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ISSN NO. 0114-2720
J4112

COMMERCE COMMISSION

Decision No. 399

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

THE SOUTHERN CROSS MEDICAL CARE SOCIETY

AND

AETNA HEALTH (NZ) LIMITED

The Commission:	M J Belgrave (Chair) M N Berry E C A Harrison
Summary of Proposed Acquisition:	The Southern Cross Medical Care Society (or a direct or indirect subsidiary) has sought clearance to acquire all the issued share capital in Aetna Health (NZ) Limited.
Determination:	Pursuant to section 66(3)(b) of the Commerce Act 1986, the Commission determines to decline to give a clearance for the proposed acquisition.
Date of Determination:	25 August 2000

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THE PROPOSED ACQUISITION

1. Pursuant to section 66(1) of the Commerce Act 1986 ("the Act"), The Southern Cross Medical Care Society ("Southern Cross") gave notice to the Commission on 18 July 2000 ("the notice" or "the application") seeking clearance for the proposed acquisition by it, or a direct or indirect subsidiary of Southern Cross, of all the issued share capital in Aetna Health (NZ) Limited ("Aetna").

THE PROCEDURES

2. The Commission on 18 July 2000 registered the notice. Section 66(3) of the Act requires the Commission, within 10 working days after the date of registration of a notice, or such longer period agreed to by the Commission and the person giving a notice, to either give a clearance or decline to give a clearance for the acquisition proposed. The tenth working day after the registration of the notice was 1 August 2000. However, the Commission and Southern Cross agreed to two extensions totalling 18 working days. Accordingly, a determination of the Commission is required by 25 August 2000.

3. Southern Cross requested confidentiality from the Commission for the fact of the notice until 20 July 2000. It also requested confidentiality for specific information in the notice on the grounds that the information is commercially sensitive and disclosure would be likely to prejudice the commercial position of the parties to the application. The Commission, in accordance with section 100 of the Act, made Confidentiality Orders on 19 July 2000:

   - prohibiting the publication or communication of the fact of the notice until 20 July 2000; and
   - prohibiting the publication or communication of specific information until 20 working days from the Commission's determination of the notice.

4. When the Confidentiality Order in respect of specific information expires, the provisions of the Official Information Act 1982 will apply to the information.

5. The Commission's determination is based on an investigation conducted by its staff, and their subsequent advice to the Commission.

6. In the course of their investigation of the acquisition proposed by Southern Cross, Commission staff had discussions with and sought the views and comments of a number of parties. The parties included insurance companies, insurance brokers, the New Zealand Treasury, the Health Funds Association of New Zealand ("the Health Funds Association") and the New Zealand Private Hospitals Association ("the NZPHA"). Commission staff received a number of written submissions on the proposed acquisition.

THE PARTIES

Southern Cross

7. Southern Cross is a "not for profit" health care organisation incorporated as a Friendly Society under the Friendly Societies and Credit Unions Act 1982. The application states that Southern Cross has four discrete activities:

- the provision of indemnity health insurance;
- ownership of 13 hospitals, which are operated on an arm's length basis by The Southern Cross Hospital Trust;
- travel insurance, through its wholly owned subsidiary Southern Cross Benefits Limited; and
- worker's compensation claims processing, injury prevention and case management activities carried out by Southern Cross Benefits Limited and its 51% owned subsidiary, GMV Associates Limited.

Aetna

8. Aetna is a health risk management services company which is ultimately wholly owned by Aetna Inc., located in Connecticut, United States of America. Aetna is being sold as part of an international reorganisation by Aetna Inc. of its operations.

9. Aetna's main business activities are:

- the provision of private indemnity health insurance and programmes designed to help manage work place injury and absenteeism; and
- the provision of health management services in the publicly funded primary care market, through its wholly owned subsidiary First Health Limited and its interest in PrimeHealth Limited, a 50/50 joint venture with a network of Tauranga physicians (through the company PrimeHealth Network Limited). Both these companies have management contracts with the Government's Health Funding Authority to provide patient services in their region on a capitation basis.

OTHER RELEVANT PARTIES

10. There are approximately 30 insurance providers registered and currently operating in New Zealand. Some of these providers offer only general insurance products. Other providers offer a range of health insurance products within their insurance product suites, while some specialise in health insurance products. Health insurers include mutual societies, friendly societies, non-profit organisations and companies. The Health Funds Association is a representative body of New Zealand health insurers. The NZPHA is the national body that works to represent, protect and promote the best interests of its member hospitals, their associated services and their clients.

General Insurers

11. The major providers offering a range of general insurance products include:

- Lumley General Insurance (NZ) Limited
- Royal & Sun Alliance Insurance (NZ) Limited
- Tower Insurance Limited
- HIH Casualty & General Insurance (NZ) Limited
- ACE Insurance Limited
- MMI General Insurance Limited
- QBE Insurance (International) Limited
- Farmers Mutual Group.

General and Health Insurers

12. Insurance providers which offer a range of health insurance products within their insurance product suites include:

- State Insurance Limited ("State Insurance")
- AXA Insurance (Australia) Limited ("AXA")
- Sovereign Assurance Limited ("Sovereign")
- AA GIO Insurance Limited ("AA GIO")
- Public Service Investment Services Limited ("PSIS")
- American International Assurance Company Limited ("AIA")
- New Zealand Police Health Plan Limited ("Police Health Plan")
- Manchester Unity Friendly Society Limited ("Manchester Unity").

Specialist Health Insurers

13. Insurance providers which specialise in offering health insurance products include:

- Southern Cross
- Aetna
- Tower Health Limited ("Tower Health")
- Union Medical Care Society ("UniMed").

Health Funds Association of New Zealand

14. The Health Funds Association represents health insurers in New Zealand on industry matters such as legislation and self-regulation. Its membership includes 15 health insurers, one reinsurer and one accident insurer. Membership of the Health Funds Association is on a voluntary basis.

New Zealand Private Hospitals Association

15. The NZPHA is a voluntary association of independent hospitals in New Zealand. It represents 142 private hospitals. Of these, 110 are predominantly concerned with long-term care of the elderly and 32 are surgical hospitals that offer a range of surgical, medical, maternity and psychiatric treatments.

