Statement of Issues — Sonic Healthcare Limited – proposed acquisition of pathology businesses of Healthscope Limited in Queensland, NSW, ACT and WA

2 August 2012

1. Outlined below is the Statement of Issues released by the Australian Competition and Consumer Commission (**ACCC**) in relation to the proposed acquisition of the pathology businesses of Healthscope Limited in Queensland, NSW, ACT and WA by Sonic Healthcare Limited (**proposed acquisition**).
2. A Statement of Issues published by the ACCC is not a final decision about a proposed acquisition, but provides the ACCC's preliminary views, drawing attention to particular issues of varying degrees of competition concern, as well as identifying the lines of further inquiry that the ACCC wishes to undertake.
3. In line with the ACCC's *Merger Review Process Guidelines* (available on the ACCC's website at www.accc.gov.au) the ACCC has established a secondary timeline for further consideration of the issues. The ACCC anticipates completing further market inquiries by **16 August 2012** and anticipates making a final decision on **30 August 2012**. However, the anticipated timeline can change in line with the *Merger Review Process Guidelines*. To keep abreast of possible changes in relation to timing and to find relevant documents, market participants should visit the Mergers Register on the ACCC's website at www.accc.gov.au/mergersregister.
4. A Statement of Issues provides an opportunity for all interested parties (including customers, competitors, shareholders and other stakeholders) to ascertain and consider the primary issues identified by the ACCC. It is also intended to provide the merger parties and other interested parties with the basis for making further submissions should they consider it necessary.

The proposed acquisition

5. Sonic Healthcare Limited (**Sonic**) proposes to acquire the pathology businesses of Healthscope Limited (**Healthscope**) in the states of Western Australia, New South Wales (including the Australian Capital Territory) and Queensland (the **relevant states**).
6. On 15 May 2012, Sonic sought informal clearance from the ACCC for the proposed acquisition.

The parties

Sonic Healthcare Limited

7. Sonic provides pathology services in Australia and overseas. It offers medical centre management services in Australia through its subsidiary company Independent Practitioners Network. Sonic also provides radiology services in Australia and New Zealand. In the 2011 financial year Sonic had revenue of $3.1bn from its worldwide business, $923 million (or 30%) of this was contributed by its Australian pathology business. Sonic is listed on the Australian Stock Exchange.

8. Relevant to the transaction proposed, Sonic operates the following pathology businesses in NSW/ACT, Queensland and Western Australia.

Table 1: Sonic pathology businesses

NSW/ACT	**Areas of operation**
Douglass Hanly Moir Pathology (including Barratt & Smith Pathology) Capital Pathology	Metropolitan Sydney, Newcastle, Port Macquarie, the Hunter Valley, Bowral, Mildura (Vic), the Southern Highlands, the Blue Mountains, throughout rural NSW and the ACT.
Southern Pathology	Wollongong, Nowra and the NSW South Coast.
Sullivan Nicholaides Pathology	The north coast of NSW in addition to Qld (see below)
Queensland	
Sullivan Nicholaides Pathology	Metropolitan Brisbane, major regional centres, North Qld and the north coast of NSW (as above).
Western Australia	
Clinipath/Bunbury Pathology	Operates in metropolitan Perth and Bunbury

9. Sonic operates the following pathology business in other states in Australia:

- Victoria: Melbourne Pathology,
- South Australia: Clinpath Laboratories
- Tasmania: Launceston Pathology, Hobart Pathology and North West Pathology.

Healthscope Limited

10. Healthscope operates private hospitals, medical centres and pathology businesses in most states of Australia as well as pathology businesses in New Zealand, Singapore, Malaysia and Vietnam.

11. Healthscope was previously a public company listed on the Australian Securities Exchange, and in October 2010 was acquired by Asia Pacific Healthcare Group Pty Ltd, a company owned by funds advised and managed by The Carlyle Group and TPG Capital.

12. Healthscope's pathology operations generally use the brand name "Healthscope Pathology", but are still known amongst industry participants as ‘Gribbles’ – which was Healthscope’s former brand name in some states

Industry background

13. Pathology is the branch of clinical medicine concerned with identifying the causes and processes of diseases and providing scientific analysis which forms an essential basis for medical diagnosis and treatment. Pathology testing involves the analysis of medical samples, for example blood cell counts, blood chemistry analyses and microbiology cultures, which are collected from patients.

14. Pathology testing is required by patients and doctors in both community and hospital settings and is provided by both private and public pathologists.

15. The supply of pathology services typically involves collecting specimens, transporting them to a testing laboratory, processing (testing) them, generating and delivering reports back to the referring practitioner/hospital, or other customers (e.g., corporate businesses), and providing further verbal reporting and commentary directly to the referring practitioner where necessary.

16. The key elements of the pathology supply chain are Accredited Pathology Laboratories (**APLs**) (the laboratories) and Approved Collection Centres (**ACCs**) where pathology specimens are taken from patients, picked up by couriers and delivered to laboratories.

17. In addition, a large number of pathology specimens, in particular tissue samples which fall into the histopathology and cytology sub-specialties, are taken from patients by medical practitioners and picked up from the practitioner’s premises by pathology providers’ couriers for subsequent delivery to a laboratory (**doctor collects**).

18. Pathology testing can be divided into the following four broad categories and relevant sub-specialties:

    - biochemistry (chemical pathology, immunology and infertility and pregnancy tests);
    - haematology;
    - microbiology; and

- histopathology and cytopathology (sometimes referred to histology and cytology).

Some pathology providers also perform genetic testing.

