COMMERCE ACT 1986: BUSINESS ACQUISITION
SECTION 66: NOTICE SEEKING CLEARANCE

31 July 2007

By email: registrar@comcom.govt.nz
The Registrar
Market Structure Group
Commerce Commission
PO Box 2351
WELLINGTON

Pursuant to s 66 (1) of the Commerce Act 1986 notice is hereby given seeking **clearance** of a proposed business acquisition.

SUMMARY

1. Clearance is sought for:

   (a) the acquisition of shares in JV Co (a new company to be formed) by the Southern Cross Health Trust ("SCHT") and QE Hospital Limited (trading as QE Health) ("QE") or companies owned by them; and

   (b) the acquisition by JV Co of the private surgical hospital businesses of Southern Cross Hospital Rotorua and QE Health Rotorua, including the shares held in QE Orthopaedics Limited by QE,

   ("the Proposal").

2. The Proposal will not substantially lessen competition in any market in New Zealand.

Rationale for the Proposal

3. Rotorua's two private hospitals owned by SCHT and QE are old and while SCHT and QE are currently satisfied "care" is not being compromised, they are concerned that unless a major upgrade is undertaken reasonably soon that "care" will be compromised. Further, SCHT and QE believe the people of Rotorua deserve better than what is currently available – at least, in terms of patient comfort. Generally, both SCHT and QE are "uncomfortable" with the state of their respective hospital facilities in Rotorua.

4. However, current revenues do not justify each of them upgrading their respective facilities. An upgrade of each hospital to meet modern standards would be significant and cannot be justified financially. Rather, the Proposal would provide for the hospital at the SCHT Otonga Road site to be refurbished. The investment needed for that is estimated at approx $8m.

5. SCHT operates for the benefit of all New Zealanders and QE operates for the benefit of the Rotorua patients and Rotorua more generally (in promoting the development of Rotorua as a health and spa city). Neither SCHT nor QE has an objective of profit maximisation. In SCHT's case its objects are to provide hospital facilities and services at low cost to New Zealanders. In QE's case, it is to provide excellence in rheumatology and rehabilitation services on its present site in Rotorua; to promote equity of access in the provision of rheumatology and rehabilitation services for the

community's benefit; to encourage the development of QE hospital at Rotorua; and to promote the development of Rotorua as a health and spa city.

6. Both SCHT and QE are of the view that if their objective was profit maximisation one or both of them would close their Rotorua hospital(s). Neither would invest in the joint venture which they believe will result in a hospital (even refurbished) which is marginal from a business perspective. Their joint objective is to provide the people of Rotorua with a better quality, safer facility, which at least covers its cost.

7. The SCHT site currently has capacity and in SCHT's view is in dire need of refurbishment. The QE site is even older than the SCHT facility and is in a "worse state". It is unsuitable for major refurbishment. Neither facility is considered viable in the long term on current revenues. While both surgical hospitals could continue to operate in the short term it is likely that either or both would be closed down in the long term if the Proposal does not go ahead in light of the cost of running the facilities and the concern that ultimately, without significant expenditure, it will not be "safe" to continue, to provide services. As already noted, the Proposal is that of the two sites the SCHT site is the one best refurbished.

8. Both SCHT and QE have carefully considered the impact of this Proposal on the people of Rotorua – acknowledging it will result in one Rotorua-based private provider for the timebeing. However, SCHT and QE believe that this is the only way the people of Rotorua will be provided with a more modern better quality facility. The Proposal is generally supported by key stakeholders in the community – the DHBs, local surgeons and general practitioners.

9. SCHT and QE believe the Proposal is supported not only because it will provide the community with a much needed and improved private hospital but recognising that, in the particular circumstances in this case, the Proposal will not, as a matter of fact, substantially lessen competition in Rotorua. That is for a number of reasons which are explained and expanded upon in this application.

10. Briefly, competition will not be substantially lessened – and in particular the JV Co would not gain any market power as a result of the Proposal – because of the following factors which would constrain it from acting unilaterally to increase prices or reduce its services:

    (a) Neither hospital currently provides significant constraint on the other due to the limited overlap of services and procedures provided at each facility. QE is equipped to service Rotorua's orthopaedic and urological surgeons who utilise its facilities almost exclusively for those procedures. In contrast, SCHT is equipped for general and other specialist surgeons who, similarly, utilise its facilities almost exclusively. There is some overlap between the two hospitals but it is minor.

    (b) Both shareholders in JV Co are "not for profit" organisations (which in fact makes this joint venture unusual – other joint venture private hospitals have one or more "for profit" partners). Unilateral and coordinated effects assume a profit maximisation objective. That objective will not be present in the case of this joint venture. Its incentives will not be the same as "for profit" organisations.

    (c) If the combined entity looked to increase prices or reduce quality, patients could be referred out of Rotorua, eg. to hospitals in nearby Hamilton and/or

Tauranga. The extent to which intra-region flows currently occur suggests that the relevant geographic market(s) are not restricted to Rotorua. But whether these other hospitals are in, or outside, the relevant geographic market(s), referrals out-of-region could increase, particularly if surgeons and referrers perceived significant price or qualitative differences between the local services and those offered in Hamilton and/or Tauranga.

(d) Post-acquisition, a major proportion (approximately **[ ]**) of the combined entity's funding would come from the ACC. As the Commission has previously found, the ACC is a price setter in the relevant markets. The combined entity would therefore be constrained from increasing its prices post-acquisition. If it did not accept the national price offered by the ACC, then the ACC could award the contract to a competing facility. In that event, the JV Co would stand to lose a significant portion of its funding.

(e) A further significant proportion (approximately **[ ]**) of the combined entity's funding is likely to come from the Lakes, Bay of Plenty and/or Waikato District Health Board's ("DHBs"). Other competitors for this work include Rotorua Public hospital and the public and private hospitals in other regions. The DHBs are major purchasers with a number of options for suppliers. They are also price setters in the relevant markets with an established national pricing structure and have significant countervailing power.

Taking (d) and (e) together, **[ ]** of the JV Co's funding would come from ACC and DHBs. Plainly, the JV Co could not put this funding at risk by unilaterally increasing prices or reducing services. This factor alone – absent others – will significantly constrain the merged hospital.

(f) The remainder of JV Co's funding will come from the insurance companies and/or private patients. The Commission has acknowledged that, like the ACC and DHBs, the health insurance companies provide some constraint on the pricing decisions of the private hospitals.

