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COMMERCE COMMISSION

Decision No. 650

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

THE SOUTHERN CROSS HEALTH TRUST

and

AORANGI HOSPITAL LIMITED

The Commission: Peter J M Taylor
Denese Bates QC
Gowan Pickering

Summary of Application: The acquisition by Southern Cross Health Trust and Aorangi Hospital Limited, or companies owned by them respectively, of shares in JV Co (a new company to be formed) and for the acquisition by JV Co of the business assets of the Southern Cross Health Trust's and Aorangi Hospital Limited's, Palmerston North private hospitals.

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

Date of Determination: 4 September 2008

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EXECUTIVE SUMMARY

Introduction

E1. On 31 March 2008, the Commerce Commission (Commission) registered an Application from Southern Cross Health Trust (Southern Cross) and Aorangi Hospital Limited (Aorangi) seeking clearance for them, or companies owned by them, to acquire shares in JV Co (a new company to be formed) and for the acquisition by JV Co of the business assets of the private hospitals of Southern Cross Health Trust and Aorangi Hospital Limited in Palmerston North.

E2. Southern Cross is a not-for-profit charitable trust established for the purposes of providing privately-funded hospital care to the general public. One of the private surgical hospitals owned by Southern Cross is located in Palmerston North.

E3. Aorangi also operates a private surgical hospital in Palmerston North and is privately owned by a group of local medical specialists.

The Relevant Markets

E4. The Commission considers that the relevant markets for the consideration of the competition effects of this acquisition are:

- the provision of private short-stay hospital facilities and related non-specialist services for elective secondary surgery in the MidCentral DHB region (the short-stay market); and
- the provision of private in-patient hospital facilities and related non-specialist services for elective secondary surgery in the MidCentral DHB region (the in-patient market).

Factual and Counterfactual

E5. The Commission compares two situations: one in which the acquisition proceeds (the factual); and one in which the acquisition does not proceed (the counterfactual). The impact of the acquisition on competition in a market is then viewed as the prospective difference in the extent of competition between these two situations.

E6. The factual scenario (with the acquisition) would remove the existing competition between Southern Cross and Aorangi in Palmerston North, and leave only one provider of private elective surgical services in the MidCentral DHB region. Essentially, the relevant markets would be reduced to a monopoly.

E7. The Commission compared this factual with the relevant counterfactual(s). When there is more than one real and substantial counterfactual, which was the case here, it is not the case of choosing the one that the Commission thinks has the greater prospect of occurring. The Commission is required to assess the counterfactual possibilities, discard those that have only remote prospects of occurring, and consider each of the real and substantial possibilities as counterfactuals against which to assess the factual.

E8. In some cases, in assessing the relevant counterfactual(s), the Commission considers arguments that the business to be acquired is, in reality, a failing firm. If the Commission accepts that a firm is failing, and that the failure will occur within the relevant timeframe, the Commission would also accept that it is inevitable that the firm cannot survive in the market and it will exit the market in the factual and counterfactual. The firm could not be considered to be a competitive constraint.

E9. The Applicants have not explicitly proposed a failing firm (or failing division) argument. Rather, they have submitted that one of the hospitals, most likely Southern Cross, will close and exit as it cannot sustain current levels of economic loss. In the Commission's view, the Applicants have made arguments within a failing firm type framework that Southern Cross Palmerston North is a failing division of the Southern Cross Health Trust by virtue of (among other factors): unsustainable economic losses; a population base that cannot support two private hospitals; and that all options to improve the business have been exhausted.

E10. The Commission has considered these arguments, along with other factors, in reaching a conclusion as to whether or not Southern Cross Palmerston North would inevitably close and exit in the counterfactual.

E11. The Commission considered that one likely counterfactual scenario is that, due to the financial situation of its Palmerston North Hospital, Southern Cross would close its Palmerston North Hospital in the relevant period, and therefore would not remain as a competitor in the relevant markets for a period of at least two years (counterfactual one).

E12. The Commission also considered that, on the evidence available to it, there was a real and not merely remote possibility that Southern Cross Palmerston North would remain as a competitor in the relevant markets for at least two years, and therefore it would continue to compete with Aorangi (counterfactual two). In the Commission's view, there was insufficient evidence for it to be able to dismiss this as a possible counterfactual scenario.

E13. In arriving at its conclusions regarding this second possible counterfactual, the Commission drew upon all the following matters in the round:

- there is a lack of evidence of Southern Cross's intentions as to the future of its Palmerston North Hospital, absent the current joint venture proposal, and any evidence there is points to Southern Cross continuing in the market(s);
- Southern Cross has recently upgraded its hospital by making substantial cash investments, and with no apparent analysis of closure and exit at that time, as an alternative and possibly better option;
- Southern Cross Palmerston North's poor financial performance is minor in comparison to the organisation's overall profit;
- closure of the Hospital may have some impact on Southern Cross's medical insurance business;
- Southern Cross Palmerston North does not appear to have exhausted options for increasing its revenue; and
- there is no evidence that Southern Cross has fully investigated sale of the Palmerston North Hospital as an alternative to JV Co or closure.

E14. The second counterfactual scenario would result in two competitors in the counterfactual in comparison to one in the factual.

Competition Analysis

E15. The Commission has not analysed any changes in competition between the first counterfactual, in which Southern Cross would exit the relevant markets, and the factual. In the Commission's view, there is another real, and not merely remote, counterfactual that the Commission has assessed to be more competitive than those involving closure and exit. The competition differences between the factual and the counterfactuals will be greatest in respect of the second counterfactual and it will, by definition, be most relevant when the Commission decides whether or not competition has been substantially lessened by the proposed acquisition.

E16. Aorangi and Southern Cross have, for some time, been competing strongly against one another. This competition, and the competitive constraints it brings, would continue in the second counterfactual but would be lost in the factual.

E17. There are considerable barriers to entry into the relevant markets. The Commission considers it unlikely that the threat of, or actual, de novo entry into, or expansion of other competitors in, the relevant markets would have the potential to provide competition that could constrain the proposed joint venture in the factual. In addition, funding providers are unlikely to provide a significant constraint on the combined entity.

E18. Given these competition factors, the scope for the exercise of unilateral market power by the joint venture, in the factual relative to the second counterfactual, in which Southern Cross remains as a competitor is likely to be enhanced by the proposed acquisition.

Conclusion

E19. The Commission is not satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the relevant markets. Therefore, the Commission declines to give clearance for the proposed acquisition.

THE PROPOSAL

1. A notice pursuant to s 66(1) of the Commerce Act 1986 (the Act) was registered on 31 March 2008. The Notice sought clearance by Southern Cross Health Trust and Aorangi Hospital Limited, or companies owned by them, to acquire shares in JV Co (a new company to be formed) and for the acquisition by JV Co of the business assets of the private hospitals of Southern Cross Health Trust and Aorangi Hospital Limited in Palmerston North.

PROCEDURE

2. Section 66(3) of the Act requires the Commission either to clear or to decline to clear the acquisition referred to in a s 66(1) notice within 10 working days, unless the Commission and the person who gave notice agree to a longer period. An extension of time was agreed between the Commission and the Applicants. Accordingly, a decision on the Application was required by 5 September 2008.
3. The Commission's approach to analysing the proposed acquisition is based on principles set out in the Commission's Mergers and Acquisitions Guidelines.[1]

STATUTORY FRAMEWORK

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

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

6. In determining whether there is a change along the spectrum which is significant the Commission must identify a real lessening of competition that is more than nominal and not minimal.[4] Competition must be lessened in a considerable and sustainable way. For the purposes of its analysis the Commission is of the view

[1] Commerce Commission, *Mergers and Acquisitions Guidelines*, January 2004.
[2] Foodstuffs (Wellington) Cooperative Society Limited v Commerce Commission (1992) 4 TCLR 713-722.
[3] *Air New Zealand & Qantas Airways Ltd v Commerce Commission*, (2004) 11 TCLR 347 Para 47.
[4] *Fisher & Paykel Limited v Commerce Commission* (1996) 2 NZLR 731, 758 and also *Port Nelson Limited v Commerce Commission* (1996) 3 NZLR 554.

that a lessening of competition and creation, enhancement or facilitation of the exercise of market power may be taken as being equivalent.

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

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

THE PARTIES

Southern Cross

9. Southern Cross Health Trust (Southern Cross) is a not-for-profit charitable trust established for the purposes of providing privately-funded hospital care to the general public.[5] Southern Cross is the largest private hospital operator in the country. It currently owns nine private surgical hospitals[6] and has partnerships in another five.[7] Southern Cross treats approximately 60,000 patients per year at these facilities. For the 2007/2008 year, Southern Cross had total revenues of $164 million and recorded a profit of $19 million.

10. Southern Cross Medical Care Society is New Zealand's largest health insurer, serving about one in five New Zealanders. The Society is governed by a board of directors. Those directors are "for reasons of efficient governance"[8] the same persons as the trustees of the Southern Cross Health Trust.

11. Southern Cross's Palmerston North hospital comprises:

- two operating theatres;
- 26 in-patient beds;
- a seven recovery chair short-stay / day-stay unit; and
- six consulting rooms.

12. In 2006/2007, Southern Cross Palmerston North treated about [ ] patients. For that year its revenues were about [ ]. Services provided at the Palmerston North hospital are divided between short stay patients [ ] and in-patients [ ]. Currently, Southern Cross performs a full range of secondary

[5] The Commission has proceeded on the basis that Southern Cross and the health insurer, the Southern Cross Medical Care Society, are "associated persons" pursuant to s47(3) of the Commerce Act. This is consistent with previous Commission determinations.
[6] Auckland Surgical Centre, Brightside, Christchurch, Hamilton, Invercargill, New Plymouth, North Harbour, Palmerston North, and Wellington
[7] Gillies Hospital (Auckland), Mercy Angiography Unit (Auckland), Norfolk Southern Cross Hospital (Tauranga), Southern Cross Oxford Hospital (Christchurch) and Southern Cross QE Limited (Rotorua).
[8] See Southern Cross Healthcare Group website www.southerncross.co.nz

elective surgical procedures including plastic surgery, orthopaedics, gynaecology, general, ophthalmology and endoscopy.

13. Southern Cross Palmerston North opened in 1987. In January 2008, Southern Cross completed a $1.1 million upgrade at Palmerston North, as part of a programme of improvements of its operating theatres. This followed an investment in 2006 to establish the six consulting rooms at the hospital for a dedicated specialist centre.[9]

Aorangi Hospital Limited

14. Aorangi hospital is privately owned by a group of medical specialists whose practices are in Palmerston North. Aorangi treats between [ ] patients per year in Palmerston North. For the 2006/2007 year, Aorangi had total revenues of about [ ] million and recorded a profit of about [ ].

15. Aorangi's hospital comprises:

- four operating theatres;
- 32 in-patient beds;
- a day-stay unit; and
- consulting rooms.

16. Services provided at the hospital are divided between short-stay patients [ ] and in-patients [ ]. Currently, Aorangi performs the same range of surgical procedures as does Southern Cross Palmerston North.

17. In 2003, Aorangi was redeveloped by its owners. The upgrade included additional operating theatres and patient rooms and an upgrade of the day surgery facilities, all at a cost of approximately [ ] million.