19. Different sub-specialties are automated to varying degrees with microbiology, biochemistry and haematology (sometimes described as "clinical pathology") tending to be more highly automated and histopathology and cytology) tending to require greater manual preparation of samples, analysis and interpretation of test results.

20. The highest pathology test volumes fall within the clinical pathology sub-specialties. As these are also the most highly automated sub-specialties, there are significant economies of scale in performing the associated tests. The ability for pathology providers to be competitive in these fields therefore depends on their capacity and ability to process large volumes of these samples.

21. All private pathology providers have invested in at least one laboratory, ACCs (except niche pathology providers that can rely on doctor collects), courier cars, IT systems and testing equipment. However, the scale of this investment varies significantly between pathology providers.

22. For instance, the larger pathology providers typically operate 'hub and spoke' business models, which consist of a network of regionally located laboratories and at least one large 'central' laboratory. Under a hub and spoke model, specimens are couriered to a regional laboratory and then may be transported to a large-scale, central laboratory for processing, depending on the type of test.[1] It is often the case that pathology sub-specialties are collated and sent to the same central laboratory which enables the providers to enhance the economies of scale of each laboratory by processing the same types of samples in one place (or as few laboratories as possible).

23. Many smaller pathology providers do not process large volumes of pathology specimens and as a result are unable to achieve the same economies as larger providers. They therefore tend only to have one laboratory rather than operating a hub and spoke model. The ACCC's market inquiries to date suggest that smaller providers can be profitable by concentrating on the less automated, less routine forms of pathology testing.

Government funding

24. The Commonwealth Government (**Government**) funds the majority of pathology tests through the Medicare Benefits Schedule (**MBS**). Much of this funding is provided by paying pathology providers on a fee-for-service basis through Medicare rebates. The Pathology Services Table (**PST**), which lists the services that attract a Medicare rebate, is a subset of the MBS.[2]

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[1] Department of Health and Ageing, *Capital expenditure in the pathology sector*, August 2010; ACCC market inquiries.

[2] Department of Health and Ageing, *Review of the funding arrangements for pathology services, final discussion paper*, March 2011.

25. The PST includes a category of items to cover the costs of collecting and transporting pathology specimens (as distinct from testing the samples). This category sets out items to cover each "Patient Episode Initiation" (**PEI**) carried out by a pathology provider.

26. The costs of pathology services provided in public hospitals are funded by state governments.

27. Government spending on Medicare fees relating to pathology services in financial year 2011/2012 was as follows:

    a. Nationally: Over $2 billion, of which $1.8 billion related to pathology tests and the remainder related to collection of specimens.

    b. NSW/ACT: $830 million.

    c. Qld: $450 million.

    d. WA: $200 million.

28. The proportion of Government spending on the major categories of pathology in financial year 2011/2012 (disregarding collection fees) was as follows:

    a. Biochemistry: 53%

    b. Microbiology: 17%

    c. Histology: 15%

    d. Haematology: 14%

Other industry participants

'Corporate' pathology providers

29. Sonic, Primary Healthcare Limited (**Primary**) and Healthscope together process the vast majority of the pathology specimens processed in Australia. Each of these pathology providers operates in all mainland states and territories of Australia.

St John of God Pathology

30. St John of God Pathology (**SJOG**) is a significant pathology provider with multiple laboratories and ACCs in Western Australia and has a larger presence in WA than Healthscope. SJOG is a not-for-profit company and also operates in Victoria.

Smaller pathology providers

31. There are a number of smaller pathology providers who operate in just one state in Australia but have several ACCs and a laboratory which tend to be concentrated in metropolitan areas. Some of these are illustrated in Tables 2 to 4.

32. There are also several very small pathology providers who either have limited ACC networks and/or operate laboratories which focus on providing pathology services in specific categories (**'niche' providers**).

Public sector pathology providers

33. Public pathology service providers have laboratories based in public hospitals which are their primary source of demand. These providers are required to provide the full range of pathology services on a 24 hours, 7 days a week basis, including complex tests.[3]

34. Public pathology providers also provide community pathology services to patients referred by GPs and specialists. Some have also established ACCs in the general community.

Market inquiries

35. On 16 May 2012, the ACCC commenced market inquiries regarding the proposed acquisition. A range of interested parties provided responses, including other suppliers of pathology services, referring practitioners and industry associations.

Relevant markets

Product dimension

36. Sonic and Healthscope each provide comprehensive pathology services. These services comprise collecting pathology specimens from patients at ACCs or from medical practitioners (i.e. doctor collects), transporting the specimens to a testing laboratory, processing (testing) them, generating and delivering reports back to the referring doctors or other customers (such as corporate businesses), and providing further verbal reporting and commentary directly to the referring practitioner where necessary. Since these activities are integrated, and the ACCC is not aware of companies active in only one component, the ACCC considers it appropriate to regard them as forming part of an overall product of providing pathology services.

37. There are three key sources of demand for pathology services:

- out-patients referred by general practitioners and specialists,
- private in-patients at public and private hospitals; and
- public in-patients at public hospitals.

38. Pathology services provided to out-patients and private in-patients attract an MBS fee and may be accompanied by an out of pocket payment from the patient.[4] This is described as 'community pathology'. The pathology expenses of public hospital in-patients are generally covered by a State based funding system covering all services provided during a hospital stay. This is described as 'public hospital pathology'.

39. Public hospital pathology services are generally carried out either in-house (that is, by the state government-owned hospital), or by private sector pathologists who have been appointed on a long term contract. Public in-patients are not contestable by pathologists operating outside of a hospital setting.

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[3] Department of Health and Ageing, *Capital expenditure in the pathology sector*, August 2010.
[4] The cost of this fee is typically covered by a health fund, in the case of private in-patients who have private health insurance.

