

INQUIRY INTO THE ANTICIPATED ACQUISITION BY DRÄGER MEDICAL AG & CO KGAA OF ASSETS REPRESENTING THE AIR-SHIELDS BUSINESS FROM HILLENBRAND INDUSTRIES INC

Notice of possible remedies under Rule 11 of the Competition Commission Rules of Procedure

Introduction

1. On 18 December 2003 the Office of Fair Trading (OFT) referred the proposed acquisition by Dräger Medical AG & Co KGaA (Dräger) of certain assets representing the Air-Shields business of Hill-Rom, Inc, a subsidiary of Hillenbrand Industries, Inc (Hillenbrand) to the Competition Commission (CC) for investigation and report. The reference was made under Section 33 of the Enterprise Act 2002 (the Act).
2. In its provisional findings on the reference notified to Dräger and Hillenbrand on 5 March 2004, the CC Inquiry Group (the Group) concluded provisionally that the acquisition of the Air-Shields business by Dräger, if carried into effect, would result in the creation of a relevant merger situation; and that the creation of that situation might be expected to result in a substantial lessening of competition (SLC) in the markets for closed care incubators, open care warmers, and transport incubators in the UK (the 'relevant products') and that as a result UK customers might face increases in price and reductions in choice of neonatal warming therapy products in each of these markets.
3. This notice sets out the actions which the Group considers might be taken by the CC for the purpose of remedying the SLC and any resulting adverse effects identified in the provisional findings and invites comments on possible remedies (see note (i)).

4. In the course of its inquiry, the Group identified a number of features of these markets which are relevant to its consideration of the appropriateness of possible remedies. These include:
 - (a) that there are elements of a bidding market which suggests that the competitive influence of small suppliers may be greater than is suggested by their market shares;
 - (b) that there is buyer power latent in the NHS which has not to date been fully exercised, but could become more significant in future as neonatal networks and purchasing consortia develop;
 - (c) that there is some history of successful market entry; and
 - (d) that new product development has been and can be expected to continue to be a stimulus to competition.

5. The Group believes that remedies which recognize these competitive features of the market and address the adverse effects of the merger in a way which takes account of them are most likely to be effective. The Group also notes that there are intrinsic economic factors (notably, the level of fixed costs in a relatively small market) which may limit the number of firms that will be able to operate profitably in these markets.

Possible remedies on which views are sought

6. Where it finds an SLC in relation to a proposed merger the CC needs to consider:
 - (a) whether it should take action to remedy, mitigate or prevent the SLC or any adverse effect resulting from the SLC;
 - (b) whether the CC should recommend that remedial action should be taken by others to remedy the adverse effects of the merger; and
 - (c) in either case, if action should be taken, what that action should be and what is to be remedied, mitigated or prevented.

7. The remedial action that the CC will decide should be taken will always depend on the facts and circumstances of the case. One option that the CC will usually consider is the prohibition of an anticipated merger. In this case the global nature of the merger and the fact that manufacturing of the relevant equipment takes place overseas makes it likely that prohibition would prove impractical. Other possible remedies are considered below.

Option 1: requiring distribution of relevant products through an independent distributor

8. This remedy would require the merged parties to sell all relevant products (that is, those currently sold by both Dräger and Air-Shields together with new products introduced into the closed care incubator market, the open warmer market and the transport incubator market) only through an independent distributor rather than through a vertically integrated sales operation, that is a wholly-owned UK branch or subsidiary. This might be achieved by divestment of the parts of the parties' UK business that are involved in distribution, including sales and technical personnel, or by licensing an existing distributor or by some combination of the two. This distributor would have exclusive rights to sell the products of the merged parties in the UK for a certain period, for instance five years. It would also be free to sell other manufacturers' products should it choose to do so; to the extent that it did so, competition in the market could be enhanced.
9. This remedy could help other manufacturers of the relevant products to enter the UK market through a credible independent distributor, as long as the distributor had the incentive to offer their products. Possible disadvantages include the loss of any advantages to trusts of dealing with a manufacturer's own branch or subsidiary and the difficulties in separating a small part of a business whose assets mainly comprise

staff. To limit the possibility that the merged firm will take advantage of the increased market power resulting from this merger to increase prices there might need to be a price control, either at wholesale level (between the merged parties and the distributor) or at retail level (between the distributor and NHS trusts).