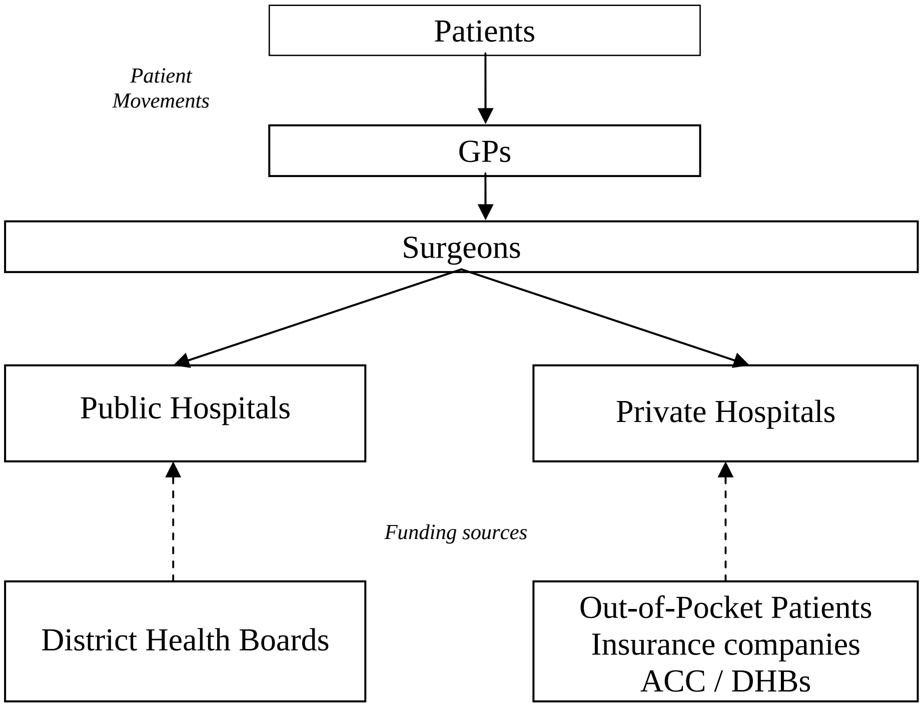
18. Evidence obtained by the Commission indicates that while Aorangi's premises are older than those of Southern Cross Palmerston North, the surgical and medical equipment in the two hospitals are of a similar, modern standard.

INDUSTRY BACKGROUND

19. In New Zealand, healthcare is provided by a range of medical practitioners and facilities. The main industry participants relevant to this proposed acquisition are shown in the diagram below.

[9] Southern Cross Media release 31/01/08 "Upgrades continue at Southern Cross Palmerston North".

Figure 1: Main Industry Participants in Healthcare



20. There is a relatively complex set of relationships leading to a particular patient being operated on by a particular surgeon in a particular hospital. As shown in Figure 1, patients are first seen by a primary healthcare provider (usually a GP). If surgery is warranted, or specialist consultation is required, the patient will be referred to a surgeon.

21. When a surgeon recommends private elective surgery the decision as to which private hospital will be used will be heavily influence by the hospital (or hospitals) where that surgeon normally operates. Typically, patients will follow their surgeon's recommendation about where the surgery is to be performed.

22. Factors that influence surgeons' choice of hospital include:

    - whether or not they have a shareholding in a facility (as is the case with Aorangi);
    - the ability to schedule surgery at a convenient time for the surgeon at a particular private hospital; and
    - the particular private hospital's charges for the provision of the necessary facilities.

23. Private hospitals provide facilities, namely, patient rooms and medical equipment, as well as the related non–specialist services such as administration staff and nursing staff. Private hospitals typically do not provide surgeons or the ancillary specialist skills such as the anaesthetists or physiotherapists. These medical professionals contract directly with the patient and therefore bill the patient separately.

24. Private hospitals focus almost exclusively on providing elective surgery. Elective surgery is defined as non-emergency treatments (including diagnostic

services) where the condition is not life threatening and does not require immediate surgery.

25. Demand for the provision of elective surgery in the public system generally outstrips supply so rationing is required. The private system caters for those patients who would not otherwise receive treatment in the public system, or who want to receive private treatment for reasons such as timeliness.

Developments in Palmerston North

26. The Applicants advised the Commission that over the past eight years they have had several discussions about merging their two businesses. For example, Johan Bester, CEO, Aorangi advised the Commission that a merger between Aorangi and Southern Cross [ ].

27. The main events are outlined in Table 1.

Table 1: Timeline of Merger Discussions in Palmerston North

Year	**Events**
2000	Sisters of Mercy Hospital offered for sale. [ ], and local medical specialists. Local specialists acquire hospital and create Aorangi.
March 2002	Discussions held between Southern Cross and Aorangi on a possible joint venture [ ].[10]
2002	Aorangi expanded its hospital from two to four theatres (completed May 2003).
Mid 2003	Aorangi and Southern Cross continue to discuss proposed joint venture.
August 2003	Southern Cross rejects a joint venture proposal [ ].[11]
July 2007	[ ].
November 2007	Formal joint venture discussions re-started between Southern Cross and Aorangi.
28 March 2008	Clearance application submitted.

[10] For example, Aorangi Board Paper, "Aorangi Hospital/Southern Cross Joint Venture: Business Plan 22 May 2003.

[11] Chief Operating Officer, Hospitals, Southern Cross "Joint Venture partnership between Southern Cross and Aorangi hospitals discussion document" 5 August 2003.

PREVIOUS DECISIONS

28. The Commission has recently considered a number of applications in respect of the private hospital industry, namely:

- *Decision 492: Wakefield Hospital Ltd* / *Bowen Hospital*, 19 Feb 2003 (the Wakefield Decision);
- *Decision 537: Southern Cross Oxford Hospital Limited / The Oxford Clinic*, 11 November 2004 (the Oxford Decision);
- *Decision 546: The Southern Cross Health Trust / Auckland Surgical Centre Limited*, 17 February 2005 (the Auckland Surgical Decision); and
- *Decision 620: Southern Cross Health Trust / QE Hospital Limited*, 28 September 2007 (the QE Health Decision).

29. In the Wakefield Decision, the Commission decided that a proposed acquisition between two private hospitals in the Wellington region. In clearing the acquisition, the Commission's view was that there was sufficient constraint on the merged entity from existing competition from Boulcott Hospital Limited (Boulcott) and Southern Cross Wellington such that a substantial lessening of competition was not likely.

30. Again, the Commission granted clearance in both the Oxford and Auckland Surgical Decisions as it considered that the proposed acquisitions would be unlikely to lead to a substantial lessening of competition, primarily due to the strength of existing competition and the presence of sufficient excess capacity in the relevant markets.

31. In the QE Health Decision, the Commission analysed the potential formation of a joint venture between the only two private hospitals in Rotorua – Southern Cross and QE Health. The Commission found that in the counterfactual, while neither QE Health nor Southern Cross Rotorua were failing firms, it was likely that one of these hospitals would not continue to operate in the short term – [ ].

32. [ ]

33. The Commission also considered on the facts, that QE Health and Southern Cross Rotorua did not compete with each other to any significant degree in the counterfactual.

34. The Commission applied those two, and other, factors in its analysis and decided to give clearance for the formation of the relevant joint venture in Rotorua.

35. In these decisions, the Commission considered that competition between individual private hospitals existed in regional markets and manifested itself by competition for:

- the price charged, and quality of service provided, to patients; and

- the price charged, and standard and availability of surgical facilities provided, to surgeons.

MARKET DEFINITION

36. The Act defines a market as:

> "… a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them."[12]

37. For the purpose of competition analysis, the internationally accepted approach is to assume the relevant market is the smallest space within which a hypothetical, profit-maximising, sole supplier of a good or service, not constrained by the threat of entry would be able to impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the SSNIP test). The smallest space in which such market power may be exercised is defined in terms of the dimensions of a market discussed below. The Commission generally considers a SSNIP to involve a five to ten percent increase in price that is sustained for a period of one year.

38. When considering the product dimension of the markets in its previous Decisions the Commission has found the following features:

    - private elective surgery is distinct from public elective surgery;
    - private hospitals provide the hospital facilities but do not themselves provide the surgical procedures. The surgeon is contracted separately by the patient;
    - only a few New Zealand private hospitals have the facilities to provide tertiary healthcare (such as an Intensive Care Unit) and these hospitals do not provide any 'acute' services. Most private hospitals in New Zealand provide secondary healthcare;
    - short-stay (less than 24 hour) services are distinct from in-patient services, primarily due to the complexity of in-patient services and the additional resources needed to provide these; and
    - surgical facilities are fungible across the different medical specialities such that there are general surgical markets. Different types of surgery are performed in the same theatres/hospitals using much common, but some separate and specific, equipment and so are in the same product market by virtue of the supply side considerations.

39. In addition, the Commission also found that geographic markets tend to be regional (e.g. the Rotorua region or the Wellington region) as patients are reluctant to travel great distances for elective surgery, although this distance can increase with the complexity or duration of a particular procedure.

Product Market

40. The greater the extent to which one good or service is substitutable for another, on either the demand-side or supply-side, the greater the likelihood that they are bought and supplied in the same market.

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[12] s 3(1A) of the Commerce Act 1986.

41. Close substitute products on the demand-side are those between which at least a significant proportion of buyers would switch when given an incentive to do so by a small change in their relative prices.

42. Close substitute products on the supply-side are those between which suppliers can easily move their production in the short run, using largely unchanged production facilities and little or no additional investment, when they are given a profit incentive to do so by a small change to their relative prices.

43. Southern Cross Palmerston North and Aorangi both operate facilities that provide private elective surgery for short-stay patients and in-patients.

44. The Applicants submitted that most of the Commission's analysis in past decisions relating to the private hospital industry, such as those mentioned above, readily translates to the present Application.[13] The Applicants submitted that the relevant product markets are those that the Commission has found in previous private hospital merger cases, that is, markets for the provision of:

- private short-stay hospital facilities and related non-specialist services for elective secondary surgery; and
- private in-patient hospital facilities and related non-specialist services for elective secondary surgery.

45. Through its investigation, the Commission found no evidence that would lead it to depart from its earlier views that these are the relevant product market definitions.

Geographic Market

46. The Commission defines the geographic dimension of a market to include all of the relevant, spatially dispersed sources of supply to which buyers would turn should the prices of local sources of supply be raised.

47. The Applicants submitted that, in the context of the present application, the relevant geographic market boundaries should extend to include Fielding, Dannevirke, Wanganui, Levin and Wellington and that the private hospital facilities in these centres act as a strong constraint on those in Palmerston North.

48. In the earlier decisions listed above, the Commission defined narrow regional markets. That was because the evidence obtained by the Commission indicated that patients and surgeons were reluctant to travel great distances for routine elective surgery, particularly for short-stay procedures. Most surgical procedures involve a number of consultation visits with the relevant specialist, both before and after the surgery. This means that patients generally prefer to be treated at a hospital within a reasonable distance from their place of residence, to minimise the time and cost associated with travel and to allow friends and relatives to more easily visit.

49. Indeed, it appears that Southern Cross itself emphasises this point on its website by providing a link to "find the nearest Southern Cross Hospital to you" and the statement that "with 13 private hospitals offering a broad range of elective

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[13] The Applicants also reference *Decision 518 Pacific Radiology Limited / Wakefield Radiology Ltd,* 28 Feb 2004; the Wakefield Decision and *Decision 449 The Ascot Hospital and Clinics / Mercy Hospital Auckland Ltd,* 14 Dec 2001.

surgery, we can provide a convenient location for most of your private surgical and treatment needs.” [14]

50. Southern Cross, suggested that surgeons “private {work} is very draining because you don't have registrars to do all the follow up work, so you not only do the surgery, you’re on call at night time, things go wrong in each day so it is quite hard to do that unless you’re resident.”[15] For this reason surgeons generally prefer to take their patients to surgical facilities nearest to where the individual surgeons live. So, Palmerston North-based surgeons tend to treat Palmerston North-based patients and Wellington-based surgeons tend to treat Wellington-based patients.

51. On the whole, the evidence suggests that surgeons who have operating schedules at either Southern Cross Palmerston North or Aorangi are domiciled in Palmerston North city and do not have patients resident in, for example, Wellington. However, the Applicants consider that the relevant geographic market boundaries should not be limited to Palmerston North city. They estimate that nearly [ ] of Aorangi and Southern Cross patients are drawn from outside Palmerston North city and consequently submitted that the relevant geographic market should be extended to include, at a minimum, Fielding, Dannevirke and Levin, as well as cities from further afield, such as Wanganui and Wellington.

52. In support of this proposition, the Applicants submitted several potential geographical boundaries of the relevant hospital facilities markets, namely:

- the Mid-Central DHB area, which would include Fielding, Levin, and Dannevirke; or
- a 75km region, which would include facilities within 75km of Palmerston North including those at Wanganui; or
- a 150km region, which would include facilities in the Kapiti Coast/Horowhenua region and Wellington. The Kapiti Coast/Horowhenua area is approximately equidistant between Wellington and Palmerston North; or
- a Lower North Island area, which would include facilities within 180km of Palmerston North, including Napier and Hastings.