(g) Entry barriers to the establishment of an alternative short-stay facility are low. The Commission has previously found that barriers to entry into the private short-stay market are low and that should surgeons or GPs become dissatisfied with the services offered, a new short-stay facility could easily be established. The relative ease with which this could happen gives surgeons a measure of countervailing power. If the Proposal goes ahead, QE will terminate is current lease arrangements for additional theatre space at Lakes PrimeCare, a private GP clinic in Rotorua which offers a range of medical services including short-stay elective surgery. Lakes PrimeCare has one theatre, which is currently leased to and equipped by QE. If QE terminates that lease, the theatre space at Lakes PrimeCare could be put to the same use again and is a potential option for surgeons/GPs.

(h) Finally, in relation to the issue of services the whole objective of JV Co is to increase the quality of services (and particularly deal with current "care" issues). Therefore, the JV Co is hardly likely to reduce services if this Proposal is implemented. Rather, both charitable trusts will be better able to fulfil their charitable objectives if the JV Co is able to proceed by increasing the quality of services available to their patients.

11. In summary, the Applicants believe that this Proposal would not result in a substantial lessening of competition in any of the relevant markets and would bring significant benefits to the Rotorua region.

PART I: TRANSACTION DETAILS

1.	What is the business acquisition for which **clearance** is sought?

1.1 Clearance is sought for:

(a) the acquisition of shares in JV Co (a new company to be formed) by SCHT and QE or companies owned by them; and

(b) the acquisition by JV Co of the private surgical hospital businesses of Southern Cross Hospital Rotorua and QE Health Rotorua, including the shares held in QE Orthopaedics Limited by QE.

1.2 Southern Cross Hospital Rotorua is owned by SCHT. QE Health is the trading name for QE Hospital Limited, which is wholly owned by the Queen Elizabeth Hospital Community Trust ("the QE Trust").

1.3 If the Proposal goes ahead, JV Co will be incorporated, capitalised by SCHT and QE, and would then undertake the redevelopment of the SCHT site. Once the refurbishment of those facilities has been completed the relevant assets of QE's surgical hospital business will be transferred to JV Co.

1.4 JV Co has yet to be incorporated and the shareholding interests of SCHT and QE have not yet been determined, but are likely to be 70:30 (SCHT:QE).

1.5 The parties have yet to negotiate an agreement for sale and purchase relating to the transaction.

2.	Who is the person giving this **notice**?

2.1 This notice is given by:

Ian Malone

Southern Cross Hospitals
Level 10, AMP Centre
29 Customs Street West
PO Box 5341
Wellesley Street
AUCKLAND

Telephone: 09 306 7566
Facsimile: 09 302 8730

Ben Smit

QE Health
PO Box 1342
ROTORUA

Telephone: 07 343 1667
Facsimile: 07 349 5252

2.2 Correspondence and inquiries should in the first instance be directed to:

Minter Ellison Rudd Watts
Lumley Centre
88 Shortland Street
PO Box 3798
AUCKLAND

Attention: Andrew Matthews
Telephone: (09) 353 9700
Facsimile: (09) 353 9701

3. Confidentiality

3.1 Confidentiality is not claimed for the fact of the proposed acquisition.

3.2 Confidentiality is sought for the information contained in bold and in square brackets in the confidential version of this application (i.e. **[ ]**).

3.3 Confidentiality is sought until the relevant applicant confirms in writing to the Commission that the particular information is no longer confidential.

3.4 This request is made because the information is commercially sensitive and valuable information which is confidential to the Applicants. Disclosure of the information would be likely unreasonably to prejudice the commercial position of the relevant applicant. Confidentiality is requested under section 100 of the Commerce Act 1986 and under section 9(2)(b) of the Official Information Act 1982 ("OIA").

3.5 The Applicants request that they be advised in writing of any requests for information under the OIA in relation to this application.

4. Who are the participants (i.e. the parties involved)?

4.1 The participants are SCHT and QE.

Southern Cross Health Trust	**QE Hospital Limited** (trading as QE Health)
c/- Southern Cross Hospitals Level 10, AMP Centre 29 Customs Street West PO Box 5341 Wellesley Street AUCKLAND	QE Health PO Box 1342 ROTORUA
Attention: Ian Malone Telephone: 07 306 7566 Facsimile: 07 302 8730	Attention: Ben Smit Telephone: 07 343 1667 Facsimile: 07 349 5252

5. Who is interconnected to or associated with each participant?

SCHT

5.1 SCHT is a charitable trust, established for the purposes of providing hospital care to the general public. It is a not-for-profit organisation, the beneficiaries of which are effectively all New Zealanders. The Trustees of SCHT are registered as a Board under the Charitable Trusts Act 1957. SCHT currently owns ten private surgical hospitals,[1] and has partnerships in another four.[2]

5.2 In Decision 537 *Southern Cross Oxford Hospital Ltd / The Oxford Clinic*, 11 November 2004 ("the *Oxford Decision*"), the Commission concluded that it would proceed on the basis that SCHT and The Southern Cross Medical Care Society ("the Society") were "associated persons" within the meaning of section 47(3) of the Commerce Act. While SCHT does not accept the Commission's conclusion on association, it does not propose to pursue the issue in this application as it has no bearing on the analysis of the Proposal.

5.3 For further information on SCHT and/or the Society see www.southerncross.co.nz.

QE

5.4 QE is a wholly owned by the QE Trust. For further information on QE Health and/or the QE Trust see www.qehealth.co.nz.

5.5 QE owns 50% of the share capital in QE Orthopaedics Limited, a joint venture with Orthopaedics Associates Limited (which is privately owned by a group of orthopaedic surgeons based in Rotorua). If the Proposal goes ahead, QE's interest in QE Orthopaedics Limited will be transferred to JV Co.

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[1] Auckland Surgical Centre, Brightside, Christchurch, Hamilton, Invercargill, New Plymouth, North Harbour, Palmerston North, Rotorua, Wellington

[2] Gillies Hospital (Auckland), Mercy Angiography Unit (Auckland), Norfolk Southern Cross Hospital (Tauranga) and Southern Cross Oxford Hospital (Christchurch).

6.	Does any participant, or any interconnected body corporate thereof, already have a beneficial interest in, or is it beneficially entitled to, any shares or other pecuniary interest in another participant?