40. Private and public pathology providers do compete in relation to the supply of community pathology services – i.e. to attract out-patient referrals. The pathology laboratories of public hospitals are used to provide community pathology testing services and several of these have established multiple ACCs throughout the community in order to provide pathology services to out-patients.

41. The ACCC's preliminary view, therefore, is that public hospital pathology services form a separate market to community pathology services, but that the pathology businesses of public hospitals should be counted as competitors to private sector providers of community pathology.

42. Pathology providers also compete to provide pathology services to corporate and government customers (**corporate pathology**), typically to perform tests on current and potential employees. Whilst some corporate customers might require or prefer to engage a pathology provider with a national presence, market inquiries have indicated that any pathology provider may potentially provide these services. In addition, in some specialised areas of testing, pathology providers may compete with a range of potential suppliers that are not active in the wider community pathology markets. Corporate pathology may be regarded as forming part of the same market as community pathology services.

43. In light of the above, the ACCC's preliminary view is that the product dimension of the relevant markets is the supply of community pathology services.

Geographic dimension

44. Consistent with the ACCC's review of Healthscope's proposed acquisition of Symbion in 2007, market inquiries indicate that the provision of community pathology services involves two interrelated functions – the collection of pathology samples and the testing of pathology samples. With regard to the collection of samples, market inquiries have indicated that having ACCs is a critical part of any full service pathology provider's business.

45. Market inquiries have indicated that it is often necessary for a pathology specimen to be tested within approximately four hours of the specimen being collected from a patient. This requirement typically means that the pathology collection and testing takes place within one state or territory.

46. That said, the ACCC is aware that some pathology providers do test samples which have been transported from an interstate collection point. The ACCC understands that in particular, larger pathology providers with widespread ACC networks and laboratories in multiple states will transport specimens interstate where this enhances the efficiency of testing those specimens. For example, specimens which involve complex testing ("esoteric tests") may be collected from one or more states and tested within the same laboratory.

47. Notwithstanding this, market inquiries have indicated that the vast majority of testing takes place in the same state in which the specimen was collected and that, in order to be an effective competitor in the relevant states, it is necessary to have a collection network and laboratory facilities in each of those states. The ACCC therefore considers it is appropriate to conduct the competition analysis on the basis of state-wide markets for the provision of community pathology services.

Conclusion – relevant markets

48. The ACCC's preliminary view is that the relevant markets are:

    - the market for the supply of community pathology services in NSW (including the ACT);
    - the market for the supply of community pathology services in Qld; and
    - the market for the supply of community pathology services in WA.

49. However, market inquiries have indicated the importance of ACCs for service delivery and competition at the local level. Therefore, the ACCC is also considering whether there are areas of closer competition on a geographic basis between the ACCs of competing pathology providers and whether, post-acquisition, the merged entity would be able to impose price increases or reductions in service levels on a targeted geographic basis where there are few or no competing ACCs or limited prospects of new entry.

50. For instance, if there is a small number of ACCs operating in competition with Sonic and Healthscope within a town or its neighbouring areas, the proposed acquisition may provide the merger parties with the ability and incentive to raise prices (out-of-pocket expenses) which are imposed on patients at the ACC or decrease service levels provided to those patients, without losing significant volumes of specimens to be tested in their laboratories.

The ACCC invites comments from interested parties on the scope of the relevant markets and in particular whether there may be competition on a more localised level.

Market concentration

51. There are a number of ways to measure market share for the supply of pathology services, including on the basis of:

    a. number of ACCs owned by each pathology provider;
    b. value of Medicare payments received for pathology services; and
    c. number of Medicare-eligible pathology tests performed.

52. The number and value of Medicare-eligible tests performed by each pathology provider are not publicly available. Medicare makes available statistics relating to the number of ACCs owned by each pathology provider, and these are shown in the tables below, as an approximation of their market shares. Specifically, the number of ACCs reflects a pathology provider's collection capacity relating to out-patients, but excludes doctor collects, which are focused in the area of histology. In addition, those numbers may be inaccurate by a small margin. The following data are therefore provided as an approximate indication of the major pathology providers' market shares in relevant regions.

Table 2: Number and share of ACCs in Queensland

Provider	Number of ACCs	Market Share of ACCs
Sonic	275	35%
Healthscope	75	9%
Merged entity	350	44%
Primary	397	50%
Mater Pathology	30	4%
Public hospitals	4	1%
Other	11	<2%

Sources: Medicare Australia website; pathology providers' websites.

Table 3: Number and share of ACCs in NSW & ACT

Provider	Number of ACCs	Market share of ACCs
Sonic	468	35%
Healthscope	172	13%
Merged entity	640	48%
Primary	458	34%
Medlab	86	6%
SydPath (St Vincents)	16	1%
Moaven	9	1%
SAN Pathology	9	1%
The Canberra Hospital	7	1%
NSW public hospitals	37	3%
Other	84	6%

Sources: Medicare Australia website; pathology providers' websites.

Table 4: Number and share of ACCs in Western Australia

Provider	Number of ACCs	Market share of ACCs
Sonic	97	25%
Healthscope	49	13%
Merged entity	146	38%
Primary	107	28%
SJOG	58	15%
Perth Pathology	40	10%
Public (PathWest)	28	7%
Other	5	1%

Sources: Medicare Australia website; pathology providers' websites.

Table 5: Number and share of ACCs nationally (pre-acquisition)

Provider	Number of ACCs	Market share of ACCs
Primary	1369	35%
Sonic	1150	29%
Healthscope	635	16%
SJOG (Vic + SA)	138	4%
Medlab (NSW)	86	2%
St Vincent's Pathology (Vic)	62	2%
IMVS (SA)	59	2%
Perth Pathology (WA)	52	1%
Mater (Qld)	40	1%
PathWest (WA)	28	1%
Other	280	7%

Sources: Medicare Australia website; pathology providers' websites.

