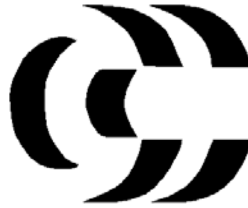
Public Version
ISSN NO. 0114-2720
J7449



COMMERCE COMMISSION

Decision No. 572

Determination pursuant to the Commerce Act 1986 in the matter of an application for clearance of a business acquisition involving:

VALLEY DIAGNOSTIC LABORATORIES LIMITED

and

WELLINGTON PATHOLOGY LIMITED

The Commission: Paula Rebstock
Denese Bates
Peter JM Taylor
Anita Mazzoleni

Summary of Application: The proposed merger of Wellington Pathology Limited and Valley Diagnostic Laboratories Limited diagnostic laboratory services businesses in the Hutt Valley and Capital & Coast District Health Board (DHB) districts.

Determination: Pursuant to section 66(3) (a) of the Commerce Act 1986, the Commission determines to give clearance to the proposed acquisition.

Date of Determination: 31 January 2005

CONFIDENTIAL MATERIAL IN THIS REPORT IS CONTAINED IN SQUARE BRACKETS

CONTENTS

EXECUTIVE SUMMARY i
The Proposal i
Relevant Markets i
Counterfactual and Factual i
Competition Analysis ii
Countervailing Power iii
Overall Conclusion and Determination iv
THE PROPOSAL 1
STATUTORY FRAMEWORK 1
ANALYTICAL FRAMEWORK 2
THE PARTIES 2
Valley Diagnostic Laboratories Limited (Valley) 2
Wellington Pathology Limited (Wellington Pathology) 3
OTHER PARTIES 3
New Zealand Diagnostic Group Limited (NZDG) 3
C&C DHB Hospital Laboratory 3
Hutt Valley Hospital Laboratory 3
Canterbury Health Laboratories Ltd (CHL) 4
PREVIOUS COMMISSION DECISIONS 4
INDUSTRY BACKGROUND 5
MARKET DEFINITION 5
Product Markets 6
Community Testing and Hospital Testing *7*
Turnaround times 7
Range of tests 8
Demand for tests 9
Reconfiguration/Facilities 9
Lab opening hours 9
Conclusion 10
Send-away Testing *10*
Cervical Screening Tests *11*
Conclusion on Product Markets *11*
Geographic Markets 11
Community testing *11*
Cervical Screening Tests *11*
Temporal Dimension 12
Conclusion on Market Definition 12
COUNTERFACTUAL AND FACTUAL 12
Factual 12
Current Contract Round *12*
Next contract round *13*
Counterfactual 13
Current Contract Round *13*
Next contract round *14*
COMPETITION ANALYSIS – COMMUNITY TESTING IN THE GREATER WELLINGTON REGION 15
Previous Providers to the Region 16
Merged Entity *16*

Wellington Pathology ... *17*
Technical Labour ... 18
Access to Capital ... 18
Scale ... 18
Incumbent Knowledge and Reputation with DHBs ... 19
Conclusion on Wellington Pathology ... 19
Valley ... *19*
Technical Labour ... 20
Access to Capital ... 20
Scale ... 20
Incumbent knowledge and reputation with DHBs ... 21
Conclusion on Valley ... 21
NZDG ... *21*
Technical Labour ... 22
Access to Capital ... 23
Scale ... 23
Incumbent Knowledge and Reputation with DHBs ... 23
Conclusion on NZDG ... 23
DHB laboratories outside the region ... 23
CHL ... *23*
Local DHB hospital laboratories ... 24
C&C DHB hospital laboratory ... *25*
Technical Labour ... 26
Access to Capital ... 26
Benchmarking ... 26
Corporate knowledge ... 27
Transfer of risk ... 27
Hutt Valley DHB hospital laboratory ... *27*
Technical Labour ... 28
Access to Capital ... 28
Benchmarking ... 29
Corporate knowledge ... 29
Transfer of risk ... 29
Conclusion on hospital laboratories ... *30*
Sealed bid process ... 30
Next contract round ... 30
Countervailing Power ... 31
Co-ordinated Market Power ... 32
Sonic and NZDG ... *33*
Sonic and Abano ... *34*
Conclusion on co-ordinated effects ... *35*
Conclusion on Community Testing in the Greater Wellington Region ... 35
Current Contract Round ... *35*
Next Contract Round ... *36*
NATIONAL CERVICAL SCREENING MARKET ... 37
OVERALL CONCLUSION ... 38
DETERMINATION ON NOTICE OF CLEARANCE ... 39

EXECUTIVE SUMMARY

The Proposal

1. A notice pursuant to s 66(1) of the Commerce Act 1986 (the Act) was registered on 7 December 2005. The notice sought clearance for:

   - the acquisition by Labco Wellington (a new company to be formed) of certain assets of the pathology services businesses of Wellington Pathology Limited (Wellington Pathology) and Valley Diagnostic Laboratories Limited (Valley); and
   - the acquisition of shares in Labco Wellington, in approximately equal proportions, by Abano Healthcare Group Limited and Sonic Healthcare Limited or their wholly-owned subsidiaries.

Relevant Markets

2. The Commission considers that it is still appropriate to define separate product markets for community testing and hospital testing. The proposed merger does not involve any aggregation in the provision of hospital testing.
3. In Decision 559 the Commission considered that the geographic markets should be defined by DHB (District Health Board) district, except where two or more DHBs are collaborating together (e.g., Otago and Southland), in which case the geographic area of the market should be the broader region comprising the relevant DHB districts.
4. In this case, the Capital & Coast (C&C) and Hutt Valley DHBs have the option to collaborate for the provision of community testing, in a similar fashion to Otago and Southland. Thus the Commission considers that the relevant geographic market is the broader region comprising both the C&C and Hutt Valley DHBs. The Commission defines this broader region as the greater Wellington region.
5. The Commission considers that the relevant markets for the purposes of analysing the proposed merger are:

   - the market in the greater Wellington region for the provision of community testing pathology services; and
   - the national market for the provision of cervical screening tests.

Counterfactual and Factual

6. In the factual scenario, the merged entity would submit a bid for the provision of community testing for the combined C&C and Hutt Valley DHB regions (the regional contract). The Commission considers that both Valley and Wellington Pathology would also submit a bid in their district of incumbency.

Regional Contract	C&C separate contract	Hutt Valley separate contract
Labco Wellington	Wellington Pathology	Valley

7. In the counterfactual scenario, the Commission considers [ ] that each party would bid for the regional contract on its own. For the purposes of assessing this Application, the Commission has also taken the conservative view of assuming that both Valley and Wellington Pathology would submit a separate bid for each of the Hutt Valley and C&C separate contracts in the counterfactual.

Regional Contract	**C&C separate contract**	**Hutt Valley separate contract**
Wellington Pathology Valley	Wellington Pathology Valley (possibly)	Valley Wellington Pathology (possibly)

8. If the joint venture is successful in securing the regional contract, in the next contract round in the factual, it is unlikely that either Wellington Pathology or Valley would submit separate bids for pathology contracts in either region, provided the joint venture operates successfully over the period of the contract.

9. In the counterfactual, if Wellington Pathology is not successful in this contract round, the Commission considers that it would not exist in five years time to bid in the next contract round. If Valley is not successful in the current contract round, the Commission considers it would still exist to bid for contracts in the future. While the Valley operation may close down, Sonic has a number of other pathology businesses around New Zealand, and could bid for work in the greater Wellington region in five years time.

Competition Analysis

10. The Commission analyses likely potential bidders according to the following categories:
    - Previous providers to the region: Wellington Pathology, Valley and New Zealand Diagnostic Group, and in the factual, the merged entity;
    - DHB laboratories outside the region: Canterbury Health Laboratories; and
    - the local DHB-owned laboratory: C&C DHB hospital laboratory, and Hutt Valley DHB hospital laboratory.

11. The Commission identifies a number of barriers to entry that potential providers would face to varying degrees when submitting a bid to provide testing in a region. These entry barriers were:
    - access to technical labour;
    - capital;
    - scale of operations;
    - incumbent knowledge; and
    - reputation and prior relationships with the purchasing DHBs.

12. The Commission analyses the potential bidders on the basis of the barriers (as identified in Decision 559) that they would face in the factual and the

counterfactual scenarios. The Commission considers that the entry barriers would be more readily overcome by some providers than others.

13. In the factual, there would be a loss of competition arising from Valley and Wellington Pathology bidding together as the merged entity, rather than bidding against each other for the regional contract in the counterfactual. In addition, the Commission considers that each of Wellington Pathology and Valley may bid against the other incumbent party for the C&C and Hutt Valley separate contracts in the counterfactual, but are unlikely to do so in the factual.

14. However, the Commission considers that the threat of competition from NZDG would be likely to provide substantial constraint on the merged entity in the factual.

15. The Commission also considers that the threat of a bid from either DHB hospital laboratory (either jointly or on their own) would provide some constraint on the merged entity in the factual, but this constraint would not be sufficient on its own to prevent a substantial lessening of competition in the community testing market.

16. Thus, the Commission considers that the competition provided by national pathology operator and previous provider, NZDG, and to some extent, potential competition from the DHB-owned hospital laboratories, would constrain the merged entity in both the factual and the counterfactual, such that a substantial lessening of competition would be unlikely.

17. The Commission has also assessed whether the proposed merger would be likely to increase the likelihood of co-ordinated behaviour between Sonic and NZDG in other regional markets. As a potential competitor to NZDG and Sonic in other regions, Abano would potentially have the ability to break up any co-ordinated behaviour by bidding against either party in the counterfactual. In the factual, Abano and Sonic would have a merged business in the Wellington region. However, in Decision 559, the Commission considered that Abano would be unlikely to exert much competitive constraint outside its regions of incumbency. The Commission continues to see this as unlikely, and considers that the barriers for Abano would still exist.

18. The Commission concludes that the characteristics and structure of the markets would not change significantly as a result of the proposed merger, and as such, the proposed merger would be unlikely to increase the likelihood of co-ordinated behaviour. In addition, the Commission has evidence of Sonic and NZDG actively competing against each other in the Otago/Southland region and in the greater Wellington region. The Commission considers that the scope for co-ordinated behaviour in other regional markets would be unlikely to increase in the factual compared to the counterfactual, as a result of the proposed merger.

Countervailing Power

19. In Decision 559, the Commission considered that in the move to a bulk-funded single-provider model, the DHB would no longer set the price, and would instead rely on market forces (i.e., through competitive bidding) to determine the price. Under this new framework, the Commission considered that in the counterfactual, DHBs would have the ability to influence this price by playing various competitors off against one another.

20. The Applicants submitted that the C&C and Hutt Valley DHBs would exert a significant degree of countervailing power over the Applicants, both in the factual and the counterfactual.

21. The C&C and Hutt Valley DHBs designed a Request For Proposal (RFP) containing a number of options, thus maintaining a level of flexibility for the DHBs. The Commission considers that the DHBs have retained a degree of countervailing power through the way in which they have structured the RFP. If the DHBs do not wish to contract with the merged entity in the factual, they have the option of continuing with separate contracts for the C&C and Hutt Valley DHB districts.