6.1 Neither SCHT nor QE, nor any of their interconnected bodies corporate, has any beneficial interest or shares or any other pecuniary interest in the other.

7.	Identify any links, formal or informal, between any participant/s including interconnected bodies corporate and other persons identified at paragraph 5 and its/their existing competitors in each market.

7.1 SCHT does not have any links, formal or informal, with QE or any competitor in any of the markets affected by the Proposal, other than the following:

(a) **Details of SCHT's contracts with DHB's in the Bay of Plenty/Waikato Region as follows:**

Funder	Term	Services	Annual Value
Lakes District Health Board	2007-08	Elective surgery	**[ ]**
Waikato District Health Board	2007-08	Cataract Surgery	**[ ]**

(b) **Details of SCHT's contracts with ACC in the Bay of Plenty/Waikato Region as follows:**

Funder	Term	Services	Annual Value
ACC – North Island excluding Auckland and Welliington	2007-08	ACC Elective Services (All specialities)	**[ ]**

7.2 QE does not have any links, formal or informal, with SCHT or any competitor in any of the markets affected by the Proposal, other than the following:

(a) QE leases additional theatre capacity from Lakes PrimeCare. Lakes PrimeCare is a private GP clinic in Rotorua offering a range of medical services. It has one operating theatre, which is leased to and equipped by QE;

(b) QE owns 50% of the share capital in QE Orthopaedics Limited, a joint venture with Orthopaedics Associates Limited (which is privately owned by a group of orthopaedic surgeons based in Rotorua);

(c) **Details of QE Contracts with DHB's in the region (as defined above) as follows:**

Funder	Term	Services	Annual Value
Lakes DHB	2007-08	Orthopaedic Surgery	**[ ]**
Bay of Plenty DHB	2007-08	Orthopaedic Surgery	**[ ]**
Bay of Plenty DHB	2007-08	Orthopaedic Surgery	**[ ]**
Waikato DHB	2007-08	Orthopaedic Surgery	**[ ]**
Waikato DHB	2007-08	Orthopaedic Surgery	**[ ]**

(d) **Details of QE's contracts with ACC in the region as follows:**

Funder	Term	Services	Annual Value
ACC	2007-08	ACC Elective Services (Orthopaedic Surgery)	**[ ]**

(e) QE's patients include patients with Southern Cross private health insurance.

8.	Do any directors of the 'acquirer' also hold directorships in any other companies which are involved in the markets in which the target company/business operates?

8.1 None of the Trustees of SCHT are directors or trustees of any private hospitals other than those owned by SCHT.

8.2 None of the directors of QE Hospital Limited or the Trustees of the QE Trust are directors or trustees of any other private hospitals.

9.	What are the business activities of each participant?

SCHT

9.1 SCHT and the Society are separate entities which operate separate businesses at arms length.

9.2 The Society operates:

(a) Southern Cross Health Insurance;

(b) Activa Health Limited; and

(c) Southern Cross Health Services Limited, incorporating Care Advantage, a claims and rehabilitation management company in the workplace accident insurance sector.

9.3 SCHT currently owns ten private surgical hospitals and has partnerships in another four. Details are provided in paragraph 5.1 above. This application concerns SCHT's Southern Cross Hospital Rotorua.

9.4 Southern Cross Hospital Rotorua ("SCHT Rotorua") is a small private surgical hospital, with two theatres and 26 in-patient beds, offering a range of procedures including general surgery, gynaecological, urological, ENT (ear, nose and throat), orthopaedic, opthalmological, laparoscopy and gastroenterological surgery. Secondary elective procedures are performed on both a short-stay and in-patient basis. For further information see www.southerncross.co.nz ("Our Hospitals – Rotorua").

QE

9.5 QE Health is wholly owned by the QE Trust.

9.6 QE operates a specialised treatment centre in Rotorua for people with rheumatism, arthritis and other disorders involving movement. QE offers a range of rheumatology and rehabilitation services. It operates a spa and offers a range of thermal treatment services.

9.7 QE also operates a fully accredited private surgical hospital offering a range of private surgical procedures. This is also a small private hospital, with one theatre, 21 in-patient beds, offering a range of procedures, primarily in orthopaedics and urology. Secondary elective procedures are performed on both a short-stay and in-patient basis.

9.8 QE leases additional theatre capacity from Lakes PrimeCare. Lakes PrimeCare is a private GP clinic in Rotorua offering a range of medical services. It has one operating theatre, which is leased to and equipped by QE

10. What are the reasons for the Proposal and the intentions in respect of the acquired or merged business?

10.1 While the two hospitals are marginal economically, it is not suggested that they are "failing". However, both QE and SCHT are of the view that any one other than a not-for-profit organisation would seriously consider closing the hospitals – given their low revenue and the significant expenditure needed to upgrade one of them (let alone two). (In this regard, note that SCHT has in the past closed provincial hospitals where they have not made reasonable returns in the long run: Wanganui (July 2000) and Napier (April 2001)). Both consider it appropriate to refurbish one facility only and as a result provide better quality services to the people of Rotorua in light of both SCHT Rotorua and QE's charitable objectives.

10.2 Annual revenues for SCHT Rotorua are approximately **[ ]** and for QE Health's surgical business approximately **[ ]**. The state of both current facilities is poor, and making it increasingly difficult to meet the compliance standards for hospital facilities. Neither facility is considered viable in the long term on current revenues.

10.3 That view (i.e. that long term both are not viable on current revenues) is supported by the fact that there is no other region with Rotorua's population size (of approx 70,000) in New Zealand that supports two (in-patient) private hospitals. In fact, many much larger regions only support one such hospital and the Applicants understand that there is only one other provincial area in New Zealand with two private hospitals (Manawatu which has a significant larger population). This is illustrated in Table 1.

Table 1: Private Surgical Hospitals in Certain New Zealand Regions

Region	Population	Number of Private Surgical Hospitals	Hospitals	Comments
Northland	149,600	1	Kensington	
Gisborne	44,500	1	Chelsea	
Rotorua District	67,500	2	Queen Elizabeth, Southern Cross	
Hawkes Bay	149,900	1	Royston Hospital	SCHT exited in April 2001
Taranaki	105,000	1	Southern Cross	
Wanganui	43,200	1	Belverdale	SCHT exited in July 2000
Manawatu	107,500	2	Southern Cross, Aorangi	
Nelson	46,400	1	Manuka Street	
Marlborough	43,200	1	Churchill Trust	
Timaru/Ashuburton	70,100	1	Bidwell	
Otago	198,300	1	Mercy Dunedin	
Southerland	92,400	1	Southern Cross	

10.4 If all operating costs are taken into account, SCHT Rotorua is loss making. Existing capacity at the SCHT site is underutilised (currently approximately **[ ]**). SCHT could not, therefore, justify investing in a large scale refurbishment and upgrade of its facilities on current revenues. Refurbishment of the SCHT site will cost approximately $8m.