53. All parties interviewed by the Commission indicated that Palmerston North had a large rural hinterland of farming areas and small towns in the Manawatu, Horowhenua, Rangitikei, Northern Wairarapa and Southern Hawkes Bay regions. The city was described as a “shopping destination” for many people in the wider region, and, as a destination, this also applied to the demand for other services such as those provided by private hospitals.

54. Aorangi advised that its administrative systems do not record the locations of its patients’ residences. However, Southern Cross was able to provide this

[14] See www.southerncross.co.nz
[15] Terry Moore, CEO, Southern Cross Health Trust during an interview with Commission staff.

information. Table 2 shows the locations of the residences of Southern Cross's Palmerston North patients since 2005.[16]

Table 2: Location of Southern Cross Palmerston North patients

Location	**Percentage of Patients**	**Cumulative percentage of Patients**
Palmerston North	[ ]	[ ]
Manawatu/Rangitikei	[ ]	[ ]
Northern Wairarapa / Southern Hawkes Bay	[ ]	[ ]
Kapiti / Horowhenua	[ ]	[ ]
Wanganui	[ ]	[ ]
Other	[ ]	100%
Total	**100%**	**-**
Total (2005-2008)	**[ ]**	**[ ]**

Source: Southern Cross

55. The Commission notes that an assumption could be made that half of the [ ] of Kapiti/Horowhenua patients of Southern Cross Palmerston North reside in Horowhenua[17] and the other half reside south of Te Horo, outside the boundary of the MidCentral DHB region (see Map in Appendix one). On the basis of that assumption the MidCentral DHB region accounts for about [ ] of Southern Cross's patient load. If it is further assumed that Aorangi's patient watershed is similar to that of Southern Cross, this [ ] inclusion is a starting point that suggests that the boundary of the relevant geographical market coincides with the MidCentral DHB regional boundary.

56. The geographical boundary of the relevant markets is now considered in more detail.

Treatment of the Wanganui region

57. The closest private surgical hospital to Palmerston North is Belverdale Private Surgical Hospital (Belverdale) in Wanganui. Wanganui is approximately 75km from Palmerston North.

58. Belverdale advised that most of its patients are from Wanganui City and it treats very few patients from Palmerston North. Belverdale currently performs a limited range of elective surgery. Outside this range, patients must travel to Palmerston North or elsewhere. As Table 2 shows, such Wanganui patients account for only a small number of Southern Cross Palmerston North's patients. In the reverse, the Commission found little or no evidence of patients travelling from Palmerston North to Wanganui for elective surgery. For example, the ACC advised that [ ].

[16] Southern Cross notes that this data includes both in-patients and out-patients who have merely consulted with a specialist and who have not necessarily gone on to have an operation.
[17] For example in the towns of Foxton, Levin and Otaki.

59. Accordingly, the Commission considers that the geographic market should not include Wanganui.

Treatment of the Kapiti/Horowhenua region

60. The Applicants advised that there is a significant population in the Kapiti/Horowhenua region that could choose between Palmerston North and Wellington private hospitals.[18] Southern Cross stated that [ ] of its Palmerston North patients and [ ] of its Wellington patients, originate from the Kapiti/Horowhenua region.

61. The Applicants submitted that this indicates that the Palmerston North hospitals face competition from the Wellington hospitals, at least in terms of the patients living in the Kapiti/Horowhenua region. For example, if there was a decline in service standards or an increase in prices in Palmerston North hospitals, a patient from Levin would have little difficulty switching to a private facility in Wellington.

62. The Commission acknowledges that some patients in the MidCentral DHB region, such as those located in Otaki and Paraparaumu, could choose between Palmerston North and Wellington when considering options for private treatment because of their relative proximity to either of the two main centres. However, this ignores the role of the patient's GP referrer and the GP's experience or relationship with, potential specialist surgeons. In many cases patients are unlikely to have personal experience of the quality of service provided by individual surgeons. Patients tend to accept their GP's recommendation. Given that surgeons generally operate in particular areas, in the Commission's view this factor will in practice bias the choice of hospital location for Kapiti/Horowhenua patients.

63. Overall, the number of patients that fall into the category of being located in the MidCentral DHB region, but having the ability to choose a Wellington private hospital, appears small. The Commission considers that it is likely that the scope for switching between Palmerston North and Wellington private hospitals only represents switching at the margin and that as a result the relevant market includes only that part of the Kapiti/Horowhenua regions that lies within the MidCentral DHB's region.

64. The Commission found no evidence that Southern Cross Palmerston North or Aorangi took into account any significant constraint offered by Wellington hospitals.

Treatment of other regions

65. Table 3 below lists the number of Southern Cross Palmerston North patients who are domiciled in other regions that have an established private hospital.

[18] Southern Cross estimates that the population of Kapiti/Horowhenua region is approximately 76,000 compared to a population of 80,000 in Palmerston North city.

Table 3: Location of Southern Cross Palmerston North's patients from outside the Palmerston North region

Year	Wellington resident patients	Masterton resident patients	Hastings/Napier resident patients	Auckland resident patients	Total number of Southern Cross Patients per year
2005	[ ]	[ ]	[ ]	[ ]	[ ]
2006	[ ]	[ ]	[ ]	[ ]	[ ]
2007	[ ]	[ ]	[ ]	[ ]	[ ]

Source: Southern Cross

66. Table 3 indicates that a very small number of Southern Cross's Palmerston North patients travel to Palmerston North city from Wellington, Masterton, Hastings, Napier or Auckland for treatment. Data from Aorangi was not available but it is reasonable to infer that the pattern would likely be similar. The Commission was not provided with any contrary material.

67. Boulcott, located in Lower Hutt, did not consider that it competed with either of the private hospitals in Palmerston North.

68. Wakefield Health advised that, in Wellington, it offers a more comprehensive range of elective surgery services than any other private hospitals operator in the lower North Island. In this respect, it attracts patients from around the lower North Island (as well as the upper South Island). Therefore, there would be less reason for a patient to travel from Wellington, where its Wakefield and Bowen hospitals are located, to either of the private hospitals in Palmerston North. [

].

69. The Commission notes that this suggests that some patients in the lower North Island, which would include Palmerston North, may be willing to travel to Wellington specifically to take advantage of the more advanced surgical facilities that Wakefield Health is able to offer for particular treatments. However, in the Commission's view, the scope for any such switching probably only represents switching at the margin. Therefore, the Commission does not accept that the Wellington region is part of the relevant geographic market.

70. Wakefield Health also operates the Royston hospital in Hastings. The Hawke's Bay region had two private hospitals until 2001, being the date when Southern Cross closed its Napier hospital. Andrew Blair[19], Wakefield Health [

].[20] This suggests that

[19] Andrew Blair was the Chief Executive of Royston Hospital at the time of the closure of Southern Cross Napier. This was before Royston Hospital amalgamated with Wakefield Health.
[20] The Commission notes that Royston Hospital increased its number of theatres since Southern Cross Napier closed.

patients in Hawke's Bay are reluctant to use a hospital outside of the region, so it is unlikely that hospitals in Hawke's Bay compete with private hospitals in Palmerston North.

71. More recently, Southern Cross Palmerston North and Aorangi (along with Royston Hospital) responded to a tender from Hawke's Bay DHB for the provision of certain surgical services. The size of the contract was approximately [ ][21]. The contract was awarded to Southern Cross Palmerston North. Hawke's Bay DHB advised that this was the first time it had ever gone "out-of-region" for a contract and [ ]. It noted that only a small number of operations were performed due to the limited funding. Wakefield Health considered that this was evidence that its Royston Hospitals faced some competition from the Palmerston North hospitals.

72. This example tends to confirm the smaller regional based market. This was the first time this option was used and it was done to test the market, that is the Hawkes Bay regional market, and on a limited basis. The Commission's view is that this is an isolated and minor example of cross-border competition and is not indicative of the normal state of competition in the MidCentral and Hawke's Bay DHB regions. It remains to be seen whether over time this approach will extend further and see a widening of the geographic market.

73. The Commission concludes that on balance private hospitals in the other regions, Hawke's Bay, Masterton and Wellington, do not directly compete with either Southern Cross Palmerston North or Aorangi.

Conclusion on the Geographic market

74. The Commission notes that Southern Cross has, for some time, considered that a joint venture would [ ].[22]

75. Given the evidence available to the Commission and its analysis, the Commission considers that as a matter of fact and commercial common sense the geographic market is the MidCentral DHB region, which includes Palmerston North City, Rangitikei/Manawatu, Horowhenua, and Northern Wairarapa/Southern Hawke's Bay. This region is shown on the map in Appendix One.

Conclusions on Market Definition

76. The Commission concludes that the relevant markets are:

- the provision of private short-stay hospital facilities and related non-specialist services for elective secondary surgery in the MidCentral DHB region (the short-stay market); and

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[21] This compares to Southern Cross Palmerston North's annual turnover of [ ] for 2007.

[22] COO, Hospitals, Southern Cross "Joint Venture partnership between Southern Cross and Aorangi hospitals discussion document" 5 August 2003.

- the provision of private in-patient hospital facilities and related non-specialist services for elective secondary surgery in the MidCentral DHB region (the in-patient market).

ANALYTICAL FRAMEWORK

77. In reaching a conclusion as to whether an acquisition is likely to lead to a substantial lessening of competition, the Commission makes a comparative judgment by considering the likely outcomes between two future hypothetical situations: one with the acquisition, the factual; and one without the acquisition, the counterfactual.[23] The Commission then views the impact of the acquisition on competition in a market as the prospective difference in the extent of competition between these two scenarios.

78. In this case, the Commission has considered any differences between the factual and the counterfactual over a future horizon of two years from the formation of the JV Co.

FACTUAL

The Applicants' View

79. The Applicants submitted that, in the factual scenario:
    - the owners of the two private hospitals in Palmerston North would form a joint venture, JV Co, to operate the two hospitals;
    - it is likely that Southern Cross would take at least a 50% shareholding in JV Co, [ ];[24]
    - initially, both hospitals would remain in operation with one hospital likely to provide in-patient facilities (Aorangi) and the other hospital likely to provide short-stay facilities (Southern Cross);
    - JV Co would achieve significant cost savings, [ ]. Primarily, this would be the result of:
        - the creation of a single management team;
        - less duplication in the provision of services;
        - the use of Southern Cross's greater buying power in the purchase of medical equipment and supplies;
        - efficiencies from the increased specialisation of the hospitals; and
        - savings in other staffing costs (e.g., it is likely that JV Co would remove the need to have both hospitals open at night or during weekends).

80. Southern Cross noted both hospitals would remain open in the factual although:

---

[23] *Air New Zealand & Qantas Airways Ltd v Commerce Commission* (2004) 11 TCLR 347, Para 42.

[24] [ ].

[

][25].

81. [

].

82. The Applicant's main argument is that the status quo, which involves two private hospitals serving the relatively small population of Palmerston North and surrounding towns, is not sustainable in the short-to-medium term.

83. The Applicants submitted that the cost savings likely under the factual would produce sustainable returns for both hospitals, relative to the status quo. They added that the potential for cost savings in the factual indicates that there would be no need for price increases to make the joint venture economically viable and it would also provide a justification for the purchase of medical equipment to replicate the service levels of other hospitals in the Southern Cross network, for example.

84. However, the Applicants did not argue that any possible efficiency gains would outweigh any substantial lessening of competition that might arise from the formation of JV Co.

The Commission's Conclusion on the Factual

85. In the Commission's view, the factual would likely have the following characteristics :

- JV Co would be formed and it would acquire the assets of Aorangi and Southern Cross;
- the two facilities would remain open although there would be a rationalisation in the provision of services and bed capacity;
- Aorangi and Southern Cross would acquire approximately equal shares in the joint venture; and
- certain efficiencies would be realised that would result in the financial performance of JV Co improving on the performance of the individual businesses separately.

86. Accordingly, in the factual scenario, JV Co would be the only provider of private elective surgical services in both of the relevant markets.

[25] Terry Moore, CEO, Southern Cross, Meeting with the Commission, 22 April 2008.