Option 2: requiring distribution of relevant products through two distributors, at least one to be independent

10. This remedy would require the merged parties to sell the relevant products from the existing range of Air-Shields through an independent distributor rather than through its own distribution operation. This independent distributor would have exclusive rights to sell Air-Shields products for a certain period, for instance five years. It would also be free to sell other manufacturers' products should it choose to do so. Under this proposal, the relevant Dräger products would continue to be distributed by the merged parties' UK distributor.
11. This remedy preserves existing competition at the distribution level. As in the case of option 1, this remedy could in principle also help other manufacturers of the relevant products to enter the UK market through an independent distributor although the Group is not clear whether this arrangement would prove attractive to prospective owners of an independent distributor which could, for example, be put off by the existence of a vertically integrated competitor. To support this remedy there might need to be a price control at wholesale level (between the merged parties and the distributor) and/or at retail level (between the distributor and purchasers).
12. The Group also considered two other arrangements involving two firms distributing the products of the merged parties in the UK:

- (a) a requirement that the relevant Dräger products also be distributed only through an independent distributor, such that Air-Shields products would be distributed through one independent distributor and Dräger products through another; or
- (b) A requirement that all the relevant products be distributed through at least two independent distributors.

However, both of these further options appeared to raise serious practical difficulties such as maintaining incentives for the distributors to compete and placing reliance on the effectiveness of wholesale price controls.

- 13. The Group notes that the effectiveness of both options 1 and 2 depends on the ongoing viability of an independent distribution business, either as a free standing business or as a part of another entity, perhaps an existing distribution business. Moreover, for either to work a number of complex issues (for example, the terms governing the supply of products to the distributor) would need to be resolved between the merging parties and the independent distribution business.

Option 3: price control without change to distribution arrangements

- 14. A third option would be to allow the merged parties to retain a vertically integrated distribution operation but to implement a price control over the price charged to customers for the relevant products for a certain period. This remedy would protect trusts from unwarranted price increases in the short term although it would not directly support market entry.

Option 4: commitments on range and service

- 15. The Group is also considering whether there is a need for additional formal commitments from the parties whether as stand-alone remedies or in support of the remedies described above. These are:

- (a) a commitment by the merged parties to maintain the availability of the current ranges of relevant equipment for a minimum period; and
- (b) a commitment by the merged parties to maintain the availability and level of service and support for the relevant equipment for a minimum period.

Price control mechanisms for options 1 to 3

16. For options 1 to 3 the Group is considering the need for an appropriate restraint on prices in the short or medium term. The Group considers that for a price control to be effective it should be based on either actual prices charged in the UK in the recent past or prices charged in other countries. The price control should also accurately reflect the extent to which list prices and discounts from list prices vary with different specifications and different quantities purchased.
17. In relation to retail prices, the Group has been told that because of the limited number of individual orders and the wide range of different configurations of equipment (with free accessories being sometimes offered as an inducement to purchase) it may be difficult to use actual prices charged (or to determine meaningful averages of such prices) as a basis of a price control. However, two other mechanisms may meet the objectives set out above:
- (a) a requirement to apply the pre-merger 'list' prices of the merged parties less a minimum discount based on discounts applied in a recent period (though the Group notes the difficulties associated with the potential for selective price rises which it identified in the provisional findings); or
 - (b) a requirement to offer customers the right to buy the relevant equipment on the same terms as previous purchases of the same equipment with a comparable specification by the same customer within a given period. This 'reserve price' would be notified to all suppliers at the outset of any tendering process, and the

merged parties would be free to bid below it if they chose to do so. Under such a scheme, customers could be empowered to transfer their rights to purchase the equipment on their previous terms to other trusts. The Group notes, therefore, that this approach would only be likely to be effective where trusts liaise over their neonatal equipment purchases.

18. In relation to wholesale price controls three alternative mechanisms may be feasible:
 - (a) Actual 2003 transfer prices paid for equipment imported into the UK by the parties.
 - (b) Marginal cost of production plus a profit margin.
 - (c) The lowest list transfer prices from the merged parties to their international distributors.

19. For any of the above mechanisms there may be a need to appoint an independent body to review and verify necessary data and resolve disputes as to the application of the framework in individual cases. The Group notes that devising a satisfactory system of wholesale price controls must overcome the significant obstacles of the provision of an objective basis for the wholesale prices supported by accessible data, and of enforcement, which are further complicated by the overseas location of manufacturing and wholesale supply.