10.5 The QE's current building is not suitable for extensive refurbishment. If QE were to upgrade, a new facility would need to be built. The capital cost of a new facility is not financially viable for QE. QE needs to commit to a significant investment in its core business health spa and rehabilitation facilities, an investment in the region of **[**

]. QE cannot afford to make this substantial investment in its health spa/rehabilitation facilities (it is currently endeavouring to raise the finance for this) as well as upgrading its hospital. Indeed, it is also because of QE's financial position that the JV Co interests will likely be 70:30 and not 50:50, reflecting the fact that SCHT will be making the larger capital contribution to the Proposal.

10.6 The Proposal would allow the parties to combine their resources and facilitate the significant capital investment required for a quality refurbished private hospital for the Rotorua region. That investment will not be made if the Proposal does not go ahead. While both hospitals could continue to operate in the short term, it is likely that either or both would exit the Rotorua area in the long term. Neither of them alone can justify the expenditure needed to upgrade the facilities with a view to meeting safety standards longer term. **[**

]

10.7 The private hospitals play an important role in attracting surgeons, anaesthetists and other health professionals to and retaining them in a region. This is particularly so for the provincial centres such as Rotorua. A stable private surgical environment is important for the recruitment and retention of these professionals in the public sector. Without a viable and stable private surgical facility to offer surgeons an option for operating in private practice the risk of losing these specialists to the major cities is high.

10.8 The joint venture would enable investment in a fully refurbished facility with significantly improved service quality. It would enable the retention of key medical staff and employees. Duplication can be removed, capacity utilisation improved, and the service made more efficient by combining. The result would be two excellent facilities for the people of Rotorua: an SCHT/QE private hospital and QE's spa and rehabilitation centre.

PART II: IDENTIFICATION OF MARKETS AFFECTED

Horizontal aggregation

11. Are there any markets in which there would be an aggregation of business activities as a result of the proposed acquisition?

    Please identify for each market:

    - the product(s), functional level, geographic area and (where relevant) timeframe;
    - the specific parties involved;
    - the relationship of those parties to the acquirer or target company as the case may be.

11.1 The Proposal would result in the aggregation of the two private surgical hospitals in Rotorua.

Market definition

Product dimension

11.2 In its most recent decision in relation to the private surgical hospital markets, Decision 546 *The Southern Cross Health Trust/Auckland Surgical Centre Limited* (17 February 2005) ("the *Auckland Surgical Decision*"), the Commission defined the relevant markets as being for the provision of private:

- short-stay hospital facilities and related non-specialist services for elective secondary surgery in [the Auckland Region] ("the short-stay market"); and
- in-patient hospital facilities and related non-specialist services for elective secondary surgery in [the Auckland Region] ("the in-patient market").

11.3 This was essentially the same market definition as adopted in Decision 537 *Southern Cross Oxford Hospital/The Oxford Clinic* (11 November 2004) ("the *Oxford Decision*"), which in turn built on previous decisions (Decision 518: *Pacific Radiology Limited/Wakefield Radiology Limited*, 28 February 2004; Decision 492 *Wakefield Hospital Limited/Bowen Hospital Limited*, 19 February 2003; Decision 449 *The Ascot Hospital and Clinics/Mercy Hospital Auckland Limited*, 14 December 2001).

11.4 In adopting this market definition, the Commission confirmed its previously held view that private and publicly funded elective surgery comprise separate product markets.

11.5 The Commission considered that both private and public hospitals operate in the publicly funded market, whereas only private hospitals operate in the privately funded market[3].

11.6 SCHT and QE operate the two private hospitals in the Rotorua area, offering secondary elective surgical procedures on both a short-stay and in-patient basis.

11.7 QE and, to a lesser extent, SCHT, also operate in the publicly funded markets. A significant proportion of QE's funding (approximately **[ ]** currently) is for publicly

[3] See the analysis at paragraphs 52-66.

funded operations and comes from the Lakes, Bay of Plenty and/or Waikato District Health Boards ("DHBs"). It therefore competes for public as well as private funding, as does SCHT albeit to a much lesser proportion. That funding cannot be put at risk.

Geographic scope

11.8 The geographic scope of the relevant markets was not in contention in the *Auckland Surgical Decision*. The applicant in that case had submitted, and the Commission accepted, that the relevant geographic market was the Auckland region. In the *Oxford Decision*, the Commission adopted the "conservative" approach of defining the relevant geographic market as Christchurch (as opposed to the broader Canterbury region), although it did not make a finding that the market was in fact so limited.

11.9 In the present case, the Applicants consider that the geographic scope of the relevant markets is wider than Rotorua and extends to the private and public hospitals (as relevant) in Hamilton and Tauranga. The hospitals in Hamilton and Tauranga are close substitutes to which referrers and/or patients can switch in response to an increase in prices or a reduction in quality locally.

11.10 Both Hamilton and Tauranga are geographically proximate. Hamilton is one and a half hours drive from Rotorua. In Hamilton, there is one major public and three private hospitals, offering a full range of procedures. Tauranga is only one hour (sometimes an hour and a quarter depending on traffic) from Rotorua. Norfolk Southern Cross Hospital is a brand new facility offering the highest service quality. These distances are not so much greater than those distances between private hospitals located on the North Shore and those South of the city in the Auckland region.

11.11 As the Commission recognised in the *Auckland Surgical Decision*[4], there is a relatively complex set of relationships which leads to a particular patient being operated on by a particular surgeon in a particular hospital. Patients are first seen by a primary healthcare provider (usually a GP). If surgery is warranted, or specialist consultation required, the patient will be referred to a surgeon. If the surgeon decides that surgery is appropriate, a decision will be made as to the hospital where the surgery will be undertaken, depending on the hospital (or hospitals) where that surgeon operates. Often the choice of hospital is influenced by the surgeon. The factors taken into account are cost, location, timeliness and anticipated quality of care. Sometimes the patient's insurer will have an influence on the choice of hospital, and that patients might be encouraged to select a particular option.