THE COUNTERFACTUAL

Introduction

87. In framing a suitable counterfactual, the Commission bases its view on a pragmatic and commercial assessment of what is likely to occur in the absence of the proposed acquisition.[26]

88. The High Court recently noted that because "likely" means something less than "more likely than not", there may be more than one "likely" counterfactual. In any acquisition, the Commission must assess what could possibly occur, and discard those possibilities that have only remote prospects of occurring. Each real and substantial possibility becomes a counterfactual against which the factual is to be assessed. It is not a case of choosing the one {counterfactual}[27] that we think has the greater prospects of occurring.[28] If in the factual, as compared with any of the relevant counterfactuals competition is substantially lessened then the acquisition has a "likely" effect of substantially lessening competition in a market.[29]

89. For example, as here, when there is more than one potential counterfactual, the Commission assesses the possibilities, discards those that have only remote prospects of occurring, and considers each of the real and substantial possibilities as counterfactuals against which the factual is to be assessed.

90. In this counterfactual section, the Commission discusses the likelihood of four potential scenarios being real, and not merely remote, possibilities within its analytical period of two years, should JV Co not eventuate:

    - first, two scenarios in relation to Aorangi are considered. One, being that Aorangi would close and exit the relevant markets, is dismissed as being merely a remote possibility. In the other Aorangi scenario, the Commission accepts that Aorangi would remain as a competitor in every potential counterfactual; and

    - next, the Commission analyses whether Southern Cross would close and exit the relevant markets. The Commission first accepts the Applicant's (and in particular Southern Cross's) submissions that there would be a real, and not merely, remote counterfactual scenario in which Southern Cross would close its Palmerston North hospital business and exit the relevant markets. Then, the Commission further analyses the issues and decides that there is also a real, and not merely remote, possibility that Southern Cross would remain as a competitor in the relevant markets for at least two years.

91. The Applicants argued that the only possible counterfactuals would involve either Southern Cross or Aorangi closing its hospital and exiting the relevant markets. The Applicants argued that all other scenarios would be only remote possibilities.

92. In two potential counterfactual scenarios - those in which either Aorangi or Southern Cross would close its hospital and exit the relevant markets, the likely

[26] *Commerce Commission, Decision No. 277: New Zealand Electricity Market*, 30 January 1996, p 16.
[27] 'Counterfactual' inserted for completeness.
[28] *Woolworths & Ors v Commerce Commission* (2008) 8 NZBLC 102,128 at 118.
[29] Ibid at 122.

factual and the counterfactual scenarios would have similarities. However, it is possible that some differences could arise. With either Applicant exiting the market it is not clear that its market share and capacity would transfer automatically to the other – entry could occur. However, the Commission does not consider it necessary to explore these issues further. As will later become clear, in the Commission's view there is another real, and not merely remote, counterfactual that the Commission has assessed to be more competitive than those involving closure and exit. That means that the competition differences between the factual and the counterfactuals will be greatest in respect of this second counterfactual and it will, by definition, be most relevant when the Commission decides whether or not competition has been substantially lessened by the Acquisition.

93. In the other two potential counterfactual scenarios in which either Aorangi or Southern Cross would remain as a competitor in the relevant markets, competition in the factual and counterfactual would be different. These counterfactuals can be analysed as one as they each involve the status quo. For both of these scenarios, the Commission must carry out a competition analysis to determine whether or not clearance should be given. This analysis is discussed later in these reasons.

Aorangi – Likelihood of Closure and Exit

94. The Commission has first considered the prospects of Aorangi continuing in the relevant markets. The likely counterfactuals in respect of Aorangi do not appear to be contentious and have been dealt with briefly below.

95. The issues that the Commission has considered in respect of Aorangi are whether there is a real, or merely a remote, possibility that Aorangi will exit the relevant markets.

96. Aorangi advised that, at present, it is competing strongly with Southern Cross. In fact, Aorangi advised that [ ].[30] [ ] Aorangi appears to be (and has been for some years) in a stronger financial position compared to Southern Cross Palmerston North.

97. Aorangi considered that there is very little prospect that it would close, absent the joint venture. [ ].

98. The Commission considers that a counterfactual scenario, in which during the next two years Aorangi's shareholders would face the necessity to close the hospital (as a result of poor financial performance) and exit the relevant markets, is merely a remote possibility.

99. The Commission also considers that it is a real, and not merely remote, possibility that Aorangi will remain in the market as a competitor for at least the

[30] Interview with Jim Jefferies, Chairman, Aorangi, 30/5/08.

two year period that the Commission analyses. Therefore, in the Commission's view, Aorangi would be included as a competitor in every potential counterfactual scenario.

Southern Cross – Likelihood of Closure and Exit

100. In its analysis of whether Southern Cross Palmerston North would close and exit the relevant markets or remain as a competitor in those markets (along with Aorangi) the Commission has considered:

- submissions from Southern Cross;
- Southern Cross Palmerston North's historic financial performance;
- the attempts by Southern Cross to restructure its Palmerston North hospital business to improve its financial position;
- whether there is evidence of planning by Southern Cross to either sell its Palmerston North hospital as a going concern or to close the hospital down;
- the value to Southern Cross as a whole (including its health insurance arm) of a presence in the MidCentral DHB region; and
- other matters as discussed below.

Closure and Exit is One Potential Counterfactual Scenario

101. In respect of Southern Cross's Palmerston North Hospital, the Commission accepts the Applicant's (and in particular Southern Cross's) submissions that one potential counterfactual scenario is that Southern Cross will close its Palmerston North Hospital and exit the relevant markets. The Commission accepts Southern Cross's submissions [ ]. In those circumstances it may be a rational decision for Southern Cross to close and exit Palmerston North.

102. However, that is not the end of the matter in this case. The Commission must go on and decide whether there are other counterfactuals that are real, and not merely remote, possibilities. In this case, as will become clear, the Commission has not been able to be satisfied that closure and exit by Southern Cross is the only likely counterfactual.

Remaining as a Competitor is Another Potential Counterfactual Scenario

103. The Commission accepts that one likely counterfactual is Southern Cross exiting from the market(s). The less clear cut question that the Commission now analyses is whether or not it can be satisfied there is not another real, and not merely remote, counterfactual that has Southern Cross Palmerston North remaining as a competitor in the relevant markets.

104. The following discussion is divided into sections on:

- the factual background in respect of Southern Cross's presence in Palmerston North under various heads;
- Southern Cross's submissions as to why its exit from the relevant markets is the only real, and not merely remote, possibility for a counterfactual scenario;

- The Commission's analysis of the facts and Southern Cross's submissions under various heads; and
- The Commission's conclusion as to whether it is satisfied that the exit by Southern Cross is the only likely counterfactual.

Factual Background

Aorangi

105. Southern Cross submitted that it had recognised in 2000 that the relevant markets were too small to support two privately owned hospitals, [ ].

106. Aorangi advised that its surgeon shareholders purchased Mercy Hospital primarily to [ ].[31]

107. In 2002/2003, Aorangi expanded the hospital from two to four operating theatres, increased the number of patient bedrooms, and upgraded the day surgery facilities at a cost of $[ ] million. Aorangi advised that the main reason for its expansion was that [ ].

2003 Merger Discussions

108. After the completion of Aorangi's redevelopment in 2003, Aorangi and Southern Cross discussed the possibility of merging their two Palmerston North-based operations. At the time, Southern Cross assessed [ ] options in respect to Palmerston North, namely:[32]
    - [ ]; or
    - merge with Aorangi hospital to create a joint venture partnership; or
    - continue to operate in competition with Aorangi Hospital.

109. After analysis, Southern Cross chose the last option:

    [ ][33]

Southern Cross Business Plan and Initiatives

110. Southern Cross submitted that its 2003 decision to continue to compete in Palmerston North was [

---

[31] Aorangi Board paper, "Aorangi Strategic Planning 2003-2007".
[32] COO, Hospitals, Southern Cross "Joint Venture partnership between Southern Cross and Aorangi hospitals discussion document" 5 August 2003.
[33] Southern Cross Board Minutes, 5 August 2003.

]

[

][34]

111. Since 2003, Southern Cross has implemented a range of initiatives to generate new business and to increase the profile of the hospital. These initiatives have included:

- various advertising and marketing strategies aimed at the general public and non-specialist support staff;
- the purchase of medical equipment and the development of specialist rooms to attract and retain specialists; and
- significant investment in the hospital's equipment.

112. [

].

<u>Capital Investment in Southern Cross Palmerston North since 2003</u>

113. Southern Cross advised that, subsequent to its decision to compete, [ ] with Aorangi in 2003, it has made major capital investments in its Palmerston North Hospital as follows:

- an annual investment to modernise hospital equipment. This totalled [ ] in 2008;
- a $1.1 million upgrade of its theatre air conditioning system which began in 2006 and was completed in January 2008;
- the conversion of nursing school rooms to specialists' consulting rooms – [ ]; and
- day procedure centre upgrades in 2003 and 2004.

114. [

]. In respect of the air conditioning equipment, the investment was not "sunk" as the air conditioning units could be dismantled and reinstalled in any other hospital in its network. Similarly, much of the general surgical equipment could be transferred to alternative sites in the event of closure.[35]

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[34] COO, Hospitals, Southern Cross "Joint Venture partnership between Southern Cross and Aorangi hospitals discussion document" 5 August 2003.

[35] The Commission has not been informed of the cost of dismantling, transporting to a new location and re-assembly of either air conditioning or general equipment in comparison to the value of new

Financial Performance of Southern Cross Palmerston North

115. The Commission has examined the internal management accounts of Southern Cross Palmerston North for the last eight years as part of its consideration of the likely counterfactual(s). It has also considered reports provided by NERA (on behalf of Southern Cross) on the financial position of the hospital.

116. Table 4 summarises the financial performance of Southern Cross Palmerston North from 2001 to 2008.

Table 4: Southern Cross Palmerston North Financial Performance 2001-2008

$000's	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Operating Revenue	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Less Direct Costs	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Gross Profit/(Loss)	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**
Gross Margin	*[ ]*	*[ ]*	*[ ]*	*[ ]*	*[ ]*	*[ ]*	*[ ]*	*[ ]*
Indirect Costs (Overheads, Depreciation & Finance)	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Portion of Network Services Charge Relating to Palmerston North								
SXPN Manager	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Other Costs (IT, Travel)	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Operating Profit/(Loss)	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**
Remainder of Network Services Charges	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Accounting Profit/(Loss) (NPBT)	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**
Patient Numbers	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]

Source: Southern Cross

Internal Cost Allocation

117. [

] The value of the accounting profit/loss is determined after subtraction of a contribution from the operating profit to the cost of the Southern Cross Health Trust's national office and other overheads. Southern Cross calls this contribution from each of its hospitals the "network services charge.[36] These charges have fluctuated by some margin over time. If Southern Cross Palmerston North were to close, its head office would no longer receive this contribution to overheads.

118. Some of the organisation's overhead costs are directly attributable to particular hospitals. In the event of the closure of its Palmerston North Hospital, Southern Cross head office would avoid:

- the salary of the general manager of Southern Cross Palmerstion North;
- information systems costs, which includes user licenses, IT equipment and the related support services used at Palmerston North; and

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equipment. The Commission considers that, while some equipment such as air conditioning heating/cooling units might be readily portable, the ease of removal of the ducting installed in the interstices of a building may be an entirely different matter.

[36] [

].

- staff travel costs between head office and Palmerston North.

119. However, even after deduction of these directly attributable national office costs, as Table 4 shows Southern Cross Palmerston North has made a [ ] contribution to the organisation's overhead costs [ ]

<u>Potential Additional DHB Outsourced Surgery</u>

120. In 2005/2006 the MidCentral DHB contracted out approximately $1.6 million of elective surgery to Southern Cross. In 2006 Southern Cross Palmerston North's operating profit was [ ] and its accounting profit [ ]. In 2008/2009 the MidCentral DHB has been provided with an additional amount of funding for non-urgent surgical operations. The DHB has announced that up to $3.787 million of the *extra* funding would be outsourced to private providers of surgical services, during the year ending 30 June 2009.

121. Private hospital providers canvassed by the Commission advised that contracts from local DHBs were speculative and could not be relied on as a revenue stream. However, private hospitals did perform DHB work when it became available because, in most cases, although it was less financially rewarding than were fully private or insurance patients, DHB work helped to increase capacity utilisation at a private hospital.

122. Southern Cross advised that, for fixed contracts such as ACC or DHB work, it receives, on average, approximately [ ] % of the total price of the procedure.[37] The remaining [ ] % of the contract is paid to the relevant specialists.