16. Hospitals owned by Southern Cross are currently not members of the NZPHA.

BACKGROUND TO HEALTH INSURANCE

Function of Health Insurance

17. The public health system does not fund all of New Zealanders' health requirements. Rather, its focus is on the delivery of urgent services, and it rations access to elective surgery. The private health insurance industry complements the public health system by covering a range of costs incurred by an insured person who undergoes a range of semi-urgent or elective procedures.

Types of Health Insurance Policies

18. The two principal types of insurance policy available in New Zealand are usually described as 'comprehensive care' or 'major medical' policies. Comprehensive care policies are more expensive than major medical policies. Both tend to exclude specific and pre-existing conditions.

19. Comprehensive care policies cover primary care costs such as those incurred for general practitioner visits and physiotherapy. Comprehensive care policies may also provide cover for hospital and surgical costs, in many cases up to pre-set limits.

20. Major medical policies cover the costs of major health problems requiring hospitalisation, often to pre-set limits.

21. In recent years, the trend in health insurance has been away from comprehensive products towards major medical products. However, [ ]% of Southern Cross' members are in major medical plans, and [ ]% in comprehensive plans.

Health Insurance Policy Pricing Methods

22. Broadly speaking, insurers price their health insurance products according to either 'community rating' or 'age-banding' risk rating models.

23. Community rated premiums are set at the average age of policy holders. This means premiums are not adjusted according to a person's age or medical condition, and premiums do not drastically increase as a person ages.

24. Age-banded premiums are commonly set within age bands. For example, insured people within a 5 year age band commonly pay the same premiums, except where greater

premiums are charged to reflect individual risk. Premiums increase as an insured person ages to more accurately reflect the true health costs of each age-band.

25. Although Southern Cross is often described as having a policy of 'community rating', it has rebalanced its premiums in recent years to align more closely with risk, and it does not consider itself to have such a policy.

New Zealand Health Insurance Trends

26. According to the Health Funds Association, the New Zealand private health insurance industry contributed approximately $495 million towards in excess of 1 million New Zealanders' 1997/1998 healthcare costs.[1]

27. In April 2000 the Health Funds Association estimated that approximately 1.25 million New Zealanders choose to make provision for the cost of their health by purchasing health insurance. The Health Funds Association also estimates that in 1999 the New Zealand private health insurance industry contributed approximately $554 million, or 9% of the combined New Zealand public and private health expenditure of $5.94 billion, towards New Zealanders' health.

28. However, the percentage of New Zealand's population with private health care insurance has declined from an estimated 51% in 1990 to an estimated 33% in 1999.

Regulatory Environment

29. New Zealand has one of the least regulated insurance markets in the world. Both health and general insurers must comply with the Insurance Companies (Ratings and Inspections) Act 1994 which requires them to obtain, register and disclose a credit rating from an approved rating agency (AM Best or Standard & Poor's) in order to demonstrate an ability to pay claims.

30. In addition, the Insurance Companies Deposits Act 1953 requires a general or health insurer to lodge approved securities with a market value of not less than $500,000 with the Public Trustee, with annual reports and statements of financial position to be provided to the Ministry of Economic Development.

Brokers

31. Brokers act as intermediaries between an insurer and an insurer's customer. Brokers may offer actuarial services and risk management advice, or specialise in a particular form of insurance.

32. The Commission understands that a significant proportion of health insurance is transacted through brokers.

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[1] Health Funds Association, *A Comparison of Health Expenditure in Public and Health Insurance Sectors in 1999,* April 2000 and *An Insight into the New Zealand Health Insurance Industry*, 1999.

MARKET DEFINITION

Introduction

33. The purpose of defining a market is to provide a framework within which the competition implications of a business acquisition can be analysed. The relevant markets are those in which competition may be affected by the acquisition being considered, and in which the application of section 47(1) of the Act can be examined.

34. Section 3(1A) of the Act provides that:

> "... the term 'market' is a reference to a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them."

35. Relevant principles relating to market definition are set out in *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1991) 4 TCLR 473 and in the *Business Acquisitions Guidelines*[2]. A brief outline of the principles follows.

36. Markets are typically defined in relation to three dimensions; namely, product type, geographical extent, and functional level. A market encompasses products that are close substitutes in the eyes of buyers, and excludes all other products. The boundaries of the product and geographical markets are identified by considering the extent to which buyers are able to substitute other products, or across geographical regions, when they are given the incentive to do so by a change in the relative prices of the products concerned. A market is the smallest area of product and geographic space in which all such substitution possibilities are encompassed. It is in this space that a hypothetical, profit-maximising, monopoly supplier of the defined product could exert market power, because buyers, facing a rise in price, would have no close substitutes to which to turn.

37. A properly defined market includes products which are regarded by buyers or sellers as being not too different (the product dimension), and not too far away (the geographic dimension), and are therefore products over which the hypothetical monopolist would need to exercise control in order for it to be able to exert market power. A market defined in these terms is one within which a hypothetical monopolist would be in a position to impose, at the least, a "small yet significant and non-transitory increase in price" ("*ssnip*"), assuming that other terms of sale remain unchanged.

38. Markets are also defined by functional level (the functional dimension). Typically, production, distribution, and sale occur through a series of stages, with markets intervening between suppliers at one vertical stage and buyers at the next.

The Relevant Market

39. The delineation of relevant markets as a basis for assessing the competitive effects of a business acquisition begins with an examination of the products or services offered by each of the parties to the acquisition.

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[2] Commerce Commission, *Business Acquisitions Guidelines*, 1999.

40. As noted earlier, Southern Cross has four distinct areas of operation. They are the provision of indemnity health insurance, ownership of 13 hospitals, which are operated on an arm's length basis by The Southern Cross Hospital Trust, the provision of travel insurance, and worker's compensation claims processing, injury prevention and case management activities. Aetna's main business activities are the provision of private indemnity health insurance and programmes designed to help manage work place injury and absenteeism, and the provision of health management services in the publicly funded primary care market.