11.12 Substitutability, both from a referrer and a patient perspective, is evidenced by the fact that referrals already occur between Rotorua – Hamilton – Tauranga. The referral flows are two-way i.e.:

(a) Rotorua patients are referred out of the Rotorua area, to both Hamilton and Tauranga; and

(b) patients from Hamilton and Tauranga (also Taupo) are referred to Rotorua, in particular to QE.

11.13 In relation to (a), at present, referrals to Hamilton and/or Tauranga are primarily for "high end" procedures such as neurosurgery, cardiac surgery and other high complexity procedures which SCHT and QE do not offer. However, the fact that this happens already is significant. There are no barriers to out-of-region referrals. They are possible for any procedure. Further, it is also likely that there are some out-of-region referrals to Hamilton and Tauranga 'at the margin' for procedures that can be

[4] See paragraphs 30-33.

done at SCHT Rotorua and QE e.g. for patients living at the boundary of the DHB geographic area. SCHT and QE are aware of this happening anecdotally, but do not know to what extent this occurs as GPs control those referrals.

11.14 In relation to (b), as already noted, both SCHT and QE have patients referred to them from outside the immediate Rotorua area. In particular, the Waikato DHB sends significant patient volumes to QE for orthopaedic surgery and has done so for a number of years under an outsourced agreement. For the current year, this contract is worth almost **[ ]** in value over over year to QE - refer para 7.2. The same DHB sends a number of patients for cataract surgery to SCHT under a contract with SCHT Hamilton and SCHT Rotorua together (para 7.1). Relevantly, the Waikato DHB has had a history of sending patients – primarily for orthopaedic surgery – outside the immediate Hamilton area. SCHT Hamilton has, for example, reasonably recently lost two tenders for this work (despite its proximity to the Waikato DHB) to Rotorua (QE). Also, the same comment above applies to referrals 'at the margin' in terms of referrals from Hamilton and Tauranga to Rotorua.

11.15 Moreover, relevantly, Rotorua prices are already currently constrained by those in the neighbouring areas of Hamilton and Tauranga. A recent example of this is that SCHT Rotorua recently had to drop its prices for ophthalmological procedures because patients were switching to the ophthalmology providers in Tauranga. At the time, a price difference of approx $200 existed resulting in SCHT reducing its overall price (including surgeon and anaesthetist) by $100 as well as absorbing an expected inflation increase.

11.16 Quality is likely to be the primary factor driving referrals. If GPs perceive a difference in quality of either facilities or the service, they may refer out-of-region, particularly if there is no price impact to the patient.

11.17 However, price is also a consideration in the referral decision. SCHT and QE could not expect to increase prices significantly without losing referrals to either Hamilton or Tauranga hospitals given their proximity. The recent experience with ophthalmological services (11.13) is illustrative of this.

11.18 If the Commission adopts the more narrow market definition, limited to the Rotorua area, it will need nonetheless to consider and take into account all relevant constraints from inside and outside the relevant markets as defined, in accordance with the approach confirmed by the High Court in *Brambles*[5].

[5] *Brambles New Zealand Limited* v *Commerce Commission* (2003) 10 TCLR 868.

Differentiated product markets

12. Please indicate whether the products in each market identified in question 11 are standardised (buyers make their purchases largely on the basis of price) or differentiated (buyers make their purchases largely on the basis of product characteristics as well as price).

12.1 There is some level of differentiation.

13. For differentiated product markets:

- Please indicate the principal characteristics of products that cause them to be differentiated one from another.
- To what extent does product differentiation lead firms to tailor and market their products to particular buyer groups or market niches?
- Of the various products in the market, which are close substitutes for the products of the proposed combined entity? – which are more distant substitutes?
- Given the level of product differentiation, to what extent do you consider that the merged entity would be constrained in its actions by the presence of other suppliers in the market(s) affected?

13.1 The "products" in these markets may be differentiated by the range of procedures offered, location of the facilities, cost, timeliness and anticipated quality of care.

13.2 As discussed at paragraph 11.11 above, GPs, surgeons and sometimes the patient's insurer can have an influence on the choice of hospital for elective surgery.

13.3 Surgeons also have an important impact on the range of procedures offered at a particular surgical hospital. Surgeons develop close working relationships with the hospitals where they choose to operate. While initially the decision to operate at a particular facility might be based on factors such as location, the quality of the facility, the presence of other surgeons/colleagues at that facility, the anticipated quality of pre- and post-operative care and price, surgeons develop loyalties to particular facilities. Their decisions, in turn, affect the procedures which the private surgical hospitals offer and the range of specialities which they are equipped to cater for.

13.4 In this case, as a result of different connections with different groups of specialists, QE is equipped to service primarily Rotorua's orthopaedic and urological surgeons while SCHT is equipped to service primarily Rotorua's general surgeons and to cater for other surgical specialities besides orthopaedics. There is a limited degree of overlap. However, it is minor and the "products" of the two surgical hospitals might be viewed as differentiated by the range of procedures offered.

Vertical integration

14. Will the Proposal result in vertical integration between firms involved at different functional levels?

14.1 For similar reasons to those found by the Commission in the *Auckland Surgical Decision*, the Proposal is unlikely to increase Southern Cross Medical Care Society's market power in the health insurance market.

15. In respect of each market identified in questions 11 and/or 14 identify briefly:

- all proposed acquisitions of assts of a business or shares involving either participant (or any interconnected body corporate thereof) notified to the Commission in the last three years and, in each case:
  - the outcome of the notification (e.g. cleared, authorised, declined, withdrawn)
  - whether the proposed acquisition has occurred.
- any other acquisition of assets of a business or shares which either participant (or any interconnected body corporate) has undertaken in the last three years.

15.1 On 8 October 2003, Southern Cross Oxford Hospital Limited (which is owned 50% by a subsidiary of SCHT, notified the Commission of its proposed acquisition of the assets of the Oxford Clinic in Christchurch. Clearance for that acquisition was granted on 11 November 2004 (see the *Oxford Decision*).

15.2 On 23 December 2004, SCHT notified the Commission of its proposed acquisition of the assets of Auckland Surgical Centre Limited. Clearance for that acquisition was granted on 17 February 2005 (see the *Auckland Surgical Decision*).