123. As mentioned, the MidCentral DHB Hospital proposes to outsource up to $3.787 million of the extra funding to private providers of surgical services during the year ending 30 June 2009.[38] It noted the following:

> The Ministry of Health has made further announcements regarding the availability of elective funding to Mid Central DHB.
>
> In addition to the $2,568,728 of elective initiative funding available for 2008/09, the Minister of Health has announced an extra $1,238,924 is available to MidCentral DHB for further elective services. If the volumes are not achieved there is a risk is that we might lose payment in the month of service.
>
> Mid Central's capacity issues are preventing achievement of current elective services targets. It is unrealistic to expect provider arm capacity will be able to be boosted sufficiently to provide the increases requested to take advantage of the funding offered for 2008/09.
>
> In order to maximise elective services provided to Mid Central DHB's population, it is proposed that volumes beyond MidCentral Health's capacity be sub-contracted to private providers.
>
> Although it is desirable to build capacity with the extra funding being made available, this will not be achieved in time to utilise the available money for 2008/09. We wish to explore with the alternative providers their capacity to provide additional services.

---

[37] Southern Cross noted that its bill to patients includes three main costs: room fees [ ]; theatre time [ ]; and consumables [ ].

[38] Hospital Advisory Committee is a sub-committee of the full Mid Central DHB. This was publicly announced on 4 June 2008. For example, Manawatu Standard 4/5/08 Janine Rankin "Elective surgery could go private".

> Work contracted out should be at a price that does not exceed revenue. Preliminary discussions with local private hospitals have commenced with both indicating they would consider additional work but price may be an issue.[39]

124. The MidCentral DHB advised the Commission that the $3.787 million figure was additional to an existing amount for elective surgery of $1.230 million that will be rolled over from the 2007/08 year.[40] Accordingly, for the 2008/09 year, the MidCentral DHB intends to out source up to $5.018 million of elective surgery. As noted above, each of the private hospitals would expect to receive approximately [ ] % of this funding between them.

125. By the conclusion of the Commission's investigations on the Application, MidCentral DHB had not awarded any new contracts for the additional funding outlined above. Rather, MidCentral DHB advised that sub-contracting will be developed on a "month-by-month" basis as the DHB identifies what are its (monthly) priorities for elective surgery. However, the DHB is expecting both Southern Cross and Aorangi to respond, once the need for elective surgery in various specialities has been identified. MidCentral DHB noted that Aorangi and Southern Cross were both recently awarded contracts for orthopaedic work. It noted that, in respect to out-sourcing, it conducted a competitive tender [ ].

126. MidCentral DHB also noted that the additional funding will be allocated at 90% of the "case weight price". The other 10% is to cover the DHB's costs of administering any contracts.[41] [ ]. In Southern Cross' view, it would be unable to repeat its financial performance from 2006 as a result of any DHB contracts during 2008/09 or beyond.

127. In addition, the Wanganui and Hawke's Bay DHBs also received additional funding from the government for elective surgery. These two DHBs may also look to contract portions of this funding to private providers. Southern Cross Palmerston North already performs contract work for the Hawke's Bay DHB.[42]

<u>Potential to Increase Southern Cross Palmerston North's Prices</u>

128. During the course of the investigation, both Southern Cross Palmerston North and Aorangi increased their hospital's charges for rooms and theatre time. Southern Cross Palmerston North's increase in charges was in the order of [ ] while Aorangi increased its charges in the order of [ ]. Nevertheless, the

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[39] 20 May 2008, MidCentral Health Memorandum, From Lareen Copper, General Manager, MidCentral Health to Hospital Advisory Committee "Increase in Funding for Elective services" see www.midcentraldhb.govt.nz/About/BoardCommittees/OrderPapers/

[40] This $1.230m is for the Orthopaedic initiative which is split between Southern Cross and Aorangi for 2007/08 and is being repeated for the 2008/09 year.

[41] The case weight price is the funding that the DHB is allocated from the Government for each procedure and is publicly known.

[42] The Hawke's Bay DHB recently went "out of region" for the first time and awarded an elective surgery contract of approximately [ ] to Southern Cross Palmerston North. Aorangi also tendered but did not win the contract. As discussed in the market definition section of these reasons, the Commission considers that such work from Hawkes Bay or Wanganui DHB would be of low volume and would not alter its view that the geographic scope of the market is confined to the region of the MidCentral DHB.

hospital charges at Southern Cross Palmerston remain, on the whole, lower than those at Aorangi.

129. Moreover, both hospitals have very different pricing polices in respect of the mark ups each charges on the consumables supplied to patients. The majority of such consumables (for example plasters, antiseptic creams, latex gloves, syringes) cost less than $100. Aorangi applies a [ ] mark up over its costs of purchase whereas Southern Cross applies a [ ] mark up. [ ][43]

130. Any potential for Southern Cross to obtain additional revenue in the counterfactual by increasing its charges is analysed later in these reasons.

<u>Decisions to Close Down Hospitals in Other Regions</u>

131. Southern Cross informed the Commission that, over the last ten years, it has implemented a number of closures or mergers of other loss-making or barely profitable hospitals in Wanganui, Napier and Rotorua. Southern Cross closed Wanganui hospital in 2000 and Napier in 2001 and formed a joint venture with QE Health in Rotorua in 2007.

132. Southern Cross noted that, based on past experience, the process for taking a decision to close down a hospital involves a number of steps, namely:

- [ ];
- [ ];
- [ ];
- [ ]; and
- [ ].

133. In addition, Southern Cross advised that, as of 2007, it had two underperforming hospitals in its network – Southern Cross Rotorua and Southern Cross Palmerston North. [ ]. In the QE Health Decision, the Commission granted clearance for the Southern Cross Rotorua to form a joint venture with QE Health Limited in September 2007. Southern Cross advised that, with the future of one of its problematic hospitals now resolved, its focus then turned to addressing the underperforming Palmerston North hospital. [ ].

Southern Cross' Submissions

134. Southern Cross submitted that its Palmerston North hospital will [

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[43] [ ]

] Southern Cross submitted that, unlike five years ago when it decided not to merge with Aorangi, there are now [ ] The measures put in place to arrest the decline in the performance of the business [ ]. Moreover, although there may be additional elective surgery outsourced from the local DHB, this would [ ] No other avenues to increase revenue are foreseen.

135. NERA Economic Consulting, on behalf of Southern Cross, submitted that a firm will stop operating if it is making sustained economic losses.[44] A firm is making economic losses when its revenue is not covering its avoidable costs (and when capital could be better deployed elsewhere.

136. Southern Cross submitted that the [ ]. Southern Cross submitted that it would be rational for it to close its Palmerston North Hospital in the counterfactual given the [ ]

137. Southern Cross submitted that it [ ]. It submits it has exhausted its options for generating new business, implementing cost savings or raising prices. [ ]

138. In Southern Cross's view, in order for its Palmerston North hospital to attain an acceptable financial performance, it would require an [ ]. That would require its Palmerston North hospital to increase its revenue by [ ].

139. Southern Cross considered that the only means by which the profitability of Southern Cross Palmerston North could be increased to a sustainable level would be if:
   - the population of the region was to increase significantly[45]; or
   - there was a switch in the loyalty of the local surgeons, which is unlikely to happen as many are shareholders in Aorangi; or
   - the local DHB outsourced elective surgery to the local private hospitals on a long term basis.

140. In Southern Cross's view, these scenarios are unlikely to occur within the next two years. In this respect, Southern Cross submitted that it is economically rational for it to close its Palmerston North hospital so that [ ]

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[44] [ ]

[45] The Mid Central DHB noted that, although it does not expect its population base to increase, it was expecting the percentage of its population needing healthcare to increase (as it will in other regions in New Zealand) as a result of an aging demographic population.

141. Southern Cross has submitted that, while its Board has not yet made any such decision, in the counterfactual, [ ].

142. Southern Cross submitted that the following [ ]

- the population base in Palmerston North and surrounding towns is too small for two private hospitals to operate sustainably. Furthermore, the demographic mix and population in this region has been stable for some time and is unlikely to change significantly in the foreseeable future [ ];
- Southern Cross Palmerston North has made losses of varying sizes in [ ];
- Southern Cross's [ ][46] [ ];
- [ ];
- additional DHB funding of operations to be carried out at Southern Cross Palmerston North will not materially improve the situation. [ ][47] [ ]; [48]
- all options to improve the business have been exhausted;
- Southern Cross has significant expansion opportunities in the four main centres [ ][49] [ ];

[46] This figure includes a contribution to Southern Cross Health Trust's overheads and an allowance for depreciation.
[47] The Mid-Central DHB outsourced a total of $1.6 million to Southern Cross in 2006 of which the hip replacement work under the Government's 'Orthopaedic Initiative' scheme was a large part.
[48] Subsequent to the logging of the clearance application, the MidCentral DHB publicly announced an increase in the out-sourcing of elective surgery for the 2008/2009 financial year. It stated that, for that year, the MidCentral DHB Hospital Advisory Committee had authorised the out-sourcing of up to $3.787 million of the extra funding to private providers of surgical services. This matter is discussed further below.
[49] For example, Southern Cross advised that it is in the process of establishing a private radiology therapy site in Auckland [ ].

- the fact that it made recent and on-going investments in its hospital does not conflict with its submission that it would exit in the counterfactual. [

  ] and

- Southern Cross has publicly acknowledged that the closure of Southern Cross Palmerston North is the alternative to JV Co.[50]

143. Southern Cross submitted that the most appropriate figure to use when forecasting the financial performance for Southern Cross Palmerston North during the next two years is the most recent figure for the financial year ending June 2008.[51] This is because:

- [
  ]

- it is unrealistic to expect its financial performance will improve without substantial growth in patient numbers, which is unlikely;

- its initiatives to materially increase its profitability have been tried [
  ]; and

- its 2008/09 budget [ ]

144. Southern Cross stated that it considered that a decision to close Palmerston North would be easier than its previous decisions to close hospitals. [

   ]. Southern Cross submitted that:

> [
>
>].

145. Jeff Todd, Chair, Southern Cross stated that, with the closures of both Wanganui and Napier, Southern Cross has had to confront the closure of hospitals in other provincial centres. He advised that although Southern Cross Palmerston North has been on a [

   ].

146. Further, Southern Cross submitted that, in the face of sustained financial losses, it has not let the concerns of surgeons undermine a decision to close, as was the case when it closed its Napier hospitals in 2001. At that time, Southern Cross noted that:

> [
>
>]

[50] In the Manawatu Standard under the headline “City Set to Lose Private Hospital” on Wednesday, 13 August 2008.
[51] See Table 4.

The Commission's Analysis

147. In some cases, in assessing the relevant counterfactual(s), the Commission considers whether the business to be acquired is a failing firm. If the Commission accepts that a firm is failing, and that the failure will occur within the relevant timeframe, the Commission would also accept that it is inevitable that the firm cannot survive in the market and it will exit the market in the factual and counterfactual. This approach is outlined in the Commission's Mergers and Acquisitions Guidelines which state:

> "There are two scenarios where the Commission considers a failing firm counterfactual. The first is where, but for the anticompetitive acquisition, the business's assets would exit the market. The assets may become scrap or may be put to an alternative use. This option may involve only one potential purchaser."
>
> "The second scenario is where there are a number of bidders for the failing firm, which must be sold. In this case, the Commission adopts a counterfactual that assumes an acquisition by a party that would not give rise to a substantial lessening of competition". [52]

148. The Applicants have not explicitly proposed a failing firm (or failing division) argument. Rather, they have submitted that one of the hospitals, most likely Southern Cross, will close and exit as it, particularly, cannot sustain its current levels of economic loss. However, in the Commission's view, the Applicants have made arguments within a failing firm type framework that Southern Cross Palmerston North is a failing division of the Southern Cross Health Trust.

149. There is no legal doctrine in New Zealand as to what constitutes a "failing firm". However international guidelines across various jurisdictions assist to inform what can be taken into account when the Commission considers a failing firm argument. These include negative cash flows; the actual, imminent, or probable failure of one firm in the proposed merger; that there is no prospect of restructuring or refinancing the business; on closure, the assets will exit the market either becoming scrap or put to an alternative use; and there are no other purchasers for the business, despite reasonable attempts to find one.