22. However, the Commission considers that the DHBs did not exercise the full extent of their countervailing power in this contract round, and the Commission is unsure whether the DHBs will more fully exercise their countervailing power in future contract rounds. The DHBs stated that they did not want to receive a joint bid as they believed they would receive more competitive bids if the merging parties bid separately. However, the DHBs advised the Commission that they did not consider specifying 'no joint bids' between private providers.

23. The Commission considers that while the countervailing power of the DHBs is not sufficient on its own to prevent a substantial lessening of competition, it does provide some constraint on the combined entity post-merger.

Overall Conclusion and Determination

24. The Commission concludes that although the proposed merger would reduce the number of likely potential private provider bidders in the factual compared to the counterfactual, the merged entity in the factual would continue to face competition from NZDG and the DHB-owned hospital laboratories in the greater Wellington region.

25. The Commission also considers that while the countervailing power of the DHBs is not sufficient on its own to prevent a substantial lessening of competition, it would provide some constraint on the combined entity post-merger.

26. The Commission is therefore satisfied that the proposed merger will not have, or would not be likely to have, the effect of substantially lessening competition in the market in the greater Wellington region for the provision of community testing pathology services.

27. Pursuant to section 66(3) (a) of the Commerce Act 1986, the Commission determines to give clearance for:

    - the acquisition by Labco Wellington (a new company to be formed) of certain assets of the pathology services businesses of Wellington Pathology Limited and Valley Diagnostic Laboratories Limited; and
    - the acquisition of shares in Labco Wellington, in approximately equal proportions, by Abano Healthcare Group Limited and Sonic Healthcare Limited or their wholly-owned subsidiaries.

THE PROPOSAL

1. A notice pursuant to s 66(1) of the Commerce Act 1986 (the Act) was registered on 7 December 2005. The notice sought clearance for:
   - the acquisition by Labco Wellington (a new company to be formed) of certain assets of the pathology services businesses of Wellington Pathology Limited and Valley Diagnostic Laboratories Limited; and
   - the acquisition of shares in Labco Wellington, in approximately equal proportions, by Abano Healthcare Group Limited and Sonic Healthcare Limited or their wholly-owned subsidiaries.
2. Section 66(3) of the Act requires the Commission either to clear or to decline to clear the acquisition referred to in a s 66(1) notice within 10 working days, unless the Commission and the person who gave notice agree to a longer period. An extension of time was agreed between the Commission and the Applicant. Accordingly, a decision on the Application was required by 31 January 2006.
3. The Applicant sought confidentiality for specific aspects of the Application. A confidentiality order was made in respect of the information for up to 20 working days from the Commission's determination notice. When that order expires, the provisions of the Official Information Act 1982 will apply.
4. The Commission's approach to analysing the proposed acquisition is based on principles set out in the Commission's Mergers and Acquisitions Guidelines.[1]

STATUTORY FRAMEWORK

5. Under s 66 of the Act, the Commission is required to consider whether the proposal is, or is likely to have, the effect of substantially lessening competition in a market. If the Commission is satisfied that the proposal is not likely to substantially lessen competition, then it is required to grant clearance to the application. Conversely, if the Commission is not so satisfied, it must decline. The standard of proof that the Commission must apply in making its determination is the civil standard of the balance of probabilities.[2]
6. The substantial lessening of competition test was considered in *Air New Zealand & Qantas v Commerce Commission,* where the Court held:

> We accept that an absence of market power would suggest there had been no substantial lessening of competition in a market but do not see this as a reason to forsake an analysis of the counterfactual as well as the factual. A comparative judgment is implied by the statutory test which now focuses on a possible change along the spectrum of market power rather than on whether or not a particular position on that spectrum, ie dominance has been attained. We consider, therefore, that a study of likely outcomes, with and without the proposed Alliance, provides a more rigorous framework for the comparative analysis required and is likely to lead to a more informed assessment of competitive conditions than would be permitted if the inquiry were limited to the existence or otherwise of market power in the factual.[3]

7. In determining whether there is a change along the spectrum which is significant the Commission must identify a real lessening of competition that is not

---

[1] Commerce Commission, *Mergers and Acquisitions Guidelines*, January 2004.
[2] *Foodstuffs (Wellington) Cooperative Society Limited v Commerce Commission* (1992) 4 TCLR 713-722.
[3] *Air New Zealand & Qantas Airways Ltd v Commerce Commission,* unreported HC Auckland, CIV 2003 404 6590, Hansen J and K M Vautier, Para 42.

minimal.[4] Competition must be lessened in a considerable and sustainable way. For the purposes of its analysis the Commission is of the view that a lessening of competition and creation, enhancement or facilitation of the exercise of market power may be taken as being equivalent.

8. When the impact of market power is expected to be predominantly upon price, for the lessening, or likely lessening, of competition to be regarded as substantial, the anticipated price increase relative to what would otherwise have occurred in the market has to be both material and ordinarily able to be sustained for a period of at least two years or such other time frame as may be appropriate in any given case.

9. Similarly, when the impact of market power is felt in terms of the non-price dimensions of competition such as reduced services, quality or innovation, for there to be a substantial lessening or likely substantial lessening of competition, these also have to be both material and ordinarily sustainable for at least two years or such other time frame as may be appropriate.

ANALYTICAL FRAMEWORK

10. The Commission applies a consistent analytical framework to all its clearance decisions. The first step the Commission takes is to determine the relevant market or markets. As acquisitions considered under s 66 are prospective, the Commission uses a forward-looking type of analysis to assess whether a lessening of competition is likely in the defined market(s). Hence, an important subsequent step is to establish the appropriate hypothetical future with and without scenarios, defined as the situations expected:

    - with the acquisition in question (the factual) ; and
    - in the absence of the acquisition (the counterfactual).

11. The impact of the acquisition on competition is then viewed as the prospective difference in the extent of competition in the market between those two scenarios. The Commission analyses the extent of competition in each relevant market for both the factual and the counterfactual scenarios, in terms of:

    - existing competition;
    - potential competition; and
    - other competition factors, such as the countervailing market power of buyers or suppliers.

THE PARTIES

Valley Diagnostic Laboratories Limited (Valley)

12. Sonic is a subsidiary of Sonic Healthcare Ltd, an Australian-based medical diagnostics company, providing pathology and radiology services to medical practitioners, hospitals, community medical services and their patients. Sonic Healthcare has an annual turnover of approximately A$1.3 billion, and is listed on the Australian Stock Exchange.

---

[4] *Fisher & Paykel Limited v Commerce Commission* (1996) 2 NZLR 731, 758 and also *Port Nelson Limited v Commerce Commission* (1996) 3 NZLR 554.

13. In New Zealand, Sonic provides pathology services in 15 different DHB (District Health Board) districts. Sonic has three other subsidiary pathology businesses in New Zealand. These are Medlab South Ltd, Medlab Central Ltd and Diagnostic Medlab Ltd.

14. Valley is a wholly owned subsidiary of Sonic Healthcare (New Zealand) Ltd, which is in turn a wholly owned subsidiary of Sonic Healthcare Australia Ltd. Valley has a contract with the Hutt Valley DHB to provide community pathology services, and operates a laboratory in Lower Hutt. The majority of Valley's testing work comes from patients in the Hutt Valley DHB district, although Valley also derives some revenue from the Capital & Coast (C&C) DHB district and the Wairarapa DHB district.

Wellington Pathology Limited (Wellington Pathology)

15. Wellington Pathology is a wholly owned subsidiary of Abano Healthcare Group Limited (Abano). Wellington Pathology has a contract with the C&C DHB to provide community services, and operates a laboratory in central Wellington. The majority of Wellington Pathology's testing work comes from patients in the C&C DHB district.

16. Abano Healthcare is a publicly-listed company, and currently has full or part ownership of a range of businesses in three key healthcare and medical service sectors – dental, diagnostics and rehabilitation. In September 2005, it also announced a move into orthotics, with the acquisition of orthotic specialists, Orthotic Centre (NZ) Limited. Abano's total annual turnover is approximately $66 million. The diagnostics sector (pathology and radiology) makes up approximately $18 million of this total.

17. Abano's pathology business comprises operations in the Nelson/Marlborough DHB district through its subsidiary Nelson Diagnostic Laboratories Ltd, and its operation in the Wellington region – Wellington Pathology.

OTHER PARTIES

New Zealand Diagnostic Group Limited (NZDG)

18. NZDG is a privately-owned group of companies providing pathology services throughout New Zealand. NZDG's annual turnover is approximately [ ].

19. NZDG operates pathology services in eight DHB districts. It has four subsidiary pathology businesses in New Zealand. These are Southern Community Laboratories Ltd (SCL), SCL Hawke's Bay Ltd, Medlab Hamilton Ltd, and Medlab Gisborne Ltd.

C&C DHB Hospital Laboratory

20. The C&C DHB hospital laboratory provides the hospital testing for Wellington Hospital. It has an annual budget of approximately [ ]. The C&C hospital laboratory provides some send-away tests for Valley and Wellington Pathology. It also provides support for the Wairarapa DHB hospital laboratory and the Hutt Valley hospital laboratory.

Hutt Valley Hospital Laboratory

21. The Hutt Valley DHB hospital laboratory provides the hospital testing for Hutt Valley hospital. It has an annual budget of approximately [ ].

Canterbury Health Laboratories Ltd (CHL)

22. CHL is the public hospital laboratory owned by Canterbury DHB. CHL is the largest medical laboratory in the South Island. It undertakes all the hospital testing for Christchurch Hospital, and, as a reference laboratory, also performs the majority of specialist send-away testing, and cervical screening testing, for the South Island and the lower North Island.

PREVIOUS COMMISSION DECISIONS

23. The Commission previously considered pathology services in *Decision 559: New Zealand Diagnostic Group Limited / Sonic Healthcare (New Zealand) Limited.*

24. On 29 September 2005, the Commission declined to give clearance for the proposed merger of the diagnostic laboratory (pathology) services businesses of New Zealand Diagnostic Group Limited and Sonic Healthcare (New Zealand) Limited or their subsidiaries in six District Health Board districts through the establishment of three joint venture companies that would operate in the following DHB regions:
    - Otago;
    - Southland;
    - Hawke's Bay;
    - South Canterbury;
    - West Coast; and
    - Canterbury.

25. The relevant markets were defined as:
    - regional markets for each of the Otago/Southland (Otago and Southland DHBs have collaborated to purchase pathology services for their respective regions), South Canterbury, Canterbury, West Coast, and Hawke’s Bay DHB districts for the provision of community testing pathology services;
    - regional markets for each of the Otago/Southland and South Canterbury DHB districts for the provision of hospital testing pathology services; and
    - a national market for the provision of cervical screening tests.

26. The Commission declined the application on the basis that the proposed acquisition would have reduced the number of likely potential private provider bidders in each region from two vigorous competitors in the counterfactual, to one in the factual. The Commission also considered that the DHB provider arm in each region was unlikely to provide constraint on the proposed joint ventures.

27. In addition, the Commission could not be satisfied that the proposals would not enhance the likelihood of co-ordinated behaviour occurring in other regional markets, such that the proposals would not have, or would not be likely to have, the effect of substantially lessening competition in other regional markets for the provision of community testing.

INDUSTRY BACKGROUND

28. The background of the pathology sector was discussed in detail in Decision 559. That decision discussed the review of pathology services currently being undertaken by the majority of DHBs in New Zealand. In most cases, the DHBs are seeking to change the way pathology services are funded, from a fee-for-service payment towards bulk funding arrangements.