41. The only area where significant post-acquisition aggregation would occur is in the provision of indemnity health insurance. Both Southern Cross and Aetna have some overlap relating to programmes which manage work place injury. The overlap is in the case of management and claims management, which Southern Cross says is a small element of the overall management of work place injuries. However, with the re-regulation of ACC, the future of these programmes is uncertain. Southern Cross is not involved in health management services to the publicly funded primary care market, which is a significant and growing part of Aetna's business.

42. There are multitudes of indemnity health insurance plans offered by the various insurers. For example, Southern Cross alone offers its members a choice of 13 different plans. Typically, the plans are distinguished by the degree of cover provided. In general terms, they range from comprehensive plans that provide cover for a diverse range of medical conditions and treatments to limited plans which exclude certain conditions and treatments, typically focusing on major medical/surgical risks. In addition, the more comprehensive plans offer a higher claims reimbursement than the limited plans, which require customers to share in the cost of their medical treatment through, for example, co-payments and excesses. The plans are priced to reflect the level of service, such that the premiums increase the more comprehensive is the cover provided.

43. The Commission has previously considered indemnity health insurance. For instance, in the 1993 clearance given by the Commission under section 66 of the Act to Southern Cross for the proposed acquisition of First Medical Corporation Limited ("Medic Aid")[3], and in the *Termination Report*, dealing with alleged contraventions by Southern Cross, Southern Cross Hospital Trust and Southern Cross Benefits Limited of certain of the restrictive trade practices provisions of the Act[4]. In both instances indemnity health insurance was considered, for the purposes of the analyses carried out, to be in a separate product market covering New Zealand. Thus, in *Southern Cross/Medic Aid* the Commission stated that "The relevant product and function markets are the provision of insurance for medical and surgical services for which charges are levied. The geographic market is New Zealand." And in the *Termination Report* the relevant market was defined as being for the provision of "medical insurance throughout New Zealand".

44. In a recent determination by the Commission giving clearance to the proposed merger of CGU Plc and Norwich Union Plc[5], the Commission determined the relevant product

[3] Commerce Commission determination of 26 August 1993, AUT/BA – S14/1: M2229 ("*Southern Cross/Medic Aid*"). Although Southern Cross received a clearance from the Commission for its proposed acquisition, the acquisition never ultimately proceeded. Medic Aid was instead acquired by Aetna in 1993.

[4] Commerce Commission, ENF/RTP-S: WN1488, 18 December 1997. The *Termination Report* concluded that there did not appear to have been a contravention of the Act, and the matter was accordingly terminated.

[5] Commerce Commission, Decision No. 391, 9 May 2000 ("*CGU/Norwich*").

markets to be specific insurance products (e.g., domestic house and contents) rather than a grouping of various products into an overall market, say the general insurance market. The Commission was not convinced that the competitive features were similar for all insurance products to justify their inclusion in a single product market. Having stated that, the Commission "noted that if there are no dominance concerns arising out of these narrower markets, there are unlikely to be any dominance concerns within the wider markets". Health insurance was not relevant in the Commission's determination.

45. In the present determination, the Commission considers that the relevant market for the purposes of competition analysis is "the market for the provision of medical insurance in New Zealand" (hereafter also referred to as "the medical insurance market"). In defining the product dimension as "medical insurance", the Commission has not seen a need to draw a distinction between different types of medical or health insurance plans offered in the marketplace. While different plans may not be perfect substitutes on the demand-side, because of different levels of cover and service provided, the Commission considers that in terms of applying a *ssnip* the plans would nevertheless be constrained by price competition between them. In terms of the Commission's approach to market definition, the different medical insurance plans therefore fall into the same market. The Commission accepts that the product market is national in scope. There is considerable uniformity in the different medical insurance plans available throughout the country, many of the insurers have a physical presence in the major provincial and metropolitan centres, and all appear to be accessible nationally by telephone, facsimile and the Internet. The Commission has concluded that for the purposes of the current analysis it is not necessary to make a distinction in the medical insurance market between functional market levels.

46. For the purposes of the application, Southern Cross accepts the relevant market as defined by the Commission, as did most industry representatives which met with the Commission's staff during the investigation of the application. However, Southern Cross does comment in the application in respect of the Commission's definition "... that the precise market boundaries cannot be clearly drawn in the health industry" and that "The existence of important alternatives just outside the artificially drawn market boundaries (such as self funding, income protection insurance and the public health system) is important for interpreting the effect of market share on market behaviour". The impact of significant factors on the medical insurance market will be considered in the competition analysis stage. However, based on evidence gathered during the investigation, the Commission does not consider income protection insurance to be a substitute for health insurance.

Individual and Group Scheme Medical Insurances

47. The Commission has considered whether there is a case for having separate market definitions encompassing "individual" and "group scheme" medical insurances. The former refers to policies arranged by individuals with their insurers (often through brokers). Group schemes typically cover employees of an organisation, and are arranged by the employer, often through a tender. In this situation the insurance premiums may be paid for or subsidised by the organisation on behalf of the group members, or the members may pay the premiums themselves, usually through salary deductions.

48. The Health Funds Association estimates that between 45 and 55% of the medical insurance market is made up of group business, whereas Tower Health submitted that 75% of the market is group business. Of Southern Cross' total membership, [ ]% is derived through employment based group schemes, as against [ ]% of Aetna's membership.

49. The Commission has considered the extent to which individual and group scheme medical insurances are substitutable. Group schemes provide the benefit of volume discounts made possible by the lower transaction costs incurred by insurers servicing this segment. Group schemes have also been subsidised by employers, although this practice is becoming less common. Otherwise, however, the pricing of individual and group medical insurances should not differ. Group insurance also differs in that the employer or association is an intermediary between the insurer and the employee or member, and is perceived by insurers to be the customer. All things being equal, it is expected that if premiums for a group scheme were higher relative to individual premiums, the members of the group would have an incentive to withdraw from the group and insure individually, either with their existing insurer or an alternative insurer. That is, individual and group insurances are likely to be substitutable by policy holders in the event of a *ssnip*. Accordingly, the Commission sees these two types of insurance as being in the one market.