53. It can be seen from Tables 2 to 4 that the relevant markets are concentrated.

Statement of issues

54. For the purposes of this Statement of Issues, the issues in this matter are categorised as 'issues that may raise concerns' and 'issues unlikely to pose concerns'.

Issues that may raise concerns

55. The ACCC's preliminary view is that the proposed acquisition may raise competition concerns in the Qld, NSW/ACT and WA community pathology services markets.

56. The ACCC notes that on the basis of ACC numbers:

- Sonic and Primary appear to be each other's closest competitor; and
- Healthscope is the next largest pathology provider in each market other than WA, where SJOG is also larger than Healthscope.

57. The ACCC notes the more even distribution of ACC market shares in WA (see Table 4), and will have regard to that factor in its analysis.

58. There are a number of smaller pathology providers in each market, including public, not for profit and niche pathology providers. However, as discussed further later in this Statement of Issues, these pathology providers do not appear to be as effective competitors as Healthscope, primarily because they do not have the scale of Healthscope or the same level of presence in related markets. In this regard, it can be seen from Table 5 that Healthscope has a much more significant national presence than any pathology provider other than Primary and Sonic.

59. The ACCC's preliminary view is that Healthscope's ownership of hospitals and medical centres in the relevant states and strong position in Victorian and South Australian pathology markets are likely to make it a particularly vigorous and effective competitor in the relevant markets.

60. Therefore the ACCC's preliminary view is that the proposed acquisition would remove an effective competitor in the provision of community pathology services in Qld, NSW/ACT and WA.

Price competition

61. The ACCC understands that pathology providers compete in a range of complex and inter-related ways. As to price-based competition, the ACCC is focussing particularly on: whether a pathology provider bulk-bills patients; the price level (i.e. gap) charged to privately-billed patients; and the rates charged to health funds for services provided to private hospital in-patients. The ACCC understands that there may be some differentiation between prices for privately billed in-patients and privately billed out-patients.

Increased proportions of private billing

62. The ACCC understands that pathology providers may choose whether to privately bill or bulk bill a patient. Market inquiries have indicated that a pathology provider may have an incentive to privately bill patients if other large pathology providers also privately bill. The ACCC is therefore considering whether the proposed acquisition would give Sonic an ability to increase the proportion of patients that it privately bills, either unilaterally (potentially on a targeted basis, such as in local areas) or in coordination with other large pathology providers.

63. Market inquiries have indicated that, while a pathology provider may choose whether to privately bill or bulk bill a patient, in practice they generally bulk bill concessional patients and otherwise they generally follow the request of the referring medical practitioner.

64. In this context, the ACCC notes that in Queensland in 2009, Sonic changed its billing policy from one where it bulk billed most outpatient referrals to a new policy where it privately billed all patients other than concessional patients irrespective of referring practitioners' requests. Sonic reverted to its previous billing policy within a matter of months due to the volume of lost referrals. Market inquiries indicate that rivals then rapidly returned to their previous level of referral volumes. Market inquiries have also indicated that pathology providers consider that this risk of not retaining additional volumes that may be gained due to a change of billing policy by a rival is a significant deterrent to expanding collection and testing capacity in response to such a change of billing policy.

65. The ACCC notes that Sonic holds a near monopoly in the supply of community pathology services in Tasmania. Submissions provided to the ACCC during its inquiries claim that bulk billing rates are higher than in mainland states. The ACCC will explore this issue in further market inquiries.

66. The ACCC is considering whether the absence of Healthscope as an alternative pathology provider might give Sonic the ability to influence the proportion of patients that it privately bills, including whether Sonic could:

    a. target particular geographic regions;

    b. target particular types of tests;

    c. target particular referring medical practitioners, such as specialists;

    d. target particular sources of referrals, such as medical centres owned by Sonic; and

    e. continue to follow referring medical practitioners' bulk billing requests but be able to influence their requests.

67. In this regard, the ACCC is considering the likely reaction of rivals to any such conduct on the part of Sonic. In particular, the ACCC is considering:

    a. the likelihood of rival pathology providers undertaking the necessary capacity investments in circumstances where Sonic could reverse any change of billing policy and return to previous levels of referrals; and

    b. the likelihood of rival pathology providers following such a change of billing policy.

68. Market participants have indicated that, when assessing of the viability of investing in additional collection and testing capacity (e.g. several new ACCs, testing equipment and pathology staff), pathology providers will take into account the expected level of referrals that they might obtain. Market participants have indicated that increases in referral volumes following a change of pricing or billing policy by a rival are not a dependable forecast of future earnings. This is because the rival could reverse such a policy at any time and rapidly regain lost referral volumes. Market inquiries indicate that such an outcome is possible because the factors that supported the rival's superior referral base prior to the change of billing policy may remain after it reverses that policy. In particular, the rival may have retained its ACCs (which may have been located conveniently but not used by patients due to the change of billing policy), reputation and personal relationships in the meantime. The relevance of these factors in supporting a referral base are discussed further in the 'Likelihood of entry and expansion' section below. Therefore, from market inquiries conducted to date, it appears that smaller market participants are reluctant to incur the costs of investments in new collection and testing capacity in response to a rival's change of billing policy due to the risk that the additional volumes would not be sustained.