29. The changes to pathology services in the C&C and Hutt Valley DHB districts occur against this background of DHB pathology funding initiatives around the country. The current contracts for the provision of community testing expire on 30 September 2006. The DHBs issued a joint RFP on 2 December 2005 for the provision of community testing for the Hutt Valley and C&C DHB districts. Proposals are to be submitted by 17 February 2006.

30. The RFP invited tenderers to submit bids for a five year sole supplier contract for each of the Hutt Valley and C&C DHB districts individually, as well as a bid for the two districts combined.

31. The DHBs are considering whether to remove specialist-referred testing from the scope of the contracts, and the RFP asks tenderers to submit prices inclusive and exclusive of specialist-referred testing. If specialist-referred testing was removed from the contracting arrangements, it would be paid for by patients individually.

MARKET DEFINITION

32. The Act defines a market as:

> . . . a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them.

33. For competition purposes, a market is defined to include all those suppliers, and all those buyers, between whom there is close competition, and to exclude all other suppliers and buyers. The focus is upon those goods or services that are close substitutes in the eyes of buyers, and upon those suppliers who produce, or could easily switch to produce, those goods or services. Within that broad approach, the Commission defines relevant markets in a way that best assists the analysis of the competitive impact of the acquisition under consideration, bearing in mind the need for a commonsense, pragmatic approach to market definition.[5]

34. For the purpose of competition analysis, the internationally accepted approach is to assume the relevant market is the smallest space within which a hypothetical, profit-maximising, sole supplier of a good or service, not constrained by the threat of expansion and entry, would be able to impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the SSNIP test). The smallest space in which such market power may be exercised is defined in terms of the five dimensions of a market, two of which are relevant to this case and are discussed below. The

---

[5] Australian Trade Practices Tribunal, *Re Queensland Co-operative Milling Association* (1976) 25 FLR 169; *Telecom Corporation of NZ Ltd v Commerce Commission & Ors* (1991) 3 NZBLC 102,340 (reversed on other grounds).

Commission generally considers a SSNIP to involve a five to ten percent increase in price that is sustained for a period of one year.

35. The Applicants submitted that the relevant markets in which there will likely be an aggregation of business activity as a result of the proposed merger are:

- the market in the Hutt Valley and Capital & Coast DHB regions (the greater Wellington region) for the provision of hospital and community referred pathology services; and
- the national market for the provision of cervical screening tests.

Product Markets

36. Initially, markets are defined for each product supplied by two or more of the parties to an acquisition. The Commission usually employs the SSNIP test to assess the scope for demand- and supply-side substitution. That is, the Commission asks, would a five to ten percent price rise, by a hypothetical monopolist, sustained over a year, induce substitution by buyers or near competitors? The point at which the SSNIP becomes profitable for the hypothetical monopolist defines the boundary of the relevant market since no potential substitute beyond this point is sufficiently close to constrain the SSNIP.

37. Practical application of the SSNIP test in this case is problematic given that competition will occur through bidding markets in future. Tenders in response to an RFP are typically sealed bids placed simultaneously (by a specified date) to the issuing DHB. Hence, in theory, in any given bidding round, players do not have the opportunity to observe each others' prices and respond accordingly. The difficulty with applying the SSNIP test in such instances is that there is no obvious price on which to add the SSNIP. Even if the hypothetical monopolist in the region were assumed to add 5% to 10% to its full costs, it is difficult to predict whether a provider elsewhere would bid.[6]

38. Notwithstanding the difficulties in applying the SSNIP test in this particular case, the notion of substitutability is useful when considering the appropriate market definition. There are several non-price factors that can help inform the extent of product substitutability on both the demand- and supply-side. These may include, among other factors: distinct product characteristics and uses; unique production facilities or processes; distinct purchasers; specialisation of sellers; and recognition and views of industry participants of market boundaries.

39. In instances where the SSNIP test cannot readily be applied because buyers and sellers cannot easily observe and respond to relative prices, the Commission may give more weight to such non-price considerations when assessing the scope for substitutability.

---

[6] It may be possible for players to glean some information about competitors' bidding strategies from experiences with tenders in other regions, or from previous contracting rounds. However, such information would be useful only to a limited extent: there are significant regional variations in terms of demographics, testing needs, relationships with DHBs, etc. Also, tender rounds will likely occur infrequently (ie every three to ten years), so market conditions may evolve significantly in the intervening years, potentially rendering past information obsolete.

40. Close substitute products on the demand-side are those between which at least a significant proportion of buyers would switch when given an incentive to do so.

41. Close substitute products on the supply-side are those between which suppliers can shift production easily and in the short-run, using largely unchanged production facilities and little or no additional investment (including investment that would be sunk), when they are given a profit incentive to do so.

Community Testing and Hospital Testing

42. Two main forms of pathology testing exist in New Zealand: community testing and hospital testing. Community testing is, in the main, carried out by private providers such as NZDG and Sonic, and prices for these tests were historically fixed according to a schedule of approximately 180 commonly-performed tests. Non-schedule tests are generally referred to hospital providers, who hold contracts to perform this work.

43. In Decision 559: New Zealand Diagnostic Group Limited / Sonic Healthcare (New Zealand) Limited (Decision 559) the Commission defined separate markets for community testing and hospital testing. The Applicants do not agree with the Commission's conclusion that community and hospital testing should be defined in separate product markets.

44. The Applicants consider that in Decision 559, the Commission over-emphasised the differences between community and hospital testing. The Applicants point to "numerous examples of DHB labs being involved in community testing or of community testing providers being engaged in hospital testing."[7] However, as discussed in Decision 559, although there are some examples of community providers undertaking all hospital testing for a DHB, the Commission was advised in the course of making that Decision that the transition from community testing to hospital testing was not smooth and it often took a number of years for the operation to run successfully. In addition, there are very few examples of DHB-owned hospital laboratories providing all (or a substantial amount of) community testing for a DHB.[8]

45. The Applicants have made comment on specific aspects of the Commission's reasoning with particular reference to the C&C and Hutt Valley regions. The Commission tested these assertions with industry participants in the Wellington region to ascertain whether the circumstances in the C&C and Hutt Valley DHB districts are sufficiently different to lead to a different conclusion regarding the appropriate product market.

Turnaround times

46. In Decision 559, the Commission stated that on the demand-side, the testing needs of public hospitals are often more time-critical than community testing.

47. The Applicants submitted that only 5% of hospital testing is urgent and would require a turn-around time of less than two hours. However, hospital laboratory managers Russell Cooke (C&C DHB hospital laboratory) and Stephen Silk (Hutt Valley DHB hospital laboratory), advised the Commission that

---

[7] The Application, paragraph 11.22.

[8] The only example the Commission is aware of involved the hospital laboratory in Whanganui taking over all community testing in the past.

approximately 50% of hospital tests could be considered urgent. Russell Cooke advised the Commission that approximately 25% of hospital tests originate from the emergency and ICU departments. These tests need to be turned around within 1-2 hours. Another 25% of tests originate from the acute medical and surgical departments, and these need to be reported within 2-4 hours.

48. The Applicants advised that only 5-10% of community testing could be considered urgent. Wellington Pathology advised the Commission that they used three categories for urgent tests:

- phone/fax: the results for these tests need to be reported before the end of the day as that is when General Practioners (GPs) leave the office;
- urgent: these tests have a four hour deadline; and
- critical: these tests are couriered within the hour.

Wellington Pathology stated that only approximately 5% of all testing would fall into the 'urgent' or 'critical' category. This is significantly lower than in the hospital testing situation, as discussed above.

49. The hospital laboratories advised the Commission that the difference in turnaround times for non-urgent tests relates to the different drivers in hospital testing compared with community testing. In a hospital environment, for non-urgent tests, blood is collected in the morning rounds and the results usually need to be delivered in time for the doctors' early afternoon ward rounds. In contrast, the driver for community providers involves meeting the requests of GPs. Wellington Pathology stated that it often aimed to provide results to GPs before the end of the working day (5pm). However it has the flexibility to put off testing by a day.

50. Given the difference in turnaround times required, the Commission considers that community providers would require some reconfiguration of operational systems, so that switching between the provision of community and hospital testing may have significant costs.

Range of tests

51. In Decision 559, the Commission was advised that hospital laboratories typically provide a range of more advanced testing than community laboratories. The Applicants stated that this is because the range of tests is largely determined by funding arrangements rather than the level of technical expertise. However, the Commission considers that this means that community testers require a smaller skill base, and therefore would have greater difficulty switching into hospital testing if they considered it desirable to do so.

52. Community providers have previously only had a contract to provide tests on the 'schedule'. However, the current RFP asks providers to include a price for the provision of send-away tests (see definition below). This could mean that the range of tests becomes quite similar for community and hospital testing providers. However, the community providers indicated that they were still likely to outsource most send-away tests and had approached hospital laboratories such as C&C DHB hospital laboratory and CHL for price lists.

53. CHL stated that although there is significant overlap in the activities of hospital and community laboratories, there are major differences in emphasis. Peter

George, Clinical Director, CHL, stated that in a hospital environment, out of 1000 tests, 800 would be abnormal. In contrast, in a community laboratory, out of 1000 tests, only 100 would be abnormal. Although the test menu in a community laboratory may be similar to a hospital laboratory, community testing is generally of a routine, high-volume nature.

54. CHL also stated that, although the hospital and community laboratories employ some staff in common, hospital laboratories tend to employ more senior staff.

Demand for tests

55. In Decision 559, the Commission considered that the demand for community and hospital tests tends to differ. The Commission was advised that demand for hospital testing is driven by the incidence rate of acute referrals, and the work routines of clinicians. Thus, the Commission considered that demand for hospital testing is quite ‘lumpy’.

56. The Applicants in this case stated that it is only the urgency of the testing that creates an element of lumpiness, and that urgent testing makes up only 5% of all hospital testing. As stated above, DHB-owned hospital laboratories advised the Commission that actually up to 50% of hospital testing could be considered urgent. The Commission considers that due to the urgent nature of a large proportion of hospital testing, the demand for hospital testing differs significantly from community testing.

Reconfiguration/Facilities

57. In Decision 559, the Commission was advised that hospital providers receive all referrals from within the attached hospital so have no need to offer ancillary services, such as facilities and staff for sample collection, or transportation of samples.

58. The Applicants in this case estimated that the time required for a community provider to reconfigure current operational systems in order to provide hospital testing would be 6-12 weeks. However, industry participants advised the Commission that the transition the other way around (from hospital to community testing) may not be as straight-forward.

59. [ ] advised the Commission that the ‘out-of-lab’ set-up presented the biggest challenge for DHB hospital laboratories in entering the market for community testing. They stated that it would take months or even years and significant effort to successfully operate collection centres, courier networks and establish relationships with GPs. The DHB laboratories did not consider that it would be a simple task to switch from hospital testing to community testing. Hospital laboratory managers described community testing as a ‘new business line’ for them and considered the ‘out-of-lab’ set-up (couriers, collection centres) to be the greatest risk in bidding for a community contract.

Lab opening hours

60. The Applicants disagreed with the statement made in Decision 559 that community providers “tend to only operate during normal working hours”. The Applicants stated that Valley and Wellington Pathology both operate from 7am to 9pm Monday to Friday and 8am to 5pm on Saturday. Wellington Pathology is also open on Sundays until 4pm.