15.3 There are no previous acquisitions notified by either QE or the Queen Elizabeth Hospital Community Trust.

15.4 In April 2005, QE acquired the assets of LakesCare Surgical. LakesCare Surgical operated the short-stay theatre on the Lakes PrimeCare site and was 50% owned by QE prior to the acquisition.

PARTS III, IV AND V: CONSTRAINTS ON MARKET POWER BY EXISTING AND POTENTIAL COMPETITION AND OTHER POTENTIAL CONSTRAINTS

16. Existing competitors

Privately funded elective surgery

16.1 The following table sets out the types of procedures performed at each of SCHT Rotorua and QE Health's surgical hospital, together with the ratio of short-stay to in-patients at those facilities.

Table 1: Surgical procedures performed at SCHT Rotorua and QE Hospital

Hospital	Procedures Performed	% Short-stay patients	% In-patients
SCHT Two theatres 26 in-patients beds	General surgery, gynaecological, neurological, ENT, orthopaedic, opthalmological, laparoscopy and gastroenterological	**[ ]**	**[ ]**
QE One theatre plus Lakes PrimeCare lease	Orthopaedic, urology and some general surgery	**[ ]**	**[ ]**

Source: parties' estimates

16.2 While SCHT and QE offer a range of secondary elective procedures, QE is equipped to service Rotorua's orthopaedic and urological surgeons, who utilise its facilities almost exclusively for those procedures. In contrast, SCHT is equipped for general surgery and other areas of specialisation for surgeons who, similarly, utilise its facilities almost exclusively.

16.3 Based on the casemix over the past 3 years, the vast majority **([ ]**) of QE's procedures are orthopaedic. Urology procedures make up **[ ] and minor procedures for all other specialties** make up the remainder **[ ]**.

16.4 In contrast, the spread of procedures at SCHT Rotorua is currently approximately as follows: endoscopy (**[ ]**); general surgery (**[ ]**); gynaecology (**[ ]**); ophthalmology (**[ ]**); ENT (**[ ]**) and all other specialities (**[ ]**). Orthopaedic and urological procedures make up **[ ]** of SCHT's procedures by volume and **[ ]** by value. Attached is SCHT's Patient Volumes by Specialty (2004 – 2007) which shows that the spread of procedures has remained reasonably constant. (QE is not able to provide similar statistics).

16.5 As is apparent from the above data, the Applicants currently compete directly against each other only to a limited extent and constrain each other only to a limited degree, (although both are significantly constrained by other factors as explained below). This is particularly in relation to orthopaedic surgery. One of the reasons for this is that QE (unlike SCHT Rotorua) can offer both orthopaedic and rheumatology services at the one facility. This linkage at QE between orthopaedic and rheumatology (and also having regard to the renowned expertise of QE in this area) has long been a reason why surgeons have favoured QE for orthopaedic procedures making it difficult for SCHT Rotorua to get more than a very small percentage of this work. In fact, currently SCHT Rotorua's orthopaedic work is limited to minor procedures carried out

by one orthopaedic surgeon. That is the only area of overlap in relation to orthopaedic surgery.

16.6 In the *Auckland Surgical Decision*, the Commission found that surgical facilities and services are fungible across medical specialities, so that general "surgical" markets can be defined rather than specific markets for each speciality or procedure.

16.7 The Applicants agree but do note that the practical reality is that it would be difficult for SCHT to capture QE's orthopaedic work or for QE to capture SCHT's general surgery and other specialist work due to the close working relationships between surgeons and the hospitals and particularly in relation to orthopaedic surgery for the reasons already given above. Also, the investments each would need to make to capture this work (see para 16.8 below). In Rotorua, over time, surgeons and anaesthetists have built up close relationships of loyalty with one or other of the private surgical hospitals and that hospital's clinical and administrative staff. For the most part they do not refer to the other hospital absent some compelling reason – such as quality of care or a significant price difference.

16.8 The hospitals, for their part, equip for the procedures that are frequently referred to their facility. The capital investment required, say, for SCHT Rotorua to invest in the required equipment for orthopaedic surgery, is significant. (Currently, SCHT does a few minor orthopaedic procedures for which it has limited equipment. For major joint replacements (of which it does none) the investment required for such surgery is significant. For example, with minor procedures a surgeon will require what is known in the industry as 'one crate' of instruments whereas with major procedures the surgeon can require up to '8 crates' of instruments. The same applies to QE in respect of the capital investment that would be required for equipment for general surgery and the other specialist procedures catered for by SCHT Rotorua. The Applicants estimate that the capital investment required for either of them to expand into these respective areas would be in the region of $1 million each.

16.9 The Applicants could not justify that level of investment on current revenues in circumstances where they consider that the referral behaviour of Rotorua's surgeons is unlikely to change absent any significant price or quality differential.

Estimated market shares

16.10 Adopting the Commission's product market definition, including the public/private split, SCHT and QE's shares of the short-stay and in-patient markets are as follows:

Table 2: Private elective surgery - market shares by number of short-stay and in-patients 2004/2005 (Rotorua only)

Private Hospital	Short-Stay		In-Patients		Total
SCHT	[ ]	[ ]	[ ]	[ ]	[ ]
QE (including Lakes PrimeCare lease)	[ ]	[ ]	[ ]	[ ]	[ ]

Source: parties' estimates

There are no other private in-patient facilities in Rotorua. For day-stay surgical procedures, Lakes PrimeCare, a private GP clinic offering a range of medical services, has one operating theatre. This is currently leased to and equipped by QE. If the Proposal goes ahead, QE will terminate its leasing arrangements with Lakes PrimeCare. That theatre space will become available and could be put to the same

use again. SCHT and QE are not aware of what Lakes PrimeCare might otherwise do with this space. (See the further discussion in the section on "potential competition".)

16.11 As noted above, however, the Applicants consider the geographic market to be wider than Rotorua, and to extend to include the private hospitals at Hamilton and Tauranga:

(a) Braemar Hospital – Hamilton: 4 theatres, 50 in-patient beds. Particular strengths include very competitive pricing with a focus on inpatient elective surgery. Braemar Hospital is 100% owned by the Braemar Charitable Trust.

(b) Braemar Day Hospital – Hamilton: 3 theatres, day-stay facility. Particular strengths include very competitive pricing and purpose built day-stay facility. Braemar Day Hospital is 100% owned by the Braemar Charitable Trust.