The ACCC invites comments from interested parties on any ability for Sonic to increase the proportion of patients that it privately bills post-acquisition, primarily through a change of billing policy (whether general or targeted). The ACCC is particularly interested in views on the likely reaction of rival pathology providers to a change of billing policy by Sonic.

Increased prices to privately billed patients

69. The ACCC is considering whether the proposed acquisition would give Sonic the ability to increase the prices charged to patients who are privately billed (i.e. the 'gap' borne by the patient). This would include any patient where the referring medical practitioner requests that a patient be privately billed and any in-patient in a private hospital who is not covered by private health insurance.

The ACCC invites comments from interested parties on the likelihood of Sonic having the ability to increase prices to privately billed patients post-acquisition.

Increased rates to health funds

70. The ACCC understands that all major pathology providers have Medical Provider Purchaser Agreements (MPPAs) in place with most private health funds which allow the funds to offer a health insurance product to members which ensures that their members do not incur out-of-pocket expenses for pathology services provided to them during admission to hospital (a 'no gap' product). Market

inquiries have indicated that the rates paid by health funds under MPPAs could increase due to the proposed acquisition, and be passed on to health fund members in the form of higher premiums.

The ACCC invites comments from interested parties on the likelihood of Sonic having the ability to increase the rates paid by health funds for pathology services provided to private in-patients (in private or public hospitals) post-acquisition. In particular the extent to which:

- health funds are able to leverage competition between pathology providers when negotiating MPPAs; and
- the bargaining position of the health funds constrains MPPA prices negotiated by the pathology providers.

Non-price competition

Decreased service levels associated with community pathology services

71. Market inquiries have indicated that pathology providers compete closely on service levels associated with pathology services. For patients who are bulk billed, and therefore not exposed to price competition, it is particularly important for pathology providers to differentiate their service. Market inquiries have also indicated that privately billed patients may be inclined to follow the recommendation of the referring medical practitioner, which is likely to be based primarily on service levels rather than price.

72. Market inquiries have indicated that pathology providers compete on a wide range of service-related aspects of their pathology activities. These aspects include:

    - **collection**: the location of ACCs; opening hours of ACCs; the frequency of courier visits;
    - **testing**: the quality and accuracy of testing; the availability of a 24/7 laboratory service; the level of expertise of pathologists including in particular fields of pathology; the range of tests offered – from routine tests through to highly specialised, esoteric tests;
    - **results**: the quality and accuracy of results reporting; turnaround time for results; availability for consultation with their pathologists; IT systems that provide better and faster test reports to doctors; the format and customisation of reports, the availability of historical results; the quality of interpretative comments provided; and
    - **relationships**: the professional relationship between pathology providers and medical practitioners; customer service (phone answering, manners and presentation of staff, resolution of queries, reliability etc); the provision of educational information.

73. The ACCC is considering whether any of these service-related aspects of pathology services might degrade due to the proposed acquisition.

The ACCC invites comments from interested parties on the incentive and ability of Sonic to increase profits by lowering service levels (i.e. without losing so many referrals that the saved costs would be outweighed by lost revenues) if the

proposed acquisition were to proceed.

Decreased access to specialised testing for smaller full service pathology providers

74. As indicated above, one service differentiator for pathology providers is the range of tests offered. Whilst some pathology providers present themselves as niche pathology providers, typically focussing on histology and cytology, others present themselves as full service pathology providers. Market inquiries have indicated that a pathology provider that presents itself as providing a full service must be able to accept any pathology referrals regardless of whether it actually possesses the necessary testing equipment. If such a pathology provider were to tell a patient that it was unable to perform a particular test, this would harm its reputation in a broader sense and it would be likely to lose referrals in other areas – including other tests that would be referred in conjunction with the specialised tests.

75. Therefore, in the event that a pathology provider does not have the necessary testing equipment, it must on-refer the test to another pathology provider which has the necessary equipment. Market inquiries have indicated that, due to the economies of scale and scope involved in pathology testing, larger pathology providers are more likely to have the necessary testing equipment for more specialised tests. However, even the largest pathology providers do not have the testing equipment required for all pathology tests.

76. Market inquiries have indicated that larger pathology providers have, on occasion, declined to perform pathology tests on behalf of smaller pathology providers. Provided that there is an alternative pathology provider with the necessary testing equipment, such conduct is not likely to raise major issues for the smaller pathology provider. The ACCC is therefore considering the extent to which the proposed acquisition might decrease the incentive of larger pathology providers to provide specialised testing to smaller pathology providers, on the basis that there will be fewer (or no) alternative pathology providers able to undertake this testing. In this regard, the ACCC is particularly considering whether Healthscope currently performs an important role in providing specialised pathology testing for smaller pathology providers.

The ACCC invites comments from interested parties on any decreased incentive for larger pathology providers to undertake specialised testing for smaller pathology providers, including any decreased incentive for larger pathology providers to provide adequate service levels relating to that testing (such as turnaround times).

Competitive constraint imposed by Healthscope

77. The ACCC's market inquiries suggest that Healthscope is a strong competitor and provides a significant competitive constraint on its rivals, particularly Sonic and Primary. Market inquiries suggest this is due to its position in the markets, including aspects such as its collection and testing capacity, existing referral base, reputation and personal relationships.

78. Healthscope owns several medical centres and private hospitals, and manages a number of private hospitals through contracts with other private hospital owners. The ACCC's market inquiries suggest that this provides Healthscope with greater potential access to referral volumes from in-patients (particularly in

clinical pathology) and the associated economies of scale and scope in its testing activities. This may support further expansion of its ACC network and therefore enable Healthscope to access greater referral volumes relating to out-patients.

