
Completed acquisition by Southern Syringe Services Limited of Hospital Management and Supplies Limited

The OFT's decision on reference under section 22 given on 24 January 2005

Square brackets denotes text removed for reasons of commercial confidentiality

PARTIES

1. **Southern Syringe Services Limited (SSS)** operates as a distributor for medical and surgical products, supplying both hospital and non-hospital customers (examples of non-hospital customers being nursing homes and police stations). **Hospital Management and Supplies Limited (HMS)** is also a distributor of medical and surgical products, concentrating more specifically on supplies to hospitals. HMS was a wholly owned subsidiary of Unichem Limited (Unichem). HMS' United Kingdom (UK) turnover for the year ended 31 December 2003 was £61,784,000.

TRANSACTION

2. []. SSS acquired all of the issued share capital of HMS on 12 August 2004 for []. In accordance with section 25(2) of the Enterprise Act 2002, the statutory deadline for consideration of this case has been extended to 24 January 2005. The OFT's administrative deadline for considering this case also expires on this date.

JURISDICTION

3. As a result of this transaction SSS and HMS have ceased to be distinct. The share of supply test in section 23 (2)(b) of the Enterprise Act 2002 (the Act) is met in respect of the supply of independent distribution services for medical and surgical supplies to non-NHS hospital customers in England and Wales (estimated combined share of supply 92 per cent). The OFT therefore believes that it is the case that a relevant merger

situation has been created.

RELEVANT MARKET

4. The parties overlap in the supply of logistics services to manufacturers of medical and surgical products supplying hospital and non-hospital customers in the Great Britain¹.

Product scope

5. In supplying medical and surgical products to their customers, manufacturers have two basic routes to market:
 - a) selling directly to customers - and either supplying direct; contracting with a logistics supplier to carry out deliveries (logistics); or the customer arranging delivery itself (contract distribution);
 - b) selling through wholesalers, who take ownership of the goods, and who, in turn, sell and deliver the product to the customer.

SSS and HMS both operate as: logistics suppliers for manufacturers; contract distributors; and as wholesalers in this sector.

6. On the supply side, manufacturers that do not have their own distribution capability within GB (perhaps because they are based abroad) may offer contracts for warehousing and logistics supply to either standard logistics companies (such as Exel) or to distributors like SSS and HMS. Alternatively, customers can negotiate the supply of a product – and agree on its price – directly with a manufacturer, and arrange ‘contract distribution’ to get the products delivered to them (such deliveries being undertaken by companies such as SSS or HMS as opposed to standard logistics companies).
7. On the demand side, obtaining logistics supply through a contract distributor (such as SSS or HMS) as opposed to a standard logistics company, may have advantages for customers in that distributors are likely to have more sector-specific knowledge and, unlike standard logistics companies, take title to their stock. Additionally, distributors may already be delivering medical and surgical products to the hospital and so a further

¹ Although both parties supply Northern Ireland, the level of HMS sales to the area is minimal (at £8,000 for the six months to 30 June 2004 compared to SSS sales of £2.3m in the same period) and this area of overlap is not considered further in this assessment.

delivery drop may not be required. There may potentially be benefits for customers that have storage difficulties, as distributors are prepared to hold and break down the stock as required into smaller units than those that are provided by the manufacturers. However, manufacturers said that their pack sizes are based on standard hospital requirements, and SSS said that they only break down the pack sizes by ward in very limited circumstances.

