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

16 June 2005

By email: registrar@comcom.govt.nz

The Registrar
Business Acquisitions and Authorisations
Commerce Commission
PO Box 2351
WELLINGTON

NEW ZEALAND DIAGNOSTIC GROUP LTD & SONIC HEALTHCARE (NEW ZEALAND) LTD

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

EXECUTIVE SUMMARY

This application relates to 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 (together, "NZDG" or "Sonic" respectively) in six District Health Board ("DHB") districts through the establishment of three joint venture companies which will acquire the relevant businesses. The relevant DHB districts are those in the Hawke's Bay, Canterbury, South Canterbury, the West Coast, Otago and Southland. The proposals do not affect the parties' activities in the other DHB districts in which they operate.

The proposals are a direct response to fundamental industry change being driven by the DHBs as contracts for service provision in their districts come up for renewal from October 2005. Many DHBs throughout the country, including four of the six DHBs in the districts affected by these proposals, have signalled their intention to move to a single provider environment. DHBs have also signalled that they wish to move away from current fee-for-service arrangements to fixed price, bulk funding and exclusive contracts. In those regions where exclusivity is sought, the parties are thus presented with a choice between consolidation or enforced exit from these markets. Similar changes are a very real possibility in other DHB districts in the short-to-medium term.

The industry is dominated by the DHBs. They are the funders of pathology services in their respective districts; the monopsonists in their markets. They are also the price setters. Over 96% of the parties' revenues come from publicly funded testing, paid for by the DHBs. The DHBs' market control can be seen from the fact that they have refused to agree to any significant price increases in the last 10 years. This DHB monopsony power – which has been acknowledged in a number of Commission determinations and staff reports – is strengthened by vertical integration. The DHBs also supply pathology services through their hospital laboratories and therefore have a "make or buy" option. They can also encourage entry by other national or international players to their district (barriers to entry are relatively low). This will be an increasingly attractive option with the move to new contracts, particularly where these are medium to longer term and exclusive. The parties have no such choices. They must continue to offer a quality service at a highly competitive price if they are to remain attractive to the DHBs in this and future contract rounds. Otherwise they risk exiting the market altogether, with the associated costs.

On the face of it, the proposals would result in aggregation in three geographic markets, namely the Hawke's Bay DHB district, the Canterbury DHB district, and the region comprising the Otago and Southland DHB districts. In both the Hawke's Bay DHB district and the Otago and Southland

region, however, the proposals are in response to DHB signals that they expect consolidation and view this as the best way of obtaining efficiency gains. In Hawke's Bay, the Hawke's Bay DHB has confirmed that it wishes to contract with one community service provider in the district and has invited the parties to merge. In Otago and Southland, the DHBs issued a Request For Proposal ("RFP") in November 2004 seeking a sole supplier for an integrated (hospital and community) service to the region. The parties, in response, submitted a joint proposal in March 2005 and were, on 3 June 2005 offered the contract. Given this course which the DHBs have chosen to take, the proposals arguably have no effect in these areas, other than a change to the identity of the supplier. The parties consider that there is a real prospect that a single supplier may also be sought in the Canterbury DHB district.

There will be no aggregation in the South Canterbury market because only Sonic operates in the district and only very minor aggregation in the West Coast market due to NZDG's insignificant presence.

In summary, the proposals will not substantially lessen competition in any relevant markets, whether now or for future contract rounds:

- The very strong countervailing power of the DHBs will not be affected. They will remain monopsonists with the option of self-supply through the hospital laboratories, together with the ability to sponsor or attract other options for third party supply;
- The hospital laboratories are integrated with other services, potentially providing economies of scale and scope advantages over the community laboratories;
- Incumbent suppliers, with their existing businesses and sunk costs, will still need to offer the best possible prices and quality of service (as specified by the DHBs). If they do not they risk losing their business entirely; and
- The proposals enable the sustainable and long-term provision of a high quality of service to the DHBs, referring practitioners and patients.

PART I: TRANSACTION DETAILS

1. The business acquisition

1.1 This application relates to the proposed merging in three geographic regions of the diagnostic laboratory services businesses of NZDG and Sonic.

1.2 It is presently intended that the proposed transactions will be effected through the formation of three new companies (together, "the Newcos") each of which will acquire the businesses of NZDG and Sonic (and/or their respective subsidiaries) in the relevant region. The shareholdings of the parties in the respective Newcos will vary by region as ownership will be determined in proportion to agreed valuations of the parties' existing businesses in each region.

1.3 The Newcos have yet to be incorporated and the proportionate shareholdings of NZDG and Sonic have yet to be finally determined. Accordingly clearance is sought by NZDG and Sonic (together, "the Applicants"), in respect of the following proposed acquisitions:

(a) **Hawke's Bay** ("the Hawke's Bay merger")

(i) A new company ("Hawke's Bay Newco") to be owned by Sonic and NZDG will acquire the Hawke's Bay business assets of the parties, namely those used to conduct diagnostic laboratory businesses in the Hawke's Bay DHB district. The shareholdings of NZDG and Sonic in Hawke's Bay Newco are expected

to be around [ ]. [ ].[1]

(b) **Canterbury / South Canterbury, West Coast** ("the Canterbury merger")

(i) A new company ("Canterbury Newco") to be owned by Sonic and NZDG will acquire the business assets of the parties, namely those used to conduct diagnostic laboratory businesses in the Canterbury, South Canterbury, and West Coast DHB districts. The shareholdings of NZDG and Sonic in Canterbury Newco are expected to be around [ ] and [ ] respectively.

(c) **Otago & Southland** ("the O&S merger")

(i) A new company ("O&S Newco") to be owned by NZDG and Sonic will acquire the business assets of the parties, namely those used to conduct diagnostic laboratory businesses in the Otago and Southland DHB districts. The shareholdings of NZDG and Sonic in O&S Newco are expected to be around [ ] and [ ] respectively.

1.4 The three regions affected by these proposals comprise one or more DHB districts (each, a "Merger Region"; together, "the Merger Regions").

2. The person giving notice

2.1 This notice is given by NZDG and Sonic:

New Zealand Diagnostic Group Limited
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Attention: David Fleming
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2.2 Correspondence and inquiries should in the first instance be addressed to:

Minter Ellison Rudd Watts
Lawyers
Bank of New Zealand Tower
125 Queen Street
PO Box 3798
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Attention: Andrew Matthews / Oliver Meech
Telephone: (09) 353 9700

[1] NZDG's business on the Kapiti Coast comprises the collection of samples from the Capital & Coast and Mid Central DHB districts. NZDG does not have a laboratory in the Wellington area and all samples are sent away for testing, primarily in Chrsitchurch. NZDG's turnover from this business is approximately [ ]. This represents approximately [ ] of community referred testing in the Wellington area (with an approximate value of [ ]) and less than [ ] of the total market in the area (for hospital and community referred testing, with an approximate value [ ]). [ ].

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3. **Confidentiality**

3.1 Confidentiality is not claimed for the fact this notice is made.

3.2 Confidentiality is sought for that information included in square brackets. A copy of this notice with the confidential information deleted is provided for the Commission's assistance.

3.3 Confidentiality is sought until the confidentiality request is withdrawn.

3.4 This request is made because the information is commercially sensitive and disclosure would be likely unreasonably to prejudice the commercial position of the parties. This request is made initially under section 100 of the Act and subsequently under section 9 of the Official Information Act 1982.

4. **Details of the participants**

4.1 The participants are NZDG and Sonic, including their interconnected bodies corporate and associated persons.

4.2 For full contact details for both NZDG and Sonic, please see 2.2.

5. **Parties interconnected to or associated with each participant**

5.1 NZDG is a privately owned group of companies providing pathology services throughout New Zealand. A diagram of the NZDG group of companies in New Zealand is attached at **Annex 1**.

5.2 Sonic is a subsidiary of Sonic Healthcare Limited, a medical diagnostics company, providing pathology and radiology services to medical practitioners, hospitals, community medical services and their patients. Sonic Healthcare is listed on the Australian Stock Exchange. For further details see http://www.sonichealthcare.com/sonic/internet/. A diagram of the Sonic group in New Zealand is attached at **Annex 2.**

6. **Inter-participant interests**

6.1 Neither NZDG nor Sonic has any beneficial interest in shares or any other pecuniary interest in the other.

7. **Inter-participants links**

7.1 Restraints of trade falling within section 44(1)(d) of the Commerce Act 1986. Under the terms of these proposals, NZDG and Sonic will be restrained from competing with:

(a) Hawke's Bay Newco in the Hawke's Bay DHB district;

(b) Canterbury Newco in the Canterbury, South Canterbury and West Coast DHB districts; and

(c) O&S Newco in the Otago and Southland region.

7.2 Joint response to DHBs' RFP in Otago and Southland. On 21 March 2005, NZDG and Sonic submitted a joint response to the RFP in respect of pathology services issued by the Otago and Southland DHBs in November 2004.

7.3 Existing arrangements with the DHBs:

(a) NZDG:

(i) Agreement between Southern Community Laboratories and the Otago DHB to provide laboratory services throughout New Zealand.

(ii) Agreement between Southern Community Laboratories and Otago DHB to provide an anatomical pathology services for Dunedin Hospital.

(iii) Agreement between Southern Community Laboratories and the Community Trusts in Balclutha, Gore and Dunstan. The Trusts are funded by the Otago and Southland DHB's.

(iv) Agreement between Southern Community Laboratories and the National Cervical Screening Unit to provide cytology testing services from Dunedin for the entire country.

(v) Agreement between Medlab Hamilton and the Waikato DHB to provide pathology services to the regions described as "the Midland and Central Health Funding Authority areas".

(vi) Agreement between Medlab Gisborne and the Tairawhiti DHB to provide pathology services in the Tairawhiti DHB district.

(b) Sonic - Medlab South:

(i) Agreement between Medlab South Ltd and the Nelson Marlborough DHB to provide laboratory services throughout Nelson Marlborough.

(ii) Agreement between Medlab South Ltd and the West Coast DHB to provide laboratory services throughout the West Coast.

(iii) Agreement between Medlab South Ltd and the Canterbury DHB to provide laboratory services throughout Canterbury.

(iv) Agreement between Medlab South Ltd and the South Canterbury DHB to provide laboratory services throughout South Canterbury.

(v) Agreement between Medlab South Ltd and Otago DHB to provide laboratory services throughout Otago.

(vi) Agreement between Medlab South Ltd and the Southland DHB to provide laboratory services throughout Southland.

(vii) Agreement between Medlab South Ltd and the National Cervical Screening Unit to provide cytology testing services.

(viii) Agreement between Medlab South Ltd and the Southland District Health Board to provide laboratory services for Lakes District Hospital.

(ix) Agreement between Medlab South Ltd and the Community Trust in Oamaru to provide laboratory services for Oamaru Hospital.

(c) Sonic - Medlab Central:

(i) Agreement between Medlab Central and the Hawke's Bay DHB to provide laboratory services to the Hawke's Bay region.

(ii) Agreement between Medlab Central and Health Care Services (the Hawke's Bay DHB provider arm or public hospital) for anatomical pathology services.

(iii) Agreement between Medlab Central and Health Care Services for specialist haematologist supervision of the public hospitals' haematology laboratory.

(iv) Agreement to provide coronial forensic services to the Coroners of Hawke's Bay.

7.4 Other arrangements: Sonic is presently in discussions with Abano in relation to a potential joint venture in the Wellington area. A term sheet has been submitted and negotiations are in progress.

7.5 Industry association. Both NZDG and Sonic are members of the New Zealand Association of Pathology Practices ("NZAPP"), formerly the Association of Community Laboratories ("ACL").

8. **Common directorships**

8.1 None.

9. **Business activities**

9.1 The core services provided by the parties are pathology services (also called diagnostic laboratory services). These services involve the examination of clinical and pathology specimens to provide information for the diagnosis, prevention and treatment of disease, and the reporting of the diagnosis to the referring health professional. The services are described in more detail below. Ancillary to the analysis itself is the collection and transportation of the samples, which is sometimes subcontracted to other parties.

9.2 In addition to these services, the parties both also provide Infection Control consultancy and Continuing Medical Education for GPs, nurses, midwives, rest home staff etc.

9.3 NZDG owns and operates diagnostic pathology laboratories in 8 different DHB districts, collecting samples from and offering services to a further 7 DHB districts where it does not have a laboratory. Sonic owns and operates diagnostic pathology laboratories in 11 different DHB districts, collecting samples from and offering services to a further 6 DHB districts where it does not have a laboratory. The proposals would result in the merger of those operations in the following DHB districts:

(a) Hawke's Bay;

(b) Canterbury;

(c) the West Coast,

(d) Otago; and

(e) Southland.

9.4 While there is also a proposed merger in the South Canterbury DHB district, no aggregation results, as currently only Sonic operates in the district.

9.5 These proposals do not affect the parties' activities in other DHB districts. The parties will, for example, continue to compete in the greater Auckland region comprising the Waitemata, Auckland and Counties Manukau DHB districts for funding from these DHBs.

9.6 The Ministry of Health's map of the 21 DHB districts is attached at **Annex 3**.[2] A chart prepared by the parties setting out, to the best of the parties' knowledge, the locations of the hospital and community laboratories in each DHB district is attached at **Annex 4**. A map showing the regions affected by these proposals is attached at **Annex 5**.

