufacturers, in 1993. In 2001, Pharmaceutical Healthcare Distributors (PHD) was created as the EDA for two other manufacturers in South Africa