8. In some instances distributors will approach customers for delivery contracts, and then attempt to negotiate a discount on the end price from the manufacturers (to represent the costs of delivery). The percentage discount is generally [] per cent, although some manufacturers do not offer any discount at all, in which case distributors may make a distribution charge to customers, or bear the delivery costs on those products themselves.
9. SSS and HMS also supply medical and surgical products as wholesalers, where they purchase stock and set the price paid by the end customer. Customers may be able to achieve cost efficiencies by buying a range of products made by different manufacturers from one wholesaler. Additionally, some customers may take the view that they are not able to obtain products direct from certain manufacturers if the volumes they require fall below the minimum order limits imposed by that manufacturer, although the majority of the manufacturers that we spoke to did not impose minimum order limits.
10. For customers, there appears to be very little difference between wholesale supply and contract distribution. Either way, customers benefit from consolidated deliveries, although, in buying from wholesalers, customers can do all of their ordering from one source instead of negotiating with a number of manufacturers. The parties have told us that this is unlikely to be arduous for customers, since they receive regular visits from manufacturers' sales representatives.
11. Direct delivery by manufacturers may involve larger orders, and requires a greater number of individual deliveries to customers by each separate manufacturer, although, in so far as customers can increase their stockholdings and therefore order sizes, it is likely that direct distribution by manufacturers will pose a constraint on contract and wholesale distribution, particularly given that the products in question are non-perishable. The OFT has received no evidence to indicate that increased storage space would be prohibitively expensive for customers.

12. The majority of customers that the OFT contacted said that, if the price of wholesale distribution through SSS and HMS were to increase, they would consider switching to supply direct from manufacturers, but that this would need to be weighed up against the economies of scale created by single deliveries and the need for greater storage space. Customers have not given consistent feedback on the demand substitutability of contract distribution and wholesale supply; some have told us that in the main, they use contract distribution and see it as a substitute to wholesale supply, while other customers do not seem to be aware that it is possible to negotiate prices with manufacturers and still receive their deliveries through SSS and HMS. However, data provided by the parties suggest that about 50 per cent of their turnover is obtained when prices are negotiated by customers direct with manufacturers (i.e. either through contract distribution, or, less so, logistics provision), which indicates that there are customers who rely on contract distribution as a substitute for wholesale supply.
13. The OFT has considered whether, for certain products, customers may not be able to go direct to manufacturers for direct supply or contract distribution, due to certain manufacturers not being prepared to negotiate prices with smaller customers or having minimum delivery limits. It is difficult to assess the extent to which such restrictions are put in place by manufacturers, although the majority of the manufactures that we spoke to said that they were willing to agree prices with smaller customers, for delivery direct (either themselves or through, for example, business post) or through contract distribution. Moreover, the fact that many manufacturers are willing to do so indicates that other manufacturers would be able to switch to such a business model in the event of customer demand to do so. Direct delivery and contract distribution may incur an additional delivery charge but the figures provided to the OFT do not suggest this would be out of line with the wholesaler margin.
14. Given the above factors, the OFT does not believe that there is a set of products where the parties could, post merger, increase prices as wholesalers without some degree of switching taking place, either to direct delivery by manufacturers or to direct price negotiation by customers and delivery through contract distribution.

Customer segmentation

15. In terms of considering the effects on competition of this merger, note must be made of the different customer groups in this sector. These can be considered to fall into three groups:

- NHS;
- Private hospital customers; and
- Non-hospital customers.

NHS

16. The majority of NHS medical and surgical supplies not purchased direct from manufacturers are obtained through NHS Logistics, which works like a wholesaler for the NHS sector in England and Wales. NHS Logistics does not stock the full range of products that an NHS Trust may need. Items not stocked by NHS Logistics are procured by NHS Trusts: by supply direct from manufacturers; or by using distributors like SSS or HMS - either through 'contract distribution' or through wholesale supply. In the event of price inflation or service reduction by SSS/HMS, NHS Logistics has said that it had no doubt that NHS Trusts would turn to NHS Logistics in order to source the product more cheaply. In Scotland, Scottish Healthcare Supplies (SHS) negotiates prices of products supplied to NHS Scotland (as the NHS Purchasing and Supply Agency does in England and Wales), but procurement of products is not (as yet) centralised – there is no equivalent to NHS Logistics.