INDUSTRY BACKGROUND

10. Before considering the reasons for the proposal in the next section of this application, it is useful to consider the industry and recent developments. This section:

(a) Describes pathology services (ie. diagnostic laboratory testing) in more detail;

(b) Describes the role of the DHBs in the industry; and

(c) Describes the DHB-led trends towards integration of the community and hospital laboratories and explains why this trend, coupled with changes to the way in which the services are being funded, means that the traditional distinction between private and public sector is now much less clear.

Pathology services/diagnostic laboratory services

10.1 The parties both provide *pathology services* (also called diagnostic laboratory services). Pathology is the branch of medicine that is involved in understanding the causes and processes of disease. Pathology services involve the examination of clinical and pathology specimens to provide information for the diagnosis, prevention and treatment of disease, and the reporting of the diagnosis to the referring health professional.

10.2 Historically, these services were provided by the publicly-owned hospital laboratories. The service was, however, limited and the hospital laboratories did not collect from the wider community. Samples had to be sent in for testing. Growing General Practitioner ("GP') demand created an opportunity for private enterprise. Diagnostic Laboratory, which became Diagnostic Medlab (now owned by Sonic), was established in Auckland in 1936.

10.3 Pathology services are now provided by both (publicly owned and publicly funded) hospital laboratories and by (privately owned and publicly funded) community laboratories.

10.4 Diagnostic testing covers a number of speciality areas:

- **Haematology –** the quantification and in some cases morphological assessment of blood cells and clotting factors
- **Clinical biochemistry –** the quantification of enzymes, other proteins and biological chemical components of the fluid fraction of the blood
- **Trace element and nutritional chemistry –** quantification of chemicals and minerals in the blood or body tissues related to performance and production
- **Endocrinology –** quantification of hormone agents in the blood or body secretions

[2] Further information, about DHBs, including their contact details can be found at: http://www.moh.govt.nz/moh.nsf/238fd5fb4fd051844c256669006aed57/387e1aaa0d074da4cc256a5a00003334?OpenDocument

- **Microbiology –** the culture and identification of bacteria and fungi from samples of biological or inert material

- **Histopathology –** the study of and diagnosis of disease processes by examination of microscopic sections of body parts

- **Serology –** using body fluids, mostly blood, to quantify and identify immune responses indicative of the state of disease or immunity

- **Toxicology –** chemical analysis of body parts or gastrointestinal content for toxic compounds or assessment of gastrointestinal content for known poisonous plants

- **Cytology –** assessment of body fluids and secretions as well as small samples of cells for disease indications. This includes a microscopic assessment visually as well as a quantification by machinery.[3]

10.5 There are approximately 1200 different pathology tests, ranging from the more routine (and, consequently, high volume) to the highly specialised and extremely rare. Most laboratories do not conduct the full range of tests. Some of the non-routine and/or more specialised tests requiring highly skilled clinical input are sent to a small number of "reference laboratories", recognised for their particular specialisation/expertise and where an aggregated "critical mass" of such tests can meaningfully be analysed. Laboratories (community and hospital) which do not perform these tests will refer the samples to the reference laboratories, and these tests are called "sendaways". The reference laboratories where such tests are aggregated into appropriate volumes are the Auckland City Hospital Laboratory ("LabPlus"), Waikato Hospital laboratories, the Institute of Environmental Science and Research ("ESR") in Wellington and the Christchurch Hospital laboratory, Canterbury Health Laboratories ("CHL").

The role of the DHBs in the industry

10.6 Since the New Zealand Public Health and Disabilities Act 2000 came into force on 1 January 2001, 21 DHBs are responsible for providing (or funding the provision of) Government funded health care services for the population of a specific geographical area. Those DHBs are the Northland, Waitemata, Auckland, Counties Manukau, Waikato, Bay of Plenty, Lakes, Tairawhiti, Taranaki, Hawke's Bay, MidCentral, Whanganui, Hutt, Capital & Coast, Wairarapa, Nelson/Marlborough, West Coast, Canterbury, South Canterbury, Otago and Southland DHBs.

10.7 The Ministry of Health ("MOH") retains overall responsibility for the New Zealand public health and disability system and monitors the functioning of DHBs through the reporting requirements imposed on them as Crown Entities.

10.8 Of the DHBs' various roles and responsibilities, two are of particular relevance to this application:

(a) the DHBs' role as *funders* of third party service provision, in particular of pathology services; and

(b) the DHBs' role as *providers* of pathology services in their own right through the public hospital laboratories.

DHBs' role as funders

[3] A comprehensive laboratory will have a range of clinical divisions. Each division within a laboratory has its own personnel and specialist expertise and undertakes a range of services within that clinical discipline.

10.9 The New Zealand government, through the MOH and the DHBs, meets the full cost of most diagnostic tests for all New Zealand citizens and permanent residents. Even where diagnostic testing is carried out in relation to a medical incident covered by the patient's medical insurance or by Accident Compensation, the DHBs fund the diagnostic testing. Neither the patient nor ACC is billed for the service. There are no part-charges to patients. As the funders, the DHBs are monopsony purchasers of pathology services. Community laboratories are wholly dependent on this public funding. Over 96% of their revenues, by value and volume, comes from publicly funded testing, paid for by the DHBs.[4]

10.10 The DHBs fund third party service providers from their own budgets. Their budgets are set in funding agreements with the MOH. Funding is effectively distributed among the DHBs according to a population-based allocation system.

10.11 Under pressure to remain within their own budgets, the DHBs are continually looking to manage their expenditure and use their considerable countervailing market power to exert pressure on third party service providers to reduce prices.

10.12 The DHBs have held down price per test in the pathology services market, refusing to agree to any significant price increases in the last 10 years. The last significant price increase which the community laboratories received was in 1992 when the Department of Health (the body then responsible for administration of "the Schedule") awarded a fee increase of 5% to be applied from July 1993.[5] In the period from 1993 to 1997 under the RHA structure, price increases ranging between 2.0% and 3.0% were applied in some of the regions resulting in slight differences in Schedule prices[6] between the regions. Following the transition to the HFA structure, and on entering into the current contracts in 2000, the community laboratories received only a 0.25% price increase. There have been no further price increases since that time. Even taking into account advances in technology, greater automation and efficiency and the benefits of consolidation over this period, the community laboratories' costs have risen and margins have declined.

10.13 The DHBs are now driving a trend towards consolidation in the industry with the aim, the parties believe, of generating reductions in costs that will be further reflected in the price of pathology services. In some cases, this is coupled with further change to the way pathology services are funded, away from, fee-for-service towards more bulk funding arrangements[7] with the DHBs using their purchasing power in other ways to extract value. These initiatives, led by the monopsony purchasers, require the parties to respond.

DHBs' role as service providers

10.14 The DHBs not only fund pathology services; they also provide pathology services through the public hospital laboratories.

10.15 Every hospital needs an appropriately sized laboratory on or very close to a hospital site. All hospitals, irrespective of geographic location, maintain some form of on-site laboratory service for urgent testing. The reference laboratories, in particular, are very large operations.

10.16 The hospital laboratories represent existing competition of substantial size and resource. DHBs, particularly those in the main urban centres, have a range of options for a "make or buy" decision. Self-supply through the hospital laboratories is a realistic option. Several hospital laboratories have already expanded into community testing. Others have sought funding to do so (see paragraph 10.24(b) below).

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4 There is a limited amount of privately-funded testing, i.e. testing that is not paid for by the DHBs. See paragraph 10.21 below.

5 The Schedule, "Schedule" and "non-Schedule" tests are explained in paragraphs 10.19 and 10.20 below.

6 Individual negotiations with the RHA similarly resulted in slight differences to the content of the Schedule between the regions.

7 See paragraph 10.29 below.

10.17 Through vertical integration into the hospital laboratories, the DHBs have the ability to position the hospital laboratories in competition with the community laboratories for pathology services in the district as and when they choose.

The trend to integration of the community and hospital laboratories

10.18 Historically, there was a clearer distinction between the community and hospital laboratories, in terms of both the environment from which testing was referred and the funding of those services by the DHBs. That is changing. There is a growing trend towards integration of pathology services to the primary and secondary care sectors,[8] led by the DHBs.[9]

10.19 Community laboratories have historically provided testing of samples referred from community or primary care sector health professionals such as GPs, specialists and midwives. The community laboratories have traditionally been funded on a fee-for-service basis and could claim reimbursement from the DHBs (and their predecessors) for tests listed on "the Schedule" (so-called "Schedule tests").[10]

10.20 The Schedule has been described by the Commission as containing the tests which GPs and specialists may readily require and which are generally carried out by community laboratories.[11] There are approximately 180 Schedule tests. It is, currently, national in application in terms of both content and prices, although there are some relatively minor and largely historic variations which arose under the former Regional Health Authority ("RHA") and Health Funding Authority ("HFA") structures (these bodies are among the predecessors to the DHBs).

10.21 The community laboratories also perform a limited amount of testing that is not paid for by the DHBs and the public health system. Such "privately-funded" tests are generally paid for by the patient or the patient's insurer. Examples of such would include tests required for immigration and/or visa applications, life insurance, superannuation and similar benefits, health and safety in employment, or tests prior to travel abroad. This work accounts for less than 4% of the business by value and volume.

10.22 In contrast, the hospital laboratories largely provide testing for the hospital or secondary care sector by testing in-patient and out-patient samples. The hospital laboratories are funded, on a bulk basis, from DHB hospital budgets rather than on a fee-for-service basis. The hospital laboratories are not limited by the content of the Schedule. Through use of the reference laboratories, hospital laboratories can offer the full range of diagnostic testing[12]. In many cases the tests routinely provided for hospital in-patients and out-patients are, of course, the same as those tests listed on the Schedule. The hospital laboratories also carry out non-Schedule testing referred from the community (except where this had been outsourced to a community laboratory).

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[8] The health sector is generally divided into three care levels, determined by the demand requirements of the recipients. These are primary, secondary, and tertiary health care:
- *Primary health care* - provided by GPs, midwives and specialists, and includes non-urgent care that can be dealt with other than by hospitalisation.
- *Secondary health care* - normally provided by public and/or private hospitals.
- *Tertiary health care* - provided in life-threatening circumstances, or under acute or trauma conditions.

[9] See paragraph 10.24 below.

[10] Tests that might be requested by a community referrer but which are not covered by the Schedule are, by definition, "non-Schedule" tests. Where a health professional requests a non-Schedule test, a community laboratory that is not funded to carry out non-Schedule testing would have to send the sample to a laboratory with a contract to perform non-Schedule tests. Generally, this would be a hospital laboratory. Smaller hospital laboratories would refer these samples to the reference laboratories.

[11] Commerce Commission Staff Report, *SGS/Diagnostic*, 14 April 1999, para 8. The Commission has also noted in an early report, that in those regions where there was no community laboratory or laboratory collection service, scheduled tests were carried out by the local hospital laboratory (Investigation Report, *Tairawhiti Healthcare Ltd/Gisborne Laboratories Ltd*, 8/12/1995, para 10).

12 Some Hospital laboratories in smaller regional centres will have more limited facilities and a more limited range of testing. Hospital laboratories in the larger urban centres will have a greater range. For highly specialised tests, samples will be sent to the reference laboratories.

10.23 A diagram showing the stages of the process, from presentation of the patient at a GP or specialist practice or in hospital, to the taking of the sample, collection and transporting, testing, analysis and reporting back to the referrer, is attached at **Annex 6**.

10.24 There is now significant convergence in the provision of pathology services to the primary (community) and secondary (hospital) sectors:

(a) On the one hand, DHBs in some districts have contracted or are seeking to contract with community laboratories for the community laboratories to provide pathology services to both sectors ie. to carry out all hospital-referred and community-referred testing. Recent examples of DHB outsourcing include:

(i) South Canterbury. The South Canterbury DHB recently awarded Medlab South (Sonic) a five year, exclusive contract to provide both hospital and community-referred testing to the district;

(ii) Otago & Southland. In November 2004 the Otago and Southland DHBs issued an RFP seeking one pathology services provider to carry out both hospital and community-referred testing to the region and, on 3 June 2005, awarded the contract to the parties;

(iii) Lakes. In December 2004, the Lakes DHB issued an RFP in respect of the supply of pathology services (both hospital and community-referred testing) to the district;

(iv) The Bay of Plenty DHB has outsourced hospital testing at Tauranga hospital to Medlab Bay of Plenty, part of Pathology Associates Limited ("PAL"). PAL also provides IT systems and some pathology cover at Whakatane Hospital;

(v) The MidCentral DHB has outsourced Palmerston North hospital laboratory to Sonic's Medlab Central; and

(vi) The Taranaki DHB has outsourced management of the hospital laboratory at New Plymouth to Medlab Taranaki, a private laboratory owned by independent pathologists.

