Anticipated acquisition by Drager Medical AG & CO. KGAA of the air-shields business of Hillenbrand Industries Inc

The OFT's decision on reference under section 33 given on 18 December 2003

PARTIES

1. **Drager Medical AG** (Drager) develops, manufactures and sells products, services and integrated solutions for acute patient care, including neo-natal warming therapy products and home care throughout the world. Drager's manufacturing plants are located in Germany, the Netherlands, USA and China. In 2002, Drager's UK turnover for neo-natal warming therapy products, which are those relevant to this merger, was approx. [1]. Drager became a joint venture between Dragerwerk AG (65 per cent) and Siemens (35 per cent) in July 2003: the European Commission having cleared this transaction in April 2003.

2. **Air-Shields** is a business within Hill-Rom Inc, which is a wholly owned subsidiary of Hillenbrand Industries Inc. Air-Shields' main business comprises the manufacturing of warming therapy devices for infant care. Air-Shields' manufacturing plant is located in the US (Hatboro, Pennsylvania). In 2002, Air-Shields' worldwide turnover was [2], of which approx. [3] was attributed to the UK.

TRANSACTION

3. Drager proposes to acquire certain assets of the Air-Shields business of Hillenbrand's subsidiary, Hill-Rom Inc, relating to the manufacture (in the USA) and worldwide supply of neo-natal warming therapy products. Drager explained that the rationale for the merger was to increase its presence in the important US market, where Air-Shields makes over 50 per cent of its sales. There are a number of restrictions to the purchase agreement which may or may not be ancillary to the merger.

4. The transaction was notified by Drager on 22 October 2003. The administrative deadline expires on 24 December. The transaction has been notified or details submitted voluntarily in a number of other European countries.

[1] Details excised at the request of the parties for reason of commercial confidentiality.
[2] See footnote 1.
[3] See footnote 1.

JURISDICTION

5. As a result of this transaction Drager and Air-Shields will cease to be distinct. The parties overlap in the supply of neo-natal warming therapy products and the share of supply test in section 23 of the Enterprise Act 2002 ('the Act') is met. A relevant merger situation is likely to be created.

RELEVANT MARKET

6. Neo-natal warming therapy products are used in hospitals for the care of very young and premature babies. The parties overlap in the UK in the distribution of the following categories of neo-natal warming therapy products:

    - closed care incubators – which isolate the newborn by means of a hood, usually transparent, that protects against heat loss. This has the advantage of providing a conditioned atmosphere within the hood but access is more difficult with any care given through hand ports;

    - open care warming beds – open to the outside environment with heating provided by a radiant heater or a warming mattress. This has the advantage of easy access to the patient but the risk of water losses through the use of a radiant heater;

    - transport incubators – smaller than a stationary incubator (above) and equipped with a mobile power source and oxygen/air cylinders. It may be possible to differentiate between transporters needed for Intra-hospital and inter-hospital use;

    - photo therapy products – 80 per cent of premature babies are jaundiced, this can be treated by 'photo therapy', that is, exposing the baby to light within a certain spectrum;

    - accessories – manufacturer supplied accessories include in-bed weighing scales, storage and organiser compartments as well as a range of other devise features. Third party accessories can also be used with the parties' products.

    In 2002, total UK turnover for these products was an estimated £5.5 million. The parties also both overlap in the supply of aftercare provision which is provided with all types of neo-natal warming therapy products.

7. The sale of closed care incubators and open care warming beds in the UK together account for the majority of turnover ([4] per cent and [5] per cent for Drager and Air-Shields respectively) of neo-natal warming therapy products.

[4] See footnote 1.
[5] See footnote 1.

Product market

Demand-side substitutes

8. Neo-natal warming therapy products are chosen, according to the parties and third parties, by their end-users based largely on clinical functionality and suitability.

9. Drager submits that there appears to be, at the margin, some choice between closed care incubators and open care warming beds which might suggest a single relevant market for all stationary warming therapy products. However, this view is not shared by those customers contacted by the OFT. They believe that the two devices are not substitutes because they serve different clinical purposes (as described above). In the event of a small but significant price increase in closed care incubators, customers indicated that they would not switch to open care warming beds. However, the parties point out that 'hybrid' incubators, performing both open and closed therapy functions, have recently been introduced onto the market, the 'Giraffe Omnibed' by Datex-Ohmeda and the Versalet 7700 by Air-Shields. This has, they say, further blurred the distinction between open and closed products. Transport incubators tend to be more expensive than stationary incubators and may have a shorter life span due to damage caused in use.

10. Customers also purchase accessories, such as oxygen modules and weighing scales, for use with neo-natal warming therapy products. Drager maintain that accessories can be subdivided into manufacturer specific add-ons and more general accessories. As the majority of accessories appear to be manufacturer specific and purchased at the point of sale, it seems reasonable to consider accessories in conjunction with the initial purchase of the specific neo-natal warming therapy product.