150. The Commission has noted that other jurisdictions take a cautious approach to failing firm arguments because of the risk that an otherwise anti-competitive merger will be allowed with long term consequences for the relevant markets. Each case is assessed on its facts. If an applicant argues something less than a failing firm then there may well be other factors to take into account. However in this case, the Commission has considered, amongst other factual issues, those factors listed in paragraph 149 above when determining whether the Commission can be satisfied there is only one counterfactual and whether closure and exit is inevitable.

151. A key argument of Southern Cross was that, whilst not submitting failing firm, it did submit that its economic losses were unsustainable and it would likely exit the market in the counterfactual. The Commission also considered other factors and evidence, including whether or not all options to improve the business had been exhausted when assessing possible counterfactuals.

152. The Commission, nevertheless, has considered whether on the evidence it could accept that Southern Cross Palmerston North was a failing firm and would

[52] Commerce Commission, *Mergers and Acquisitions Guidelines*, January 2004, subsection 4.2.

inevitably close and exit in the counterfactual. The Commission's analysis of the factors is discussed later in paragraphs 195 to 197.

Inherent Elective Surgery Capacity Requirement

153. While the Applicants have submitted that no "provincial" centre in New Zealand currently supports two independent private hospitals, the MidCentral DHB region has a larger geographic scope and patient catchment area than that of a provincial city. In the Commission's view, an analysis of the elective surgery capacity requirements of a region, based on a narrow supposed "provincial city/non - provincial city" divide does not necessarily shed light on the inherent capacity requirements of the relevant markets.

154. Southern Cross's arguments were supported by [ ]:

[

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155. The issue of capacity in Palmerston North is inconsistent. In 2002/2003 Aorangi made a $[ ] million capital investment to double the surgical capacity of the hospital. This recent investment in capacity was made when Southern Cross was also providing full surgical services. The outlook for patient growth has not changed significantly in that time. The Commission considers that Aorangi must have been very aware of the capacity issues. By implication, it appears that in 2003 there was a sound case for more surgical capacity.

156. Adding to the uncertainty is that the Southern Cross was not able to provide the Commission with any written material in the form of Board minutes or staff papers to the Board that evidenced the Board addressing a Palmerston North closure scenario in recent years. Southern Cross submitted that, instead, it has concentrated its efforts on the proposed joint venture with Aorangi as it considered this to be only viable option for the hospital. Given the expressed concerns as to the impact of capacity and ageing population this absence of consideration by the Board is surprising. The Commission would have expected the closure option to have at least been discussed in confidential sessions of the Board, if closure was imminent. Southern Cross could not provide evidence of any such discussions.

157. In fact the Southern Cross internal documents give a different view. [

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158. The Commission also notes that factors other than population alone may influence capacity in a region. These factors may include:

- the ownership structure of private hospitals in a region. For example with hospitals owned by surgeons, convenient operating times may be preferable than efficient utilisation of theatre capacity;

- whether capacity is determined by the number of operating theatres, rather than the number of private hospitals in a region. For example Palmerston North might support three hospitals with two operating theatres each, or one with six operating theatres; and
- the actual mix of surgical services in each private hospital. For example a region could have one full service private hospital and a number of smaller specialist hospitals that might only provide individual surgical procedures (for example, ophthalmology or plastic surgery).

159. While the Commission accepts that there will have been changing circumstances in the relevant markets over time, it nevertheless notes that there have in fact been two private hospital businesses in Palmerston North for over 20 years (in a period of relatively static population). The Commission appreciates that the current position could reflect a changed environment but there is little evidence to suggest this is the case.

160. The Commission also notes that there is unlikely to be any reduction in capacity in the factual. The Applicants plan to retain both private hospitals under JV Co in the factual, albeit with a rationalisation of services.

161. The Commission considers that it is not clear that the relevant markets can necessarily only accommodate one private hospital in the counterfactual scenario. The number of potential participants will depend on the particular business models adopted by the participants and market conditions.

<u>Analysis of Documentary Evidence</u>

162. Southern Cross stated, during its further submissions on its application for clearance, that [ ]. However, the application for clearance was more equivocal in that it stated that it was not certain which of the two Applicants would be forced to close in the absence of JV Co. The Commission notes that the joint venture proposal was initiated by Aorangi.

163. Pre-application documentary evidence that Southern Cross did recently consider closure could support the case that its closure and exit was the only alternative option. In this respect it is relevant to consider prior internal materials and the Commission notes that its business plan for 2007/2008 [ ]. More importantly, there is no written record of the Southern Cross Health Trust Board having considered the option of closure and exit from Palmerston North, in recent years.

164. While Southern Cross argued that it had focussed on the joint venture option, rather than the closure and exit option, the Commission considers that this lack of documentary evidence in support of Southern Cross's submission regarding closure and exit, is relevant. It is not the case that there is a strategy to consider the joint venture as an alternative to closure. The Commission considers that at the least as part of the current joint venture negotiations, the Commission would expect to see a formal analysis of the benefits of closure and exit compared with investment in JV Co.

165. The Commission notes that Southern Cross did carry out such an analysis of potential closure when considering an earlier joint venture proposal [ ].

The Recent Capital Investments in its Hospital by Southern Cross

166. The Commission notes that the fact of the recent major capital investments is not, on its own, evidence that Southern Cross would retain a hospital in Palmerston North in the counterfactual. The fact of the investments is, however, another factor the Commission should consider when analysing the Applicants' arguments as to closure in the counterfactual. The Commission also notes that these capital investments were made relatively recently and to a greater or lesser extent are continuing. Also the capital investments in the Palmerston North Hospital were made in the context of:

- [ ]; and
- the need to provide new air conditioning [ ]

167. In respect of these most recent investments, if closure and exit was a real potential scenario on the horizon, the Commission would have expected to see some hesitancy and formal analysis, before the substantial investments were made, concerning which of the two options (ie closure and exit or invest) was better. While the absence of such analysis is not fatal to Southern Cross's arguments, it does raise doubt in the Commission's mind because it is more consistent with continuing operations at the Hospital, rather than closure, to make the investments.

Financial Position of Southern Cross Palmerston North

168. The Commission notes that Southern Cross Palmerston North has made [ ] losses during [ ] years since 2000. That said on average the hospital has [ ] over this period if network service charges are excluded. This is arguably consistent with a not for profit operation.

169. The initiatives put in place by Southern Cross over the last five years have not lead to consistent improved financial performance. It is often the case that if a firm cannot improve its performance and continues to sustain significant losses it will close or sell its business or seek to increase its prices. If a company cannot compete successfully in a market it can elect to exit. This is not to say that this should enable an otherwise anti-competitive merger to occur.

170. The Commission does not consider that the submission of Southern Cross that, the appropriate figure for it to use to analyse financial performance is the year ending June 2008.[53] The June 2008 figure was [ ] result for Southern Cross Palmerston North since 2000, whereas over the past eight years its financial performance (excluding network charges) has varied [ ]

171. The Commission notes that as a stand alone venture the Hospital made a cumulative [ ] over the last eight years.[54] Its operating profit is net of a deduction for the overheads that are directly related to the operation of the Hospital[55] so that amount is a contribution to the general overhead of the Southern Cross Health Trust. In the Commission's view, that is not a level of

[53] See Table 4.
[54] See Table 4.
[55] See Table 4.

loss that means a business will inevitably fail but in effect, Southern Cross has sought to put its case on this basis.

<u>Impact of Closure on Southern Cross Health Insurance Arm</u>

172. As noted in paragraph 10, Southern Cross Health Trust (hospitals) and Southern Cross Medical Care Society have, "for reasons of efficient governance" the same persons as directors of the one and trustees of the other. The Commission assumes the statement about efficient governance implies that the interests of the Southern Cross organisation as a whole may be considered together when individual decisions are being made in respect of the Trust or Society.

173. Southern Cross Palmerston North has remained open [ ]. This suggests that to some extent, Southern Cross considers it important to have a presence in Palmerston North. The value attached to that position potentially outweighs the Hospital's losses. This view is supported when the Commission compares the historic losses accruing in some years from the Southern Cross Palmerston North hospital with the current net profit of the Trust of $19.3 million. In the context of this profit, the losses could be described as relatively minor. In the Commission's view, Southern Cross would not need to place much value on a Palmerston North presence for it to be prepared to subsidise relatively minor losses from the large total profit from its other hospitals.

174. The following factors suggests that Southern Cross Medical Care Society places some value on having a physical hospital presence of its own in the large region separating its hospitals in Wellington and Hamilton/Rotorua.

175. [ ]

> [ ]

> [ ].

176. [ ].

177. [ ] private hospital stated to the Commission that it is very unlikely that Southern Cross Palmerston North would be closed because Southern Cross "sells its medical insurance on the basis that it also provides private hospital care, so it needs a hospital in Palmerston North".

178. In this respect the Commission has noted the Southern Cross Healthcare website (www.southerncross.co.nz) where the following statements are prominent:

> New Zealand's largest private hospital network…Click here to find the Southern Cross Hospital nearest to you" (that takes the viewer to another page on the web site that states):

> With 13 private hospitals offering a broad range of elective surgery, we can provide a convenient location for most of your private surgical and treatment needs; and
>
> Our group of hospitals now extends from Auckland, Hamilton, Rotorua, Palmerston North, New Plymouth and Wellington in the North Island, to Christchurch and Invercargill in the South Island. We are New Zealand's only national private surgical hospital group.

179. As noted previously, Southern Cross appears to see the extent of the contiguity of its hospital network as a marketing tool for its health insurance business. [ ]. In the Commission's view, it is likely that Southern Cross, when contemplating Palmerston North's closure, would have regard to potential damage to its brand, its national market presence (filling the space between Wellington and Hamilton/Rotorua), and loss of competitive constraint raising the costs of its insurance arm. This would likely be more so today given that Southern Cross no longer has hospitals in the Wanganui or Hawke's Bay regions, adjacent to that of the MidCentral DHB.

180. The Commission recognises that there must be a limit to the extent that Southern Cross is willing to sustain a less than satisfactory financial performance in order to maintain presence and brand reputation. The difficulty in this case is that Southern Cross, contrary to the evidence quoted in paragraph 175 and its public statements on its web site, denied that insurance brand considerations were currently important to its view of closure and exit at Palmerston North. Given the absence of any fuller analysis on the effect on the insurance business provided to the Commission, the Commission has assumed that there is some value to Southern Cross's insurance brand from the presence of its Palmerston North Hospital.

<u>Other Potential Sources of Revenue in the Counterfactual</u>

181. The Commission has examined Southern Cross Palmerston North's prospects for obtaining additional sources of revenue. If these exist that would militate against the possibility of closure as the only viable option. In doing so the Commission has analysed:

- the potential for additional future DHB outsourcing returning Southern Cross to profitability as it did in 2006; and
- the potential for Southern Cross Palmerston North to raise its prices to obtain additional revenue.

182. The Commission considers it reasonably likely that a greater amount of MidCentral DHB work would be outsourced to private providers in 2008/2009 than was outsourced in 2005/2006, with the likely recipients being the two existing private hospitals, Southern Cross and Aorangi. The Commission considers that this could be a factor that could [ ], improve the profitability of Southern Cross's Palmerston North Hospital such that it might remain as a competitor in the relevant markets in the event that the joint venture with Aorangi does not proceed. [ ].

In addition the Commission also considers that there was the potential for Southern Cross Palmerston North to obtain some surgical work outsourced under the Government's new funding initiative by the Wanganui and Hawke's Bay DHBs.

183. The Commission notes that while it is generally accepted that DHB contracts are not highly profitable for private hospitals, nevertheless, private hospitals actively compete for such work as its helps to increase their capacity utilisation and also makes some additional contribution to overhead and profit. While the Commission accepts that it is unlikely that Southern Cross would maintain its hospital in Palmerston North solely to perform contract work on behalf of the MidCentral DHB, it is likely that these contracts would increase the Hospital's revenue in the short term and that would be a factor that would likely be relevant to any decision to close within the next two years.

184. Overall the Commission considers that the extra funding for additional elective surgery is another factor in the mix that points to Southern Cross remaining in the relevant markets being a real, and not merely remote, possibility.