(b) On the other hand, a number of hospital laboratories have expanded into community-referred testing. This has been happening since 1998, when the HFA began encouraging competition between community and hospital laboratories by allowing them both to carry out and charge for Schedule tests. Recent examples of DHB insourcing include:

(i) Waikato. In 2002, Waikato Hospital began offering services to referring practitioners in the Hamilton area, securing community testing contracts with Vercoe Clinic (a one GP practice), Redicare (a three GP practice), and the Family Planning Centre. The parties estimate that Waikato hospital currently carries out approximately 1-2% of community-referred testing in the district;

(ii) Canterbury. The parties estimate that CHL currently carries out approximately 1-2% of community-referred testing in the district and has indicated ambitions to secure a greater market share. CHL also supports the activities of hospital laboratories in other DHB districts as a reference laboratory providing both expertise and additional capacity;

(iii) Auckland region. The parties estimate that LabPlus currently carries out approximately 1% of community-referred testing in the region;

(iv) Whanganui. The parties estimate that Whanganui Hospital laboratory currently carries out approximately 30% of community-referred testing in the district;

(v) Nelson / Marlborough. The parties estimate that Blenheim Hospital laboratory currently carries out approximately 10-20% of community-referred testing in the district supported, the parties understand, by CHL; and

(vi) West Coast. The parties estimate that Greymouth Hospital laboratory currently carries out over 40% of community-referred testing in the district.

10.25 It is worth noting that these hospital laboratories in paragraph 10.24(b) continue to do *all* hospital-referred testing in the district *in addition* to the levels of community referred testing indicated. Where the hospital laboratories carry out community-referred testing, they are able to claim reimbursement from the local DHB on a fee-for-service basis on Schedule prices.

10.26 The DHBs are the driving force towards greater integration of pathology service provision to the community and hospital sectors. This is a process which has been gathering momentum for several years as the date for renewal of the current funding contracts approaches. The current funding contracts between the DHBs and the community laboratories expire on 30 September 2005, presenting the DHBs with the opportunity to drive through further change to the way in which those services are both structured and funded.

10.27 The process is cost-driven. A number of the DHBs have commissioned economic analyses of the supply of laboratory diagnostic services in their districts.[13] Consolidation is a common theme of these reports and analyses, although there are differing views between the districts as to how this (and the resulting benefits) can best be achieved.

10.28 In some regions (for example, Otago and Southland), DHBs have determined that optimum benefits and efficiencies are likely to be achieved through the integration of hospital and community laboratories under one management and ownership structure. In other regions (for example, Hawke's Bay), DHBs have taken the view that best results are likely to be achieved through outsourcing of community laboratory services to a single private service provider. There is no one "answer" as the situation in each DHB district varies. It appears likely that all 21 DHBs will be carrying out some form of review of the provision of pathology services to their districts, although not all have started this process and a number of the DHBs are yet to express clear views.

10.29 This consolidation is likely to affect sample collection arrangements as well. At present, samples for community testing may be collected in a variety of ways, ranging from a GP or practice nurse taking the sample and either not charging for it, or being reimbursed for that cost by the community laboratory, through to the patient visiting a collection facility owned and staffed by the laboratory itself. Samples are then couriered or transported back to the processing laboratory.

10.30 In recent years, some DHBs have taken a variety of steps to prevent or limit the level of reimbursement payments to GPs or medical practices made by laboratories, (except in cases where collection facilities would otherwise not be available). Some DHBs took the view that reimbursements incentivised doctors to order more tests, which helped drive

[13] See *Options for Reform of Diagnostic Laboratory Services Markets*, Simon Terry Associates Ltd (Reinhard Pauls) August 2002; *DHBNZ discussion paper and related matters*, EW Consulting P/L, 26 May 2003; *A Response to Reinhard Pauls' Paper*, Brown, Copeland & Company Ltd, Prepared for the Association of Community Laboratories 16 June 2003; *Discussion Document – The future of laboratory services delivery in the central region* , LECG, 16 September 2004; *Laboratory services in the Auckland region - A Review of Future Options for Supply-side Configuration*, Final report to the DHB Chief Executives, December 2004; *Central Region Laboratory Project – Report from the Central Region Laboratory Working Party*, LECG, February 2005; *Waikato DHB Laboratory Service Strategy* Waikato DHB March 2005, under cover of a memorandum to the Community and Public Health Advisory Committee dated 27 April 2005. A bundle containing copies of these papers is provided separately.

excessive growth in test volumes paid for by the DHB. When contracting with suppliers some DHBs have specified detailed conditions on when such costs could be reimbursed. This practice has developed as permitted under DHB contracts in some regions.

10.31 In the merger regions, it now appears that reimbursements are under further review and the new sole supplier contracts being offered are likely to prohibit reimbursements, or only allow them on such tight criteria that effectively the DHBs will be specifying where collection points are located. For instance, the Otago & Southland RFP has specified the number and location of collection centres and any additional centres will require specific DHB approval. Further, the DHBs will only allow reimbursements where collection is more than 20km from the nearest collection centre.

10.32 Another trend which appears likely to emerge is a move away from fee-for-service arrangements under the Schedule towards bulk funding. Although, again, not all DHBs have stated a position, it appears likely that a number of the DHBs may offer fixed-price, single provider, exclusive contracts, in some cases for all pathology services in the district or, where the DHB prefers, for community-referred testing only.

10.33 A table summarising, to the best of the parties' knowledge, the current position in the 21 DHB districts (whether DHBs are insourcing or outsourcing part or all pathology services) and the DHBs' likely stance in the coming contract round is attached at **Annex 7**.

10.34 The proposals and the parties' reasons and intentions need to be considered in this context.

Reasons and intentions

10.35 The parties are, in these proposals, responding to the DHB initiatives towards greater integration, greater consolidation, and towards fundamental change in the manner and nature of funding for pathology services described above.

10.36 Having held down Schedule prices and refused to increase prices for Schedule tests for over 10 years, DHBs are, in the forthcoming contract rounds, looking to explore new ways to further reduce their costs and obtain greater value for their health expenditure given budgetary constraints.

10.37 A number of the DHBs (including, in the Merger Regions, the Hawke's Bay, South Canterbury, Otago and Southland DHBs and, in other regions, the Waikato, Tairawhiti, Capital & Coast and Hutt Valley DHBs) have signalled that they wish to move to a single provider environment at least in respect of community testing (if not for both hospital and community testing). They have also signalled that they wish to move away from fee-for-service arrangements to fixed price, bulk funding. The course the DHBs have chosen to take leaves the parties with only two options: on the one hand, responding to these signals from the DHBs through mergers offering the efficiencies desired by the DHBs to factor into price negotiations or, on the other hand, "going it" alone and risking exiting the market if they cannot negotiate a contract.

10.38 The proposals must be also considered in the context of the hospital laboratories' expansion into community-referred testing. Many DHBs will be considering whether this option is cheaper than outsourcing, and must, as part of this exercise also consider the costs and risks associated with full service provision by the hospital laboratories. However, the DHBs will not be dependent upon community laboratories remaining in the market. In contrast, the community laboratories are wholly dependent on the public sector. In order to compete properly with the alternative, namely self-supply by the DHB hospital laboratories (which are not required to generate a profit and could price on the basis of marginal costs), community laboratories are being forced to come up with even lower prices. Further reductions in price are not possible without a reduction in costs, which the parties believe can best be achieved through the efficiencies that the mergers present.

PART II: IDENTIFICATION OF MARKETS AFFECTED

11. **Horizontal aggregation**

11.1 The proposals will result in aggregation in the provision of pathology services in:

(a) the Hawke's Bay DHB district;

(b) the Canterbury DHB district; and

(c) the Otago and Southland DHB districts.

11.2 While there is also a merger in the South Canterbury and West Coast DHB districts, no aggregation results in the market in South Canterbury because currently only Sonic operates in the district and only very minor aggregation results in the market on the West Coast due to NZDG's very small presence there.[14]

11.3 In previous determinations the Commission has focused on the provision by community laboratories of pathology and medical laboratory testing (including collection and transport of samples) for the carrying out of Schedule tests to the primary care sector in the relevant geographical area.[15]

11.4 The Applicants consider, however, that market conditions have materially changed and that the appropriate product market against which to consider the competition implications of the proposals is the market for the provision of pathology services (or diagnostic laboratory services), both hospital- and community-referred, including the collection and transport of samples.

11.5 The reasons for this view are as follows:

(a) A public/private split based on the Schedule no longer reflects market conditions;

(b) The services offered by the community and hospital laboratories are essentially the same. There is no difference between the community and hospital laboratories in terms of the underlying science or technology. Laboratory set up, equipment and staffing requirements are very similar. Public sector staff and specialist salaries are very competitive, particularly in the larger cities. The bulk of public hospital tests are identical to schedule tests referred from the community. Both types of laboratory do the same tests in large volumes;

(c) For the vast majority of referrals, the same test could be performed by either a community or a hospital laboratory;

(d) Whereas previously there was a clearer distinction between the community and hospital environments, that is no longer the case:

(i) more DHBs are contracting with community laboratories to provide pathology services to both the primary and secondary sectors;

(ii) community laboratories are facing increasing competition from hospital laboratories which are expanding into community-referred testing;

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[14] As noted in paragraph 1.3(a)(i) and footnote 1 above, [

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[15] Previous decisions relating to laboratory testing are: *Tairawhiti Healthcare/Gisborne Laboratories* (8/12/1995); Commission Staff Report (14/4/1999) relating to the proposed merger of SGS New Zealand Limited (Medlab) and Diagnostic Laboratory (*"SGS/Diagnostic"*); Commission Clearance Decision No. 488 (4/2/2003) granting clearance to The Gribbles Group Limited's acquisition of Alpha Scientific Limited (*"Gribbles/Alpha"*), which related to the provision of veterinary pathology laboratory services.

(e) Whereas previously there was a clearer distinction in the way services to the community and hospital environments were funded, that is no longer the case. The MOH and its predecessors used to contract directly with the community laboratories while separately funding the public hospitals and the hospital laboratories through the RHA/HFA structure. The MOH no longer contracts directly with the community laboratories. It now funds only the DHBs, who fund service provision in their districts as they see fit. Moreover, a number of DHBs wish to replace fee-for-service arrangements and the Schedule with fixed price contracts;

(f) Where DHBs opt for a single service provider for both community-referred and hospital-referred work, there is scope for intense competition between community and hospital laboratories, as demonstrated by the competing bids submitted by the parties and the hospital laboratories in response to the Request For Proposal issued by the Otago and Southland DHBs in November 2004;

(g) In the result, earlier statements by the Commission that there was generally no competition between the providers of Schedule tests, on the one hand, and non-Schedule tests, on the other, no longer hold[16];

(h) Over 96% of the parties' business, by value and volume comes from public funding. Privately funded testing represents less than 4% of the business and is a very small segment of the broader market rather than a separate market.

11.6 In any event, should the Commission consider the market to be narrower based on a public/private, hospital/community or secondary/primary split, this is of little effect to consideration of the application:

(a) the constraints operating on the Newcos in each district, in particular the countervailing power of the vertically integrated DHBs, remain the same;

(b) while, on this analysis, hospital laboratories will be existing competitors only if they continue to carry out community-referred testing, they nevertheless impose a significant constraint through the potential to compete directly (to the extent they do not already) and to price on a marginal cost basis if the DHBs opt for greater insourcing at a later point in time;

(c) arguments in relation to the DHBs' ability to create options at the next contract round still apply.

11.7 The geographical area of the relevant markets should, in the Applicants' view, from 1 October 2005, be defined by DHB district. While referring practitioners currently make some consumption decisions, the DHB's are the funders of the services consumed (and the party setting price, demand and quality requirements). The DHBs are now positioning themselves very much as the "customer" on the demand-side and each DHB should be viewed as the customer in its market for the purposes of the competition analysis. There are no "part charges" and patients have very little input into the consumption decision.

11.8 Sonic is currently funded under separate contracts with the relevant DHBs for its operations in each district. This will apply in respect of NZDG from 1 October 2005.[17]

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[16] *SGS/Diagnostic*, para 12. This conclusion was due to the "difference in payment systems" which "creates a fundamental difference in the markets for the two categories of service" (para 12). The same comment was made in *Tairawhiti/Gisborne Laboratories*, with the funding difference being that scheduled testing was on a fee-for-service basis, while non-scheduled testing is done on a bulk-funded basis (paras 12-13). This distinction seems to be disappearing with the move by DHBs to want to bulk-fund scheduled testing.

[17] NZDG's current funding arrangements are unusual in the sense that it is presently funded by the Otago DHB for its operations throughout the country. This is a historical anomaly which arose as a result of the transition from the former RHA and HFA structures. Contracts originally entered into between the community laboratories and the HFA in 2000 were, in July 2001, devolved to the DHBs with a "lead" DHB appointed for each community laboratory. While Canterbury DHB, formerly the "lead" DHB in respect of Medlab South (Sonic), has since terminated these arrangements, the Otago DHB remains the "lead" DHB in

11.9 The Applicants consider, therefore, the relevant geographical area of the markets should be defined by DHB district except where two or more DHBs are collaborating together (as is the case, for example, in Otago and Southland), in which case the geographic area of the market in the broader region comprising the relevant DHB districts.

11.10 The move towards single supplier contracts may mean that there is a temporal dimension to the market for the term of the relevant contracts with competition for the contract in each geographical market at each contract round (although, in the Applicants' view, little would turn on a dimension to the markets as the constraints remain the same).

12. **Differentiated product markets**

12.1 There is very little product differentiation. The products offered, in terms of the testing available the speed of turnaround and the quality of assessment and reporting, are relatively homogenous.

13. **Vertical integration**

13.1 The proposal will not result in any vertical integration.

14. **Previous acquisitions**

14.1 Neither party has notified any acquisition or proposed acquisition to the Commission in the past three years.

14.2 NZDG was in December 2003 formed to acquire Southern Community Laboratories Limited, Medlab Hamilton Limited and their respective group companies.