61. Hospital laboratories operate a 24-hour/7-days a week service. The Commission considers that the operations of community laboratories in the greater Wellington region would need to be altered significantly to be able to offer the 24 hour service necessary for hospital testing. Russell Cooke, C&C DHB hospital laboratory advised the Commission that after-hours work undertaken by the community laboratories is often subcontracted to a hospital laboratory.

Conclusion

62. The Commission recognises that there are a number of similarities between community and hospital testing, and that there may also be a number of synergies achieved by combining the two types of testing (for instance, they may complement each other by smoothing out the peaks in volume and demand). However, the Commission also recognises that there are a number of significant differences between the two types of testing. These differences suggest that the scope for substitution between community and hospital testing, both on the demand- and supply-side, may be limited.

63. The Commission considers that the differences identified in Decision 559 still exist for the provision of pathology services in the regions relevant to this Application. On this basis, the Commission considers that community and hospital testing should be defined in separate product markets.

64. The Application does not involve aggregation in markets for hospital testing. The Applicants are both participants in the community testing market only, and the DHBs have excluded hospital testing from the RFP. For these reasons, the Commission has not analysed the effects of this proposal on markets for hospital testing.

Send-away Testing

65. Within what is broadly referred to by industry participants as 'hospital testing' lies a category of complex or rare tests that are performed by only a few specialised laboratories ('reference laboratories') around the country. There are four reference laboratories in New Zealand: LabPLUS, Waikato Hospital Lab, Environmental Science and Research; and CHL. Samples for these tests are collected, either by community or hospital providers, and are sent away to a reference laboratory where an aggregated 'critical mass' of such tests can meaningfully be analysed. Such tests are therefore termed 'send-away tests'.

66. In general, send-away tests are very labour-intensive and require highly qualified and specialised staff, such as pathologists and scientists, to be able to perform them. Given the global shortage of such specialised staff, the Commission considers that it is unlikely that supply-side switching into send-away testing could readily occur.

67. On this basis, the Commission, for the purposes of the present Application, defines a discrete market for send-away tests.

68. Valley and Wellington Pathology do not currently perform send-away testing. In order to do so, a pathology provider would need to pool a critical mass of specimens to support the investment in the specialist equipment. In addition, in the past, contracts held by community testing providers did not include send-away tests.

69. The current RFP requires bidders to submit a bid inclusive of send-away tests. Valley and Wellington Pathology advised the Commission that whilst they may choose to provide a small proportion of these tests themselves, they are seeking proposals and price lists from send-away test providers such as CHL, and it is likely that the majority of send-away tests will continue to be outsourced.

70. Thus, as the proposal did not give rise to much (if any) aggregation with respect to send-away testing, and no competition issues relating to this market were contemplated, send-away testing was not analysed further as a relevant market.

Cervical Screening Tests

71. In Decision 559, industry participants advised the Commission that cervical screening work was a distinct category of testing that is both funded differently to other pathology services and has special accreditation standards that determine who can perform such testing.

72. In respect of this Application, the Commission has found nothing to change its conclusion in Decision 559, in which cervical screening tests were defined in a discrete product market.

Conclusion on Product Markets

73. For the purposes of the present Application, the Commission concludes that the relevant product markets are:

- the provision of community testing pathology services (excluding send-away and cervical screening tests) – ‘community testing’; and
- the provision of cervical screening tests – ‘cervical testing’.

Geographic Markets

Community testing

74. The Commission defines the geographic dimension of a market to include all of the relevant spatially dispersed sources of supply to which buyers would turn, whenever competition occurs.

75. In Decision 559 the Commission considered that the geographic markets should be defined by DHB district, except where two or more DHBs are collaborating together (e.g., Otago and Southland), in which case the geographic area of the market should be the broader region comprising the relevant DHB districts.

76. In this case, the Capital & Coast (C&C) and Hutt Valley DHBs have the option to collaborate for the provision of community testing, in a similar fashion to Otago and Southland. The two DHB have issued a joint RFP for community testing. Thus the Commission considers that the relevant geographic market is the broader region comprising both the C&C and Hutt Valley DHBs. The Commission defines this broader region as the greater Wellington region.

77. Thus, the Commission considers that the appropriate geographic market for the purposes of assessing the application is the greater Wellington region.

Cervical Screening Tests

78. In Decision 559, the Commission defined a national market for the provision of cervical screening tests. The Commission does not depart from that definition in its consideration of this Application.

Temporal Dimension

79. The Commission typically adopts a two year time horizon over which to analyse the likely future competition effects of a proposed merger. However, where a market is characterised by infrequent transactions, the Commission may define a time dimension for the market that deviates from this two year horizon. Time considerations are important where there are long-term contracts, as in the markets considered for this application, where the exclusive right to provide community testing is conferred for five years.

80. The Commission considers the impact of the proposed merger at the point in time at which it would have effect, which is when pathology contracts are next awarded. In this case, the proposed contract term is five years.

81. Thus, the Commission analyses competition at the current point in time (the current contract round) as well as in five years' time (the next contract round).

Conclusion on Market Definition

82. On balance, the Commission concludes that the relevant markets for the purpose of analysing the proposed acquisition are:

    - the market in the greater Wellington region (comprising the C&C DHB region and the Hutt Valley DHB region) for the provision of community testing pathology services; and
    - the national market for the provision of cervical screening tests.

COUNTERFACTUAL AND FACTUAL

83. In reaching a conclusion about whether an acquisition is likely to lead to a substantial lessening of competition, the Commission makes a "with" and "without" comparison rather than a "before" and "after" comparison. The comparison is between two hypothetical future situations, one with the acquisition (the factual) and one without (the counterfactual).[9] The difference in competition between these two scenarios is then able to be attributed to the impact of the acquisition.

Factual

Current Contract Round

84. In the factual scenario, the Commission considers that there is likely to be a sole supplier of community testing in either each of the Hutt Valley and C&C geographic markets or in the wider greater Wellington region (if the DHBs award the regional contract to a sole supplier).

85. In the factual, the merged entity would submit a bid for the provision of community testing for the combined C&C and Hutt Valley DHB districts (the regional contract). The Applicants stated that the submission of a bid will be conditional on Commerce Commission approval and the transaction is conditional on that bid being successful. This means that if the merged entity is not the successful bidder, the merger would not proceed. The shareholdings of the proposed merged company Labco are yet to be determined.

---

[9] Commerce Commission, *Decision 410: Ruapehu Alpine Lifts/Turoa Ski Resorts Ltd (in receivership), 14 November 2000*, paragraph 240, p 44.

86. Both parties advised the Commission that in the factual they would each bid for [

].

Table 1: Applicants Intentions to bid in the factual

Regional Contract	C&C separate contract	Hutt Valley separate contract
Labco Wellington	[ ]	[ ]

87. As stated above, Wellington Pathology and Valley are both likely to bid [

].

88. Because of this, the Applicants stated they have adopted a strict process to ensure that confidential information of each Applicant, that would otherwise not be available about their individual business, is not disclosed to the other.

89. Lindsey Lawton, an independent consultant, was engaged to gather and collate costing information about the Applicants' business and likely costs to supply the regional contract on their own, and the Applicants' views of the likely costs for the DHB laboratories to provide the services. CRA International was also engaged to review the costing data provided by Lindsey Lawton.

90. Both Lindsey Lawton and CRA International signed undertakings not to disclose to either Applicant the information provided by the other or to disclose to either Applicant any information containing data from both Applicants or any report they produce.

Next contract round

91. Although the terms and conditions of the merger have not yet been determined, the Applicants advised the Commission that there would be provisions in the contract for the merged company to 'de-merge' should the DHBs desire to return to separate contracting, or if Labco does not operate successfully.

92. However, if the joint venture is successful in securing the regional contract, and operates successfully over the period of the contract, then the Applicants advised the Commission that it is unlikely that either Wellington Pathology or Valley would submit separate bids for pathology contracts in either district in future. It is likely that there would be specific restraint of trade provisions in the merger contract preventing such behaviour.

Counterfactual

Current Contract Round

93. In the counterfactual scenario, the Commission considers that there is likely to be a sole supplier of community testing in either the greater Wellington region (if the DHBs award the regional contract to a sole supplier) or in each of the Hutt Valley and Capital & Coast (C&C) geographic markets.

94. In addition, the Commission considers [
] that each party would bid for the regional contract on its own. The Commission also considers that in the

counterfactual each party would bid for the separate contract in its area of incumbency - Valley would submit a bid for the Hutt district alone, and Wellington Pathology would submit a bid for the C&C district alone.

95. In its individual confidential submission to the Commission, Valley stated that it [

] the Commission considers it would be a relatively simple operation to set up collection centres in the neighbouring region and transport samples from Wellington Central back to Valley's laboratory in the Hutt Valley. The Commission considers that Valley would have the incentive to submit a bid for the C&C contract alone, and would have the ability to provide services to the region in the counterfactual.

96. Wellington Pathology's individual confidential submission to the Commission stated that it would [

].

97. It is uncertain whether Valley and Wellington Pathology would submit a bid for the district in which each is not the incumbent. For the purposes of assessing this Application, the Commission has taken the conservative view of assuming that both Valley and Wellington Pathology would submit a separate bid for each of the Hutt Valley and C&C separate contracts in the counterfactual.

Table 2: Potential Bids in the counterfactual

Regional Contract	C&C separate contract	Hutt Valley separate contract
Wellington Pathology Valley	Wellington Pathology Valley (possibly)	Valley Wellington Pathology (possibly)

Next contract round

98. If Wellington Pathology is not successful in this contract round, it would likely not exist in five years time to bid for another contract. Abano has one other pathology operation in New Zealand – Nelson Diagnostic Laboratory – but this laboratory does not employ any pathologists and is supported to some extent by Wellington Pathology. Wellington Pathology stated that its Nelson laboratory would not be a sustainable operation on its own.

99. If Valley is not successful in the current contract round, the Commission considers it would still exist to bid for contracts in the future. While the Valley operation may close down, Sonic has a number of other pathology businesses around New Zealand, and could bid for work in the greater Wellington region in five years time.

COMPETITION ANALYSIS – COMMUNITY TESTING IN THE GREATER WELLINGTON REGION

100. The Commission identifies the likely potential bidders in the greater Wellington region both presently and in five years time, under the factual and the counterfactual.

101. In Decision 559 the Commission analysed competition by identifying the potential bidders in the factual and counterfactual scenarios under the following categories:
    - previous providers to the region;
    - new domestic bidders;
    - international bidders;
    - DHB-owned laboratories outside the region; and
    - the local DHB-owned hospital laboratory.

102. The Commission identified a number of barriers to entry that potential providers would face to varying degrees when submitting a bid to provide testing in a region. These entry barriers were:
    - access to technical labour;
    - capital;
    - scale of operations;
    - incumbent knowledge; and
    - reputation and prior relationships with the purchasing DHBs.

103. The Commission has analysed the potential bidders on the basis of the barriers (identified in Decision 559) that they would face in the factual and the counterfactual scenarios. The Commission considers that the entry barriers would be more readily overcome by some providers than others.