11. The provision of aftercare servicing raises similar considerations. Servicing can be purchased in three ways: direct from the manufacturer as part of a service contract; as training provided by the product supplier to a hospital's in-house maintenance staff; or from a manufacturer-accredited independent provider either on a long term or ad hoc basis. The parties suggest that the first two methods are the most popular. Third parties have indicated that there is a growing tendency for hospitals to choose the in-house option. Third parties have maintained, however, that access to a supplier's aftercare service is an important factor when choosing a supplier and examples have been provided where customers have switched suppliers because the provision of service was poor. As such it appears reasonable to consider aftercare also in conjunction with the initial purchase of the product.

Supply-side substitutes

12. The parties submit that most manufacturers are able to supply all types of neo-natal warming therapy products, as the technology involved is mature, the manufacturing process similar and there are no significant patent barriers. They said that they were able to switch their own manufacturing output as demand for particular products required. The parties also cite the example of Fisher & Paykel

Healthcare Ltd, which originally provided humidifiers for ventilation machines and from this expanded into producing an open care unit. However, the parties also state that investment in research and development for neo-natal warming therapy products would be required and that it would take approximately three years to get to the production stage.

13. Third parties agreed that there may be some similarities in the manufacturing process, but considered that those competitors who currently do not supply a given product category of neo-natal warming product in the UK would not necessarily be in a position to enter the UK with such a product in the event of a small but significant price rise. One third party also suggested that due to the regulations applicable to medical devices, it would be difficult to bring a new product to market within a year.

Conclusions on product market

14. In conclusion it would appear that on the demand-side, substitutability is limited between the different types of neo-natal warming therapy products, as they are designed to meet specific needs. On the supply-side, the parties suggest that a manufacturer of one type of neo-natal warming therapy product would be able to switch production to another type. However, whether such a manufacturer would also be able to distribute this product successfully in the UK sufficiently readily to count as supply substitutability appears unlikely.

15. For the purposes of this Decision there appear to be cogent arguments in favour of either a frame of reference covering all neo-natal warming therapy products or ones for each category of neo-natal warming therapy product. However, it is not necessary to decide between these perspectives because similar competition issues appear whichever frame of reference is considered.

Geographic market

16. The parties and third parties have stressed the importance of suppliers having a local or national presence, especially with regard to the supply of an effective aftercare service. Some customers have stated that when considering potential suppliers they would not purchase from a manufacturer without a UK presence. This also seems an important aspect of product marketing in that much of it seems to take place on a face-to-face basis with prospective customers often having the option of 'testing' out machines being offered.

17. However, the parties submit that the geographic scope of supply is global due to transport costs being a small proportion of the total cost of the product; the parties have stated that on average this cost is approximately 3 per cent. All of these products sold in the UK are imported, as are a significant proportion of those sold in the EU. Neither party has any manufacturing capability within the UK although both have in-house distribution businesses operating in the UK.

18. The parties also maintain that a manufacturer of neo-natal warming therapy products active outside the UK could appoint a UK distributor to market its products and provide training and sales support. The parties cite Atom as an

example of a competitor who has appointed a UK distributor. However, it is unclear from third party comments how long it would take for a manufacturer to find a distributor and for them to be able to market the product successfully.

19. Although manufacturers outside the UK may have the capability to supply neo-natal warming therapy products into the UK, due to the uncertainty of distribution and the need to have a UK base for effective marketing and aftercare provision, the relevant geographic scope at the distribution level appears likely to be the UK.

HORIZONTAL ISSUES

Market shares

20. The parties' combined shares of supply for 2002 range from [55-65] per cent[6] (increment [20-30] per cent[7]) in closed care incubators to [in excess of 90] per cent[8] (increment [40-50] per cent[9]) in transport incubators. For all neo-natal warming therapy products the combined share of supply would be [75-85] per cent[10] (increment [30-40] per cent[11]). The HHIs and the increments for these categories and for all neo-natal warming therapy products indicate high levels of concentration.

21. Post-merger the combined entity will, in all categories except for closed care incubators, face competition in the UK from only one other main supplier, Datex-Ohmeda[12] (with some [10-20] per cent[13] of all products). Within the closed care incubator category, Atom (with [less than 10] per cent[14]) is also a supplier through a UK-based distributor. While there are other competitors, as well as those cited above, they are of a much smaller scale in the market than the parties, as evidenced by the fact that their total share of supply is less than [10] per cent[15]. This would suggest that it is unlikely that they will place a significant competitive constraint on the parties post-merger. Against this, the parties point out that Datex-Ohmeda is now part of GE Medical Systems, a leading global medical supply company, and can be expected to become a far more effective competitor to the parties within the UK.