PART III: CONSTRAINTS ON MARKET POWER BY EXISTING COMPETITION

Introduction

15. The proposals will not result in the Newcos or any other parties gaining market power. The strong countervailing power of the DHBs as the funders of pathology services in their districts, strengthened by their ability to self-supply through the hospital laboratories, is the most significant factor and will continue, post-acquisition, to constrain the merged entities from gaining or exercising any market power.

15.1 With the DHB-driven trend towards single service providers to a district, there will be a change to competition "for" the market at each contract round. However, the lack of any impediment to expansion of the hospital laboratories means there will be actual or potential competition from the hospital laboratories in the current and future contract rounds which, together with low barriers to entry and the potential for players to enter from other markets, means the DHBs will continue to have a choice of service providers in the current and future contract rounds. Accordingly, the DHBs' market power will not decrease as a result of the proposals, and nor will the merged entities market power increase.

15.2 The countervailing power of the DHBs applies with equal force in each of the markets affected and is addressed in the following section. This is followed by a more detailed analysis of the constraints and existing competition in each of the markets. The conditions of expansion – relevant to the ability of the DHBs to expand and to the ability of existing players to enter other markets - are addressed in paragraphs 16 and following below.

respect of Southern Community Laboratories (NZDG). In the result, NZDG's Southern Community Laboratories is presently funded by the Otago DHB in respect of its activities in Southland, Otago, Canterbury, the Wellington Region, Hawke's Bay and the Auckland Region. The Otago DHB has given notice to terminate this "national" funding arrangement and it will be phased out in the forthcoming contract round.

Countervailing power of the DHBs

15.3 The DHBs are the price setters in the market. The community laboratories are price takers. This will remain the case post-acquisition, and the overwhelming market power of the DHBs will continue to constrain the Newcos from raising prices or reducing quality.

15.4 As to price, DHBs and their predecessors have exercised considerable control on prices over time. The last significant price increase which the community laboratories received was in 1992 when the Department of Health (the body then responsible for administration of the Schedule) awarded a fee increase of 5% to be applied from July 1993. In the period from 1993 to 1997 under the RHA structure, price increases ranging between 2.0% and 3.0% were applied in some of the regions resulting in slight differences in Schedule prices[18] between the regions. Following the transition to the HFA structure, and on entering into the current contracts in 2000, the community laboratories received only a 0.25% price increase. There have been no further price increases since that time. Even taking into account advances in technology, greater automation and efficiency and the benefits of consolidation over this period, the community laboratories' costs have risen and margins have declined.

15.5 History demonstrates how little market power the community laboratories have had in price negotiations. This will not change in the processes leading to renewal of the supply contracts from 1 October 2005. The DHBs will be very much in control of the process and have a number of options available to them including:

(a) continued or even greater levels of self-supply through the hospital laboratories (where the hospital laboratories carry out hospital-referred testing, they already supply to 50% of the market);

(b) putting single service provider contracts for some or all pathology services in the district out to tender;

(c) setting a market "cap" within which providers would need to operate[19];

(d) offering fixed price, exclusive contracts.

15.6 A number of the DHBs have signalled a wish to move away from fee-for-service arrangements to bulk funding requiring the community laboratories to take some of the risk in relation to growth (and associated costs). Tendering for these fixed price, exclusive contracts will require the community laboratories to continue to be very competitive on price in light of the hospital laboratories' ability to compete for the same work.

15.7 This dynamic is reinforced by barriers to exit; laboratories cannot readily be converted to an alternative use (other than, perhaps, veterinary laboratories) and the community laboratories' choice is between taking the prices offered by the DHBs, and remaining in the market, or exiting completely.

15.8 These factors are unaffected by the proposals. A combination of the DHBs' considerable bargaining power and the threat which they pose as existing/potential competitors mean that price effects as a result of the proposal are highly unlikely, as is demonstrated by the recent process in Otago and Southland.[20] The DHBs' countervailing power will not be reduced nor will the Newcos gain bargaining power as a result of the mergers.

15.9 Price increases in relation to privately-funded testing are similarly unlikely:

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[18] Individual negotiations with the RHA similarly resulted in slight differences to the content of the Schedule between the regions.

[19] Where, for example, two or more community service providers remain in the market the local DHB could specify a fixed sum available to be spent on pathology services in the district which would be split between the service providers. Such structure could also involve some mechanism for sharing the risk of volume growth over anticipated levels.

[20] See paragraphs 15.50 to 15.55 below.

(a) where hospital laboratories continue to do hospital-referred testing there will be direct competition for this work;

(b) privately-funded testing is generally non-urgent and able to be transported around the country. There is therefore some scope for broader price competition between the hospital and community laboratories within a district and even between community laboratories in different districts, particularly in respect of higher volume/work (e.g. commissioned by research groups);

(c) in any event, privately-funded testing represents only 4% of the business by value and volume.

15.10 Nor will there be any effect on the quality of service. Quality standards are set and monitored by International Accreditation New Zealand ("IANZ")[21]. In any event, the DHBs would be well positioned to monitor any impact on quality through Service Level Agreements and the community laboratories will have to continue to deliver a high quality service, in terms of the extent of their collection networks, speed of reporting and quality of interpretative assessment, in order to win the current and subsequent contracts.

15.11 The countervailing market power of funders of healthcare services has been acknowledged by the Commission in a number of previous decisions.

15.12 In *SGS/Diagnostic*[22], the countervailing market power of the purchasers of healthcare services, particularly the Health Funding Authority (replaced now, effectively, by the DHBs[23]) was stated by the Commission to be "*… the critical issue in determining the competition implications of the proposal.*"[24]

15.13 The Staff Report noted:

- at paragraph 20:

> "… the HFA has a major influence on the behaviour of SGS and Diagnostic (as it has on all health providers) through its role as the monopsony purchaser of publicly funded healthcare services, including pathology services."

- at paragraph 24:

> "… the HFA's conduct in restraining any fee increases over a six year period] demonstrates that the HFA has very strong countervailing power, and that it is not reluctant to exercise that power. Further, that it does not appear that the merged entity would have any more bargaining power in the post-acquisition market than is currently held… . The HFA has advised the Commission that the HFA does not consider that the acquisition will have any impact on its ability to exercise countervailing power."

- at paragraph 25:

> "… the HFA currently exercises a very strong countervailing power on the parties to the acquisition… this power is unlikely to diminish to any significant extent should the proposed acquisition proceed."

- and concluded, at paragraph 26:

> "… the countervailing power of the HFA will prevent the combined entity from exercising any undue market power."

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21 All laboratories require IANZ accreditation to be registered and publicly funded. See paragraph 16.5 below.

22 Commission Staff Report dated 14 April 1999.

23 The functions of the HFA were in 2000, taken over by the Ministry of Health, which is now the funding body to the DHBs.

24 *SGS/Diagnostic*, at para 19.

15.14 In *iSoft/Hewlett-Packard*[25], the Commission found the countervailing power of the DHBs to be "*strong and likely to significantly constrain the combined entity.*"[26] That decision concerned a DHB tender round (for IT software and systems) and is, therefore, of some relevance in light of the current tender process. The Commission in that case considered:

> "… that the DHBs possess some countervailing power in the process… due to the nature of the tendering process and the high value, long term contracts that are typical to this market. And when recent moves towards collaboration and alignment [ ] are considered the countervailing power in respect of DHBs in collective negotiations is considered strong and likely to significantly constrain the combined entity."[27]

15.15 In *Wakefield Hospital/Bowen Hospital*[28] and *Southern Cross/The Oxford Clinic*[29], the Commission concluded that the cumulative impact of the funders (in that case, the Accident Compensation Corporation ("ACC"), insurers and surgeons) would provide a sufficient constraint on the merged entity.

15.16 The Commission referred to the *Wakefield* and *Oxford* decisions in *Southern Cross/Auckland Surgical Centre*[30] finding, in its conclusion in the latter case, that the countervailing power of the ACC and surgeons would continue to provide constraint on the merged entity.[31] It appears to have been particularly persuasive that the ACC was a price setter. The ACC had developed its own benchmark prices, it had recently set a national price for all medical procedures, and had also introduced a number of mechanisms aimed at encouraging new entrants to apply for funding and would consider a new entrant at any time throughout the year.[32] DHBs and insurance companies were, in that case, considered to provide only limited constraint, but that was because their proportion of funding was low in comparison to that of the ACC.[33] That is not the case here, where DHB funding accounts for over 96% of the Applicants' business by value.

15.17 Moreover, the proposals, and mergers of the parties' businesses in the relevant markets, will not adversely affect the DHBs' choice of service providers in the current or future contract rounds:

(a) as is apparent from negotiations in relation to the current contract round, DHBs have a range of options, including insourcing hospital-referred testing, funding the hospital laboratories to expand into community-referred testing, outsourcing hospital-referred testing, or outsourcing all pathology services in the district. DHBs will have the same options in the next contract round;

(b) some hospital laboratories will continue to do hospital-referred and may also continue to do community referred testing. They will remain credible competition for community-referred testing in future contract rounds;

(c) where hospital-referred testing is outsourced, the supply contracts with the DHBs are likely to contain provision allowing the DHBs an option whereby they may take back service provision and all assets at the end of the contract term;

(d) single provider, exclusive contracts could be put out to tender with sufficient time in advance of the next contract round to attract new entry from existing operators in other districts and/or overseas players;

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25 Decision 535 *iSoft NZ Limited and Hewlett-Packard New Zealand*, 29 September 2004.

26 *iSoft/Hewlett-Packard*, at para 155.

27 *iSoft/Hewlett-Packard*, at para 155.

28 Decision 492, *Wakefield Hospital Limited and Bowen Hospital Limited*, 19 February 2003.

29 Decision 537, Southern Cross Oxford Hospital Limited and the Oxford Clinic, 11 November 2004.

30 Decision 546, *Southern Cross Health Trust and Auckland Surgical Centre Limited*, 17 February 2004.

31 *Southern Cross/Auckland Surgical Centre*, at para 158.

32 *Southern Cross/Auckland Surgical Centre*, at paras 145 to 148.

33 *Southern Cross/Auckland Surgical Centre*, at paras 152 to 154. DHB contracts "sporadic and unpredictable." (para 153).

(e) moves towards further regionalisation (i.e. groups of DHBs collaborating together) are possible. Regionalisation would further strengthen the DHBs already considerable bargaining power and larger markets could attract interest from new entrants.

The constraints operating and existing competition in the individual markets

Hawke's Bay

15.18 Existing competitors in the Hawke's Bay DHB district are currently NZDG, Sonic and the DHB hospital laboratories at Healthcare Hawke's Bay and Wairoa Hospital.[34]

15.19 **Table 1** below sets out the Applicants' estimates of market shares:

Table 1: Pathology services in the Hawke's Bay DHB district
Estimated market shares post-acquisition

Player	Value (turnover ($))	% market
Sonic		
NZDG		
Merged entity		
HB hospital laboratories: – Healthcare HB Wairoa Hospital lab		
Total		

Source: parties' estimates

15.20 The Applicants note that it is very difficult to obtain market share data in relation to the hospital laboratories, whether by value (turnover) or volume (number of tests). The hospitals do not use standardised methods either for the naming or the counting of tests, and there is no public source of volume data, and issues such as inconsistency over the inclusion or exclusion of indirect overheads and the inclusion or exclusion or tests for patients from outside the district mean it is difficult to obtain directly comparable data. The Applicants understand that DHB spend on hospital-referred testing is approximately equal to spend in respect of community-referred testing (i.e. the split in funding between hospital and community testing is approximately 50:50). This is generally consistent with figures produced in the various DHB review processes[35] and is the basis on which market shares have been estimated. The parties have not exchanged this market share data.

15.21 The Hawke's Bay DHB recently carried out a review of the provision of laboratory services to the district in conjunction with the Hutt Valley and Capital & Coast DHBs. LECG was contracted to advise. A key theme of LECG's Discussion Document, released in September 2004[36], was integration of the hospital and community sectors and the preferred option presented was, "*…regional integration via full integration of community and hospital laboratory services through a joint venture structure. This would combine the interests of the three DHBs with the interests of a (possibly minority) private sector partner*."[37]

15.22 Although a round of consultation on the discussion document has revealed less appetite for regional integration in the short term, it was apparent to the parties throughout this review process that the likely result was the integration and/or rationalisation of service provision in the Hawke's Bay district.

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34 LabPlus, and the hospital laboratories in Wellington and Palmerston North (outsourced to Sonic)) all provide small levels of subcontracted services to the Hawke's Bay hospital laboratories.

35 See for example *Central Region Laboratory Project – Report of the Working Party* at pages 6 and 7.

36 *The future of laboratory services delivery in the Central Region: a discussion document*, LECG, September 2004.

37 LECG discussion document at page 35.

15.23 Towards the end of 2004 the parties approached the Hawke's Bay DHB with a proposal to merge their businesses in the district and move to a single service provider of community services in the district. The proposal, which is viewed as delivering the best result in terms of efficiency gains and a quality and sustainable service to the district at this time, was, on 10 June 2005, approved by the DHB (subject to merger clearance) and the Chairman has invited the parties to enter into commercial negotiations on the terms of a contract for community-referred testing. A copy of the Heads of Agreement relating to the proposal is attached at **Annex 8**.

15.24 The DHB hospital laboratories will continue to carry out hospital-referred testing for Healthcare Hawke's Bay and Wairoa Hospital as well as urgent after hours testing referred by the community laboratories.