(c) Southern Cross Hospital – Hamilton: 6 theatres, 60 in-patient beds. Particular strengths include very competitive pricing and complete range of inpatient and day stay elective surgery. This hospital is wholly owned by SCHT.

(d) Bridgewater - Hamilton: 2 theatres, day-stay facility. Particular strengths include eye surgery, dental and plastic surgery. Bridgewater is owned 100% by private investors, primarily Medical specialists.

(e) Clarence Street : 1 theatre. Particular strengths include ENT and Dental day stay surgery. Clarence Street Medical is 100% owned by 1 private investor.

(f) Tokoroa Private - Tokoroa: 1 theatre. Particular strengths include varicose veins and hernia surgery. Owned 100% by 2 private investors.

(g) Norfolk Southern Cross – Tauranga: Just about to move into a new purpose built facility of 6 theatres and 60 beds. Offers complete range of inpatient and daypatient elective surgery excluding eye surgery. This is a joint venture between SCHT (40%) and local doctors (60%). The Board makeup reflects this: SCHT (4 appointees) and the local doctors (6 appointees). SCHT does not control this entity.

(h) Park Street - Tauranga: 2 Theatres. Particular strengths include daypatient eye surgery. Park Street is owned 100% by private investors, primarily medical specialists.

16.12 If the merged hospital were to attempt to increase prices or reduce services in the Rotorua region, the Applicants believe that these private hospitals in nearby Hamilton and/or Tauranga could easily look to attract referrals from Rotorua GPs to their facilities.

16.13 The Applicants estimates of market shares for this wider region are as follows:

Table 3: Private elective surgery - market shares by number of short-stay and in-patients 2004/2005 (Rotorua, Hamilton and Tauranga)

Private Hospital	Short-Stay		In-Patients		Total
Braemar Hospital	250	1.9%	2,000	24%	2,250
Braemar Day Hospital	2,000	15.2%	0	0%	2,000
Southern Cross Hamilton	[ ]	[ ]	[ ]	[ ]	[ ]
Bridgewater	1,000	7.6%	0	0%	1,000
Clarence Street	700	5.3%	0	0%	700
Tokoroa	500	3.8%	0	0%	500
Norfolk Southern Cross	[ ]	[ ]	[ ]	[ ]	[ ]
Park Street	500	3.8%	0	0%	500
SCHT Rotorua	[ ]	[ ]	[ ]	[ ]	[ ]
QE (including Lakes PrimeCare lease)	[ ]	[ ]	[ ]	[ ]	[ ]
Total	*13,137*	*100%*	*8,326*	*100%*	*21,463*

Source: parties' estimates

The Applicants acknowledge that post acquisition their market shares in both the short-stay and in-patient markets will fall outside the Commission's Safe Harbours. The Applicants post acquisition market share in the short-stay market will be over **[ ]** in a market where the three largest providers account for over **[ ]** of market share. Similarly, the Applicants post acquisition market share in the in-patient market will increase to approximately **[ ]**. While outside the Commission's Safe Harbours, the Applicants contend that there will be no substantial lessening of competition in light of other factors, including the significant countervailing power of purchasers of services and low barriers to entry in relation to short stay (see further below). Furthermore, the Commission needs to recognise that Norfolk and the Rotorua hospitals will both be joint ventures (and the Norfolk joint venture controlled by the local doctors), and that this will mitigate the ability of these hospitals to raise prices (see attached CRA report).

16.14 As previously noted, even if, however, the market is not defined as widely as Hamilton-Tauranga-Rotorua, competition from those other hospitals cannot be ignored especially in the event the merged hospital did unilaterally increase prices or reduce services**.** Market shares are therefore a starting point only.

Publicly funded elective surgery

16.15 A significant proportion of, in particular, QE's funding comes from the Lakes, Bay of Plenty and Waikato DHBs. SCHT also does some publicly funded work, although less than QE.

16.16 In the *Auckland Surgical Decision*, the Commission confirmed its previous view that both private and public hospitals operate in the publicly funded market. In so finding, the Commission also recognised that public surgical facilities may provide some degree of constraint on private surgical facilities in that:

(a) public hospitals have the potential to carry out private work, even if this would require a change in Government policy; and

(b) public work can be contracted out to private providers to reduce waiting lists and that funding for such public surgery is determined according to independently derived formulae which tend to set the benchmarks for how the private providers are paid.

16.17 In Rotorua, Rotorua Public Hospital does the majority of publicly funded secondary elective surgery, as well as all acute surgery.

16.18 For the same reasons as in relation to the private hospital markets, the Applicants consider the geographic scope of the relevant market to be wider than the Rotorua area.

16.19 In Waikato, the Waikato Public Hospital is a major Tertiary hospital (one of only seven throughout the country) and funds a considerable volume of secondary elective surgery, as well as all acute surgery for the population of the Waikato and surrounding areas.[6]

16.20 In Tauranga, the Tauranga public hospital is a provincial hospital and does the majority of publicly funded secondary elective surgery, as well as all acute surgery.

Conditions of expansion

16.21 The Applicants are not aware of any constraints on the ability of the private hospitals at either Hamilton or Tauranga to accept more referrals. They are aware that Braemar is about to rebuild its facility with a planned opening in 2009. Southern Cross Hamilton has new capacity, while Norfolk Southern Cross is about to move into a new hospital with 50% increased capacity.

16.22 Lakes PrimeCare is discussed under paragraph 17 below.

Coordinated market power

16.23 In the *Oxford Decision*, the Commission accepted that collusion is unlikely as the industry's structure does not enable discipline due to low barriers to entry in the short-stay market, and the close monitoring of price and countervailing power of the insurance providers and ACC.

16.24 The Applicants do not consider that the relevant markets are susceptible to collusion and agree with the Commission's comments in the *Oxford Decision*.

16.25 There would be no incentive for the JV Co to coordinate with the private hospitals in either Hamilton or Tauranga, and little scope for it to do so. While SCHT owns 40% of Norfolk Southern Cross it does not "control" that entity – the local doctors hold the majority interest. Moreover, given Norfolk is a new facility, the substantial investment which has been made in it, and that it has excess capacity at present, Norfolk is likely

[6] The Applicants understand that the others are Auckland, Counties Manukau, Waikato, Mid Central (Palmerston North) – although probably only for tertiary oncology, Wellington, Christchurch and Dunedin. This means that the Central North Island is under the tertiary catchment of Waikato DHB.

to be looking to increase volumes. Any co-ordination with JV Co would be likely to be counterproductive to this.