Pre-existing Conditions

50. An issue considered by the Commission in relation to market definition is the ability of members in a group medical insurance scheme with pre-existing medical conditions to switch to individual insurance. In most cases a prospective insurer will not accept the pre-existing risk. By contrast, group schemes generally provide for employees with pre-existing conditions to be covered on the same terms as other employees. As a result, members with pre-existing conditions in a group scheme have a disincentive to move from a group scheme to individual insurance. The Commission considers that the level of potential substitution by employees without pre-existing conditions would mean that it would not likely be profitable to attempt to apply a *ssnip* to the group segment alone.

Private Hospitals

51. One final matter which the Commission considered under market definition was whether there was a need, for the purposes of considering the application, to introduce a market encompassing private hospitals. This was because of concerns raised by various parties about Southern Cross' involvement and behaviour in the private hospitals sector. The Commission considers that there are no issues of dominance on the part of Southern Cross with regard to this sector which need to be assessed in terms of the proposed acquisition. There is no aggregation of market share in the private hospitals sector as a result of the proposed acquisition. Any alleged anticompetitive behaviour by Southern Cross, either currently or in the future, could be a matter for the restrictive trade practices provisions of the Act.

Conclusion on Market Definition

52. The Commission has concluded that the appropriate market for assessing the competitive effects of the acquisition proposed by Southern Cross is "the market for the provision of medical insurance in New Zealand".

COMPETITION ANALYSIS

Introduction

53. Section 47 of the Act prohibits particular business acquisitions. It provides:

> "(1) No person shall acquire assets of a business or shares if, as a result of the acquisition, -
> (a) That person or another person would be, or would be likely to be, in a dominant position in a market; or
> (b) That person's or another person's dominant position in a market would be, or would be likely to be, strengthened."

54. The key issue for the Commission is to satisfy itself under section 66 of the Act that the acquisition as proposed by Southern Cross will not result, or would be likely to not result, in the acquisition or strengthening of a dominant position by any person in a market. In accordance with the Act, if the Commission were satisfied that dominance would not result, or would be likely to not result, it is required to give a clearance for the acquisition. Conversely, if the Commission is not satisfied, it must decline to give a clearance for the acquisition.

55. Section 3(9) of the Act defines a person as having a dominant position in a market:

> "... if that person as a supplier or an acquirer ... of goods or services is ... in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in that market...".

56. In determining whether a person has such a dominant influence, section 3(9) states that regard shall be had to:

> "(a) The share of the market, the technical knowledge, the access to materials or capital of that person ... :
> (b) The extent to which that person is ... constrained by the conduct of competitors or potential competitors in that market:
> (c) The extent to which that person is ... constrained by the conduct of suppliers or acquirers of goods or services in that market."

57. The leading exposition on "dominant position" is the High Court's discussion in *Commerce Commission v Port Nelson Limited* (1996) 6 TCLR 406 (approved by the Court of Appeal). There McGechan J held at p. 441:

> "The test for 'dominance' is not a matter of prevailing economic theory, to be identified outside the statute. ... 'Dominance' includes a qualitative assessment of market power. It involves more than 'high' market power; more than mere ability to behave 'largely' independently of competitors; and more than power to effect 'appreciable' changes in terms of trading. It involves a high degree of market *control*.

> How high? Clearly, not absolute control. There need not be monopoly. There need not be ability to act totally without regard to competitors, suppliers, or customers. Expression of the required degree of control in terms of mastery – eg as 'commanding', 'ruling', or 'governing' – is perhaps to that extent misaligned, and needs to be read down." (Emphasis in the original)

58. The *Business Acquisitions Guidelines* reflects the dominance test stated by the High Court and approved by the Court of Appeal:

> "A person is in a dominant position in a market when it is in a position to exercise a high degree of market control. A person in a dominant position will be able to set prices or conditions without significant constraint from competitor or customer reaction."

59. The *Business Acquisitions Guidelines* further states that:

> "A person in a dominant position will be able to initiate and maintain an appreciable increase in price, or reduction in supply, quality or degree of innovation, without suffering an adverse impact on profitability in the short or long term. The Commission notes that it is not necessary to believe that a person will act in such a manner to establish that it is in a dominant position; it is sufficient for it to have that ability."

Private Hospitals

60. During the course of the investigation of the application, the Commission received submissions from private hospitals situated throughout New Zealand and related parties. Submissions were received from [

]

61. The general nature of the submissions were against the proposed acquisition on the grounds that, *inter alia*, the likely result of the acquisition would be to strengthen an already dominant position held by Southern Cross in both the private hospital and medical insurance markets. By being dominant in both markets, it was claimed that Southern Cross was able to create disincentives to use non-Southern Cross hospitals and non-Southern Cross insurers. The main submissions can be summarised as follows:

- Southern Cross and The Southern Cross Hospital Trust are inter-linked, despite claims to the contrary made by Southern Cross;
- Southern Cross is not a "not-for-profit organisation" as evidenced by its aggressive pursuit of market share;
- Through its high post-acquisition market share in the medical insurance market, Southern Cross will have the ability to "steer" customers into its hospitals;

- Southern Cross offers discounts to its medical insurance policy holders who use its hospitals;
- Through its vertical links Southern Cross is able to (and does) subsidise its loss-making hospitals through profits made by its medical insurance business;
- As a result of it being the major funder of private hospital procedures, Southern Cross has incentives to induce private hospitals to lower their charges. It does this

by setting artificially low charges in its own hospitals, which other private hospitals are then compelled to match;

- By setting maximum rebates at low levels, Southern Cross can discourage its policy holders from using more expensive private hospitals, procedures and surgeons;
- Southern Cross could dissuade its policy holders from using hospitals not owned by Southern Cross by offering a better service (e.g., by refunding claims more promptly) to those policy holders electing to use Southern Cross' hospitals; and
- Southern Cross encourages members to use those hospitals that are, by agreement with Southern Cross, "affiliated providers", based on the hospitals' acceptance of wholesale prices for procedures.

62. In reply, Southern Cross has made submissions to the Commission that dispute the concerns voiced by private hospitals. Southern Cross does not believe that the private hospital sector will be affected in any way by Southern Cross' vertical integration. Southern Cross argues that it does not have any significant influence over the management of its hospitals, or over the hospitals which policy holders or surgeons choose.