15.25 Given the Hawke's Bay DHB's clear preference for one community service provider to the district, a reduction in the number of competitors in the district could reasonably be anticipated whether or not the proposal proceeds. The merger of the parties' businesses does not result in a substantial lessening of competition in comparison to a counterfactual tender scenario. In either case there would be only one community service provider to the district, and in either case the DHB's ability to integrate the hospital and community laboratories (i.e. to self-supply through the hospital laboratories) exerts a significant competitive constraint.

15.26 The DHB's choice, between public and private sector provision of an integrated service is, as the Working Party's Final Report states, not clear cut but "*a comparative problem, to which there is no right answer*".[38] The Hawke's Bay DHB has, in this contract round, indicated that it will opt to outsource, but the threat of its ability to insource is a real constraint in the negotiation of a supply contract. That constraint would be the same in a tender scenario. Competition is not lessened as a result of the merger and, in any event, the merger would result in cost reductions and efficiencies through rationalisation and economies of scale, and enable Hawke's Bay Newco to offer the Hawke's Bay DHB lower prices compared to its current spend.

15.27 The hospital laboratories will continue to carry out community-referred testing. They will, therefore, remain in the market and to continue to exert a constraint on the merged entity through the ability to expand and compete in future contract rounds.

15.28 The constraint exerted by the hospital laboratories will gain even more force if the preferred option in LECG's Discussion Document is adopted. The Discussion Document recommended regional integration and one service provider to the broader region comprising the Hawke's Bay, Hutt Valley and Capital & Coast DHB districts. Although the DHBs appear to be indicating a preference for more localised solutions at this stage, the Applicants believe there could well be further moves towards regionalisation in the medium term.[39]

15.29 If this turns out to be the DHBs' collective strategy, and LECG's preferred option is adopted, this would result in one service provider to the Hawke's Bay, Hutt Valley and Wellington region in a public/private joint venture with the DHB hospital laboratories. There would be several contenders for such a contract:

(a) The hospital laboratories. The hospital laboratories clearly have the capability and capacity to provide hospital-referred testing and could credibly tender for further expansion into community-referred testing.[40] To the extent that they did not wish to

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38 *Central Region Laboratory Project – Report of the Working Party* at page 22.

39 The Final Report of the Working Party noted at page 9, "*Local integration showed through as the preferred option in the immediate term in submissions, with many suggesting sub-regional integration in the future.*"

40 Although the Final Report of the Working Party noted (at pages 3, 20 and 23) that the Capital and Coast DHB is not presently able to integrate the community laboratory on its site due to space constraints within the hospital, the Working Party recommended that the DHB works towards full integration for 2008.

invest in a collection network, this could potentially be outsourced (eg. to GPs or their Primary Health Organisation);

(b) Healthscope and Abano. Healthscope currently operates in the Northland DHB district. Abano currently operates in the Capital & Coast and Nelson/Marlborough districts. Both could present as credible alternatives to the merged entity as a potential joint venture partner for the DHBs. Both are experienced operators of community laboratories and are well resourced. Moreover, and given that they would be more likely to proceed with entry by way of acquisition rather than *de novo*, these existing players would represent a real competitive threat;

(c) Similarly, an exclusive supply contract for the broader region might well attract interest from overseas competitors (see paragraph 22 below in relation to potential competition).

15.30 The possibility for further regionalisation, the prospect of an exclusive contract being offered for pathology services to the wider region, the ability of the DHB hospital laboratories to compete for some or all of that market, the ability of existing players operating in other markets in New Zealand to expand into the region and the potential for the larger market to attract interest from overseas competitors are all factors that would constrain Hawke's Bay Newco in future contract rounds.

15.31 In summary, Hawke's Bay Newco will, in the Hawke's Bay DHB district, continue to be constrained by:

(a) the very strong countervailing power of the Hawke's Bay DHB as the funder of pathology services in the district;

(b) existing competition from the Hawke's Bay Hospital laboratories at Healthcare Hawke's Bay and Wairoa Hospital, which will continue to do hospital-referred testing;

(c) competition from the hospital laboratories in future contract rounds;

(d) potential competition, in the event of further moves towards regionalisation (and one service provider to the Hawke's Bay, Hutt Valley and Capital & Coast DHB districts), from the DHB hospital laboratories, existing players and/or overseas players.

Canterbury

15.32 Existing competitors in the Canterbury DHB district are currently NZDG, Sonic and the Canterbury Hospital Laboratory, CHL.

15.33 **Table 2** below sets out the Applicants' estimates of market shares:

Table 2: Pathology services in the Canterbury DHB district
Estimated market shares post-acquisition

Player	Value (turnover ($))	% market
Sonic		
NZDG		
Merged entity		
CHL		
Total		

Source: parties' estimates

15.34 The Canterbury DHB has not yet stated a clear view of how it will wish to see service provision in the district. It has indicated that it will be conducting a review of the supply of pathology services in the district, although it has only recently started this process and may

have been monitoring the situation in Otago and Southland with a view to considering its own options in light of the outcome.

15.35 Given CHL's size, strength, and position as a reference laboratory it is unlikely the Canterbury DHB would opt for full integration of community and hospital testing services. The more likely scenario, in the parties' view, is a single contract for community-referred testing in the district.

15.36 CHL could be expected to compete vigorously for this work. CHL presently does some community-referred testing and has indicated intentions to gain market share over the community laboratories. The parties understand CHL has approached Pegasus Health, a Private Health Organisation which holds approximately 50% of the budget for community-referred testing in the district through a funding contract with the Canterbury DHB, with a view to securing more of the group's referrals. Moreover, the parties understand that CHL supported the Otago and Southland hospital laboratories' bid in response to the RFP in Otago and Southland, providing advice on the hospital laboratories' bid and offering supporting expertise and additional capacity. The parties understand that CHL has committed to offering similar support to the hospital laboratories operated by the Nelson/Marlborough DHB in the Nelson and Blenheim area in relation to an RFP process which the DHB has indicated is imminent. As a reference laboratory, CHL supports a number of hospital laboratories around the country, providing expertise and additional capacity. For example, a large proportion of non-Schedule testing from the Hawke's Bay, Hutt Valley and Capital & Coast DHBs is sent to CHL.[41] CHL is an active competitor and Canterbury Newco would have to be highly competitive on price to win any tender in the forthcoming contract round.

15.37 Pegasus Health is an additional constraint in the Canterbury region. As indicated above, Pegasus Health holds approximately 50% of the budget for community-referred testing in the district through a funding contract with the Canterbury DHB. While the community laboratories' contracts are with the DHB, they are paid by Pegasus Health in respect of testing referred by its members. Pegasus Health is, therefore, a paying agent of the DHB, although it nonetheless has considerable leverage and is an important customer. This will not change post-acquisition; its business would remain very important to the merged entity which would have to compete vigorously to retain Pegasus Health's business.

15.38 If Canterbury Newco were successful in securing an exclusive contract for the supply of community-referred testing services to the Canterbury DHB district, it would be constrained in future contract rounds by the potential for competition from CHL, other players such as Healthscope and Abano and, potentially, overseas players (see paragraph 22 below in relation to potential competition).

15.39 In summary, Canterbury Newco will, in the Canterbury DHB district, continue to be constrained by:

(a) the very strong countervailing power of the Canterbury DHB as the funder of pathology services in the district;

(b) existing competition from CHL, which currently does some community-referred testing and will continue to do hospital-referred testing;

(c) in the event that a contract for community-referred testing in the district is put out for tender, competition from CHL;

(d) competition from CHL in future contract rounds;

[41] *Central Region Laboratory Project – Report from the Working Party* (prepared with the assistance of LECG, February 2005) at page 6.

(e) potential competition in future contract rounds from other players and/or overseas players.

South Canterbury

15.40 The proposals will not result in any aggregation in the South Canterbury DHB District as only Sonic's Medlab South ("MLS") currently operates there. South Canterbury DHB and MLS have recently entered into a five year exclusive contract. All pathology services in the district (both community-referred and hospital-referred) have been outsourced to MLS. The proposed merger, therefore, results in no change other than to the identity of the party providing the service to the South Canterbury DHB (from MLS to Newco).

15.41 **Table 3** below sets out the Applicants' estimates of market shares:

Table 3: Pathology services in the South Canterbury DHB district
Estimated market shares post-acquisition

Player	**Value (turnover ($))**	**% market**
Sonic		
NZDG		
Merged entity		
Total		

Source: Sonic

15.42 In any event, Canterbury Newco will, in the South Canterbury DHB district, continue to be constrained by:

(a) the very strong countervailing power of the South Canterbury DHB as the funder of pathology services in the district;

(b) the fact that the South Canterbury DHB continues to own the district's hospital laboratory. The DHB has [

] the ability to take back and insource hospital and/or community-referred testing in future contract rounds;

(c) competition in future contract rounds from CHL;

(d) potential competition in future contract rounds from other players such as Healthscope and/or Abano and/or overseas players;

(e) potential competition from the same players in the event of further moves towards regionalisation (one service provider to the broader Canterbury region).

West Coast

15.43 The proposal will result in only very minor aggregation in the West Coast DHB district. Neither party operates a laboratory in the district. All samples are collected and transported (mainly to Christchurch) for testing. NZDG's activities in the district account for less than 3% of the market by value and volume. The only laboratory in the region is owned and operated by Grey Hospital in Greymouth.

15.44 Existing competitors in the West Coast DHB district are currently NZDG, Sonic and Grey Hospital laboratory.

15.45 **Table 4** below sets out the Applicants' estimates of market shares:

Table 4: Pathology services in the West Coast DHB district
Estimated market shares post-acquisition

Player	Value (turnover ($))	% market
Sonic		
NZDG		
Merged entity		
Grey Hospital laboratory (includes sendaways to CHL)		
Total		

Source: parties' estimates

15.46 Grey Hospital laboratory currently does a significant amount of community-referred testing in addition to all hospital-referred testing in the district. This appears unlikely to change.

15.47 Canterbury Newco will, in the West Coast DHB district, continue to be constrained by:

(a) the very strong countervailing power of the West Coast DHB as the funder of pathology services in the district;

(b) existing competition from Grey Hospital laboratory;

(c) in the event of a tender scenario, in the current or future contract rounds, competition from:

(i) Grey Hospital laboratory;

(ii) CHL;

(d) potential competition, in the event of moves towards further regionalisation (one service provider to a larger South Island region) from:

(i) Grey Hospital laboratory and CHL;

(ii) Other players such as Healthscope and/or Abano and/or overseas players.

Otago and Southland

15.48 Existing competitors in the Southland and Otago and Southland DHB districts are currently NZDG, Sonic and the DHB laboratories, Otago Diagnostic Laboratories (Dunedin hospital) and Healthcare Kew (Invercargill hospital).

15.49 **Table 5** below sets out the Applicants' estimates of market shares:

Table 5: Pathology services in the Otago and Southland DHB district
Estimated market shares post-acquisition

Player	**Value (turnover ($))**	**% market**
Sonic		
NZDG		
Merged entity		
O&S hospital labs: - Dunedin Hospital lab Invercargill Hospital lab (includes sendaways to CHL)		
Total		

Source: parties' estimates

15.50 In November 2004, the Otago and Southland DHBs issued a RFP indicating wish to purchase a "comprehensive and integrated laboratory service":

(a) Clause 4.1.2 stated that the DHBs wished to see "*collaboration between service providers…*" (i.e. those presently funded by both DHBs - NZDG, Sonic and the hospital laboratories) "*… to ensure a cost-effective, sustainable and efficient laboratory service*";

(b) Clause 4.1.3 stated that the DHBs "… *wish to most cost-effectively utilise the laboratory infrastructure and capacity, by integrating the activities of the community and hospital laboratories under one governance / ownership, and management structure. Full integration of staff, management, IT, property etc. would be highly desirable";*

(c) Clause 20.1 stated that the DHBs were seeking proposals priced for the delivery of all services being purchased; and

(d) Clause 20.2 stated that the DHBs "*… recognise that there are current providers delivering different parts of this service. [The DHBs] wish to enter into one contract for all services. Where a joint venture is the preferred proposer, only one exclusive contract will be negotiated*."

15.51 It was in response to these signals, and the DHBs firm preference for one service provider to the region, that NZDG and Sonic submitted a joint response to the RFP on 21 March 2005.

15.52 Competition for the contract was intense. The parties understand that the hospital laboratories submitted a joint response, supported by CHL. The bid was competitive, giving the DHBs leverage to come back to the parties on several occasions throughout the process seeking further concessions on price and other terms. [ ]

15.53 [ ]

(a) [ ]

(b) [ ]

(c) [ ]

(d) [ ]

15.54 [ ]

15.55 The parties accepted the DHBs' conditions on 3 June 2005 and were awarded the contract. A copy of the RFP, together with the parties' proposal and correspondence with the Otago and Southland DHBs in relation to their proposal is attached at **Annex 9**.

15.56 Given the DHBs' expressed preference in the RFP for one contract for all services in the region, the status quo of multiple service providers would not have continued. In the result, the merger does not result in a substantial lessening of competition in comparison to the tender scenario. There would be a 4 to 1 consolidation in the region, with or without the merger.

15.57 Moreover, in selecting the parties as the preferred provider, the Otago and Southland DHBs have made a clear determination that the parties' proposal presents the best option for the provision of services to the region. The parties' proposal was premised on cost savings and efficiencies arising from the merger of the businesses and full integration with the hospital laboratories and offered a significant reduction in price compared to the DHBs' current spend.