79. These reasons, in addition to Healthscope's large network of ACCs and laboratories across Australia and in the relevant states, may give it the ability to provide a particularly strong constraint on the larger pathology providers in the relevant markets (Sonic, Primary and, in WA, St John of God).

80. The ACCC is therefore considering the extent to which a pathology provider's activities in one of the relevant markets may be assisted by its presence in geographically or functionally-related markets. In particular, in light of the barriers to expansion faced by pathology providers (discussed further below), the ACCC is considering the extent to which a pathology provider may benefit from enhanced:

    a. reputation or testing capacity if it has a presence in community pathology markets in other states or a presence in public pathology markets (i.e. the provision of pathology services to public hospitals); and

    b. reputation or access to referral volumes if it has a presence elsewhere in the health sector, such as through ownership of medical centres and hospitals.

81. The ACCC will continue to explore the nature of the competitive constraint offered by Healthscope in the relevant markets.

The ACCC invites comments from interested parties on the significance of Healthscope in the relevant markets.

In particular, the ACCC seeks further information (and where possible, specific examples) on:

- the extent to which Healthscope has acted as a particularly strong competitive constraint as it has entered and expanded its presence in the relevant markets;
- Healthscope's relative competitive strength in each of WA, Qld and NSW/ACT;
- the significance of Healthscope's presence in related markets through its ownership of medical centres and private hospitals; and
- the significance of Healthscope's strong presence in South Australian and Victorian pathology markets as giving it additional competitive strength in the relevant states.

Significance of other pathology providers

82. Market inquiries have indicated that Primary is the most immediate rival to Sonic in the relevant markets and therefore represents the most direct competitive constraint on Sonic. As discussed under the previous heading, however, market inquiries have indicated that Healthscope also plays a significant role in the relevant markets.

83. The ACCC is therefore considering whether a market structure in which Sonic and Primary are the only major competitors may result in higher prices or lower

service levels (as outlined above), including through any greater scope for them to act in a coordinated manner. In this regard, it is necessary to consider the ability of other pathology providers effectively to replicate the competitive constraint currently exercised by Healthscope in the relevant markets.

84. Market inquiries have indicated that pathology providers other than Healthscope may provide some degree of competitive constraint on Sonic and Primary. However, market inquiries have indicated that:

    a. smaller general pathology providers face significant challenges when seeking to expand their referral base, particularly due to the larger pathology providers' established economies of scale, collection and testing capacities, reputation and personal relationships (as discussed further below);

    b. niche pathology providers do not actively constrain full service pathology providers in relation to automated, volume-driven pathology tests; and

    c. public and not for profit pathology providers may not act in such a vigorous competitive manner as private pathology providers.

The ACCC invites comments from interested parties on the competitive constraint imposed by other pathology providers.

In particular, the ACCC seeks further information (and where possible, specific examples) on:

- the degree of competitive constraint exercised by Primary in the relevant states, including the likelihood that Primary might be a less vigorous competitor in the absence of Healthscope;
- the degree of competitive constraint exercised in WA by St John of God;
- any other pathology providers likely to provide a particularly strong competitive constraint in any of the relevant markets following the proposed acquisition; and
- the competitive constraint exercised by Healthscope's other rivals in each of the relevant states, including any difference in the relative degree of competitive constraint exercised by smaller general pathology providers, niche pathology providers, public pathology providers and not for profit pathology providers.

Cost advantages of the larger pathology providers

85. Market inquiries have indicated that there are significant economies of scale and scope in collection and testing by pathology providers. The businesses of the three largest pathology providers, Sonic, Primary and Healthscope are structured and positioned to provide pathology services at lower costs than most other pathology providers and are therefore in a stronger position to expand their businesses and compete for referral volumes. Pre-acquisition, then, Primary, Sonic and Healthscope are likely to act as each other's strongest competitive constraint.

86. Market inquiries have indicated the following:

    a. Given the high number, geographic breadth and density of the ACCs owned by Sonic, Healthscope and Primary and collection points that

they service for doctor collects, they tend to face lower incremental costs of establishing and servicing further ACCs, or collection points.

b. Where testing equipment may be relatively expensive to acquire relative to the likely revenues from performing tests, a pathology provider may instead rent equipment. Given their greater volumes, it may be more viable for larger pathology providers to acquire testing equipment outright and avoid the rental costs. When a pathology provider rents testing equipment, it will often rent the equipment from the supplier of the reagents that are required for the relevant tests. The ACCC understands that reagent suppliers will often charge pathology providers on a 'per test' basis, which would also cover the supply of reagents. The ACCC understands that the 'per test' cost is generally set at a higher level for pathology providers that perform fewer tests. In this context, larger pathology providers may have a lower 'per test' cost of test inputs.

c. Whereas all pathology providers are required to have a category GX or GY laboratory, larger pathology providers are able to operate a 'hub and spoke' laboratory network, within which the 'spoke' laboratories perform standard tests, while the centralised laboratory is also capable of performing more specialised tests and processing a greater volume of tests more rapidly. This appears to give larger pathology providers a lower marginal cost for tests and enables them to expand their test volumes at comparatively lower incremental costs.

d. Testing-related economies of scale and scope are of particular relevance for the most automated test types, which typically fall in the categories of haematology, microbiology and chemical pathology ("clinical pathology"). The specimens required for these types of test are also very often capable of being collected by ACC staff, rather than requiring a doctor to collect them. The significant economies of scale and scope mean that pathology providers seeking to operate a profitable business in these areas will focus on maximising volumes and the providers who have large networks of ACCs are best placed to do this.

e. The least automated test types typically fall in the categories of histology and cytology, where medical practitioners typically place more value on the ability of individual pathologists and scientists employed by a pathology provider, as well as the quality of the results analysis provided by the pathology provider. The specimens required for these types of test are typically collected by a doctor, meaning that ACCs are of less importance.

f. Given the point immediately above, small and niche pathology providers and new entrants typically focus on histology and cytology, where they are better able to compete with larger pathology providers. They may later seek to expand their operations into clinical pathology, however this would ordinarily represent a significant departure from their existing business model.