63. [ ] has submitted that Southern Cross funds approximately [ ]% of all treatments provided in the private surgical-medical sector, or [ ].[6] This, however, equates to a proportion of insurance funded procedures of approximately [ ].[7] The proportion of funding that Southern Cross accounts for does not correspond to its market share in the medical insurance market of about [ ]%. Southern Cross submits that this is a reflection of the amount of high risk policy holders it insures.

64. Southern Cross has stated that "… Southern Cross has no means to ensure that Southern Cross' members are treated in hospitals managed by the Trust…". Instead it is claimed that the surgeon and the customer jointly decide. Southern Cross notes that only [ ]% of its members have surgery undertaken at a hospital operated by The Southern Cross Hospital Trust.[8] Southern Cross claims that this demonstrates that those hospitals are not performing the majority of surgical procedures for Southern Cross' members. In addition, Southern Cross notes that in some instances surgeons have equity stakes in private hospitals. Southern Cross believes that where this is the case, those surgeons will be more inclined to use their hospitals. No surgeons have equity stakes in hospitals managed by The Southern Cross Hospital Trust.

65. Southern Cross further submits that the imposition of maximum rebates is purely in response to consumer demand, and that its "affiliated provider" programme is designed to create certainty over the size of co-payments for those customers.

66. Southern Cross disputes any suggestion that it is a price maker in the private hospitals sector, or that it sets its prices at anticompetitive levels. It has provided the Commission with a fee schedule that shows that fees charged by Southern Cross hospitals are in some

[6] The remainder is accounted for by ACC, self-insuring patients, and other public sources.
[7] This figure is estimated from figures provided by [ ].
[8] The figure of [ ].

instances higher and in other instances lower than those of other private hospitals. Southern Cross claims that this demonstrates that the Southern Cross hospitals do not force other hospitals to lower their prices.

67. [ ] which operates a private hospital in [ ] does not share the concerns of other private hospitals. It agrees with Southern Cross that medical insurance policy holders are able to choose which hospitals will provide their treatment. [ ] claims that it is the specialist surgeon that determines which hospital he or she will operate at and this is dictated by matters of convenience and location.

68. The Commission has considered those concerns raised by the private hospitals and also Southern Cross' responses. The Commission observes the following:

- No market aggregation would occur in the private hospital sector if Southern Cross' proposed acquisition were to proceed. Hence, the choices available to policy holders and surgeons would remain unchanged.
- Allegations that policy holders can be "influenced" are not borne out by the respective market shares figures of Southern Cross or The Southern Cross Hospital Trust.
- The private hospitals argue that The Southern Cross Hospital Trust is trying to undercut them by anticompetitive means. This is a concern better dealt with under Part II of the Act.

69. Generally, the incentives which Southern Cross is expected to use – such as setting low maximum rebates – tend to work against customer choice. The Commission considers that restriction of customer choice in such a way would be likely to open up opportunities for competition.

70. The Commission concludes that any concerns raised or allegations made about anticompetitive behaviour in the medical insurance market or private hospitals sector are not matters which fall under section 66 of the Act when considering the application. Such matters could only be addressed under the restrictive trade practices provisions contained in Part II of the Act.

Constraints from Competition within the Medical Insurance Market

Market Concentration

71. An examination of concentration in the market for the provision of medical insurance in New Zealand is a useful starting point for analysing the effect that the acquisition as proposed by Southern Cross might have on that market, in terms of the constraint that Southern Cross would face from other market participants. In general, the higher the share of a market held by the merged entity, the greater the probability that a proscribed

dominant position will, or will likely, be acquired or strengthened in that market. However, market shares are insufficient in themselves to establish a dominant position in a market. As well as market structure, behavioural factors, including the extent of actual and potential rivalry in the market, also typically need to be considered and assessed.

72. In respect of business acquisitions, the *Business Acquisitions Guidelines* specifies certain "safe harbours" determined on the basis of market concentration:

> "In the Commission's view, a dominant position in a market is generally unlikely to be created or strengthened where, after the proposed acquisition, either of the following situations exists
>
> - the merged entity (including any interconnected or associated persons) has less than in the order of a 40% share of the relevant market;
> - the merged entity (including any interconnected or associated persons) has less than in the order of a 60% share of the relevant market, and faces competition from at least one other market participant having no less than in the order of a 15% market share."

73. These safe harbours recognise that both absolute levels of market share and the distribution of market shares between the merged entity and its rivals are relevant when considering the extent to which the rivals are able to constrain the merged entity.

74. In respect of a business acquisition triggering an intervention by the Commission based on market concentration, the *Business Acquisitions Guidelines* states:

> "Except in unusual circumstances, the Commission will not seek to intervene in business acquisitions which, given appropriate delineation of the relevant market and measurement of market shares, fall within these safe harbours."

75. Southern Cross has provided in the application what it considers to be "roughly" the current market shares of the largest health insurers. The market shares are estimated by Southern Cross based on its belief that its [ ] members as at July 1999 account for [ ]% of the relevant market and that therefore the number of people with health insurance in New Zealand would be roughly 1.375 million, the membership of Aetna of [ ] as at December 1999, and its general industry knowledge and experience. Table 1 sets out the current market shares of the largest market participants estimated by Southern Cross.

Table 1: Southern Cross' estimate of current market shares in the medical insurance market

Health Insurer	**%**
Southern Cross	[ ]
Aetna	[ ]
AXA	[ ]
CGNU	[ ]
UniMed	[ ]
Tower Health	[ ]

76. Based on Southern Cross' assessment of current market concentration, its post-acquisition market share would be about [ ]%. No other market participant would have greater than [ ]% market share.