15.58 The Otago and Southland DHBs will continue to have a choice of service provider in future contract rounds. [ ]

(a) [ ]

(b) [ ]

15.59 [ ]

15.60 In summary, O&S Newco will, in the Otago and Southland DHB region, continue to be constrained by:

(a) the very strong countervailing power of the Otago and Southland DHB's as the funders of pathology services in the region;

(b) existing competition from the DHB hospital laboratories in the current contract round (demonstrated by the hospital laboratories' joint bid);

(c) [ ]

(d) in the result, potential competition in future contract rounds from:

(i) the Otago and Southland DHB hospital laboratories; and

(ii) other players such as Healthscope and/or Abano and/or overseas players.

Conditions of expansion

16. Where the DHBs opt either:

(a) for a single service provider to the district (as is the case in South Canterbury and as appears likely in Otago & Southland); or

(b) for a single community service provider (as appears likely in Hawke's Bay, Canterbury and possibly also the West Coast),

expansion or new entry is unlikely during the contract period.

16.2 The conditions of expansion will, however, be relevant:

(a) to the position of the hospital laboratories who might wish to compete for community-referred testing whether in this or in future contract rounds; and

(b) to the position of existing operators in other districts (such as, for example, Healthscope and Abano) who might wish to compete for some or all services in the next contract round.

16.3 In the Applicants' view, the critical issue is funding for the testing. While funding is a barrier to expansion and/or entry, it is a factor entirely within the DHBs' control. Provided a source of funding can be secured, setting up and staffing a laboratory and setting up a collection network would be no particular difficulty for an existing operator.

16.4 The capital cost to establish a new laboratory depends on the breadth of testing to be offered, but equipment could be purchased or leased from large chemical diagnostic companies (such as Abbott, Roche or Bayer) or from hospital laboratories. A full laboratory with equipment could be established quickly and at a relatively low capital cost. All up, including fit out and other establishment costs, a medium sized operation could be set up within a period of 3-6 months at an approximate cost of $500-$750,000. As the Commission found in *SGS/Diagnostic*, the capital cost of establishing a laboratory is not a barrier to entering the market.

16.5 Since January 2004, all laboratories in New Zealand offering laboratory testing are required to be accredited to ISO15189. This international industry standard is administered by International Accreditation New Zealand ("IANZ"), which approves accreditation.

16.6 To gain accreditation a laboratory needs to demonstrate three basic elements: an effective quality management system, the technical validity of its testing methods and the competence of its staff. IANZ accreditation does not impose any real barrier to entry for any firm with experience in running a diagnostic laboratory business.

16.7 In addition, certain basic regulatory requirements are usually set out as quality and service specifications in the DHB contracts. These do not present difficult standards for an experience laboratory operator to meet.

16.8 Access to clinical support is essential. There is presently a shortage of pathologists in New Zealand, but this is unlikely to present any barrier to a firm with reasonable size and resources, and no difficulty to an established laboratory operator. In any event, the likely scenario for expansion would be by way of purchasing or utilising an existing laboratory practice. It can be assumed that staff, including pathologists, would be likely to be available from the practice being purchased.

16.9 A collection network would also be required.

16.10 Samples can be collected one of two ways – either by collecting samples and specimens from various sites and then sending them to be processed at a central laboratory location; or by setting up and processing on site locally.

16.11 It is not necessary for a new entrant to develop an extensive collection network. A few strategic collection points can be as effective as a large number of scattered rooms. In addition, medical practitioners and their staff are frequently involved in the process and their existing facilities can be utilised.

16.12 The easy transportability of samples by courier service and the electronic availability of reporting and results mean an extensive local collection network is not always necessary. If a new entrant has an attractive price, expertise and service quality package to offer to referrers and DHBs, then the absence of a large collection network would certainly not be a significant barrier to entry.

16.13 The best example of expansion/new entry in recent years is Cardinal Laboratories/Southern Community Laboratories entry into the Auckland region and Hawke's Bay district. Cardinal/SCL were located in the South Island. They decided to enter these areas and quickly built up a reasonable foothold share of the market by setting up a small number of strategically placed collection points. Rather than duplicate an extensive network of collection points, they could arrange the collection from a few key points and then courier all the samples south to be processed at a South Island laboratory. There has also been expansion/new entry by Medlab South into the Blenheim region in February 2001 and into Queenstown in December 2001, although both were relatively small scale.

16.14 As to expansion by the hospital laboratories, Waikato Hospital began offering services to referring practitioners in the Hamilton area in 2002, securing community testing contracts with Vercoe Clinic (a one GP practice), Redicare (a three GP practice), and the Family Planning Centre. For details of other hospital laboratories currently carrying out community-referred testing please see paragraph 10.24(b) above.

16.15 Given that the DHBs could in subsequent contract rounds either in-source to the hospital laboratories, or award contract to another player, that this would force the merged entity to sell its assets and exit the market, and that the incoming player would be likely to acquire the existing assets and recruit from former employees, the relative ease with which a new player could take over from the merged entity would act as a significant and ongoing constraint on the conduct of the merged entities in their dealings with the relevant DHBs.

Co-ordinated Market Power

17. These markets are not, in the Applicants' view, susceptible to collusion. It is inherently unlikely the DHBs, as the funders, would collude with their service providers to raise prices. Nor do the hospital laboratories, which are vertically integrated into the funders, have any incentive to collude with the community laboratories. Collusion between the community laboratories in different districts is unlikely and, in any event, unlikely to be effective as the DHBs will be able to benchmark against prices in other districts.

18. Given the above, the Applicants briefly reproduce the Commission's criteria below.[42]

19. Table 6: Testing the Potential for Collusion

Factors conducive to collusion	Presence of factors in all relevant markets

[42] The Applicants note that the Commission's Mergers & Acquisitions Guidelines refer to retaliation as part of this analysis. The Applicants do not view that factor as adding any further to the analysis in this case.

Factors conducive to collusion	**Presence of factors in all relevant markets**
High seller concentration	Yes
Undifferentiated product	Yes
Static production technology	No
New entry slow	No
Lack of fringe competitors	No
Acquisition of a maverick business	Neither business is a “maverick” within the meaning of the Commission’s Guidelines
Price inelastic demand curve	Yes – fixed price contracts or Schedule prices, in either case set by the DHBs
Industry’s poor competition record	No
Presence of excess capacity	Not for community laboratories. Hospital laboratories must carry some excess capacity at all times in order to cope with peak demand in case of emergencies.
Presence of industry associations/fora?	Yes – the NZAPP (formerly the ACL)

20. Table 7: Testing the Potential for Discipline

Factors conducive to discipline	**Presence of factors in all relevant markets**
High seller concentration	Yes
Sales small and frequent	Yes, where Schedule prices. No, where fixed price contracts.
Absence of vertical integration	DHBs and hospital laboratories are vertically integrated. The community laboratories are not vertically integrated.
Demand slow growing	Growth in demand growth is in general slow to steady, although there is some regional variation
Firms have similar costs	For community laboratories yes. Costs of hospital laboratories not known to the parties.
Contact in a variety of markets	No. The parties are active in the Auckland region and the Lakes DHB district. Otherwise no contact outside the markets with which this application is concerned[43]
Price transparency	Yes. Currently:- Schedule prices. Going forward:- Fixed price contracts.

43 [ ]

PART IV: CONSTRAINTS ON MARKET POWER BY POTENTIAL COMPETITION

Conditions of Entry

21. The conditions of entry are the same as those discussed in the context of conditions of expansion/new entry from another region.

22. **Potential New Entrants**

22.1 There are several pathology providers in Australia with the requisite expertise and resources to set up operations in New Zealand, if they perceived an opportunity. These are:

(a) Healthscope Limited

(i) Healthscope is the third largest private hospital operator in Australia. It acquired the pathology operator Gribbles in December 2004 for approximately AU$285 million and currently operates in Northland.

(b) Mayne Pathology

(i) Mayne Pathology is one of Australia's largest pathology providers, with laboratories in Victoria, New South Wales, ACT, Queensland, Western Australia and Northern Territory. Entering the New Zealand market would appear to be a logical strategic extension of its operations

(c) St John of God Pathology

(i) St John of God Pathology is a division of St John of God Healthcare, a national non-for-profit Catholic health care provider operating 10 hospitals and medical imaging and pathology services throughout Australia. St John of God Healthcare is Australia's fourth largest private hospital group. St John of God Pathology has 23 laboratories and 56 collection centres throughout Western Australia and regional Victoria. It provides pathology services to more than 500,000 patients a year.

22.2 Healthscope already has a presence in New Zealand and the parties understand that it may have intentions to expand operations.

22.3 Although it is unlikely that the other firms presently perceive a sufficient commercial opportunity to consider entering New Zealand’s relatively small and fragmented markets, they will be monitoring recent developments and this view could well change. This is particularly so in light of:

(a) recent moves towards fixed price, exclusive contracts;

(b) greater integration of the primary and secondary care sectors; and

(c) the possibility for further moves towards regionalisation, with groups of DHBs co-operating in relation to service provision to the larger region.

22.4 In the Applicants’ view, these firms should be viewed as potential competitors for contracts in the next round and, therefore, as exerting a degree of constraint on the merged entities in the future.

Likelihood, Sufficiency and Timeliness of Entry

23. The lead time and capital cost would be similar for *de novo* entry from overseas as for expansion/new entry by an existing operator into a different region. See paragraph 16 above. Entry by acquisition is, however, the most likely scenario.

PART V: OTHER POTENTIAL CONSTRAINTS

Constraints on market power by the conduct of suppliers

24. Suppliers to the merged entities include the pharmaceutical companies Roche, Abbott and Bayer, who supply equipment. These are multi-national companies who will also impose some degree of constraint on the Newcos.

Constraints on market power by the conduct of acquirers

25. The DHBs countervailing market power is discussed in detail in Section III.

THIS NOTICE is given by **David Fleming** of **New Zealand Diagnostic Group Limited** and by **Colin Jackson** of **Sonic Healthcare 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 2005

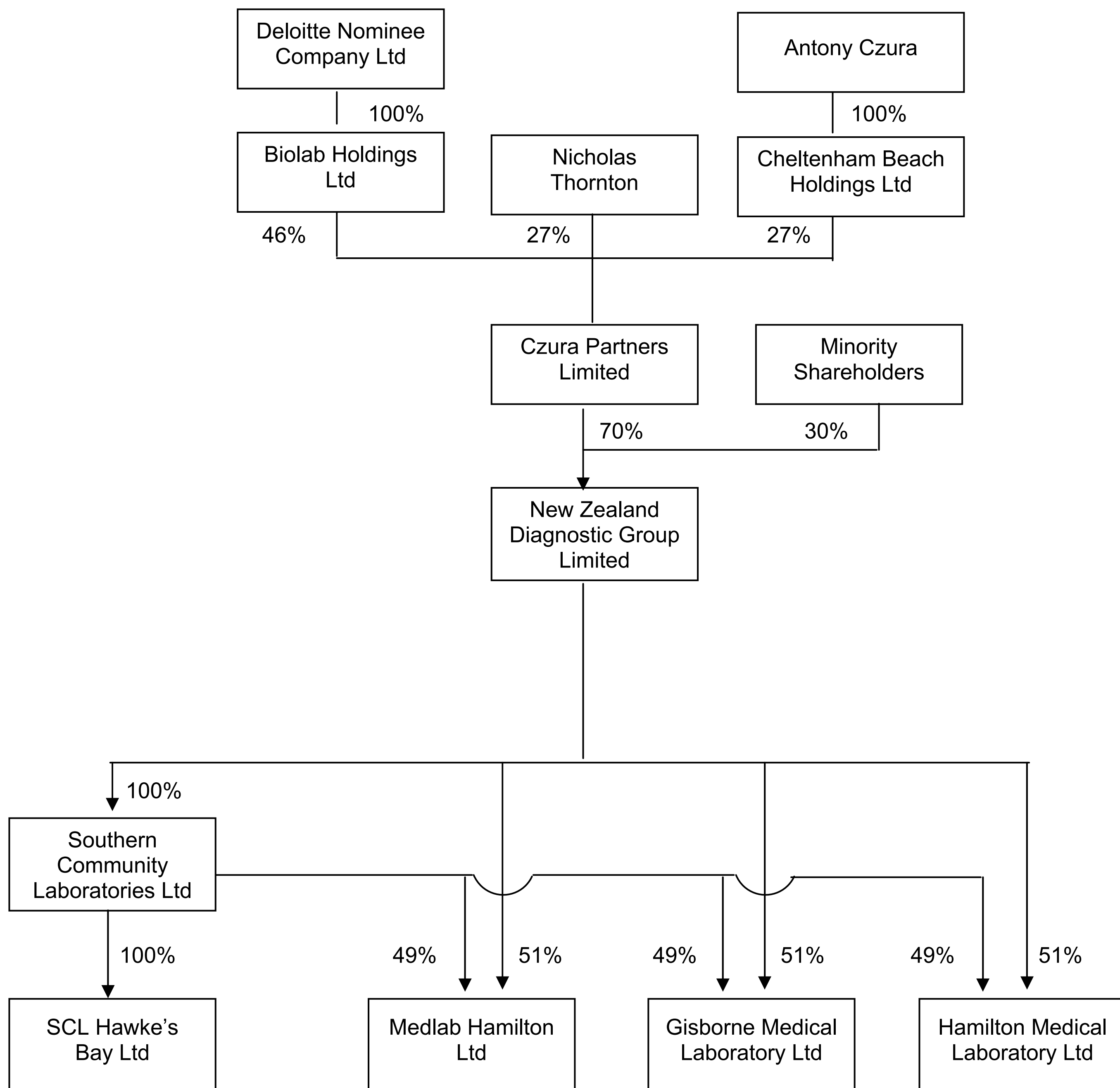
Signed by:

I am duly authorised to make this application on behalf of New Zealand Diagnostic Group Limited.	I am duly authorised to make this application on behalf of Sonic Healthcare (New Zealand) Limited.