87. In light of the above factors, it would appear that the business models of Sonic, Healthscope and Primary enables them to achieve significant economies of scale and to provide pathology services at lower costs than most other pathology providers. In this way, these pathology providers are more likely to be able to constrain each other than smaller competitors are.

The ACCC invites comments from interested parties on the ACCC's preliminary views regarding economies of scale and scope involved in providing community pathology services.

In particular, the ACCC seeks further information (and where possible, specific examples) on:

- the extent to which the smaller providers' relatively higher costs of providing pathology services limits their ability to provide an effective competitive constraint in the relevant markets;
- the efficiencies associated with establishing, expanding and running a collection network; and
- the economies of scale and scope associated with pathology testing, such as equipment costs, employment costs and reagent costs.

88. In light of the above discussion, the following section considers whether smaller competitors are likely to be in a position to grow to a level that would constrain the larger pathology providers.

Likelihood of entry and/or expansion by smaller pathology providers

89. The ACCC is considering whether the loss of competition between Sonic and Healthscope as a result of the proposed acquisition is likely to be replaced by new entrants or the expansion of smaller pathology providers who already operate in the relevant markets.

90. The ACCC considers that given the high market shares of the merger parties in terms of the numbers of ACCs they own and the pathology volumes they process, it would be necessary for a new entrant or existing competitor to be in a position to win substantial volumes of referrals away from the larger parties in order to provide an effective competitive constraint in the relevant markets. In this context, market inquiries have indicated that pathology providers face substantial impediments to timely expansion of their referral base, which is necessary for any investment in pathology collecting and testing capacity to be viable.

91. Market inquiries indicate there are two main categories of issues relating to the likelihood of new entry and expansion:

    i. The role of personal relationships and reputation in building referral volumes; and

    ii. Impediments to establishing ACCs in locations that are likely to deliver referral volumes to support viable entry or expansion.

The ACCC seeks further information and evidence relating to the likelihood of entry and expansion sufficient to off-set any loss of competition arising from the proposed acquisition. In particular, the ACCC seeks information on the two main categories of issues relevant to this question, as described below.

Obtaining referrals: Establishing reputation and relationships

92. As a general principle, a patient has a choice of pathology provider. However, market inquiries have indicated that patients generally follow the recommendation of their general practitioner or specialist.

93. Market inquiries have indicated that the quality and reliability of testing and reporting by pathology providers are very important to referring medical practitioners. While pathology providers must comply with minimum standards imposed by the National Association of Testing Authorities (NATA), the authority responsible for accreditation of laboratories in Australia, market inquiries have indicated that there are many other aspects of the quality and reliability of testing and reporting that are important to medical practitioners. Market inquiries have indicated that these factors are particularly important for non-standardised, non-automated tests.

94. These factors mean that trust between a medical practitioner and pathology provider is critical. Trust must be acquired over time. In the longer-run, a pathology provider may establish personal relationships with individual medical practitioners and a reputation in the broader market. Market inquiries have indicated that, for this reason, a pathology provider's reputation and personal relationships with medical practitioners are critical to obtaining referrals.

95. In this context, the ACCC is considering whether incumbent pathology providers may hold an advantage over new entrants seeking referrals (including established pathology providers seeking to expand their referral base). More specifically, the ACCC is considering the extent of time and effort required to establish a reputation and personal relationships and, conversely, the extent to which rivals' pre-existing personal relationships and reputation may act as a further impediment to obtaining referrals – even with a superior price or service offering.

96. Market inquiries have indicated that the process of establishing a reputation and relationship with medical practitioners is slow and difficult, with no guarantee of success. As a result, expansion of a referral base tends to be gradual and incremental.

97. Quicker expansion may be possible if a pathology provider recruits staff (primarily pathologists) from established players or if a pathology provider has an established presence in a related market.

    a. With an established presence in pathology in another geographic region, a pathology provider may have an established brand reputation and may be able to use established laboratory facilities in that region.

    b. A pathology provider may have an established brand reputation in the health sector that could assist in pathology markets. Similarly, a pathology provider that owns hospital or medical centres may be able to use that ownership to its advantage in pathology markets.

98. Rapid increases in referral numbers may also follow from a change of billing policy by a rival pathology provider, such as Sonic's change of billing policy in Queensland in 2009.

The ACCC invites comments from interested parties on the significance of reputation and personal relationships for obtaining referrals and the difficulty in establishing a good reputation and close personal relationships.

In particular, the ACCC seeks further information (and where possible, specific examples) on:

- the difficulties involved in establishing a reputation and personal relationships with medical practitioners;
- the extent to which reputational issues are more relevant for certain types of

tests or type of medical practitioner (e.g. GPs and specialists);

- the extent to which personal relationships are more relevant for certain types of tests or type of medical practitioner (e.g. GPs and specialists);
- the most viable means by which a pathology provider may rapidly expand its referral base and retain that expanded referral base; and
- the feasibility of a new entrant or expanding smaller pathology provider recruiting staff from a rival as a means to achieve greater referrals.

Obtaining referrals: Collection centres and doctor collects

99. Market inquiries have indicated that having ACCs is a critical part of any full service pathology provider's business. Without ACCs, a pathology provider must rely on doctor collects. This may be a viable option for a niche pathology provider focussing on fields such as histology and cytology because a medical practitioner typically will take tissue samples and pap smears. In general though, patients will use an ACC for more routine specimens, such as blood (which can be taken by a nurse), urine and stools (both of which can be provided by a patient with minimal assistance).