77. In addition to the above market share data, the Commission obtained estimates of market shares in the medical insurance market from the Health Funds Association. Its estimates are based on the total earned premiums for the 12 months to the end of March this year and also on the number of lives covered as at 31 March 2000. Table 2 shows the market share estimates provided by the Health Funds Association based on earned premiums and the number of lives covered, rounded to the nearest percent.[9]

Table 2: Health Fund Association's estimate of current market shares in the medical insurance market

Health Insurer	Earned Premiums %	Lives Covered %
Southern Cross	[ ]	[ ]
Aetna	[ ]	[ ]
AXA	[ ]	[ ]
Tower Health	[ ]	[ ]
UniMed	[ ]	[ ]
Police Health Plan	[ ]	[ ]
Sovereign	[ ]	[ ]
State Insurance	[ ]	[ ]
Others	[ ]	[ ]

78. Table 2 shows that Southern Cross' post-acquisition market share would be [ ]% based on earned premiums and [ ]% based on the number of lives covered. The merged entity's nearest rival would have only [ ]% market share, depending on which base is used to calculate market share. The Commission sought Southern Cross' view on the use of earned premiums as a yardstick for measuring market share in the medical insurance market. Southern Cross considers that the use of premium revenue overstates the market shares of those insurers which provide more comprehensive plans, such as Southern Cross and Aetna. This is because comprehensive cover commands higher premiums to cover higher payouts. However, Southern Cross noted that the two sets of market share data are broadly consistent and that, in any event, either measure of market share is consistent with the existence of low barriers to entry for the medical insurance market.

79. The Commission notes Southern Cross' views on market shares derived on the basis of earned premiums. The Commission will, for the purposes of its assessment, adopt the Health Funds Association's measure of market share based on earned premiums, as this yields the highest level of combined market share for the parties to the acquisition. The Commission considers that this will lead to an appropriately conservative assessment of concentration.

80. With a post-acquisition market share in the order of [ ]%, the acquisition would be well outside the Commission's "safe harbours" stated in the *Business Acquisitions Guidelines*. The Commission cannot therefore preclude the possibility of dominance.

[9] The market share data provided by the Health Funds Association does not include medical insurance policies provided by Combined Insurance or Farmers Mutual, which the Health Funds Association has estimated to be less than [ ]% of the medical insurance market. Hence, the market share data is substantially complete.

The Commission below considers mitigating factors such as constraints on market behaviour and barriers to market entry and expansion.

81. An interesting comparison can be made between the current market shares in the medical insurance market and those in 1993. In the Commission's 1993 decision concerning *Southern Cross/Medic Aid*, the Commission, for the purposes of its assessment, relied upon market share estimates produced from a large-scale survey undertaken by the Consumers' Institute. The results of that survey were published in the July 1993 issue of *Consumer*. The Chief Executive of Southern Cross at the time considered that the figures obtained from the survey gave a valid view of the market. Table 3 shows the market shares from the survey.

Table 3: Market shares used by the Commission in 1993 in *Southern Cross/Medic Aid*

Health Insurer	**%**
Southern Cross	66.6
Medic Aid	13.8
Aetna	6.9
Blue Cross (now with AXA)	2.9
UniMed	2.7
PSIS	1.5
Others	5.6

82. A comparison of Tables 2 and 3 shows that Southern Cross' current market share is [ ]. Southern Cross was by far the major health insurer in New Zealand in 1993, as it is now. Following Aetna's acquisition of Medic Aid in 1993, Aetna had a market share of around 20%, based on Table 3. Since 1993, Aetna's share of the medical insurance market has [ ]. Comparing Tables 2 and 3 also shows that there has [ ].

Existing Competition

83. Although Southern Cross and Aetna are by far the largest health insurers in terms of market share, the medical insurance market is currently characterised by a high number of market participants. Many of them are substantial multinational insurance and financial companies, either in their own right or as a result of being part of larger groups of companies, with portfolios in New Zealand and internationally covering the full spectrum of insurance risks. These participants include Tower Health Limited (a subsidiary of Tower Limited), AXA Insurance Australia Limited (part of the AXA International Group), Sovereign Assurance Co Limited, State Insurance Limited (a subsidiary of Norwich Union Plc, which has recently been cleared to merge with CGU Plc to form a new group called CGNU), AA GIO Insurance Limited and American International Assurance Co Limited (a wholly owned subsidiary of the American International Assurance Co Limited).

84. In addition to these major corporates, the medical insurance market is supplied by niche operators such as Public Service Investment Services (like Southern Cross, a Friendly Society), Police Health Plan Limited, and Manchester Unity Friendly Society Limited.

Some of these health insurers only provide cover plans to members with a shared interest or background. For instance, Police Health Plan provides a range of medical insurances to employees and retired employees of New Zealand Police and their families.

85. Table 4 shows approximately when some of the market participants began offering medical insurance in New Zealand.

Table 4: Year of entry by insurers into the medical insurance market

Health Insurer	Year of Entry
Southern Cross	1960
Aetna	1987
Tower Health	1992
AXA	1995
Sovereign	1997
State Insurance	1996
PSIS	1992
AA GIO	1995
American International Assurance	1999
UniMed	1979

86. Group scheme medical insurances are predominantly underwritten by Southern Cross, Aetna, AXA and UniMed, with the latter two being relatively minor participants. Other health insurers such as Tower Health, Sovereign, State, AA GIO and American International Assurance currently choose to underwrite individual medical insurances.

87. As well as the incumbent market participants, Southern Cross has suggested that there are approximately 30 insurance companies in New Zealand offering a range of general insurance products which could expand into medical insurance, and thus currently provide a constraint on existing suppliers should they decide to raise prices or reduce output or quality in the medical insurance market. Southern Cross states that these "near entrants" include Lumley General Insurance (NZ) Limited, Royal & Sun Alliance Insurance (NZ) Limited, HIH Casualty & General Insurance (NZ) Limited, ACE Insurance Limited, MMI General Insurance (NZ) Limited, and QBE Insurance (International) Limited. The Commission has contacted several of these "near entrants" to ascertain their views. Some such as [ ] have indicated the possibility of entering the medical insurance market. Others such as [ ] have indicated that they have no plans to enter that market in the near future.

88. There are a number of features relating to existing competition in the medical insurance market which have been suggested to the Commission by various parties, including in some instances by Southern Cross. These include:

- Southern Cross' ownership structure and governance arrangements give it a competitive advantage. As a Friendly Society, Southern Cross is not liable to pay income tax on its profits. In addition, it does not face the same commercial incentives that its corporate rivals do. For instance, it is not under the same pressure to earn a commercial rate of return and does not have to pay a dividend to shareholders (in fact, as a Friendly Society, Southern Cross is prevented from

"returning" surpluses to members). This is said to assist Southern Cross to contain its premiums relative to its competitors and to make larger payments for claims.