22. Competition in the supply of the overlap products appears to exhibit some characteristics of a bidding market. As such, shares of supply in any one year may not necessarily be a good indicator of the competitive strength of each player. The OFT has considered the share of supply figures for the last four years, but these figures show the same trends as those for 2002. The parties

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[6] Actual figures replaced by a range at the parties' request for reasons of commercial confidentiality.
[7] See footnote 6.
[8] See footnote 6.
[9] See footnote 6.
[10] See footnote 6.
[11] See footnote 6.
[12] Datex-Ohmeda was acquired by GE Instrumentarium in September 2003.
[13] Actual figures replaced by a range for reasons of commercial confidentiality.
[14] See footnote 13.
[15] See footnote 13.

maintain that there are a number of competitors that win significant tender contracts and have provided some bid data which appear to support that contention. However the bid data also indicate that the parties may be each other's closest competitor, and this view was supported by customer comments.

Portfolio effects

23. A few third parties raised concerns about the impact of the merger on the 'portfolio power' of the merged entity, specifically on its ability to tie purchases of different neo-natal warming therapy products together. They believed that the merger would increase pressure for Trusts to use the parties as a 'one-stop-shop'.

24. However, one customer contended that is was unlikely that the merged entity would be able to tie products together, because hospitals operate to tight budgets and, therefore, they will only purchase products as and when they are required. The bidding information provided by the parties, although limited, did suggest that equipment was acquired essentially on a replacement basis only, which would further reduce the scope for the use of any portfolio power. (In any event there is the question of whether there would be any incentive for the merged entity to exploit anticompetitively any scope to use portfolio power.)

Barriers to entry and expansion

25. The parties state that the basic technology needed to manufacture neo-natal warming therapy products is well known and that there are no particular intellectual property requirements. To market neo-natal warming therapy products in the UK the CE quality assurance mark is required. This process of certification takes 3-6 months and is carried out by the suppliers on their own products in accordance with the existing EU legislation.

26. However, responses from customers would tend to suggest that in order to sell the product in the UK, the manufacturer needs to have access to a UK-based sales force, either through a subsidiary or via a distributor. This sales force then markets the products to hospitals and provides demonstrations and training for users – the cost of this has been estimated by one third party at 15 per cent of turnover. A technical team may also be required in order to provide maintenance, servicing and technical training. One third party highlighted that the product and public liability cover insurance costs alone accounted for approximately 1.5 per cent of its estimated turnover, which added to the cost of entering the market. Another third party estimated that the minimum cost of entry into the UK is approximately £460k per annum, as against the total UK turnover for neo-natal warming therapy products estimated at £5.5 million in 2002.

27. Customers maintain that quality, safety and reliability are more important than price when choosing a product and so the brand and reputation of the supplier are of vital importance. One third party stated that they would only choose a well-known name and not a new entrant, which could indicate that there may be some strategic first-mover advantage. However, there were customers that said that they would consider buying from a new entrant, providing they could trial the equipment first.

28. Customers also emphasised that it was important for them to be able to build an on-going relationship with the supplier, which helped them when negotiating terms in relation to price and aftercare. One competitor explained that they were prevented from entering some categories for neo-natal warming therapy products because the requirement for UK aftercare by customers was too costly. As such, smaller firms may not find it cost-effective to start supplying other types of neo-natal warming therapy products.

29. The parties submit that there are two types of potential entrant: manufacturers that are active outside the UK and who could appoint a UK distributor; and manufacturers in related medical equipment sectors who could diversify into neo-natal warming therapy products. The parties have cited three potential entrants into the UK and four distributors that have the potential to market their products.

30. However, from third party comments received it appears unlikely that such potential entrants would attempt to enter the UK market. We understand from these comments that attempts have been made, but they have been unsuccessful. Reasons for this include the presence of three large competitors hitherto accounting for a significant proportion of the UK market and the difficulty in finding a reliable distributor to market their products successfully.

Buyer power

31. When purchasing neo-natal warming therapy products hospitals have the choice of buying direct or entering a joint collective purchasing agreement. The parties have estimated that over 90 per cent of purchases are made by individual NHS Trusts.

32. The parties submit that customers have negotiating strength and have cited examples where they have had to offer significant discounts in order to secure sales. They also highlighted the role of the Purchasing and Supply Agency (PASA) in this market. However, PASA has no national contracts in place for neo-natal warming therapy products. PASA did inform the Office that they are due to next year look at setting up a national framework agreement for procuring warming products for babies. However, this would take the form of a procurement guide, and PASA will still not negotiate a price for the equipment.