104. In relation to new domestic bidders, the Commission considers that the conclusions in Decision 559 still hold for the greater Wellington region. Accordingly, the Commission considers that new domestic bidders such as Medlab Taranaki Ltd, Pathology Associates Ltd and Northland Pathology Laboratory Ltd[10] would face a number of significant barriers to entering the greater Wellington region. The Commission considers that in both the factual and the counterfactual, these new domestic bidders would be unlikely to bid for community testing in the greater Wellington region.

105. In Decision 559 the Commission considered Abano (parent company of Wellington Pathology) as a new domestic bidder and concluded that it would be unlikely to bid for contracts outside its current area of operation. This Application concerns Abano's incumbent area of operation, and thus Wellington Pathology is analysed as a 'previous provider to the region'.

---

[10] NPL attended the 6 September RFP meeting. [

].

106. In relation to international bidders, the Commission considers that the conclusions in Decision 559 still hold for the greater Wellington region. The Commission considers that in both the factual and the counterfactual, international bidders such as Mayne Pathology Ltd, St John of God Pathology Ltd and Healthscope Ltd would face substantial entry barriers and would be unlikely to bid for contracts in the greater Wellington region.

107. Therefore, in this instance the Commission has analysed likely potential bidders according to the following categories, under the factual and counterfactual:

- previous providers to the region: Wellington Pathology, Valley, NZDG, and in the factual the merged entity;
- DHB laboratories outside the region: CHL; and
- the local DHB-owned laboratories: C&C DHB hospital laboratory, and Hutt Valley hospital laboratory.

Previous Providers to the Region

Merged Entity

108. In the factual, the merged entity would submit a bid for the regional contract (Hutt Valley and C&C districts combined), but would not bid for either single-district contract on its own.

109. Between them, Wellington Pathology and Valley provide the majority of community testing for the two regions. As both providers are incumbents in their respective regions, the merged entity would enjoy the benefits of incumbency that follow. By combining the current facilities, staff and infrastructure each party has in place in the greater Wellington region, the merged entity would not face any barriers to undertaking the regional contract.

110. The Applicants considered that considerable savings can be derived in the factual by the Applicants utilising their complementary collection facilities and resources in the Hutt Valley and C&C DHB districts, and providing community pathology services for both districts through Labco.

111. The DHBs expect efficiencies to arise from combining the testing of the two regions, which may offer the greatest savings to the DHBs. However, the Commission considers that there is no certainty that the DHBs will pursue the regional contract. A bid for the C&C or Hutt Valley district alone may be more attractive to the DHB and there may be greater savings and efficiencies gained from combining the hospital and community testing in either of the separate districts.

112. Wellington Pathology stated that from its perspective, the major rationale for the merger was the elimination of risk regarding the recruitment of technical labour, particularly pathologists. Wellington Pathology and Valley have sufficient pathologists between them to carry out the regional contract, and would have no need to recruit additional staff.

113. As the parties have current facilities and infrastructure covering each of the regions, the capital outlay for the merged entity would be minimal. The parties expect that Wellington Pathology's current laboratory would be expanded to be able to perform the extra volumes of testing, while Valley's laboratory would be

closed down[11]. The expansion of Wellington Pathology's current laboratory may require some capital investment, but any additional equipment needed would be provided by Valley.

114. Capital is unlikely to be a substantial barrier in any case, as Valley is a subsidiary company of Sonic Healthcare, one of the world's largest medical diagnostics companies with an annual turnover of approximately $1.3 billion.

115. The merged entity may be able to benefit from the scale of operations of Sonic, which would give the merged entity greater buying power with respect to reagents, equipment and other raw materials. Although the merged company would be a new entity, both Wellington Pathology and Valley have long standing relationships with the DHBs in the greater Wellington area and have reputations as strong and capable service providers.

Wellington Pathology

116. Wellington Pathology was originally formed from a medical partnership established in 1932. It was one of the first private medical testing services established in New Zealand. Wellington Pathology has a large central laboratory on Courtenay Place and 10 collection centres located around the Wellington area.

117. Wellington Pathology is the incumbent in the C&C DHB district. It has an annual revenue of approximately [ ], [ ] of which comes from pathology testing undertaken for and paid by the C&C DHB. The remainder includes private pathology testing and cervical screening tests. It performs approximately [ ]% of all community testing in the area (the remainder is performed by Valley and NZDG, and relates primarily to specialist testing and testing in the Kapiti area).

118. Although it does not have a contract with the Hutt Valley DHB, Wellington Pathology provides a small amount of testing for Hutt Valley. This work relates to testing done on the fringes of the two regions. [

] the Commission considers that the barriers faced by Wellington Pathology in bidding for the Hutt Valley contract alone would be similar to the barriers faced when bidding for the regional contract. The Commission considers that Wellington Pathology may bid for the Hutt Valley contract alone in the counterfactual scenario.

119. Wellington Pathology stated [

].

120. The Commission considers that Wellington Pathology would submit a bid for the regional contract in the counterfactual. The Commission assessed the extent to which Wellington Pathology would be a strong competitor for the regional contract, based on the barriers it would face in expanding to undertake all testing for the combined region.

---

[11] These details are yet to be agreed between the parties.

Technical Labour

121. Wellington Pathology stated that one of the major risks of bidding on its own for the regional contract is being unable to recruit the necessary pathologists. If it was successful in securing the regional contract, it would need to recruit a part-time microbiologist, a part-time biochemist, a part-time haematologist and a full-time anatomical pathologist. It would attempt to recruit the outgoing Valley pathologists. However, as Valley is a Sonic subsidiary, Sonic could attempt to find employment for these pathologists in its other operations in New Zealand or Australia.

122. Alternatively, Wellington Pathology would attempt to increase the proportion of time its current pathologists work for it rather than for the C&C hospital laboratory (most of its pathologists work part-time at both). However, the Commission understands that pathologists tend to prefer to work in a mix of the private and public sector, and would be unlikely to accept employment in the private sector only.

123. Unlike Sonic and NZDG, Wellington Pathology does not have access to a pool of pathologists from other regions. Thus, it is unable to fill temporary shortages using pathologists from regions outside Wellington. Abano's Nelson pathology business does not employ any pathologists.

124. Wellington Pathology stated that [ ]. The Commission considers that access to technical labour would be a moderate barrier for Wellington Pathology in bidding for the regional contract in the factual.

Access to Capital

125. Capital is unlikely to be an issue for Wellington Pathology as it already has substantial infrastructure in the region. It would need to increase the capacity of its existing laboratory by expanding the facilities and purchasing (or leasing additional equipment), and would need to set up collection centres in the Hutt Valley region.

126. Wellington Pathology is a subsidiary of Abano, which has an annual turnover of approximately $66 million. The Commission considers that access to capital is unlikely to represent a barrier for Wellington Pathology bidding for the regional contract in the counterfactual.

Scale

127. Wellington Pathology would be at a scale disadvantage compared to the national scale of operations of Valley (Sonic) and NZDG. As stated above, it does not have a pool of expertise around the country. It is unable to centralise testing by shifting samples to an operation in another region, and it would not benefit from scale advantages when purchasing reagents and equipment.

128. However, Wellington Pathology is the largest pathology provider in the greater Wellington region, and would not have to upscale to the same extent as Valley or a new entrant to the region.

Incumbent Knowledge and Reputation with DHBs

129. Wellington Pathology would have good knowledge of the C&C district, but limited knowledge of testing in the Hutt Valley. This incumbent knowledge may give Wellington Pathology an advantage over completely new providers, when forecasting the cost of provision.

130. As Wellington Pathology has operated in the region since 1932, it is likely to be recognised by the DHBs as a strong and capable service provider.

Conclusion on Wellington Pathology

131. The Commission considers that Wellington Pathology would face barriers relating to access to technical labour and lack of scale, in contesting for the regional contract.

132. However, as the largest pathology provider in the greater Wellington region, the Commission considers it would be likely to overcome these barriers and would be a strong competitor for the regional contract in the counterfactual.

133. The Commission considers that Wellington Pathology would also be a strong competitor for the C&C contract alone in the factual and the counterfactual. As stated in the counterfactual section above, it may also be a contender for the Hutt contract in the counterfactual, but not in the factual.

Valley

134. Valley has a laboratory located in Lower Hutt and seven collection centres, four of which are located within the Hutt Valley DHB district, two on the Kapiti Coast and one in Wairarapa.

135. Valley is the incumbent in the Hutt Valley DHB district. It has an annual revenue of approximately [ ], [ ] of which comes from pathology testing undertaken for and paid by the Hutt Valley DHB. The remainder includes private pathology testing, cervical screening tests and testing for the C&C DHB district.

136. Although Valley does not have a contract with the C&C DHB, approximately [ ]% of Valley's revenue is derived from testing undertaken for the C&C DHB. These volumes are then accounted for in intra-district flows. This volume of testing accounts for approximately [ ] of all community testing in the C&C district. Valley advised the Commission that the testing undertaken for the C&C DHB district was mainly specialist referred testing and testing for the Kapiti area.

137. Dr Karen Wood, Pathologist, Valley, stated that Valley picked up this volume of testing from the C&C DHB district as it was able to offer superior service and faster turnaround times than Wellington Pathology.

138. [ ].

139. [ ] the Commission considers that the barriers faced by Valley in bidding for

the C&C contract alone would be similar to the barriers faced when bidding for the regional contract. The Commission considers that Valley may bid for the C&C contract alone in the counterfactual scenario.

140. The Commission considers that Valley would submit a bid for the regional contract in the counterfactual. The Commission assessed the extent to which Valley would be a strong competitor for the regional contract, based on the barriers it would face in expanding to undertake all testing for the combined region.

Technical Labour

141. Although Valley has some technical staff and pathologists in the region, if it was successful in securing the regional contract it would need to recruit a part-time microbiologist, a part-time biochemist, a part-time haematologist and a full-time anatomical pathologist.

142. Valley would attempt to increase the proportion of time its current pathologists work for it rather than for the Hutt Valley hospital laboratory, or recruit Wellington Pathology's outgoing pathologists. However, even if it was unsuccessful in doing this, the Commission considers that access to technical labour would be less of an issue for Sonic than it would be for smaller providers.

143. Given Sonic's scale and access to funds, it would have the financial resources to offer sufficiently attractive employment conditions to secure the requisite staff. In addition, Sonic has access to a significant pool of technical staff outside the Hutt Valley district. In Decision 559, Sonic advised the Commission that it regularly moves staff between regions to meet short-term needs.

144. The Commission considers that although Valley would need to recruit additional staff to undertake the regional contract, access to technical labour would not be a significant barrier to entry for Valley.

Access to Capital

145. In bidding for the regional contract, Valley is likely to face a larger capital outlay than Wellington Pathology, as the C&C testing is worth approximately [ ] compared to the [ ] of Hutt Valley testing. Dr Karen Wood advised the Commission that Valley's laboratory in Lower Hutt is [ ] and would need to be expanded or relocated to be able to cope with the extra volume from the C&C district.

146. However, the Commission considers that access to the necessary capital is unlikely to be a significant barrier for Valley. Sonic Healthcare has an annual turnover of $1.3 billion. Through its three other subsidiary companies in New Zealand, Sonic may be able to source excess equipment to aid expansion for the regional contract. It may also be able to shift some non-urgent samples to its operations in other regions, thus limiting the capital investment necessary within the greater Wellington region.