Annex 1

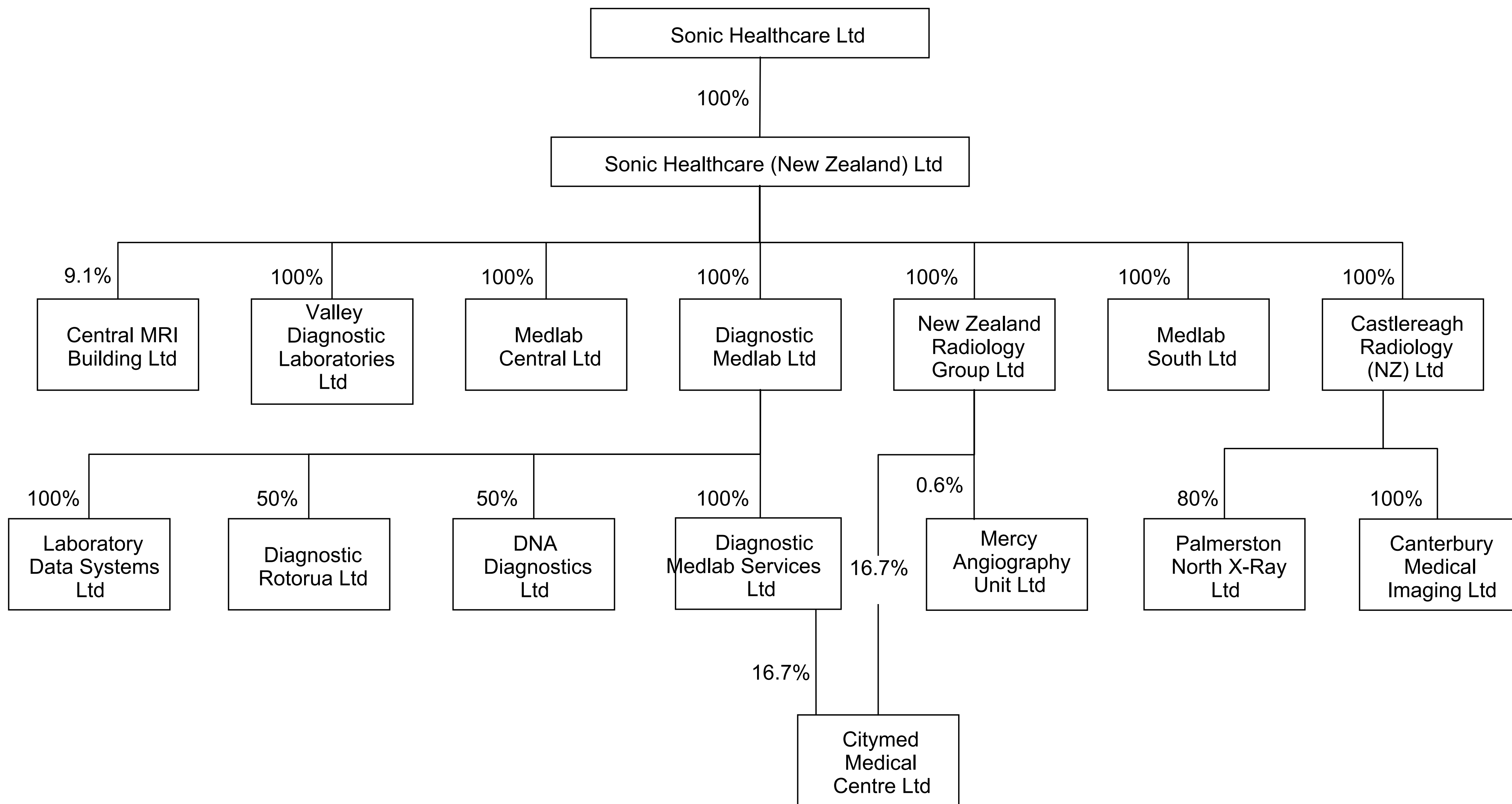
New Zealand Diagnostic Group Limited

Group Structure Chart



Annex 2

Sonic Corporate Structure (significant shareholdings) in New Zealand



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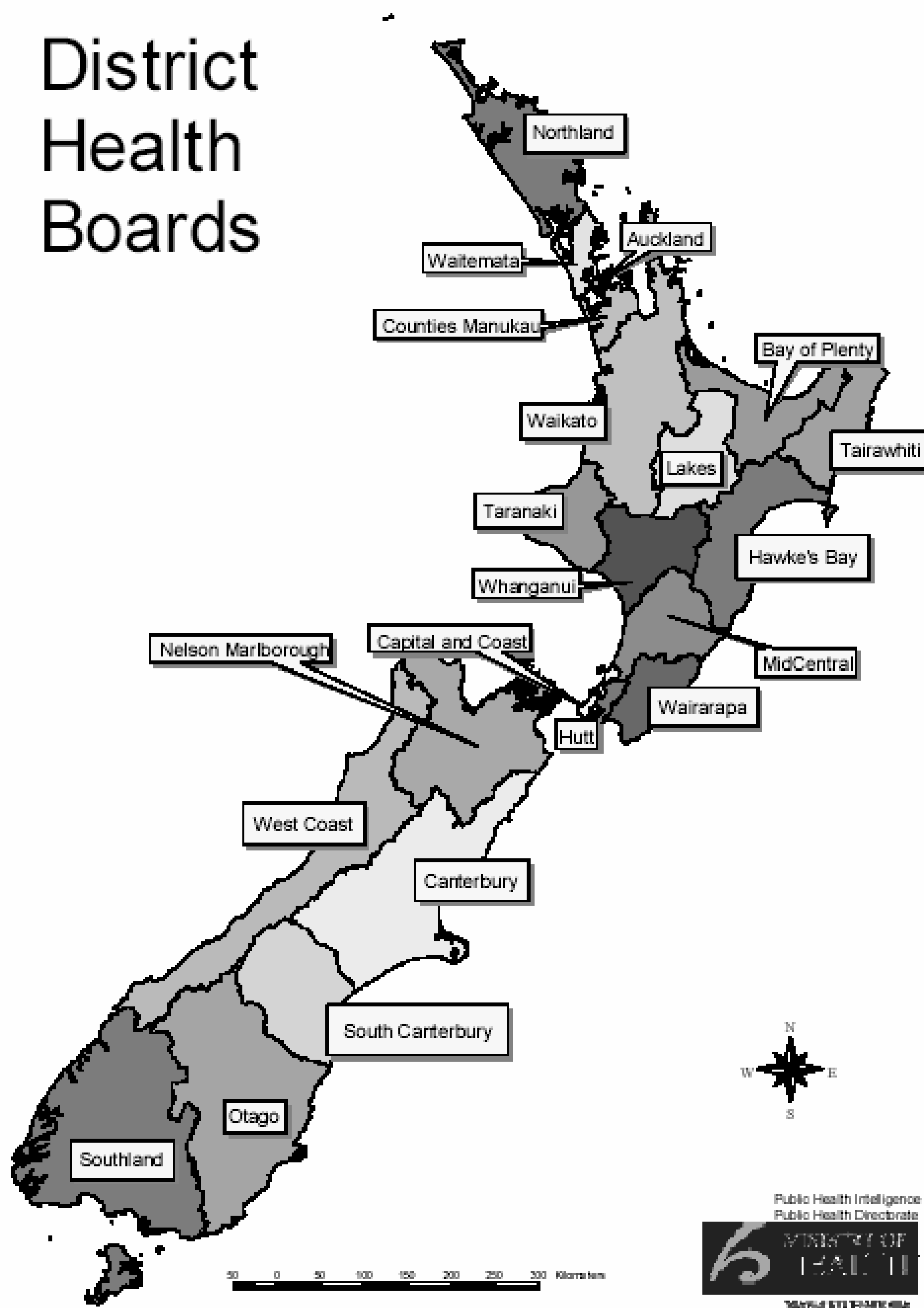
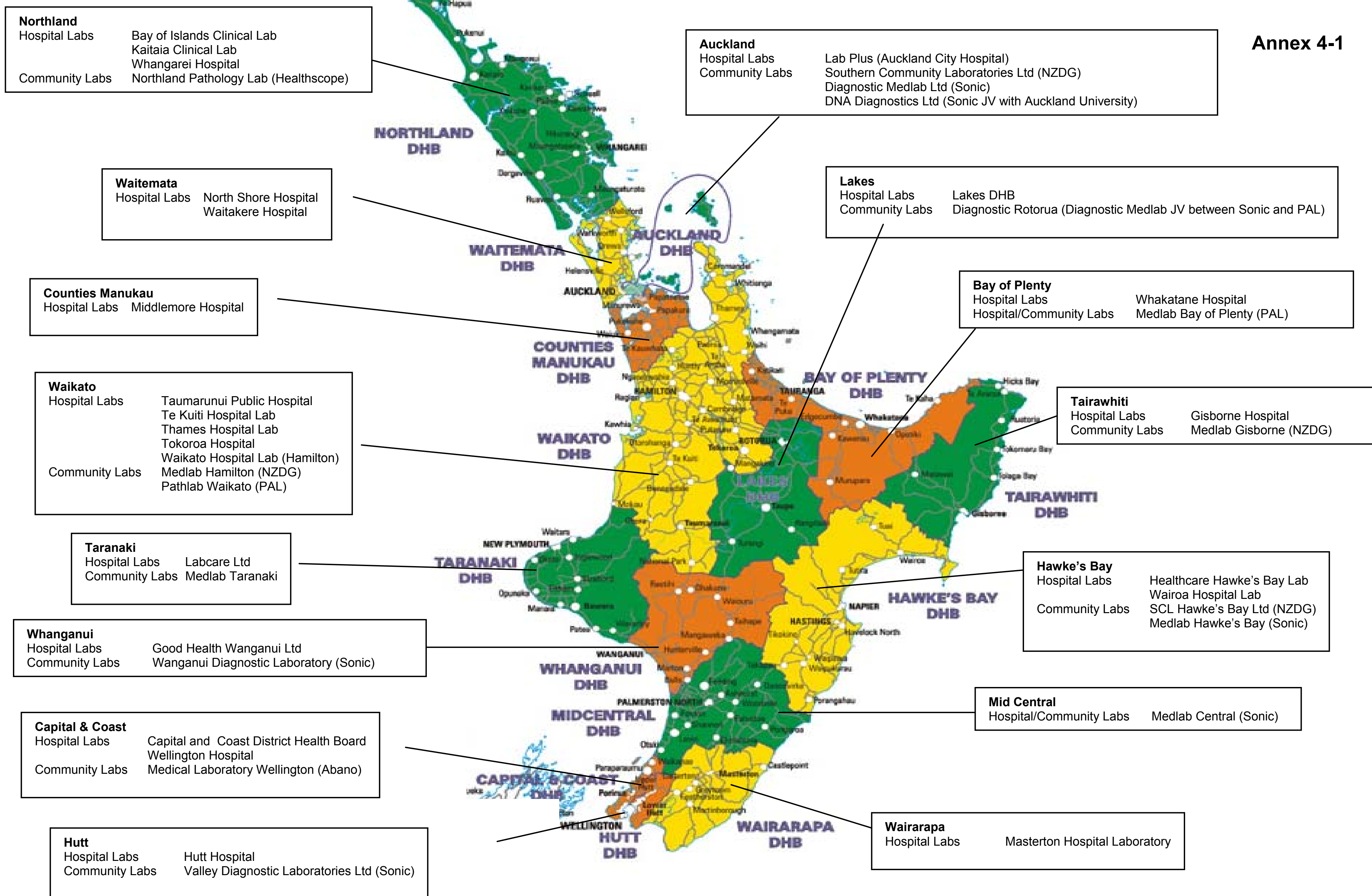