Private hospitals and Non-hospital customers

17. Supply by NHS Logistics is currently not a viable option for private hospitals or non-hospital customers because NHS Logistics is limited by its framework agreement to obtain a maximum of 5 per cent of its revenues from non-NHS organisations². While in principle, NHS Logistics might be able to compete effectively up to its maximum turnover threshold, in practice, all of the third parties the OFT has contacted have suggested that NHS Logistics does not provide a competitive constraint on the wholesale distributors in the non-NHS sector (at present less than [] of its revenues come from outside the NHS).
18. In addition, the ability of non-NHS hospital customers to procure products direct from a manufacturer may be affected by the smaller volumes purchased (third party evidence suggests that BUPA as a whole is about the size of an NHS Trust), although our enquiries suggested that most manufacturers do not have minimum order limits.

² In 2003, NHS Logistics' revenues were at £678 million; on this basis, NHS Logistics' turnover from non-NHS customers would be limited to £33.9 million (compared to HMS with a turnover of over £60million).

19. In addition to non-NHS hospital customers the parties also overlap in the supply of medical and surgical products to non-hospital customers (such as nursing homes and police stations). Non-hospital customers have a more limited need in terms of the range of products and are therefore less reliant on full-range wholesalers such as SSS and HMS than their hospital counterparts.

Geographic market

20. Manufacturers procuring logistics services would most likely require national coverage. In the supply of products to NHS hospitals, there may be geographic frames of reference for England and Wales and separately for Scotland. NHS Logistics only operates in England and Wales. The supply to NHS Scotland through SHS could therefore be considered a separate customer segment.
21. For the non-NHS hospital segment, the customers that operate nationally and have centralised procurement require suppliers with national coverage. This is, in the main, the larger private hospital groups, such as BUPA or Nuffield Healthcare which are likely to have similar demands to the NHS sector. While customers that themselves operate in a particular region require only regional supply this is not considered by the OFT to be sufficient, in itself, to contend that the market is necessarily regional.

Frame of reference

22. On the basis of the above, the appropriate frame of reference for considering this merger is therefore considered to be the supply of logistics services to manufacturers of medical and surgical products and the supply of such products to NHS and private hospitals respectively, and non-hospital customers, in Great Britain, with specific note being taken of the split between the provision of logistics services and the provision of contract and wholesale distribution, and the Scottish NHS distinction outlined above.

HORIZONTAL ISSUES

Shares of supply

23. The parties overlap in the supply of logistics services and in the supply of medical and surgical products to the NHS, in England and Wales and in

Scotland, and to non-NHS customers. As noted above, in addition to NHS Logistics, such supply takes place by a range of other means.

Supply of logistics services to manufacturers for the hospital sector

24. The parties have not been able to provide details of shares of supply based on pure logistics provision alone. However, the OFT's analysis of the parties' figures for logistics provision and contract distribution taken together give the combined share of supply for SSS and HMS at 4 per cent overall with a combined share at its highest level in the private hospitals sector in England and Wales estimated by the OFT at 16 per cent, with the majority of logistics work being carried out either by the manufacturers themselves (or by business post), or using standard logistics firms such as Exel. While precise figures are not available, this analysis is consistent with the lack of third party concern about the loss of competition at this level.

Contract and wholesale distribution

NHS Sector, England and Wales

25. The majority of NHS Trusts' medical and surgical needs are procured directly from the manufacturers. For those products that the hospitals do not procure directly from manufacturers, the first port of call for NHS Trusts is NHS Logistics, accounting for some 75 per cent of non-manufacturer distribution to NHS Trusts. SSS and HMS have a much smaller share of supply in this segment, together accounting for around 23 per cent of non-manufacturer distribution, with Squadron Medical (Squadron) and Williams Medical Supplies (WMS) accounting for the remainder.