- The overall size of the medical insurance market has significantly declined during the last decade. The Health Funds Association has indicated that the market has shrunk from an estimated 51% of the New Zealand population being covered by medical insurance in 1990 to 33% in 1999. Southern Cross has noted that in the three years from 1995 to 1998 the medical insurance market shrank by around 11%. Reasons suggested by various parties for the market's decline include that expenditure on medical insurance is from discretionary income, and that rising premiums have forced many New Zealanders to rely on self funding and/or the public health system (self funding, including reducing the scope of medical insurance, and the public health system are generally seen by market participants as being a factor in setting premiums). In other words it is claimed that the price elasticity of demand is high. In addition, the fringe benefit tax system, although now changing, has been cited as a reason why employers have withdrawn from subsidising medical insurance, preferring instead to gross up employees' salaries. Government policy with regard to public health expenditure is seen as potentially discouraging reliance by consumers on medical insurance.
- Profit margins in the medical insurance business are low and act to deter incumbents from expanding their presence or new entry. The Commission understands that the major general insurance companies competing in the medical insurance market do so to ensure that they are able to offer a full range of insurance products, rather than because of the inherent attractiveness of the market.
- [ ]. Nonetheless, medical insurance for group schemes is perceived by many insurers to be commercially unattractive because of what are understood to be very low margins in this sector. The Commission has been told that this is largely because of strong competition for group scheme business. In addition, covering group schemes requires the insurer to accept pre-existing risks and to offer comprehensive cover plans. It is claimed that this requires the insurer to have a relatively high market share in order to cover claims.
- Southern Cross' high market share allows it to benefit from economies of scale, giving it a competitive advantage in setting premiums.
- Health insurers need to have a diversified pool of risks. That is, if an insurer's portfolio is overloaded with high risk/claim customers (for example, customers with pre-existing conditions), it will find it difficult to compete against an insurer with a more balanced risk portfolio. Accordingly, insurers have an incentive to protect themselves from the problem of adverse selection.
- Substantial increases in premiums for comprehensive cover plans have led to a large-scale migration by customers to 'major medical' cover plans. Similarly, increasing costs relating to comprehensive cover has seen some insurers tending toward a greater focus on major medical plans.

Barriers to Market Entry or Expansion

89. The Commission considers that potential competition in the medical insurance market from new entry or expansion by existing market participants can act as a constraint on

behaviour in that market. An assessment of the nature and extent of the threat of market entry or expansion is a significant part of the Commission's analysis of competition and market dominance. The focus of the Commission's assessment here is an examination of the barriers to entry or expansion. In addition, in order for the threat of market entry or expansion to be a sufficient constraint so as to alleviate concerns of market dominance, the Commission needs to be satisfied that entry or expansion in response to the exercise of market power will be likely, sufficient in extent, timely and sustainable.

90. In *Southern Cross/Medic Aid* the Commission concluded at paragraph 32 that "Southern Cross is not dominant in the medical insurance market and that, given the absence of significant entry barriers to, the history of, and the number of providers of cover in, that market, the proposal would not result in, and would not be likely to result in, dominance in that market." This was so even though the Commission found that the acquisition of Medic Aid would have increased Southern Cross' market share from around 66% to about 80%. While the Commission has given due consideration to its earlier determination, it considers that the earlier determination must be distinguished from the proposed acquisition presently being considered. In the intervening seven years since the earlier determination, the medical insurance market has seen significant contraction and at best modest increases in the market shares held by market participants. The Commission's current analysis must therefore be more rigorous than simply relying on the determination made seven years earlier.

91. In the view of the Commission, new entry into the medical insurance market remains relatively straightforward. The number of participants presently in the market supports the view that entry is not difficult. A successful new entrant does not face major barriers to entry in respect of, for example:

- regulatory approval;
- access to investment capital;
- access to, or the ability to generate, data to facilitate risk profiles and premium settings; or
- brand recognition and market credibility.

92. The Commission recognises that the regulatory environment is not particularly onerous in the insurance industry. In *CGU/Norwich*, the Commission noted at paragraphs 19 and 20 that:

> "New Zealand has one of the least regulated insurance markets in the world. The Insurance Companies (Ratings and Inspections) Act 1994 requires companies to obtain, register and disclose a credit rating from an approved rating agency (AM Best or Standard & Poor's), to show their ability to pay claims.
>
> The Insurance Companies Deposits Act 1953 requires an insurance company to lodge approved securities with a market value of not less than $500,000 with the Public Trustee. This Act further requires annual reports and statements of financial condition to be provided to the Ministry of Economic Development."

93. Similarly, the Commission does not consider that any of the other requirements for entry would deter existing financial and insurance organisations from entering the medical

insurance market. There are significant organisations either presently in the medical insurance market or within the wider financial and insurance sectors (including the near entrants previously identified) for whom issues such as investment capital, branding, reputation, access to data, and systems development would not pose, in the Commission's view, significant or high barriers in the event that they were to chose to enter the medical insurance market.

94. Despite the apparent ease of new entry by medical insurers, past entry into and expansion in the medical insurance market tends to indicate to the Commission that the likelihood of future significant entry or expansion is unlikely. While there has been some new entry in the last several years (see Table 4), the impact of this entry has been insignificant. Competitors have not been able to make significant inroads to capture market share from Southern Cross. The third largest market share, based on earned premiums, after Southern Cross and Aetna, is no greater than [ ]% (see Table 2). Even Aetna seems to have reached its existing market share more through acquisition of other market participants than through competition, and that market share has subsequently declined. Indeed, as noted earlier, it has been suggested to the Commission that much of the new entry has only occurred in order to enable diversified insurers to offer their customers a full insurance portfolio, rather than because of a strong interest on the part of the participants in the medical insurance market.