Annex 4-1



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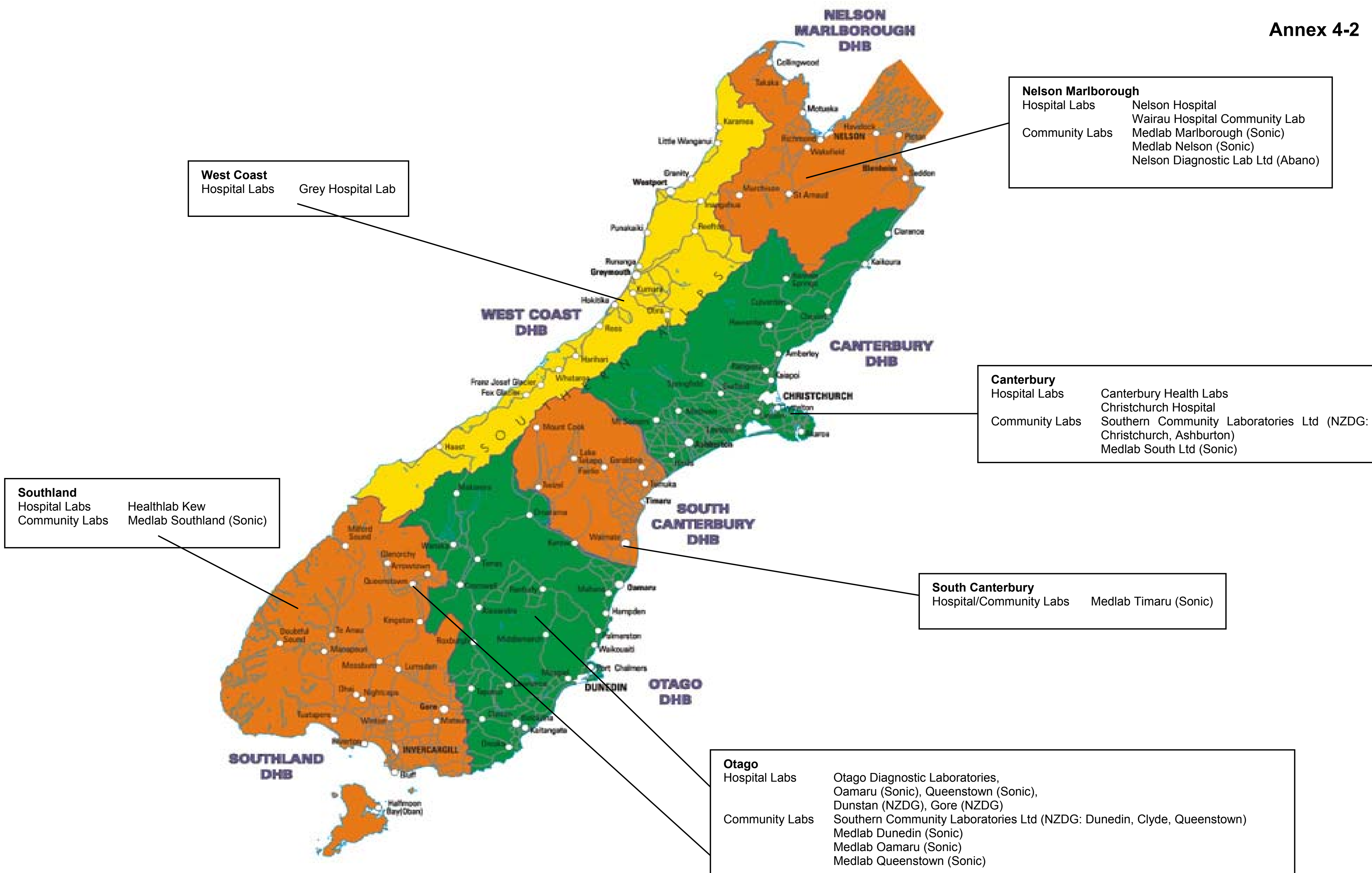

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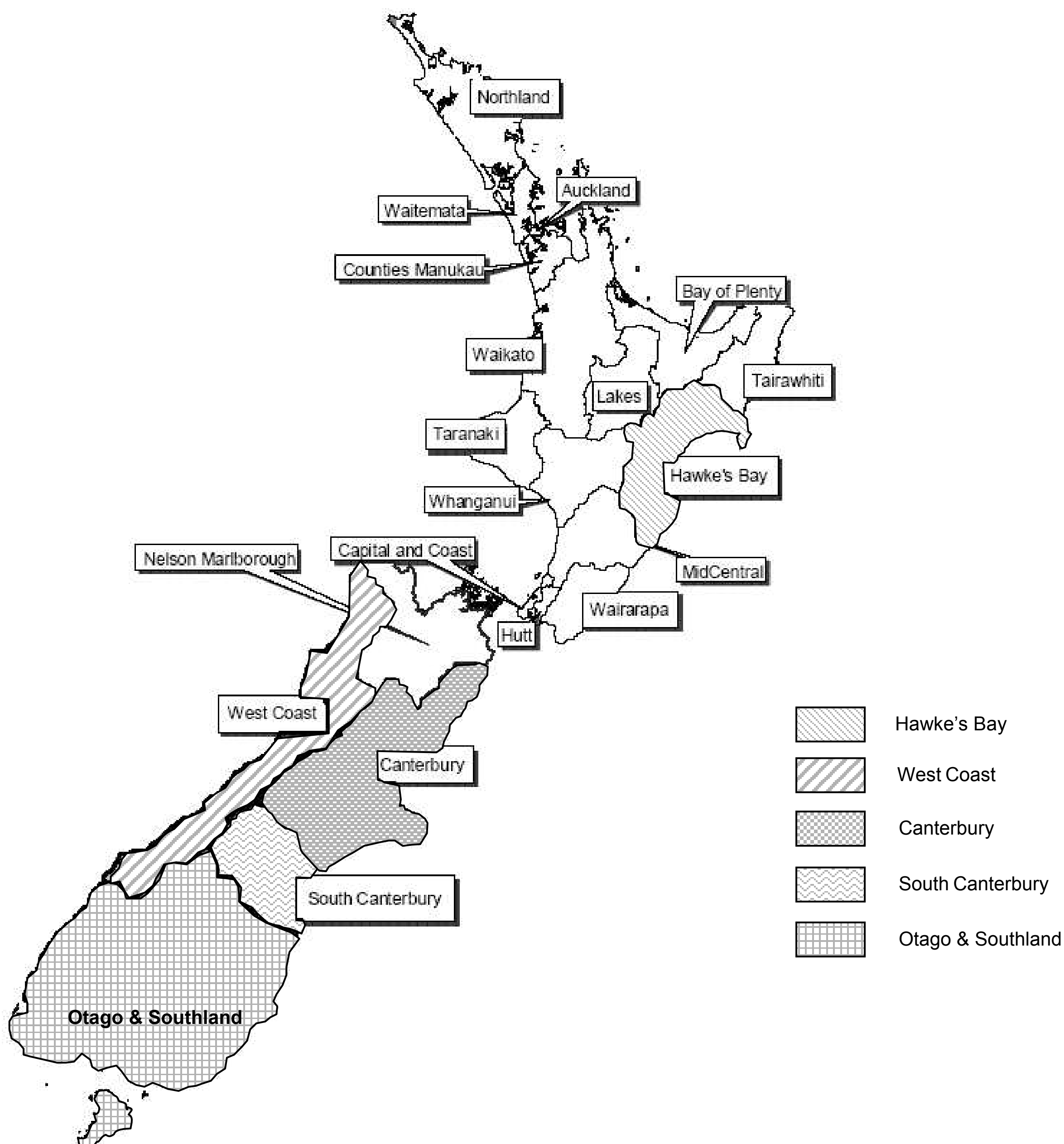

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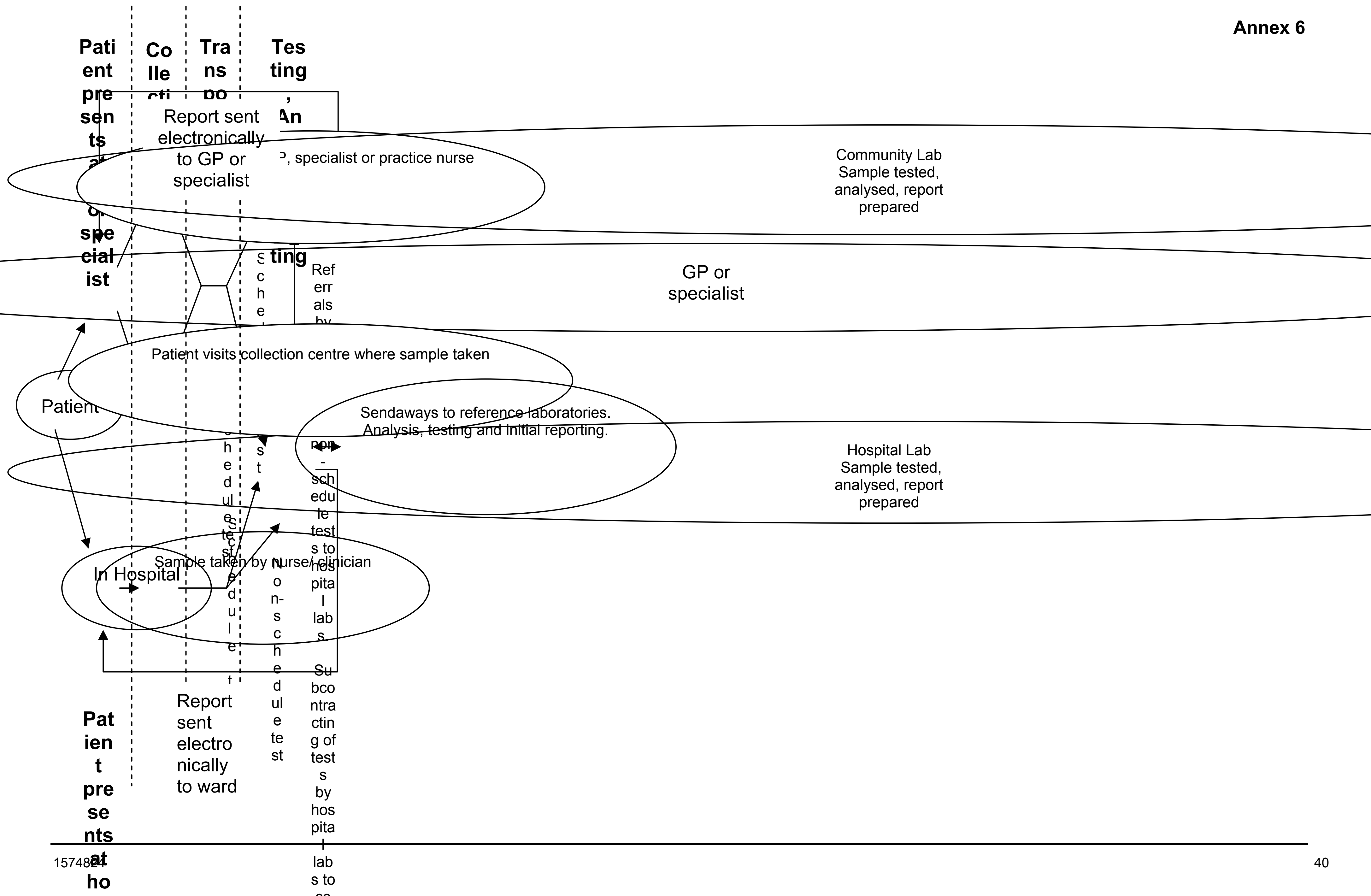

Annex 7

	DHB	DHB presently does some community referred testing?	DHB has contracted out hospital lab to private operator?	Proposal for next 5 years?
1.	Northland	No	Yes (Whangarei Hospital) – but brought back in-house	Unknown
2.	Waitemata	No	Yes – but brought back in-house many years ago	Under review
3.	Auckland	Yes (LabPlus estimated 1-2%)	No	Under review
4.	Counties Manukau	No	No	Under review
5.	Waikato	Yes (Waikato Hospital)	Yes (Thames Hospital) – but brought back in-house 10 years ago	Under review
6.	Bay of Plenty	No	Tauranga hospital lab fully outsourced to MedLab Bay of Plenty	Unknown
7.	Tairawhiti	No	Yes – Gisborne hospital currently outsourcing histopathology & cytology to MedLab Central	Under review
8.	Lakes	No	No	Under review
9.	Taranaki	No	Yes – part of the inpatient work (histopathology & autopsies?)	No change
10.	Hawke's Bay	Yes (estimated only 1%)	Yes – Hastings hospital currently outsourcing histopathalogy to MedLab Central	Board indicating preference for single supplier for all community testing
11.	Whanganui	Yes Q Lab (estimated 20%)	No	Consultation document issued not clear yet if RFP or JV proposal likely?
12.	Mid Central	No	Palmerston North hospital lab fully outsourced to Medlab Central	Status quo likely to remain
13.	Wairarapa	Yes, small volume (estimated 1%)	No	To be put to tender – but not moving particularly fast
14.	Hutt Valley	Minimal	No	Still to be determined. Hospital to stay in hospital Community work out to tender with hospital lab putting in a bid.
15.	Capital & Coast	No	No	Same as Hutt Valley above
16.	Nelson Marlborough	The Wairau Hospital laboratory in Blenheim does community work but the Nelson Hospital laboratory does not	No	A discussion paper was widely circulated in 2004 and a RFP for laboratory services is expected in June 2005
17.	West Coast	Yes (Greymouth Hospital)	No	Tender process likely
18.	Canterbury	Yes (CHL estimated 1-2%)	No	Consultant appointed for scoping exercise to report back by 30 September
19.	South Canterbury	No	Fully outsourced to Medlab South	All under contract with Medlab South (schedule and non-schedule)
20.	Otago	Yes	Yes – currently outsourcing some histopathology only to Southern Community Laboratories regional hospitals contracted to private providers	RFP for single provider for all services (schedule and non-schedule) awarded to joint community provider
21.	Southland	Yes	Yes – currently outsourcing some biochemistry tests to Medlab South and regional hospitals contracted to private providers	

Heads of Agreement with the Hawke's Bay DHB

Annex 9

Correspondence with the Otago and Southland DHBs