NHS Sector, Scotland

26. The NHS sector in Scotland differs from that in England and Wales in that NHS Logistics does not operate in Scotland. As with England and Wales, the majority of products are procured direct from manufacturers. For those products not distributed by manufacturers (around 20 per cent of total spend (or £29m)), the parties' combined share of distribution would be 88 per cent but the OFT considers this distinction is too narrow and disregards alternative methods of distribution. The Scottish Executive has recently approved an Outline Business Case for a new logistics strategy, which includes a National Distribution Centre (NDC) for Scotland. The target date for NDC being operational is late 2006 (or sooner) and it is

expected that all the Health Boards will use the service by 2008 with this centralised procurement acting as a further constraint in the same way that NHS Logistics does in England and Wales. The effect of this proposal also limits any incentive the parties may have to increase prices in the interim period, due to their desire to preserve business once the NDC starts.

Non-NHS hospital sector

27. In the non-NHS hospital sector, Squadron and WMS are also present. WMS specialises in the non-hospital, primary care sector, and, according to the parties, it has only recently started supplying hospitals.

28. Table 1 below shows the parties' estimates of shares of supply to private hospital customers in Great Britain. As can be seen, the parties' combined share of overall distribution of medical and surgical products is quite limited at about 22 per cent. For independent or non-manufacturer distribution sector (consisting of either contract or wholesale distribution) the parties would have an estimated combined share of supply of over 90 per cent. However, as with the situation in Scotland, such a narrow segmentation is not considered appropriate. Most of the supply is met by direct deliveries from manufacturers and the OFT considers that there is no reason why this could not be expanded if the parties sought to increase wholesale prices. The evidence provided to the OFT does not suggest that there is a particular set of products that private hospital customers rely on obtaining through wholesale supply or contract distribution.

29. Some private hospital customers did raise concerns about the loss of choice (at wholesale level) arising from the merger. While a number of the private hospital groups already provide their own internal distribution from a central warehouse (or regional distribution centre) they still rely upon the parties for certain items. This concern was not universal, however, and other customers contended that direct supply or contract distribution was a realistic alternative for them.

Table 1: Shares of supply, distribution to non-NHS hospital customers in Great Britain

	HMS	SSS	NHS Logistics	Other distributors	Manufacturers	Total	SSS/HMS share of overall distribution
Private hospitals	7.9%	13.9%	0%	2%	76.2%	100%	15.1%

Source: the parties

30. In the non-hospital sector, the parties combined share of supply is low (at 13 per cent if manufacturer supply is excluded). As mentioned above, this customer group tends to have more limited needs which can be met from a wide range of general wholesalers.

Barriers to entry and expansion

31. The parties estimate that for a firm to enter and replicate a nationwide business of the size of HMS (turnover £60million+) would cost £8-9 million, with a further £1 million requirement for capital investment. Entry at a local or regional level (to meet any local customer demand) would, however, cost substantially less. The main barrier to entry identified by the parties – for both logistics provision and distribution – was low returns [].
32. In the supply of **logistics** to manufacturers, the experience of many manufacturers suggests that it is also relatively easy for a manufacturer to supply direct. Direct delivery seems to be a viable and a widely used business model in the industry. Of the five manufacturers that the OFT initially interviewed, four were already engaged in direct sales to customers, and three of those supplied 70 per cent of their products directly to their consumers (using either business mail or haulage companies). [].
33. As regards contract **distribution** and **wholesale supply**, barriers to entry may result from reputation effects and there may also be barriers to expansion possibly from economies of scale in stock purchasing, although the parties thought that, outside of the NHS, these would be limited and the fact that manufacturers have not expressed concerns about buyer power from SSS or HMS also suggests that economies in stock purchasing are not high.
34. One further possible form of entry, for private hospital customers, would be to emulate the NHS Logistics model. This has already been undertaken by some larger private hospital groups, although some private hospitals still believed that there were products for which its centralised procurement still did not involve sufficient volumes to request direct delivery from the manufacturers. For smaller organisations, the benefits of such centralisation may well be outweighed by its costs. However, in capturing economies of scale in purchasing, those central distribution centres of private hospitals may themselves consider moving into providing distribution for entities outside of their hospital group.