185. Secondly, Southern Cross Palmerston North has some potential to increase its revenue by:

- raising its room and theatre charges; and
- increasing the mark-up on its consumables,

to match, or at least bring them closer to, those of Aorangi. That Southern Cross has not done so is not of itself a key factor but the Commission has taken some account of the matter in reaching its final decision as to the appropriate counterfactuals.

186. The Commission notes that Southern Cross has stated that it does not consider it can increase its prices. One of the reasons given is the constraint provided by Aorangi. It also maintains national pricing structures and considers Palmerston North to be at the high end of its national pricing schedules. The Commission considered the data[56] and found it to be equivocal. There is an absence of sufficient information on this issue that leads the Commission to the view that Southern Cross has not exhausted all options available to it.

187. Southern Cross also submitted that it would be constrained by its main purchasers, ACC and private insurers. These points may be correct at some level but not at the level that Aorangi charges. This appears to be a question of degree. The difficulty for the Commission is the absence of sufficient material to allow it to be satisfied that price increases by Southern Cross Palmerston North (that would improve its financial position) could not be achieved. This doubt is heightened in this case as it seems likely that in the factual the JV Co would adopt the higher prices currently charged by Aorangi.

188. Therefore, the Commission considers that an ability to raise additional revenue by providing contract surgical services to DHBs together with the potential to somewhat increase its prices are factors that point to Southern Cross likely remaining in the relevant markets.

<u>The Views of Industry Participants</u>

189. Industry participants canvassed by the Commission consider that it is unlikely that Southern Cross would close its Palmerston North hospital within the next two years. The primary reasons for this view were that:

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[56] Data about prices of theatre and room charges, and consumables, that was provided by Aorangi and Southern Cross during the Commission's investigation.

- as a result of the substantial profits made by its national network of 14 hospitals, Southern Cross has the wherewithal to sustain any short term losses at Palmerston North; and
- the Southern Cross organisation as a whole desires a presence in the region between Wellington and Hamilton/Rotorua, especially after the closures of its hospitals in Wanganui and Napier.

Any Southern Cross Consideration of a Sale Option

190. The Commission notes that unusually, for an organisation proposing closure and exit from a market, Southern Cross has not sought to sell, establish interest in, or obtain a base price for its Palmerston North hospital as a going concern to determine a less anti-competitive alternative to JV Co. The Commission contacted Wakefield Health and Boulcott in Wellington, Mercy Ascot in Auckland and Braemar in Hamilton, to determine their views on the relevant MidCentral region markets. None of those obvious potential purchasers had been recently approached by Southern Cross with a view to establishing their interest in its Palmerston North Hospital.

191. Southern Cross submitted that it was not persuaded that sale of Southern Cross as a going concern was a better strategy than closure and exit from Palmerston North. It believed, because of its (previously described) view that Palmerston North (and the surrounding towns) has too small a population base to sustain two full-service private hospitals, that any new owner (absent joint venture synergies with Aorangi) would face the same difficulties as has Southern Cross.

192. The absence of evidence that Southern Cross had applied its mind to the option of sale to a third party as a going concern is problematic in this case. From a competition analysis perspective the Commission must consider whether closure and exit is the only alternative or whether there is the potential for the relevant assets and market shares to pass to another competitor. In the Commission's view, the absence of any evidence that Southern Cross has taken reasonable steps to offer its Palmerston North hospital to the market is another indicator that closure and exit is not the only alternative open to Southern Cross.

Conclusion on Whether Closure and Exit is a Real, and not Merely Remote, Possibility

193. The Commission concludes on the evidence before it that:
    - because of its [ ] history, there is a real, and not merely remote, possibility that Southern Cross will close its Palmerston North Hospital in the relevant period and that this is a relevant counterfactual; and
    - in addition, there is also a real, and not merely remote, possibility that Southern Cross Palmerston North will remain open in the relevant period such that this is also a relevant counterfactual.

194. To arrive at the second conclusion, the Commission has drawn upon all the following matters in the round:
    - the evidence that Palmerston North is a provincial centre and, therefore, by definition has too small patient numbers in its catchment region to sustain two hospitals is not persuasive and is not consistent with Southern Cross'

view of its market nor is it consistent with the investments made by the applicants;

- there is a lack of evidence of Southern Cross's intentions as to the future of its Palmerston North Hospital absent the current joint venture proposal and any evidence there is points to Southern Cross continuing in the market;
- Southern Cross has recently upgraded its hospital by making substantial cash investments, and with no apparent analysis of closure and exit at that time, as an alternative and possibly better option;
- Southern Cross Palmerston North has a variable history of profits and losses, and when it has sustained losses these have been small in comparison to the organisation's overall profit;
- closure of the Hospital may have some impact on Southern Cross's medical insurance business;
- Southern Cross Palmerston North has not sought to increase its prices to match those of Aorangi and so does not appear to have exhausted options for increasing its revenue; and
- there is no evidence that Southern Cross has fully investigated sale of the Palmerston North Hospital as an alternative to JV Co or closure.

195. In addition, when the above evidence is assessed against the international guidelines for considering failing firm arguments[57], the Commission is not satisfied that Southern Cross Palmerston North is a failing division of Southern Cross.

196. Although underperforming, Southern Cross Palmerston North's operating profit has varied over the recent years. When assessed as a division of the Southern Cross Health Trust, and excluding network services charges, the operating revenues at Southern Cross do not appear to be at a level that would indicate that its exit was necessarily inevitable. Importantly, Southern Cross has made no efforts to find an alternative purchaser (to Aorangi) for its Palmerston North Hospital. In addition, the recent investments in the Hospital would indicate an intention to continue operating at the facilities and there appears to be some opportunity for it to increase its operating revenues.

197. Overall, the Commission is unable to conclude, with any certainty, that Southern Cross Palmerston North is actually failing as a business division of Southern Cross or that its closure is imminent.

OVERALL CONCLUSION ON COUNTERFACTUAL

198. The Commission, therefore, concludes that one likely counterfactual scenario is that, due to the financial situation of its Palmerston North Hospital, Southern Cross would close its Palmerston North Hospital in the relevant period, and therefore would not remain as a competitor in the relevant markets for a period of at least two years (counterfactual one).

199. The Commission concludes that there is also a likely counterfactual that Southern Cross Palmerston North would remain as a competitor in the relevant

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[57] See paragraph 149.

markets for at least two years (counterfactual two). In that scenario Southern Cross and Aorangi would remain as competitors in the counterfactual.

200. The Commission has not analysed any changes in competition between the first counterfactual, in which Southern Cross would exit the relevant markets, and the factual. In the Commission's view, there is another real, and not merely remote, counterfactual that the Commission has assessed to be more competitive than those involving closure and exit. The competition differences between the factual and the counterfactuals will be greatest in respect of this second counterfactual and it will, by definition, be most relevant when the Commission decides whether or not competition has been substantially lessened by the proposed acquisition.

201. The second counterfactual scenario would result in two competitors in the counterfactual in comparison to one in the factual. The analysis of the change in competition in this case is required.

COMPETITION ANALYSIS

Introduction

202. The Commission's analytical framework is to assess the impact of the merger by analysing whether the proposed acquisition would lead to a substantial lessening of competition in the affected markets.

203. A substantial lessening of competition could be likely if the Commission reached the view that in the factual, the potential for the merged entity, or other market participants, to exercise market power is enhanced in comparison to the counterfactual. Acquisitions that increase concentration in markets enhance the potential for market power to be exercised in two main ways:

- by reducing competition constraints that lead to an increase in market power of the remaining firms acting independently (non-coordinated, or unilateral, effects); and/or
- by changing the nature of competition in a way that makes tacit or express coordination between firms more likely, effective and stable (coordinated effects).

204. The potential for the enhancement of unilateral or co-ordinated market power, is assessed in terms of:

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

205. This section sets out the Commission's reasoning and views on the likelihood of a substantial lessening of competition occurring when the factual is compared to the counterfactual(s).

Unilateral Effects

206. An acquisition that significantly increases seller concentration in a market may lead to circumstances where competition between firms in the market is seriously reduced. In markets that are sufficiently concentrated, the actions of

individual firms can have identifiable effects on their competitors, such that firms recognise their interdependence. The interdependence of firms may lead them to anticipate competitors' responses to their own actions and take this into account in their own decisions. The repeated nature of such decisions can have significant effects on business strategies and on competition.

207. This section assesses the potential for unilateral market power to be exercised, and whether a substantial lessening of competition would arise in the factual when compared to the counterfactual. The potential for unilateral market power to be enhanced takes into account the scope for existing and potential competition, and other potential constraints, such as any countervailing power held by purchasers, as between the two scenarios.

Existing Competition

208. Existing competition occurs between those businesses in the market that already supply the product, and those that could readily do so by adjusting their product-mix (near competitors).

209. In the factual scenario, JV Co would result in the Applicants being the sole provider of private elective surgery services in the MidCentral DHB region.

210. 2006 and 2007 market shares of Southern Cross Palmerston North and Aorangi (used as a proxy for those in the counterfactual), are shown in Tables 5 and 6.

Table 5: Patient Numbers in the Short-stay Market

Facility	2006		2007	
	Patients	Market Share	Patients	Market Share
Southern Cross	[ ]	[ ]	[ ]	[ ]
Aorangi	[ ]	[ ]	[ ]	[ ]
Total	**[ ]**	**100%**	**[ ]**	**100%**

Source: Southern Cross, Aorangi.

Table 6: Patient Numbers in the In-Patient Market

Facility	2006		2007	
	Patients	Market Share	Patients	Market Share
Southern Cross	[ ]	[ ]	[ ]	[ ]
Aorangi	[ ]	[ ]	[ ]	[ ]
Total	**[ ]**	**100%**	**[ ]**	**100%**

Source: Southern Cross, Aorangi.

211. The Commission recognises that concentration is only one of a number of factors to be considered in the assessment of competition in a market. In order to understand the impact of an acquisition on competition the Commission considers the behaviour of the businesses in the market.

212. The Commission now has set out its analysis of the differences in existing competition between Southern Cross and Aorangi in the factual and in a counterfactual in which Southern Cross would continue to operate in the relevant markets.

213. Given the similar characteristics of the short-stay market and the in-patient market, the Commission has assessed these two markets together.

Private elective surgery in the Short-Stay and In-patient Markets

The Sale of the Mercy Hospital

214. Southern Cross considered purchasing the Sisters of Mercy hospital in 2000. At the time, Southern Cross considered that, if a group of medical specialists acquired the Mercy Hospital, this would [ ].[58]

215. In the Commission's view, it is clear that Southern Cross saw Aorangi, when owned by a group of local specialists, as a competitive threat to its Palmerston North Hospital business.

216. Further, if Southern Cross acquired the Sisters of Mercy Hospital in 2000, there would have only been a single provider in the region. The potential for this scenario was of enough significance to the local specialists that it induced a group of them to purchase the hospital themselves. Again, this would indicate that the two hospitals were in direct competition with one another.

Competition between Aorangi and Southern Cross Palmerston North

217. Southern Cross has stated that, in its view, one reason why it cannot increase prices is due to the constraint provided by Aorangi. It would risk losing customers to Aorangi and hence a price increase would be counterproductive.

Capital Expenditure and Infrastructural Investments

218. As noted above, Southern Cross and Aorangi have both continued to make significant capital investments in their facilities since 2000.

219. In 2003, Aorangi upgraded its hospital, at significant expense, to attract and accommodate additional work from surgical specialists. Subsequent to Aorangi's expansion, Southern Cross reviewed its options for its Palmerston North hospital and decided to compete [ ][59] with Aorangi.

220. [ ][60] In this respect, the Commission notes that, although Aorangi may have a competitive advantage with its shareholders also being the specialists who use its facilities, Southern Cross considers that its Palmerston North hospital has its own advantages.

The Range of Surgical Services

221. Both Southern Cross and Aorangi perform a full range of elective secondary surgical procedures. In this respect, the Commission considers that neither facility could be considered a "specialist" provider of any particular surgical speciality. Each facility provides a comprehensive range of elective surgery

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58 Southern Cross Board Minutes, 7 June 2000.
59 Southern Cross Board Minutes, 5 August 2003.
60 Southern Cross Board Minutes, 5 August 2003.

services in order to attract as many specialists and patients as possible, in direct competition with the other facility.