100. The use of ACCs is not an option for hospital in-patients.

101. Market inquiries have therefore indicated that ACCs are used by pathology providers as a means for capturing out-patient referrals for testing of specimens such as blood, urine and stools. In this context, the principal basis on which pathology providers are able to maximise referrals obtained from ACCs is on the basis of their convenience to patients.

102. The price to the patient may also be a relevant factor overriding convenience, particularly if the most convenient pathology provider would privately bill a patient that could obtain bulk billed pathology services elsewhere (as occurred with Sonic's change of billing policy in Queensland in 2009).

103. Market inquiries have indicated that there are two respects in which a pathology provider can maximise the convenience of ACCs: their location and their opening hours.

104. ACCs can be characterised as falling into two broad categories: 'co-located' and 'standalone'. Co-located ACCs are located at or very close to medical practices, with the primary aim being to obtain referrals from patients attending the medical practice, some of which will be providing specimens on the same day as a consultation. Standalone ACCs are located at an independent site, located close to the homes or work places of as many potential patients as possible, whilst also taking into account the locations of rival ACCs.

105. The viability of a co-located ACC depends primarily on the number of patients attending the relevant medical practice. In some cases, a co-located ACC will be located on the premises of the medical practice and the pathology provider will sub-lease part of the site for the ACC. In those cases, the principal of the medical practice (sometimes acting through a practice manager) will have the ability to determine which pathology provider may establish a co-located ACC.

106. Market inquiries have indicated that there are two broad bases for selecting a pathology provider: the amount of rent offered and the quality of the pathology service provided. Principals vary widely in the respective priority that they place on these two elements. To the extent that a principal is concerned as to the

quality of the pathology service provided, they will typically consult the medical practitioners working at the medical practice.

107. Market inquiries have therefore indicated that:

    a. in some cases, a pathology provider will be able to establish a co-located ACC on the basis of an ability to pay a greater amount of rent – this will typically be one of the pathology providers with the greatest economies of scale, bearing in mind that the types of specimens collected at an ACC tend to be those that are subject to economies of scale in testing – in this respect, the economies of scale of a pathology provider will tend to be self-reinforcing; and

    b. in other cases, a pathology provider will be able to establish a co-located ACC on the basis of the actual or perceived quality of pathology services that they provide – for these ACCs, a pathology provider's reputation and personal relationships with medical practitioners are particularly important – as discussed above, these factors tend to favour incumbents.

108. Prior to 1 July 2010, pathology providers were very limited in the number of ACCs that they were able to open, due to restrictions on the number of ACC licences that a pathology provider could hold. Following deregulation of ACC licence numbers, there was a rapid increase in the number of ACCs being operated by pathology providers.

109. Since deregulation, most new ACCs have been opened by the larger providers – Sonic, Healthscope and Primary. However, there has been significant expansion by some smaller pathology providers relative to their size before deregulation. In the relevant states, these include Medlab in NSW and Perth Pathology in WA. The ACCC is exploring whether this expansion means that smaller providers, such as these, could readily expand to provide a stronger competitive constraint post-acquisition. The ACCC is also considering whether, alternatively, this expansion was the result of a one-off opportunity (following deregulation) and whether similar levels of expansion are likely.

The ACCC invites comments from interested parties on the factors relevant to the significance of ACCs for obtaining referrals and the ability of pathology providers to establish viable ACCs in current market conditions.

In particular, the ACCC seeks further information (and where possible, specific examples) on:

- whether the expansion of ACCs by smaller pathology providers such as Medlab in NSW or Perth Pathology in WA is evidence that smaller providers are likely to expand to constrain the merged entity post-acquisition;
- whether smaller pathology providers are able viably to expand their ACC networks as quickly as they did immediately following deregulation of ACC licences in 2010;
- the factors relevant to whether a new ACC is likely to be profitable, including the minimum number of referrals required;
- the geographic range over which a smaller pathology provider is likely to locate new ACCs, particular where a potential location lies substantially outside the existing coverage of its ACCs;
- the geographic range over which doctor collects are viable, particularly where

the location for an additional doctor collect lies substantially outside the existing coverage of a pathology provider;

- the extent to which a new entrant would face different challenges now relative to a new entrant in the first year following removal of those restrictions; and
- any advantages held by incumbents in relation to the establishment of further ACCs.

110. The ACCC's concern is that neither potential new entry nor the prospect of smaller pathology providers expanding their capacity, are likely to provide a strong competitive constraint on the merged entity in the relevant markets.

Issues unlikely to pose concerns

Pathology services for corporate customers

111. Market inquiries to date have indicated that competition concerns are unlikely to arise in relation to the supply of pathology services to corporate customers.

ACCC's future steps

112. The ACCC will finalise its view on this matter after it considers market responses invited by this Statement of Issues.

113. The ACCC now seeks submissions from market participants on each of the issues identified in this Statement of Issues and on any other issue that may be relevant to the ACCC's assessment of this matter.

114. Submissions are to be received by the ACCC no later than **16 August 2012**. The ACCC will consider the submissions received from the market and the merger parties in light of the issues identified above and will, in conjunction with information and submissions already provided by the parties, come to a final view in light of the issues raised above.

115. The ACCC intends to publicly announce its final view by **30 August 2012**. However the anticipated timeline may change in line with the *Merger Review Process Guidelines*. A Public Competition Assessment for the purpose of explaining the ACCC's final view may be published following the ACCC's public announcement.