35. On the whole, therefore, barriers to entry and expansion seem to be relatively low, and entry could take place from a number of different sources. The parties have also pointed to recent entry in the industry, for example by Kingspeed which has entered as a wholesale distributor on a local basis in the Greater London area.

Buyer power

Logistics provision

36. The OFT considers that manufacturers have buyer power over logistics providers by virtue of the fact that they have the option of self-supply, and a large pool of potential competitors, in the form of logistics companies.

Contract distribution/wholesale

37. Third party comment suggests that buyer power in this sector is related to volumes ordered. In this respect, third parties have said that private hospitals and non-hospital customers have significantly less buyer power than the NHS, for example. However, third parties have also told us that a number of private hospital groups have centralised their purchasing (akin to the NHS Logistics model) thereby increasing their buyer power. Data from the parties shows that 75 per cent of private hospitals in the UK (excluding private patient units within NHS Trusts) are accounted for by five private hospital groups, which either have, or could adopt, centralised procurement policies.
38. Customers may also have purchasing power in relation to SSS and HMS in that for many products they can switch away from wholesale distribution by SSS and HMS, in favour of direct distribution by manufacturers. Similarly, they can choose to continue to be supplied by SSS and HMS but negotiate prices with the manufacturers instead in the form of contract distribution.
39. As a result of the above, the OFT considers that there is some degree of buyer power in this sector.

Potential competition effects

Exclusive provision

40. There are a small number of product areas where both HMS and SSS have exclusive dealing relationships with competing manufacturers (for example in respect of certain brands of surgical gloves). These tend to be manufacturers with no UK supply chain so the parties are, in effect, providing a storage and logistics service. The merger may therefore limit the ability of customers to switch supply to other manufacturer's products in the event of price increases or reduced levels of service on certain exclusively distributed products. This might be a concern if there was no direct access to these manufacturers and/or they were the only suppliers of such products.
41. The parties pointed out that none of these agreements are 'solus' and thus manufacturers can, and do, continue to negotiate prices direct with the customer with SSS and HMS acting solely as contract distributors or logistics supplier. Moreover, customers would have alternative manufacturers to turn to. So, even in those cases where prices are set by SSS or HMS as a wholesaler, manufacturers retained (and would wish to retain) the option of switching logistics provider or developing their own supply capabilities in the event of increased prices (or reduced levels of service) on the part of SSS or HMS since this would affect the sales of their products. Given these factors, the OFT does not expect competition concerns to arise in respect of exclusively distributed products.

Distribution

42. As regards distribution to NHS hospitals in England and Wales, and NHS Scotland the OFT does not consider that post-merger, SSS will be able to unilaterally raise prices or reduce service levels. In the NHS sector in England and Wales, NHS Logistics is the largest distributor and provides a strong competitive constraint to other distributors; the impending introduction of a similar model for NHS Scotland should also provide a further competitive constraint in Scotland.
43. In the private hospital sector, SSS and HMS are by far the two biggest distributors of medical and surgical products, and account for practically all non-manufacturer distribution. This is the customer segment where customer concerns have also tended to concentrate.