Competition for DHB Contracts

222. In addition to competing to attract specialists and patients, both Southern Cross and Aorangi have been active in responding to tenders from the MidCentral DHB (and in one case, Hawke's Bay DHB) to perform elective surgery. As discussed above, the MidCentral DHB is expected to offer additional contracts over the 2008/2009 years and Wanganui DHB is also considering outsourcing strategies.

223. Mike Grant, General Manager, Funding Division, MidCentral DHB advised that JV Co would [

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Constraints from Outside the Market

224. The Applicants submitted that, due to technological advances in the health industry, they are facing increased competition from a range of other health care providers. For example, the Applicants consider that a number of procedures that were traditionally performed in their surgical theatres are now performed at a GPs clinic or in a specialist's consulting room, thereby reducing the two hospitals' workloads.[61] These procedures include:

- vasectomies;
- certain gynaecology procedures, such as culpolscopy and IUD insertions; and
- the removal of minor skin lesions.

225. In particular, the Applicants submitted that The Palms Medical Centre Limited (The Palms), in Palmerston North, currently provides, and would continue to provide, a competitive constraint on the combined entity, due to its ability to perform a range of minor surgical procedures. The Palms is a private facility that has a number of tenants who provide various (primary) medical services, including GPs, skin care therapists, physiotherapists, radiology services and a pharmacy.

226. The Palms noted that it has a number of vacant consulting rooms and any specialist could use its facilities for out-patient services. However, it could not offer a specialist any elective surgery facilities at present. [

].[62] In this respect, it did not consider it was in competition for the provision of any elective surgical service with either Aorangi or Southern Cross.

[61] In the past, the Commission has referred to such rooms as 'procedurals rooms'. Procedural rooms have been excluded from the product market for private elective secondary surgical services. For example, see Auckland Surgical Decision.

[62] [

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227. Further, industry participants advised that procedural or consulting rooms do not offer the range of surgical services that a fully equipped operating theatre does. For example, the Dannevirke Community Hospital advised that it, primarily provides maternity services and patient’s needing elective surgery are required to go to one of the hospitals in Palmerston North.

228. Nevertheless, the Commission acknowledges that some minor surgical procedures can now be performed, with less invasive techniques, in procedural or consulting rooms. However, the level of constraint on the provision of elective surgery for short stay patients and in-patients is limited.

229. Accordingly, the Commission does not consider that The Palms, the Dannevirke Community Hospital, surgeons’ rooms or general practices that carry out minor procedures (using only local anaesthetics) would provide any significant degree of constraint on JV Co in the factual.

Conclusion on Existing Competition in the Short-stay and In-patient Markets

230. In the Commission’s view, Aorangi and Southern Cross have, for some time, been competing strongly against one another. All industry participants interviewed by the Commission considered this to be the case. This competition would continue in the counterfactual but would be lost in the factual. In this respect, the Commission notes:

- the statements by the Applicants and market participants that Southern Cross and Aorangi are competing strongly with one another;
- the significant infrastructural investments made by both Aorangi and Southern in their facilities in Palmerston North; and
- the numerous initiatives by both Southern Cross and Aorangi to attract and retain specialists and the associated medical support staff to their facilities.

Potential Competition

231. An acquisition is unlikely to result in a substantial lessening of competition in a market if the businesses in that market continue to be subject to real competitive constraints from the threat of market entry. The Commission’s focus is on whether businesses would be able to enter the market and thereafter expand should they be given an inducement to do so, and the extent of any impediments they might encounter should they try. In order for market entry to be a sufficient constraint, entry must satisfy the LET test (be likely, sufficient in extent and timely).

232. The Applicant submitted that in respect of both in-patient services and short stay services, slow growth and excess capacity in the region would mean that greenfields entry in any scenario, whether the status quo, factual or any counterfactual, is unlikely in the immediate future.

233. Other industry participants canvassed by the Commission agreed that entry was unlikely in the foreseeable future in the MidCentral DHB region, noting that there is a nationwide shortage of medical specialists and there has been no full range of elective surgery hospital entry anywhere in New Zealand for some time.

234. [ ] described establishing a greenfields hospital as “frightening due to the capital outlay and the success of your business would depend on your access to

a sufficient number of surgeons. Only the Auckland region might attract greenfields entry in New Zealand."

235. [ ] also advised that de novo entry in New Zealand is very difficult because the barriers to entry are high. On-going consolidation or amalgamations in the industry was seen as more likely than new entry.

236. Further, the ACC, one of the main funders of private elective surgery, advised the Commission that it considered that, as a whole, there was sufficient number of facilities throughout the country and it was actively discouraging new entrants.

237. The Applicants noted that the Commission has previously considered that the barriers to entry into the short stay market in the Auckland region to be relatively low.[63] In the Auckland Surgical Decision, the Commission noted that access to specialist staff, such as nursing staff and surgeons, in the Auckland region was not a significant barrier to entry. Several industry participants spoken to in the course of the current investigation noted that the Auckland region had the population to attract the necessary staff but that this was not the case in the MidCentral DHB region.

Conclusions on Potential Competition in the Factual

238. In the Commission's view, there would be barriers to entry into the relevant markets in the factual:

- there is an on-going shortage of surgeons, anaesthetists and nursing staff and an entrant would compete for these staff with the JV Co;
- a substantial percentage of Palmerston North surgeons own Aorangi, further increasing the difficulty for an entrant to attract those surgeons to regularly use its facilities; and
- the existing capacity of the markets will continue to be provided by the Applicants as they intend for both Aorangi and Southern Cross Palmerston North to remain open in the factual.

239. In this respect, the Commission has found no evidence that any other provider is likely to enter the relevant markets de novo either in the factual or the counterfactual.

240. Therefore, Commission considered that it is unlikely that threat of, or actual, de novo entry into, or expansion of other competitors in, the relevant markets would have the potential to provide competition that could constrain JV Co in the factual.

Countervailing Power

241. In some circumstances the potential for the merged entity to exercise market power may be sufficiently constrained by a buyer or supplier to redress concerns that an acquisition may lead to a substantial lessening of competition.

242. There are four main providers of funding for the private hospitals in Palmerston North:

[63] See the Auckland Surgical Decision.

- health insurance companies;[64]
- the Accident Compensation Corporation (ACC);
- DHBs; and
- private patients.

243. In the QE Health Decision, the Commission noted that the ACC and insurance companies have a degree of countervailing buyer power (although the degree varies between each insurance provider). Both these types of customer are national purchasers and, with this, they have an ability to monitor prices and respond accordingly.[65] However, private patients are unlikely to possess any countervailing buyer power.

244. The Applicants consider that the large purchasers, such as the ACC and health insurers would act as a significant countervailing force in the factual scenario. In addition, the not-for-profit and specialist-owned nature of Southern Cross and Aorangi respectively would mean that it is unlikely to be in the interests of the combined entities directors (even if fiduciary obligations permitted) to raise prices, post acquisition.

245. The Commission considers that while there may be some ability of large purchasers, such as the MidCentral DHB or the ACC, to trade off between Aorangi and Southern Cross in the counterfactual, this would be eliminated in the factual. No funding provider would have the ability to switch to another provider in the factual scenario and would be faced with monopoly pricing.

Conclusions on Countervailing Power

246. The Commission considers that, in the factual scenario, major purchasers are unlikely to provide a significant constraint on the combined entity.

Governance Arrangements for JV Co – Implications for Pricing

247. The Applicants submitted:

- Southern Cross's not for profit status would constrain the JV Co from increasing prices in the factual because it is a not for profit organisation; and
- the point of the JV Co is not to increase prices but to gain efficiencies from the proposed merger.

248. First, the Commission observes that despite Southern Cross having a not-for-profit status it, nevertheless, made an overall profit of $19 million for the 2007/2008 year. Although noting that a not-for-profit organisation would not operate at a level of "zero" returns, it does raise some questions as to how the presence of Southern Cross would constrain the pricing of the proposed joint venture on the basis argued by Southern Cross that the very nature of being a not-for-profit organisation would constrain JV Co.

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[64] The three main health insurance providers are Southern Cross Medical Care Society, Tower Health and Life Limited and Sovereign Assurance Company Limited. Together, these providers account for approximately [ ] of insured policy holders.

[65] For example, ACC has a set national price for each elective surgical procedure it funds and it does not allow a private hospital to charge an ACC patient any additional fee for the specified procedure.

249. Secondly, the Commission cannot be satisfied that the governance structure would prevent price increases. The parties have not determined the structure of JV Co, including the respective holdings. The Commission can not make any firm conclusions in such circumstances. The Commission considers that, at the very least, it is likely that the JV Co would adopt the prices charged currently by Aorangi, which are higher than those charged by Southern Cross. It is unlikely that the JV Co would apply different charges for each of its two hospitals (in the factual) to reflect the current differences in prices for rooms, theatre use and consumables. It is unlikely that Aorangi would reduce its charges. This would likely lead to an increase in the prices currently charged by Southern Cross.

250. Despite the submission of Southern Cross that it would constrain price increases by JV Co, it is difficult to see why JV Co would not have incentives to raise prices to the maximum possible level in the factual. Losses are being incurred and returns are not currently seen as adequate by the parties. Further Southern Cross argues in its application that it cannot continue to sustain these losses, which would indicate an incentive to raise prices in the counterfactual. A major part of Southern Cross' submission is that it cannot continue to sustain losses. Aorangi has submitted that its level of return is inadequate. The Commission considers that the likely constraint from Southern Cross in the JV Co, whatever the governance structure might be, is likely to be much weaker than the constraint provided by competitor(s) in the relevant markets.

Conclusion on Competition assessment

251. As discussed above, the competition analysis relates only to a hypothetical in which Southern Cross Palmerston North remains as a competitor in the relevant markets

252. In the counterfactual scenario, with Southern Cross remaining in the relevant markets, Southern Cross Palmerston would continue to compete with Aorangi.

253. In the factual scenario, JV Co would eliminate this competition and the merged entity would not face any competitive constraint from an existing competitor or the threat of a potential entry In addition, funding providers are unlikely to be able provide any countervailing power to prevent a substantial lessening of competition. In these circumstances, competitive constraints would be insufficient to nullify market power created by JV Co.

254. Accordingly, the Commission considers that the combined entity would be likely to have the ability to exercise unilateral market power much more strongly, compared to the counterfactual scenario where there would be two substantial competitors.

255. Further, the Commission notes that the Applicants did not dispute the existing level of competition between Southern Cross and Aorangi. Rather, the Applicants submission concerned whether one of the facilities would continue to operate in the counterfactual. The Commission’s assessment of the relevant counterfactuals is outlined above.

OVERALL CONCLUSION

256. The Commission considers the probable nature and extent of competition that would exist, subsequent to the proposed acquisition, in the markets for:

- the provision of private short-stay hospital facilities and related non-specialist services for elective secondary surgery in the MidCentral DHB region (the short-stay market); and
- the provision of private in-patient hospital facilities and related non-specialist services for elective secondary surgery in the MidCentral DHB region (the in-patient market).

257. In the factual scenario, the formation of JV Co would result in there being only one provider of private elective surgical services in the MidCentral DHB region.

258. The Commission considers that it cannot be satisfied that absent the clearance Southern Cross will not remain in the relevant markets. This has led the Commission to analyse competition differences between the factual and a counterfactual in which Southern Cross and Aorangi would remain as competitors in the relevant markets.

259. The Commission considers that the scope for the exercise of unilateral market power is likely to be enhanced by JV Co, relative to a counterfactual scenario in which Southern Cross would remain as a competitor in the relevant markets.

260. Therefore, the Commission is not satisfied that the proposed acquisition will not have, or would not be likely to have the effect of substantial lessening competition in the relevant markets.

DETERMINATION ON NOTICE OF CLEARANCE

261. Pursuant to section 66(3)(b) of the Commerce Act 1986, the Commission declines to give clearance for Southern Cross Health Trust and Aorangi Hospital Limited, or companies owned by them, to acquire shares in JV Co (a new company to be formed) and for the acquisition by JV Co of the business assets of Southern Cross Health Trust's and Aorangi Hospital Limited's, Palmerston North private hospitals.

Dated this 4th day of September 2008

Peter J M Taylor
Division Chair

APPENDIX ONE – MAP OF MIDCENTRAL DHB REGION