Scale

147. In Decision 559, industry participants advised the Commission that operational scale offers many advantages in the provision of pathology services. Valley would benefit from the scale advantages of its parent company, Sonic, which

has pathology operations in a number of other regions nationwide, and in Australia.

148. Sonic's scale of operations may offer benefits such as:

- purchasing power in relation to equipment, reagents and raw materials;
- access to a large pool of technical expertise; and
- the ability to shift samples between regions for non-urgent testing.

Incumbent knowledge and reputation with DHBs

149. In bidding for the regional contract, Valley would have good knowledge of the Hutt Valley district and some knowledge of the C&C DHB district (as it undertakes a small amount of testing for that district). This incumbent knowledge may give Valley an advantage over completely new providers when accurately forecasting the cost of provision. Valley (through its parent company Sonic) also has the ability to pool information and benchmark volumes and costs with its other operations.

150. Valley has a long-standing relationship with Hutt Valley DHB but no current relationship or contract with C&C DHB. However, Sonic is a nationwide (and worldwide) pathology provider and would likely be recognised by the DHBs as a strong and capable service provider.

Conclusion on Valley

151. The Commission considers that Valley would face minimal barriers to undertaking the regional contract in the counterfactual scenario and would be likely to provide strong competition to Wellington Pathology for this contract.

152. The Commission considers that Valley would also be a strong competitor for the Hutt Valley contract alone in the factual and the counterfactual. As stated in the counterfactual section above, it may also be a contender for the C&C contract in the counterfactual, but not in the factual.

NZDG

153. NZDG performs some testing for the Kapiti area (with a value of [ ]). It does not have a laboratory in the area, but transports all samples to its Christchurch laboratory.

154. NZDG advised the Commission that it has attended all pre-tender meetings for the current RFP process in the greater Wellington region. [

].

155. [

].

156. [

].

157. [

].

158. [ ] and are likely to view NZDG as strong competitive threat because of its past behaviour and the low barriers to entry it faces.

159. NZDG has the reputation of being an aggressive competitor from the perspective of other pathology services providers. Historically, NZDG has been aggressive in entering new regions. Its expansion plans were initially facilitated by its nationwide contract with Otago DHB, under which it could provide testing in any region and all testing would be paid for by the Otago DHB. This contract has now been devolved, but the new "winner-takes-all" arrangements via RFP processes are likely to give NZDG the opportunity to continue to expand into other regions.

160. [

].

161. [ ] the Commission considers the threat of competition from NZDG would place a constraint on bid prices in the factual and the counterfactual scenarios. This threat is heightened due to the low barriers to entry that NZDG would be likely to face.

<u>Technical Labour</u>

162. NZDG may be at a disadvantage to either incumbent operator (Wellington Pathology or Valley) with respect to technical labour. Although Wellington Pathology and Valley would need to recruit additional staff, they each have some pathologists located within the region. NZDG does not currently have a laboratory or pathologists within the wider region.

163. However, the Commission understands that the RFP does not specify that pathologists must be employed within the region, or that all testing must be undertaken within the region. Providers simply need to ensure they can meet the required turnaround times. NZDG confirmed this with the DHBs at a pre-tender meeting. [

].

164. NZDG stated that it currently has a large pool of pathologists and would not necessarily want to pick up outgoing pathologists from Valley and Wellington Pathology if it was successful in winning a contract for the greater Wellington region.

165. Decision 559 concluded that access to technical labour would be less of an issue for NZDG than it would be for other smaller operators. In the greater Wellington region, even if NZDG was required to employ pathologists within

the region, NZDG did not perceive this to be a major barrier, as it would be able to fill temporary vacancies with staff from other regions.

Access to Capital

166. [ ], the capital investment needed would be minimal. [ ].

167. [ ], it may be able to source excess equipment from its other operations. NZDG operates from an asset base of [ ] so access to capital is unlikely to present a barrier.

Scale

168. NZDG is a national pathology services operator and is able to benefit from the scale advantages that follow. NZDG's scale of operations may offer benefits such as:

- purchasing power in relation to equipment, reagents and raw materials;
- access to a large pool of technical expertise; and
- the ability to shift samples between regions for non-urgent testing, [ ].

Incumbent Knowledge and Reputation with DHBs

169. NZDG has only a small presence in the C&C region (Kapiti) and no presence in the Hutt Valley region. However, the Commission concluded in Decision 559 that NZDG would have the ability to pool information and benchmark volumes and costs when tendering for new contracts. The Commission considers that this continues to be the case.

170. NZDG does not have a contract with the C&C or Hutt Valley DHBs. However, as a well respected national operator, the DHBs are likely to view NZDG as a strong and competent operator. NZDG has provided services at some point to 13 of the 21 DHBs around the country.

Conclusion on NZDG

171. The Commission considers that NZDG would face minimal barriers in contesting for community contracts in the greater Wellington region. The Commission considers that other providers would recognise this and would view NZDG as a strong potential competitor for either the regional contract or either separate contract in both the factual and the counterfactual.

172. The Commission considers that the threat of competition from NZDG would be likely to provide substantial constraint on the merged entity in the factual.

DHB laboratories outside the region

CHL

173. In Decision 559, the Commission assessed the possibility of bids from DHB laboratories outside the relevant regions. The Commission considered that CHL and LabPLUS, as the two largest specialised laboratories in NZ, would be the most likely DHB-owned laboratories to expand beyond their own DHB district. The Commission concluded that LabPLUS and CHL would face a number of

barriers to entering another region and would be unlikely to bid for contracts outside their own DHB district.

174. The Applicants submitted that there are strong reasons to believe that CHL is gearing up to bid for community work in regions outside the Canterbury area.

175. In Decision 559, CHL advised the Commission that it would not tender for full service contracts outside its traditional region because:

- [ ]; and
- expansion into other regions is outside the terms of reference set by DHBs for their own hospital laboratories, and would be unlikely to receive DHB approval.

176. The Commission revisited these issues with CHL in relation to the current merger proposal. CHL again reiterated the reasons given in the last decision.

177. It stated that it had attended the 6 September pre-tender meeting because it receives a substantial volume of send-away tests from the providers in the region and does not want to risk losing these tests as a result of the current RFP round. Peter George, Clinical Director, CHL stated that [ ].

178. CHL listed barriers it would face in bidding outside its traditional area of operation relating to:

- access to capital;
- the inability of a DHB-owned hospital laboratory to act in a business-like manner outside their region; and
- DHB approval.

179. CHL has been contacted by all four providers in the greater Wellington region (the two hospital laboratories and the two community providers) in relation to subcontracts for send-away testing for the region.

Local DHB hospital laboratories

180. The Applicants submitted that the threat from the DHB hospital laboratories in C&C and Hutt Valley is a very real constraint.

181. Representatives from the C&C and Hutt Valley hospital laboratories attended the RFP discussion meeting of 6 September 2005. The Applicants submitted that they have been given the impression by the DHBs that the DHB hospital laboratories are likely to submit serious responses to the RFP and that responses are to be submitted only if they are considered to be realistic and achievable. The DHB funder arms confirmed this.

182. [ ].

183. [

].

184. [ ], the Commission has assessed the extent to which a bid from each hospital laboratory for its respective district would constrain the merged entity's bid for the regional contract in the factual.

185. In Decision 559, the Commission considered that in each of the relevant regions, the hospital laboratory would be unlikely to provide sufficient constraint on its own to prevent a substantial lessening of competition. The Commission identified a number of barriers to entry for hospital laboratories:

- the uncertainty of securing critical technical labour such as pathologists;
- access to the capital necessary to set up an integrated laboratory services business;
- the ability of the DHB to benchmark and appropriately cost services after the length of the contract period;
- the absence of managerial community laboratory services knowledge; and
- the transfer of volume and cost risk back to the DHB.

186. The Commission has revisited the barriers for hospital laboratories identified in Decision 559, in the context of the greater Wellington region.

C&C DHB hospital laboratory

187. [

].

188. As stated above, [

].

189. The C&C DHB hospital laboratory is a large, capable and specialised hospital laboratory. CHL advised the Commission that the C&C hospital laboratory was probably the third-most specialised hospital laboratory in the country, behind LabPLUS and CHL. It performs most send-away specialised tests itself, sending only a small proportion to CHL. It also performs send-away tests for the Hutt Valley hospital laboratory and the community laboratories in the region. The hospital laboratory also provides support to other DHB-owned hospital laboratories, such as Wairarapa and the Hutt Valley.

190. NZDG considered its most competitive threat in the C&C and Hutt Valley districts would have come from the hospital laboratories in the districts because:

- the hospital laboratories can marginally cost; and
- there are efficiencies to be gained from combining the hospital and community testing.

Technical Labour

191. Russell Cooke of the C&C hospital laboratory stated that the laboratory currently employs pathologists in every specialty. In order to perform the community testing as well as the hospital testing for the C&C region, the hospital laboratory would need to recruit additional staff. It would need to recruit 3 FTE pathologists and to make full-time all the clinical pathologists that are currently part-time. It would also need to recruit approximately 50 technical staff (lab technicians). The hospital laboratory considered that access to the required technical labour represents a barrier for it.

192. However, nearly all of the pathologists working in the C&C DHB district work in both the private and public sector. If the hospital laboratory was successful in its bid for the community work in the region, it could attempt to simply increase the proportion of time its current pathologists work for it rather than for the community laboratories (these pathologists would no longer have work in the private sector if Wellington Pathology did not win the contract). Increasing the work time of currently employed pathologists may be simpler than recruiting pathologist from elsewhere.

193. In Decision 559, the Commission was advised that pathologists in the private sector are typically better paid than in the public sector. However, Wellington Pathology advised the Commission that in the Wellington region DHB pathologists' salaries are on a par with the salaries paid by private providers. In fact, Wellington Pathology stated that it recently had to match the salary of a pathologist in the public sector.

194. The Commission considers that although access to technical labour may represent a moderate barrier for the hospital laboratories, it is a barrier that could be overcome.

Access to Capital

195. The C&C hospital laboratory's business case included a proposed required capital investment of [ ]. This outlay would be needed for additional equipment, expansion of the current laboratory, collection centres and a courier network. Russell Cooke estimated that the current laboratory at the hospital would need to increase in size by about [ ].

196. Although the level of capital investment would be larger for the hospital laboratories than for a private provider such as Wellington Pathology or the merged entity, [ ]. Consequently, the Commission considers that access to capital is unlikely to be a substantial barrier to entry for the C&C DHB hospital laboratory.

Benchmarking

197. When estimating the cost of provision, the hospital laboratory would be at a disadvantage to the community providers, as it has never undertaken a substantial amount of community testing. The hospital laboratory may be able to benchmark the costs of community testing against its current costs of hospital testing in the district. There are however, a number of differences between the two types of testing and resultant cost estimates may not be accurate.

198. The C&C and Hutt Valley DHB funder arms considered that it was important for them to ensure that the DHB-owned hospital laboratories submitted realistic

cost estimates for the provision of services. [

].

199. The DHB hospital laboratories have been provided with testing volumes for all community testing, including specialist testing, which may be included or excluded from the community contract. Russell Cooke of the C&C hospital laboratory believed [

].

200. [

].

201. The Commission considers that the ability to benchmark represents a moderate barrier to entry for the C&C hospital laboratory.