33. Competitors generally believed that buyers do have some negotiating strength because purchases were made through a tendering process. Customers believed that they could currently negotiate discounts, but were concerned that, post-merger, buyer power was likely to be reduced, which may lead to increased prices and deterioration in service levels. It may also be the case that since the merger would result in the loss of one of the sector's stronger suppliers, customers would find that the threat of switching was no longer such a credible tactic.

VERTICAL ISSUES

34. A few third parties raised concerns that because some Trusts are outsourcing their medical engineering divisions to companies such as Siemens, who jointly own Drager, the technical staff employed might have a preference for Drager products. The merger could then enhance the ability of parties to influence the purchasing decisions of hospitals. However, we have been informed that Drager provides outsourced services to a very small proportion of NHS Trusts and that Air-Shields does not provide this service to any. As there is no accretion to the share of supply in this area it is unlikely that it will enhance the merged entity's ability to influence the purchasing decisions of hospitals.

THIRD PARTY VIEWS

35. Third parties, both customers (whose views we value particularly) and competitors, expressed concerns about the merger, they believed that it would result in a reduction in competition and choice leading to an increase in prices, a deterioration in service levels, and reduction in product innovation. However, some customers did believe that they would retain a degree of buyer power and so might be able to resist price increases.

ASSESSMENT

36. The parties are the two major suppliers of neo-natal warming therapy products to hospitals in the UK. The merged entity would have shares of supply that range from [55-65] per cent[16] in closed care incubators to [in excess of 90] per cent[17] in transport incubators. For all neo-natal warming therapy products its share would be [75-85] per cent[18]. The HHI figures and increments are also very high. In short the market is already highly concentrated and would become more so.

37. The merger would reduce the number of major suppliers of closed care incubators in the UK from four to three and the number of major suppliers of other types of neo-natal warming therapy product from three to two. This limits the choice that customers would have when putting an order out to tender. Although customers may still possess some buyer power in negotiating discounts, this is likely to be weakened by the loss of a strong competitor and alternative supplier. The parties say that Datex-Ohmeda, now part of GE Medical Systems, can be expected to become a much more effective competitor in the UK. Be that as it may, the merger appears likely to lead to a reduction from three to two in the number of major players providing the full range of neo-natal warming therapy products to the UK.

38. Although technical barriers to entry may be low, the experience of other potential competitors trying to enter the UK market for neo-natal warming therapy products suggests that barriers to effective distribution do exist. Customer comments have

[16] Actual figures replaced by a range at the parties' request for reasons of commercial confidentiality.
[17] See footnote 16.
[18] See footnote 16.

also implied that branding and reputation are vitally important to them and that this could impede potential entry. With regard to barriers to expansion, smaller competitors currently active in the supply of types of neo-natal warming therapy product indicated that the cost of expansion was too high to be profitable for them, partly because of the cost involved in providing aftercare services.

39. In sum, the merger would substantially increase concentration and reduce customer choice in a market that is already highly concentrated. Buyer power and potential entry cannot confidently be relied upon to avert a lessening of competition. The OFT therefore believes that there is a significant prospect that the merger would substantially lessen competition. That is a sufficient condition for the OFT to refer the merger to the Competition Commission. To reach a reference decision in this case, therefore, it has not been necessary to assess the merger further in relation to the interpretation of the test for reference given in the recent judgment of the Competition Appeal Tribunal (CAT) in IBA Health v OFT [2003] CAT 27.

UNDERTAKINGS IN LIEU OF REFERENCE

40. Where the duty to make a reference under section 33(1) of the Act is met, pursuant to section 73(2) of the Act the OFT may, instead of making such a reference, accept undertakings for the purposes of remedying, mitigating or preventing the substantial lessening of competition concerned or any adverse effect which may be expected to result from it. Having reached a reference conclusion, the OFT has considered whether there might be undertakings in lieu of reference which would address the competition concerns outlined above. The OFT's guidelines on undertakings in lieu of reference state that, 'undertakings in lieu of reference are appropriate only where the competition concerns raised by the merger and the remedies proposed to address them are clear cut.'[19] The OFT has also considered the recent judgment of the CAT in IBA Health Ltd v OFT.

41. In this case there does not appear to be a clear cut remedy to the competition concerns that the OFT would be capable of implementing readily. [20]. Given that the concerns arise from a significant change in the structure of the UK market, the OFT does not believe that the [21] undertakings offered by Drager [22] would adequately remedy the competition concerns arising from the merger. [23].

42. Accordingly, the OFT has decided not to exercise its discretion to seek undertakings in lieu of reference.

DECISION

43. This merger will therefore **be referred** to the Competition Commission under section 33(1) of the Act.

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[19] Mergers, 'Substantive assessment guidance' May 2003.
[20] Details excised at the request of the parties for reasons of commercial confidentiality.
[21] See footnote 20.
[22] See footnote 20.
[23] See footnote 20.