44. The OFT has therefore considered whether it is plausible that, post merger, SSS could raise prices above competitive levels and/or reduce service levels in the private hospitals sector. However, in terms of price increases, significant constraints exist on SSS and HMS. Many customers have told the OFT that they are in a position to switch from 'wholesale' supply by SSS and HMS to 'contract distribution' where manufacturers agree prices of goods with customers that are then delivered by SSS and HMS. (About 50 per cent of SSS's and HMS's distribution already functions on this basis.) While SSS may, post-merger, have the ability to increase the price of contract distribution through imposition of additional delivery charges, it is the case that, as noted above, direct supply by manufacturers is also an option in many circumstances and such alternatives would severely restrict the parties' ability to increase prices post-merger. As noted above barriers to entry and expansion are considered to be relatively low in contract distribution and wholesale supply, acting as an additional post-merger constraint on the parties.
45. In the private hospital sector the majority of products are already delivered direct by manufacturers. Private hospital responses also indicate that direct distribution is considered as an alternative to contract distribution or wholesale supply for any given product, even though administrative costs may make a total shift to direct manufacturer distribution unfeasible. The OFT does not believe that the delivery charges levied by manufacturers are out of line with current SSS / HMS margins. Moreover, we have no evidence that there is a particular set of products for which private hospitals are dependent on wholesale supply. The OFT does not therefore consider that the parties will be able to discriminate against particular customers or along particular product lines.
46. SSS and HMS have a low combined share for the supply of medical and surgical equipment to non-hospital customers. Such customers also have a wider range of potential suppliers since they do not require the full-range offered by the parties.
47. The OFT has also considered whether SSS will be able to reduce the service levels more generally as the merger removes its closest competitor, and service levels (in terms of numbers of deliveries) are currently likely to be higher through SSS and HMS than through the manufacturers. The OFT considers that the ease of entry and expansion in the sector mitigates this risk. In addition, the key element of service for these products is frequency of delivery, and the service level required by customers is dependent on their ability to hold stock. Customers could therefore make

direct manufacturer delivery a more viable option for a greater number of products by increasing their storage capabilities.

VERTICAL ISSUES

48. No vertical competition issues arise as a result of this merger.

THIRD PARTY VIEWS

49. While many third parties who the OFT contacted were unconcerned, a number did raise competition concerns with regard to the merger. Some manufacturers were concerned that the merger reduced the choice of distributor available to their customers, however, the majority of manufacturers did not have concerns about the merger, and some thought that the transaction may actually be beneficial by creating a sizeable company to counteract the buyer power of NHS Logistics.

50. A number of private hospitals objected to the merger but others were unconcerned. Some respondents felt that the merger removes the only viable competitor to SSS. Concerns were expressed both in terms of the potential for price increases, and about the service quality levels of SSS relative to HMS. Concerns were also expressed by some non-hospital customers, although many of them felt that they would be able to source their supplies from other distributors or from manufacturers.

ASSESSMENT

51. The parties overlap in the supply of logistics services to manufacturers of medical and surgical products for supply of such products to hospital and non-hospital customers in Great Britain.

52. As regards specific logistics provision to manufacturers supplying the hospital sector, the parties' combined share of supply is low with the majority of logistics work being carried out either by the manufacturers themselves or by standard logistics companies.

53. In contract distribution and wholesale distribution, the merger removes SSS' closest competitor in the independent distribution of medical and surgical products. However, the majority of NHS purchases of medical and surgical products (in England and Wales and in Scotland) are made direct from manufacturers who act as a strong constraint against the merged entity. Additionally in England and Wales, NHS Logistics offers a further constraint to the parties with a similar service about to be implemented in

Scotland. Given these factors, the OFT does not consider that competition concerns will arise in respect of the supply of medical and surgical products to NHS hospitals.

54. In the private hospital sector, which is the area of most concern, it is estimated that the parties currently account for most of the supply by independent distributors. However, this position – which includes both contract and wholesale distribution - has to be considered in the context of the fact that around 76 per cent of medical and surgical products are being supplied to the sector by manufacturers direct. The ability of customers to switch to direct supply by manufactures on any set of products limits the ability of SSS and HMS to increase prices or reduce service levels at the wholesale level. Moreover, entry and expansion barriers are not considered to be high and private hospital groups may be able to increase their buyer power by more effective use of centralised procurement and a number have already done so.
55. Non hospital customers have a wider range of choices of supply and the parties combined share of supply and increment is so low that the merger cannot be expected to substantially lessen competition.
56. Consequently, the OFT does not believe that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

DECISION

57. This merger will therefore **not be referred** to the Competition Commission under section 22(1) of the Act.