Corporate knowledge

202. [ ] stated that the biggest challenge for the hospital laboratory was the 'out-of-lab' set-up as it would represent a 'new business line' for the laboratory. [ ] stated that the hospital laboratory had no history in the provision of community testing and the successful set up of collection centres and courier networks posed a real risk to its bid for community testing. Of the [ ] of capital outlay required, [ ] related to setting up infrastructure in the community.

203. [

].

Transfer of risk

204. The DHBs are seeking to generate reductions in the cost of pathology services. The DHBs stated that one of the major rationales for the move from a fee-per-test funding model to a single provider model was the shift of volume and cost risk from the DHB to a pathology provider.

205. If the DHB decided to contract community testing to its provider arm, it would continue to bear the volume and cost risk for the provision of community testing. The C&C and Hutt Valley DHBs confirmed that the inability to transfer this risk would be a consideration for it when assessing the hospital laboratory's proposal.

Hutt Valley DHB hospital laboratory

206. The Hutt Valley hospital laboratory currently has a budget of [ ] to perform hospital testing for the Hutt Valley hospital. The hospital laboratory employs 3.6 FTE pathologists. It receives pathologist support from C&C hospital laboratory, for microbiology and serology in particular.

207. Representatives from the Hutt Valley hospital laboratory attended the RFP discussion meeting of 6 September. As with the C&C hospital laboratory, the Applicants submitted that they have been given the impression by the Hutt

Valley DHB that the hospital laboratory is likely to submit a bid, either on its own or jointly with C&C DHB laboratory.

208. [

]:

- [ ].

209. However, Patrick Hussey, CFO, Hutt Valley DHB, also stated that [

].

210. The Hutt Valley hospital laboratory is likely to receive support from the C&C hospital laboratory for any potential bid for community testing. The C&C and Hutt Valley DHBs have signed a memorandum of understanding (MoU), which states that the hospital laboratories will work together and support each other in achieving their objectives "to collaborate on the hospital laboratory services".

211. The MoU provides for joint purchasing of reagents and other consumables for bulk discounts, and the purchase or lease of similar equipment to improve the comparability of testing across the sub region and the ability to provide back-up.

Technical Labour

212. Stephen Silk, laboratory manager, Hutt Valley hospital laboratory, stated that the laboratory currently employs anatomic pathologists and two private pathologists. It receives pathologist support from the C&C DHB hospital laboratory for microbiology and serology. Stephen Silk stated that the hospital laboratory needs this experience and it also helps the laboratory maintain its IANZ accreditation.

213. In order to undertake community testing for the Hutt Valley DHB region, the laboratory would need to recruit additional staff. Patrick Hussey, CFO, Hutt Hospital, stated that the hospital laboratory would need to recruit a total of 60 additional staff, including a number of senior pathologists. Mr Hussey stated [

] the laboratory would be likely to receive some pathologist support from the C&C hospital laboratory.

214. The Commission considers that access to technical labour represents a substantial barrier for the Hutt Valley hospital laboratory.

Access to Capital

215. Employees of the hospital laboratory advised the Commission that the volume of testing required for combined hospital and community testing in the Hutt Valley region would be four times the hospital laboratory's current volume. [

].

216. [

].

217. The Commission considers that access to capital would likely present a substantial barrier to entry for the Hutt Valley DHB hospital laboratory.

Benchmarking

218. As stated above, hospital laboratories would be at a disadvantage to the community providers when estimating the cost of provision, as they have never undertaken a substantial amount of community testing. The hospital laboratory may be able to benchmark the costs of community testing against its current costs of hospital testing in the district. There are however, a number of differences between the two types of testing and resultant cost estimates may not be accurate.

219. The Commission considers that the ability to benchmark represents a moderate barrier to entry for the Hutt Valley hospital laboratory.

Corporate knowledge

220. [

].

221. [

].

222. The Commission considers that lack of corporate knowledge would represent a substantial barrier to entry for the Hutt Valley hospital laboratory.

Transfer of risk

223. As stated above, if the DHB decided to contract community testing to its provider arm, it would continue to bear the volume and cost risk for the provision of community testing. The C&C and Hutt Valley DHBs confirmed that the inability to transfer this risk would be a consideration for it when assessing the hospital laboratory's proposal.

224. In addition to the volume and cost risk associated with contracting with the DHB hospital laboratory, [

].

Conclusion on hospital laboratories

225. The Commission considers that the C&C hospital laboratory would face some barriers to providing community testing in the C&C DHB district. However, the hospital laboratory seemed confident that it would be able to overcome these barriers and [ ] submit a competitive bid for the provision of community testing. The community providers in the region view the C&C DHB hospital laboratory as a strong competitor for the contract.

226. The Commission considers that the Hutt Valley hospital laboratory would face substantial barriers to providing community testing in the Hutt Valley DHB district. The Commission considers that the Hutt Valley DHB hospital laboratory is unlikely to be as strong a competitor for community testing as the C&C hospital laboratory. The hospital laboratory [ ] the community providers in the region view the Hutt Valley DHB hospital laboratory as a strong competitor for the contract.

227. The Commission concludes that the threat of a bid from either DHB hospital laboratory (either jointly or on their own) would provide some constraint on the merged entity in the factual, but this constraint would not be sufficient on its own to prevent a substantial lessening of competition in the community testing market.

Sealed bid process

228. Industry participants advised the Commission that a number of interested parties attended the 6 September 2005 meeting held by the DHBs to discuss the bid process. Among these attendees were CHL, NZDG, Northland Pathology Lab, Valley Diagnostics, Wellington Pathology, representatives from the C&C hospital laboratory, and representatives from the Hutt Valley hospital laboratory.

229. Although the actual number and identity of bidders may differ from the full list of potential bidders identified above [ ], the RFP process is a closed bid process and the Commission understands that neither the DHB funder arms nor any of the potential bidders are aware of which parties will actually submit a bid. In this sealed bid scenario, the threat of competition from each potential bidder may place a constraint on the bid prices of the merged entity in the factual scenario.

230. For instance, it may be the case that [ ] for the regional contract. However, [ ]. As discussed above, NZDG has historically been an aggressive competitor continually looking to expand its operations into new regions around the country. [ ].

Next contract round

231. The Commission has assessed the potential bidders for the regional contract (presuming the DHBs decided to pursue this option) at the end of the contract

period. In the factual, the potential competitors would be as set out in Table 3 below:

Table 3: All Likely Potential Bidders at the Next Contract Round

Factual	Counterfactual (if Wellington Pathology won the regional contract in this contract round)	Counterfactual (if Valley or another party won the regional contract in this contract round)
	Wellington Pathology	
Labco	Sonic	Sonic
DHB hospital laboratories	DHB hospital laboratories	DHB hospital laboratories
NZDG	NZDG	NZDG

232. As Table 3 indicates, in the counterfactual, if Wellington Pathology is not successful in the current contract round, it would not exist to bid for a community testing contract in the C&C and Hutt Valley DHB districts at the next contract round.

233. In the counterfactual, if Valley is not successful in this contract round, its Sonic parent would still exist (as it has three other pathology subsidiaries) to bid in the next contract round.

234. In the factual and counterfactual scenarios, both NZDG and the hospital laboratories would exist to bid for either the regional contract or separate contracts. The barriers faced at this point in time would likely be similar to the barriers discussed above in relation to each party.

235. Both NZDG and the hospital laboratories advised the Commission that they hope to be strong contenders for future contracts in the region, should they not be successful in this round. [

].

236. The C&C and Hutt Valley DHBs stated that [

] set the hospital laboratory up to be a stronger bidder the next time the services are tendered.

Countervailing Power

237. In some circumstances the potential for the combined entity to exercise market power may be sufficiently constrained by a buyer or supplier to eliminate concerns that an acquisition may lead to a substantial lessening of competition. DHBs fund approximately 96% of all pathology services for their regions. As such, they are effectively the sole purchaser of pathology services in their region. The Commission has assessed the extent to which the countervailing power of the C&C and Hutt Valley DHBs as the sole purchasers of pathology services would provide a constraint on Labco in the factual.

238. In Decision 559, the Commission considered that in the move to a bulk-funded single-provider model, the DHB would no longer set the price, and would

instead rely on market forces (ie through competitive bidding) to determine the price. Under this new framework, the Commission considered that in the counterfactual, DHBs would have the ability to influence this price by playing various competitors off against one another.

239. The Applicants submitted that the C&C and Hutt Valley DHBs would exert a significant degree of countervailing power over the Applicants, both in the factual and the counterfactual.

240. The RFP designed by the C&C and Hutt Valley DHBs contains a number of options, thus maintaining a level of flexibility for the DHBs. The Commission considers that the DHBs have retained a degree of countervailing power through the way in which they have structured the RFP. If the DHBs do not wish to contract with the merged entity in the factual, they have the option of continuing with separate contracts for the C&C and Hutt Valley DHB districts.

241. The DHBs [

]. However, the DHBs did consider that they would have options at the end of the five year sole supplier contract because NZDG would exist to bid and the DHB-owned hospital laboratories would also pose a constraint. The Commission considers that the DHBs' options in this current contract round would be similar to its options at the end of the five year period.

242. However, the Commission considers that the DHBs did not exercise the full extent of their countervailing power in this contract round, and the Commission is unsure whether the DHBs will more fully exercise their countervailing power in future contract rounds. The DHBs stated that they did not want to receive a joint bid but did not consider specifying 'no joint bids' between private providers.

243. In conclusion, the Commission considers that while the countervailing power of the DHB is not sufficient on its own to prevent a substantial lessening of competition, it does provide some constraint on the combined entity post-merger.

Co-ordinated Market Power

244. An acquisition may lead to a change in market circumstances such that co-ordination between the remaining businesses is made more likely, or the effectiveness of pre-acquisition co-ordination is enhanced.[12]

245. The Commission has assessed whether the proposed merger would increase the likelihood of co-ordinated behaviour between Sonic and Abano, or Sonic and NZDG, in the greater Wellington region or in other regional markets.

246. The Commission has assessed whether the Application, if approved, would materially increase the prospects of co-ordination between:

- the Applicants (Sonic and Abano) in other regional markets; or
- Sonic and NZDG in the greater Wellington region or in other regional markets.

---

[12] Commerce Commission, *Mergers and Acquisitions Guidelines,* p33.

The Commission has assessed whether the potential for co-ordination would be such that the Commission can be satisfied that the mergers will not have, or would not be likely to have, the effect of substantially lessening competition in those other markets.

Sonic and NZDG

247. In Decision 559, the Commission considered that the proposed joint venture arrangements would inevitably establish strong relationships between NZDG and Sonic in the Otago/Southland, Hawke's Bay, Canterbury, South Canterbury and West Coast DHB regions. The Commission considered that establishing the relationship would change the market circumstances in other regions such that co-ordination between the parties, whether tacit or explicit, either is made more likely, or the effectiveness of pre-merger co-ordination is enhanced.

248. In Decision 559, the Commission declined Sonic and NZDG's Application to form joint venture arrangements in six DHB districts. The Commission considered that in the counterfactual scenario, NZDG and Sonic would continue to compete head-to-head in other regions.

249. However, in this Application the Commission has again assessed whether the current proposed merger would have the effect of changing market circumstances such that co-ordination between Sonic and NZDG would be made more likely, and whether the market circumstances would change through Abano and Sonic merging in the Wellington region.