Recommendations to others

20. In considering various ways of addressing the SLC there are possible actions the CC could recommend that other bodies carry out. Because of the critical importance of this equipment to neonatal care the Group is anxious that any recommendations it makes will be as helpful as possible to users and consistent with the development of best practice in NHS procurement. Bodies to which recommendations might be

made include the NHS Purchasing and Supply Agency (PASA), individual NHS trusts and certain groups of NHS trusts that work cooperatively in the neonatal area. There are also professional associations such as the British Association of Perinatal Medicine, trade associations such as Association of British Health-Care Industries (ABHI), charities such as the premature baby charity BLISS, regulatory organizations such as the Medicines and Healthcare products Regulatory Agency (MHRA) and evaluation centres such as the Cedar medical device evaluation centre at the University Hospital of Wales. The Group wishes to determine through consultation which individual body or group of bodies would be in the best position to implement any recommendations it might make.

21. The first category of recommendations that the Group is considering concern steps that could be taken to help foreign manufacturers of the relevant products to enter the UK market. The Group recognizes that any such measures could not be expected to affect the competitive structure of the UK market unless the manufacturers concerned could establish effective and economic arrangements for the distribution of their products in the UK. This might be achieved through one or more of the following steps:
 - (a) a systematic investigation by a specialist body of the suitability of equipment manufactured by firms not currently active in the UK but with a potential interest in the UK market;
 - (b) a programme of meetings between clinicians, medical equipment distributors and foreign manufacturers;
 - (c) a mechanism by which equipment could be trialled in one or a few hospitals and lessons learnt from this shared with other purchasers; and

- (d) the publication of guidance to trusts as to sources of equipment together with an assessment of the clinical suitability of the equipment and contact details for trusts where the equipment is in use.
22. The second category of recommendations that the Group is considering concern steps that could be taken to increase the exercise of purchasing power by NHS trusts. These might include:
- (a) wider use of the practice of consolidating individual trusts' requirements into larger orders, possibly facilitated by a central service to identify others making purchases at a similar time;
 - (b) the collation and publication of data on recent purchases to show trusts the prices that have been paid for a range of products and including details of the specifications involved; and
 - (c) the establishment of framework agreements between the NHS and suppliers, from which trusts or groups of trusts could then negotiate specific prices, possibly allowing the aggregation of discounts across participating trusts.

Other remedies

23. The Group would welcome proposals for any alternative remedies involving action either by the CC or by others to address the expected SLC arising from this merger.

Criteria

24. In choosing appropriate remedial action, the Group will have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to remedy the SLC and any adverse effects resulting from it. When deciding what is an appropriate remedy, the Group will consider the practicality and effectiveness of different possible remedies and their associated costs and will have regard to the principle of

proportionality. Between two remedies which the Group considers equally effective, it will choose that which imposes the least cost or restriction.

25. In exceptional circumstances the CC may conclude that no action by it is appropriate, for example where the costs of any practicable remedy seem disproportionate in the light of the relevant market or where the only appropriate action would fall outside the UK's jurisdiction. However, even in these circumstances the CC, having decided that no action should be taken by it, may recommend action by others.

Relevant customer benefits

26. The Group may also have regard to the effects of any remedial action on any relevant customer benefits arising from the merger situation and welcomes views on the nature and likelihood of such benefits. These might comprise lower prices, higher quality or greater choice of goods or services or greater innovation in relation to such goods and services.

Next steps

27. The main parties are requested to provide any views in writing, including any alternative remedies they wish the Group to consider, by Wednesday 24 March (see note (ii)).
28. A copy of this notice will be posted on the CC's web site. Other interested parties are requested to provide any views in writing, including any alternative remedies they wish the Group to consider, by Wednesday 24 March (see note (ii)).

Sir Derek Morris
Group Chairman
10 March 2004

Notes

- (i) This Notice of possible actions to remedy the SLC and any resulting adverse effects is given having regard to the Group's provisional findings notified to the main parties on 5 March 2004. The main parties have until 26 March 2004 to respond to those provisional findings. In the light of any responses by the main parties, or by other interested or affected third parties, the Group's findings may alter, in which case the Group may consider other possible remedies, if appropriate.
- (ii) As noted in the Dräger/Air-Shields inquiry Administrative Timetable published on the CC's web site, the final deadline for all parties' submissions and responses is 23 April 2004.