95. In considering whether post-acquisition entry or expansion in the medical insurance market in response to the exercise of market power will be likely, sufficient in extent, timely and sustainable, the Commission notes:

- the historically low profit margins in the medical insurance market;
- the track record of past entry and expansion suggests that it is difficult to achieve growth in the medical insurance market, and new entry or expansion is more likely to focus on niche areas of the market or on having a presence in the market in order to be able to offer a complete range of insurance products;
- the competitive advantage that Southern Cross enjoys through its ownership structure and governance arrangements;
- the substantial market share or size which Southern Cross would have post-acquisition, and the corresponding scale economies it would achieve;
- the fact that the overall size of the medical insurance market has been in significant decline for a number of years;
- the discretionary nature of spending on medical insurance and the options for consumers to self-fund their medical costs or reduce the scope of their medical insurance;
- the availability of the public health system as an alternative to private health treatment and care; and
- the political risk of entry or expansion, perceived by some in the industry, because of what is said to be uncertainty with regard to government policy in respect of expenditure on the public health system.

96. The Commission concludes that, taking into account the history of the medical insurance market, the structure of the market (including factors unique to Southern Cross), and the

lack of expansion in the market, the likelihood of significant expansion by current participants or new entrants in the market is low. The Commission also concludes that the extent of entry or expansion following the acquisition is likely to be on a small scale and more likely to be in niche areas of the market.

Conclusions

97. The Commission has considered the impact of the acquisition proposed by Southern Cross on the market for the provision of medical insurance in New Zealand.

98. The Commission has concluded the following from its competition analysis:

- The acquisition would result in a very high level of market concentration.
- Southern Cross notes in the application that high market shares can in some instances give rise to competition issues where, for example, the cost structures of smaller rivals are higher than that of the merged firm due to economies of scale. The Commission considers that the acquisition would lead to economies of scale for Southern Cross. Southern Cross itself notes that a large membership base can assist in avoiding statistical clustering of risks. With substantially smaller market shares, its competitors would have higher average cost structures. Their fixed costs would be spreadable over a smaller premium base. Southern Cross has argued that research into insurance markets strongly suggests that economies of scope across various markets are more important than economies of scale in any one market. Based on the responses of general insurers which offer medical insurance, the Commission considers that economies of scope are less important for entry into the medical insurance market than economies of scale. The Commission considers that having critical mass and economies of scale in the medical insurance market gives Southern Cross an advantage which serves as a barrier to expansion.
- The acquisition would have the effect of removing from the medical insurance market Southern Cross' principal competitor and the market participant with the best chance of matching Southern Cross' economies of scale. In the view of the Commission it would remove the most important current constraint on Southern Cross' level and quality of service.
- Barriers to entry into or expansion in the medical insurance market do not appear to be particularly onerous or high.
- Notwithstanding the apparent low barriers to entry or expansion, new entry has not been able to secure market share from Southern Cross to any significant extent.
- Whilst the Commission accepts that the options of self funding medical costs (including through downgrading the cover provided by medical insurance) and relying on the public health system for medical treatment and care act as factors that health insurers need to take account of when setting premiums and levels of service, the Commission considers that these factors alone would not be sufficient to place a constraint on a hypothetical monopolist in the medical insurance market from initiating and maintaining an increase in premiums, or reducing the level and quality of service.

- The Commission considers that the likelihood of expansion by current participants in the medical insurance market post-acquisition is low, that the extent of entry or expansion post-acquisition is likely to be on a small scale and more likely in niche areas of the market, and that, with the exception of niche areas, entry or expansion post-acquisition is unlikely to be sustainable.

99. The Commission has considered whether the merged entity would be able to initiate and maintain an increase in premiums, or reduction in the level or quality of service, consistent with dominance, or whether it would be constrained from doing so by competitive pressure. In assessing the level of competitive pressure that would apply in such circumstances, the Commission considers it relevant to take into account the lack of significant expansion by new entrants since 1993. In the Commission's view, the lack of expansion raises doubts as to the degree of competitive constraint that new entrants or existing participants would provide in the event of an increase in premiums, or a reduction in the level or quality of service, consistent with dominance.

100. Southern Cross has identified the shrinking market for health insurance and the commercial unattractiveness of this market as the key factors contributing to the lack of expansion by other market participants. Despite these factors, Southern Cross considers that the threat of a competitive response will still constrain Southern Cross from attempting to raise prices, or reduce services or benefits significantly following the acquisition. The Commission considers that these factors, together with other factors identified by the Commission such as economies of scale, may constitute disincentives to expansion that are sufficiently strong to limit the competitive response to an increase in premiums, or a reduction in the level or quality of service, consistent with dominance. In these circumstances, the Commission cannot be satisfied that the acquisition will not result in an effect described in paragraph (a) or paragraph (b) of section 47(1) of the Act.

101. Section 47 of the Act provides that:

> "(1) No person shall acquire assets of a business or shares if, as a result of the acquisition, -
> (a) That person or another person would be, or would be likely to be, in a dominant position in a market; or
> (b) That person's or another person's dominant position in a market would be, or would be likely to be, strengthened."

102. Section 66(3) of the Act provides that the Commission shall:

> "(b) If it is not satisfied that the acquisition will not result in an effect described in paragraph (a) or paragraph (b) of section 47(1) of this Act, by notice in writing to the person by or on whose behalf the notice was given, decline to give a clearance for the acquisition."

103. The Commission notes that Southern Cross may, both before and after the acquisition, have some advantage in its pricing structure because of the taxation benefits conferred by its Friendly Society status. It is arguable that some of the discretion the merged entity may have over price and quality is attributable to this advantage. That is, competitors will not compete aggressively on price until the merged entity begins charging prices at a competitive level – the level a competitor would choose if it did not have to allow for Southern Cross' tax advantage. However, the Commission considers

that the evidence on this point is not sufficiently clear for it to be satisfied that the acquisition of Aetna by Southern Cross would not result, nor would be likely to result, in the acquisition or strengthening of dominance.

104. Having regard to the various elements of section 3(9) of the Act, and all the other relevant factors, the Commission concludes that it is not satisfied that the proposal would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position in the market for the provision of medical insurance in New Zealand.

DETERMINATION ON NOTICE OF CLEARANCE

105. Accordingly, pursuant to section 66(3)(b) of the Commerce Act 1986, the Commission declines to give a clearance for the proposed acquisition by The Southern Cross Medical Care Society ("Southern Cross"), or a direct or indirect subsidiary of Southern Cross, of all the issued share capital in Aetna Health (NZ) Limited.

Dated this 25th day of August 2000

M J Belgrave
Chair