250. In the present Application, [

].

251. As a potential competitor to NZDG and Sonic in other regions, Abano would potentially have the ability to break up any co-ordinated behaviour by bidding against either party in the counterfactual. In the factual, Abano and Sonic would have a merged business in the Wellington region.

252. However, in Decision 559, the Commission considered that Abano would be unlikely to exert much competitive constraint outside its regions of incumbency. The Commission considered that Abano would face barriers relating to operational scale, access to technical labour, reputation and lack of prior relationship with DHBs. The Commission continues to see competitive constraint from Abano as unlikely, and considers that the barriers for Abano would still exist. Given that the Commission considers that Abano would be unlikely to overcome these barriers, it is unlikely that Abano would pose a credible threat to Sonic and NZDG in either the factual or the counterfactual.

253. In the Wellington region, NZDG [

]. Thus, NZDG has signalled its intention to continue to compete head-to-head with Sonic in the greater Wellington region.

254. In addition, the Commission has evidence of Sonic and NZDG bidding against each other in other regions, as well as the regions relevant to this Application.

Industry participants advised the Commission that the Otago and Southland DHBs are re-tendering hospital and community services for the combined region and have asked all previous bidders (the hospital laboratories, Sonic and NZDG) to re-submit bids, with Sonic and NZDG submitting separate bids rather than a combined bid.

255. NZDG also advised the Commission [

].

256. The Commission considers that in the factual and the counterfactual NZDG and Sonic have the incentive to compete head-to-head for pathology contracts and appear to be doing so. As Abano does not intend to bid outside its regions of incumbency, the Commission considers that the proposed merger would not change the degree of constraint provided by Abano on Sonic and NZDG.

Sonic and Abano

257. The Commission considers that the proposed merger would give rise to a relationship between Sonic and Abano in the greater Wellington region, and the Commission has assessed the extent to which this relationship would change the market circumstances in other regions such that co-ordination between the parties, whether tacit or explicit, is made more likely, or the effectiveness of pre-merger co-ordination is enhanced.

258. The Applicants did not consider that a merger in the Wellington region would change their individual propensities for bidding for contracts in other DHB regions.

259. The Applicants stated that the merger of Valley and Wellington Pathology provides no incentive for Sonic to co-operate with Abano for other DHB contracts. Sonic has independent businesses in other regions where it has no commercial incentive to engage with Abano in bidding for any contracts.

260. Abano has a pathology business in one other region, the Nelson Marlborough DHB. Sonic has operations in this region, through its subsidiary Medlab South.

261. Both Applicants advised the Commission that they were [ ] for the Nelson Marlborough RFP, and these bids were due on 10 February, before bids for the greater Wellington region RFP. The Nelson Marlborough RFP contains a number of options for potential bidders. Providers could submit bids for either:

- hospital testing in the Nelson region;
- hospital testing in the Marlborough region;
- community testing in the Nelson region;
- community testing in the Marlborough region; or
- any combination of the above, including a bid for all testing for the entire DHB region.

The Nelson/Marlborough DHB is open to a single provider or multiple providers for the provision of services.

262. Abano stated that it has no incentive to co-ordinate with Sonic in this region as Sonic has quite a small presence in the region. Sonic does not employ any pathologists in the region – access to pathologists was a major rationale for Wellington Pathology merging with Sonic in the Wellington region. Sonic has a small Medlab South laboratory in the region, but transports the majority of testing to its Christchurch Medlab South operation.

263. Abano advised the Commission that it is the incumbent in the Nelson/Marlborough region, and will submit bids for the Nelson region on its own, the Blenheim region on its own, and for all testing for both regions.

264. The Commission understands that the Nelson and Blenheim DHB hospital laboratories [

].

265. The Commission considers that even if Sonic and Abano had the incentive to co-ordinate in other regions such as the Nelson/Marlborough region, there are likely to be other bidders such as the hospital laboratories and NZDG, who would disrupt or undermine any plans for co-ordinated behaviour.

266. The Commission considers that although the proposed merger would establish a relationship between Sonic and Abano in the greater Wellington region, the merger is unlikely to alter the market circumstances in the factual compared to the counterfactual such that co-ordination would be made more likely in other markets.

Conclusion on co-ordinated effects

267. The Commission concludes that the characteristics of the markets would not change significantly as a result of the proposed merger, and as such, the proposed merger would be unlikely to increase the likelihood of co-ordinated behaviour between any of the parties. In addition, the Commission has evidence of Sonic and NZDG actively competing against each other in the Otago/Southland region and in the greater Wellington region.

268. The Commission considers that the scope for co-ordinated behaviour in other regional markets would be unlikely to increase in the factual compared to the counterfactual, as a result of the proposed merger.

Conclusion on Community Testing in the Greater Wellington Region

Current Contract Round

269. The Commission has analysed the likely bidders for the greater Wellington region (separate contract and regional contract), both in terms of actual bidders and those that would pose a threat to the merged entity. Table 4 below details the potential bidders in the factual and the counterfactual scenarios.

Table 4: Current Contract Round - Potential Bidders in the Factual and the Counterfactual.

Factual	Counterfactual

Merged Entity (regional contract)	Wellington Pathology (regional contract and separate contracts)
[ ] [ ] [ ] [ ] [ ]	Valley Diagnostics (regional contract and separate contracts) [ ] [ ] [ ]

270. In the factual, there would be a loss of competition arising from Valley and Wellington Pathology bidding together as the merged entity, rather than bidding against each other for the regional contract in the counterfactual. In addition, the Commission considers that Valley may bid against the incumbent Wellington Pathology for the C&C contract alone in the counterfactual, and Wellington Pathology may bid against the incumbent Valley for the Hutt Valley contract alone in the counterfactual. Both parties are unlikely to do so in the factual.

271. However, the Commission considers that the competition provided by national pathology operator and previous provider, NZDG, as well as some constraint from the DHB-owned hospital laboratories, would constrain the merged entity in both the factual and the counterfactual, such that a substantial lessening of competition would be unlikely. In addition, the threat of other potential bidders in the closed bid process may place a constraint on the bid prices submitted by the merged entity in the factual.

272. The Commission also considers that while the countervailing power of the DHB is not sufficient on its own to prevent a substantial lessening of competition, it would provide some constraint on the combined entity post-merger. This constraint is derived from the way in which the RFP has been structured. The DHBs also have the option of continuing with separate contracts if they do not wish to contract with the merged entity.

Next Contract Round

273. In the next contract round, the Commission considers that there would continue to be competition provided by NZDG, as well as some constraint from the DHB-owned hospital laboratories.

274. In the factual and counterfactual scenarios, both NZDG and the hospital laboratories would exist to bid for either the regional contract or separate contracts. The barriers faced at this point in time would likely be similar to the barriers discussed above in relation to each party. The Commission concludes that NZDG and the DHB hospital laboratories would constrain the merged entity in both the factual and the counterfactual, such that a substantial lessening of competition would be unlikely. In addition, the threat of other potential bidders in future closed bid processes may place a constraint on the bid prices submitted by the merged entity in the factual.

Table 5: Next Contract Round - Potential Bidders in the Factual and Counterfactual

Factual	Counterfactual (if Wellington Pathology won the regional contract in this contract round)	Counterfactual (if Valley or another party won the regional contract in this contract round)
Labco DHB hospital laboratories NZDG	Wellington Pathology Sonic DHB hospital laboratories NZDG	Sonic DHB hospital laboratories NZDG

275. In addition, in the counterfactual, if Wellington Pathology is not successful in the current contract round, it would not exist to bid for a community testing contract in the C&C and Hutt Valley DHB districts at the next contract round. In this situation, there would be little difference between the factual and counterfactual scenarios.

NATIONAL CERVICAL SCREENING MARKET

276. The National Screening Unit (NSU) is a separate business unit within the MoH. It is responsible for the funding and operation of the Cervical Screening Programme, which governs the provision of cervical cytology testing in New Zealand. The NSU also contracts for histology services. Approximately 410,000 cervical smears are taken each year.

277. Wellington Pathology and Valley both have contracts with the NSU to provide cervical screening tests.

278. Cervical cytology is funded on a fee-per-test basis. The cost per test is set nationally across all providers in New Zealand [ ]. The duration of the contracts varies between one and three years, with annual review clauses.

279. In Decision 559, the Commission found that there are currently 12 pathology laboratories that hold contracts with NSU to provide cytology testing services. These providers are:

- Diagnostic Medlab (Sonic);
- Valley Diagnostic (Sonic);
- Medlab Central (Sonic);
- Medlab South (Sonic);
- Medlab Hamilton (NZDG);
- SCL Christchurch (NZDG);
- SCL Dunedin (NZDG);
- Medlab Bay of Plenty (PAL);

- Pathlab Waikato (PAL);
- Wellington Pathology (Abano);
- LabPLUS – Auckland hospital laboratory; and
- CHL – Christchurch hospital laboratory.

280. Post-merger, the cervical screening tests of Valley and Wellington Pathology would be provided by the proposed merged entity. In the factual, there would continue to be four other (non-Sonic / Abano subsidiary) providers in the national market for the provision of cervical screening tests: NZDG, PAL, CHL and LabPLUS.

281. As in Decision 559, the Commission considers that post-merger, there would continue to be considerable existing competition in the national market for the provision of cervical screening tests. In the factual, there would continue to be four providers of cervical cytology, other than Abano or Sonic subsidiaries.

282. In addition, the Commission considers that the NSU has a substantial degree of countervailing power. It decides who to contract with, and can cancel any providers' contract if it is not satisfied with the level of service provided. The Commission considers that the NSU is a price-setter. The fee per test is set across all providers. The NSU seemed particularly willing to maintain contracts with the two hospital laboratories and stated that it would be possible for these laboratories to undertake all cervical screening testing in New Zealand.

283. In conclusion, the Commission is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the national market for the provision of cervical screening tests.

OVERALL CONCLUSION

284. The Commission concludes that although the proposed merger would reduce the number of likely potential private provider bidders in the factual compared to the counterfactual, the merged entity in the factual would continue to face competition from NZDG and to some extent, the DHB-owned hospital laboratories in the greater Wellington region. The Commission considers that this constraint would exist in the current contract round as well as future contract rounds.

285. The Commission also considers that while the countervailing power of the DHB is not sufficient on its own to prevent a substantial lessening of competition, it would provide some constraint on the combined entity post-merger.

286. The Commission is therefore satisfied that the proposed merger will not have, or would not be likely to have, the effect of substantially lessening competition in the market in the Greater Wellington region for the provision of community testing pathology services.

287. In addition, the Commission is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the national market for the provision of cervical screening tests.

288. The Commission is therefore satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in any market.

DETERMINATION ON NOTICE OF CLEARANCE

289. Pursuant to section 66(3) (a) of the Commerce Act 1986, the Commission determines to give clearance for:

- the acquisition by Labco Wellington (a new company to be formed) of certain assets of the pathology services businesses of Wellington Pathology Limited and Valley Diagnostic Laboratories Limited; and
- the acquisition of shares in Labco Wellington, in approximately equal proportions, by Abano Healthcare Group Limited and Sonic Healthcare Limited or their wholly owned subsidiaries.

Dated this 31st day of January 2006

Paula Rebstock
Chair
Commerce Commission