16.26 In Hamilton, there is active competition among the three private hospitals. There is no reason to believe that this is likely to change as a result of the Proposal.

16.27 As the Commission has noted, any collusion between hospital providers would be easily detected by patients, surgeons, insurance companies and the ACC. The DHBs could and would closely monitor any potentially collusive behaviour.

17. Potential competition

17.1 In both the *Auckland Surgical* and *Oxford Decisions*, the Commission found that barriers to entry into the short-stay market are low[7]. It follows that should surgeons or GPs become dissatisfied with the service from JV Co's hospital a new short-stay facility could be easily established.

17.2 If the Proposal goes ahead, QE will terminate its leasing arrangements with Lakes PrimeCare. That theatre space would become available and could be put to the same use again. Set up costs to equip the theatre would not be prohibitive. Lakes PrimeCare could put the space to alternative use. (The Applicants note that they are not aware of Lakes PrimeCare's intentions in this regard).

17.3 In the *Oxford Decision*, the Commission considered the capital costs of setting up a short-stay private surgical facility to be low.[8] In the *Auckland Surgical Decision*, the Commission noted that all industry participants interviewed had indicated the ease with which specialists could access the capital required to establish a greenfield private short-stay facility.[9] Nor did the Commission consider access to surgeons or nursing staff to be an issue.

17.4 In the *Oxford Decision*, the Commission noted that it had previously found that a new day surgery could be made operational within 6-12 months, that de novo entry on a significant scale can be accomplished within two years of planning being commenced and that, therefore, the prospect of entry in the event of the merger entity (in that case) attempting to exercise market power was sufficiently tangible to be a constraint on the joint venture in the post-acquisition market.

17.5 As the Commission has acknowledged, new entry is possible and this is a constraining factor. Presently, new entry is unlikely given that there is existing capacity and both hospitals are marginal. However, if this Proposal proceeds then, in the event of increased prices or reduced services, there is a potential for new entry into the short stay market.

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[7] See the discussion in the Auckland Surgical decision at paragraphs 130-141, and the Oxford decision at paragraphs 128-142.

[8] The Oxford Decision at paragraphs 128-142. The Commission noted its findings in Decision 492 *Wakefield Hospital/Bowen Hospital*.

[9] The Auckland Surgical Decision at paragraph 135. See general the discussion at paragraphs 130-141.

18. Other potential constraints

18.1 In both the *Auckland Surgical* and *Oxford Decisions*, the Commission accepted that ACC is a price maker in the relevant markets, has strong countervailing power and is a significant constraint, and that the DHBs, insurance companies and surgeons also have some countervailing power.

18.2 The various sources of the merged entity's funding are set out in the following table:

Table 4: Merged entity's sources of funding

Private hospital	Insurance companies	ACC	Private Patients	District Health Boards	Other
SCHT	**[ ]**	**[ ]**	**[ ]**	**[ ]**	Minimal
QE	**[ ]**	**[ ]**	**[ ]**	**[ ]**	Minimal
Combined	**[ ]**	**[ ]**	**[ ]**	**[ ]**	Minimal

18.3 As the table shows:

(a) post-acquisition, approximately **[ ]** of the merged entity's funding will come from the ACC. If JV Co did not accept the national price offered by the ACC, the ACC could send the work to Hamilton or Tauranga or, possibly, sponsor the entry of a new facility. In any event, JV Co would stand to lose a significant proportion of its funding which it cannot put at risk especially in view of the substantial investment to be made in upgrading the SCHT Rotorua site. The ACC is a price maker and could constrain the merged entity from increasing its prices post-acquisition;

(b) a further and significant proportion (approximately **[ ]**) of the combined entity's funding is likely to come from the Lakes, Bay of Plenty and/or Waikato DHBs. Other competitors for this work include Rotorua Public hospital and the public and private hospitals in other regions. The DHBs are major purchasers with a number of options for suppliers. They have significant countervailing power;

(c) Consequently, taking (a) and (b) together, **[ ]** of the JV Co's income will come from the ACC and DHBs. Plainly, the JV Co cannot put at risk such a significant portion of its funding such that this constraint alone – absent others – will prevent the merged hospital from acting unilaterally to raise prices (or reduce services). Although, given the whole objective of the Proposal is to increase the quality of services offered, the likelihood of a reduction in services (or output) is remote.

(d) the remainder of JV Co's funding will come from the insurance companies and/or private patients. The Commission has acknowledged that, like the ACC and DHBs, the health insurance companies provide some constraint on the pricing decisions of the private hospitals.

18.4 Moreover, if the combined entity looked to increase prices or reduce quality, as already noted, patients could be referred out of the Rotorua region, e.g. to hospitals in nearby Hamilton and/or Tauranga. The extent to which intra-region flows currently occur suggests that the relevant geographic market(s) are not restricted to the Rotorua region. Referrals out-of-region could increase, particularly if surgeons perceived significant price or qualitative differences between the local services and those offered in Hamilton and/or Tauranga.

18.5 The Commission has also found that surgeons whilst loyal to their providers still have significant countervailing power through the ability to switch between private hospitals. As the Commission pointed out in the *Oxford Decision*, the joint venture will have to encourage surgeons to use the new facility or risk losing them to other regions. Combined with the ease with which a new short-stay clinic could be established, the threat of losing referrals would be an additional constraint on the merged entity.

19. **CRA Report**

19.1 The Applicants attach a short report from CRA in support of this application. CRA comment, in particular, on the constraints that will be present – despite a merger of two to one if the geographic market is narrowly defined – as a result of the combined joint venture/not for profit structure of the merged hospital. (The JV Co will be the only private hospital in New Zealand to be a joint venture of two not for profit entities.)

THIS NOTICE is given by Ian Malone of Southern Cross Health Trust and by Ben Smit of QE Hospital Limited. We confirm that:

- all information specified by the Commission has been supplied; and
- all information known to the applicant(s) which is relevant to the consideration and determination of this application/notice has been supplied; and
- all information supplied is correct as at the date of this application/notice.

We undertake to advise the Commission immediately of any material change in circumstances relating to the application/notice.

Dated this day of 2007

Signed by:

I am duly authorised to make this application on behalf of Southern Cross Health Trust

I am duly authorised to make this application on behalf of QE Hospital Limited