

Anticipated acquisition by iSOFT Group plc of Torex plc

The OFT's Decision on reference under section 33 of the Enterprise Act 2002 given on 6 November 2003

PARTIES

iSOFT Group plc (iSOFT), a company founded within KPMG in 1994 as a specialist in innovative healthcare technology and bought out by its management team in 1998, provides software and systems to the healthcare applications market. From 1999 to 2002 iSOFT has acquired a number of businesses in the healthcare applications sector. In the year ended 30 April 2003, iSOFT's worldwide turnover was £91.5 million. **Torex plc** (Torex) provides health care technology software and systems for healthcare providers to GPs, laboratories, hospitals and community care. It also provides the hardware, installation and support that customers require, and supplies computer systems and services to the retail sector. Torex entered the primary (GP) healthcare market in 1997 and has since acquired a number of further companies in this sector. It entered the secondary (hospital) healthcare market in 2000, going on to acquire a number of further companies in this sector. In March 2003, when Torex acquired the secondary healthcare business of InHealth Group SA, it also acquired the exclusive right to sell certain IBA Health Ltd (IBA) software products in the UK. (IBA is an Australian company active in IT solutions to the healthcare industry and in the UK its products are sold to a number of NHS trusts.) In the year ended 30 December 2002, Torex achieved worldwide turnover of £161.8 million with UK sales of £107m.

TRANSACTION

iSOFT proposes to acquire Torex and has offered Torex's shareholders new iSOFT shares representing approximately 44 per cent of the issued share capital of the enlarged company. This places an estimated value of £337.5 million on Torex.

This transaction was notified to the Office of Fair Trading (OFT) on 1 August 2003 and the 40 day administrative target expired on 29 September 2003.

JURISDICTION

The OFT believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation pursuant to sections 33(1)(a) and 23 of the Enterprise Act 2002 (the

Act). As a result of this transaction iSOFT and Torex will cease to be distinct for the purposes of section 26 of the Act. The merger situation meets both the turnover test and share of supply test in section 23 of the Act. The parties overlap in the supply of software systems to the secondary healthcare sector and the share of supply test is met in respect of the supply of Electronic Patient Records and the supply of Laboratory Information Management Systems to National Health Service (NHS) hospitals in the UK.

BACKGROUND

Proposed changes to the procurement of IT Systems in England

Until now, hospitals and/or their Strategic Health Authorities have purchased IT systems on an individual basis as and when required with the effect that the NHS has many different installed legacy IT systems, creating interface and interoperability issues.

Following a detailed review of its IT needs, the Department of Health proposed a new IT regime (see note 1) to update IT systems in England. The National Programme for IT (NPfIT) will allow for cross-referencing of patients' records by creating a complete electronic medical record for each patient across all NHS providers in England. National projects will create a "national spine" of archived records and introduce an electronic (e-booking) system for appointments.

Five regions have been created in England, with a single Local Service Provider (LSP) to be appointed as project manager to oversee the implementation of the NPfIT in each region. Following a competitive tender, the DoH will shortly announce the appointment of the five LSPs and their preferred suppliers, who will be responsible for developing and managing the process of transition from legacy systems to the new systems. The appointment of LSPs will result in a fundamental change to the procurement process, significantly reducing the number of contracts available in England (but increasing their size) with the effect of increasing the buyer power of the LSPs (and thus the NHS).

RELEVANT MARKET

Product market

The parties overlap in the supply of IT software systems for use in hospitals. The IT requirements of each hospital will vary significantly but the parties are key suppliers to the secondary healthcare sector of Electronic Patient Records (EPRs) and Laboratory Information Management Systems (LIMS).

The sophistication of EPRs varies considerably, with the simplest systems recording demographic details of each patient on a Patient Administration System (PAS) and the more sophisticated systems incorporating clinical procedures and high-tech processes. LIMS are designed to prompt clinical processes in the face of specific diagnoses and ensure best practice by clinicians in the laboratory. EPRs can be developed on the back of the PAS, becoming more sophisticated by incorporating departmental modules (such as LIMS) as required, or they can be developed as integrated systems in which modules are "bundled" into the whole but can be replaced by alternative systems if these are thought to suit the hospital's needs better.

Interoperability is a key requirement of the NPfIT – the NHS has stated that it wants IT systems to be user-friendly with common databases and the same “look and feel” so that users do not need to be retrained when they move to different hospitals and/or departments. The functionality of each programme is specific to a particular department and this means that there is no demand side substitutability between different programmes.

The parties have argued that IT software is characterised by a high degree of supply side substitutability: while the parties acknowledge that different programming codes may be used in different applications, they consider that the same equipment, skills and know-how are used to develop and supply a wide range of IT products and services and that, where particular knowledge is required, it can be acquired by secondment or sub-contracting. This argument is undermined by the fact that companies are highly specialised in a particular facet of programming and, historically, acquisition appears to have been a favoured method of acquiring access to specialist modules.

Geographic market

IT software for the healthcare sector can be developed anywhere in the world – iSOFT employs programmers in India for example. UK public sector contracts in excess of £100,000 must be advertised in the Official Journal of the European Communities (OJEC) and this will attract bids from worldwide competitors, who will adapt their products to meet local specifications and requirements. While healthcare IT requirements vary nationally (and indeed regionally within the UK), such variations appear to be minor and the key requirement in implementing a new system appears to be a local presence. (Overseas bidders for LSP partnerships have recognised this and engaged in a process of recruitment in the UK.)

The Office takes the view that the appropriate frame of reference in this case appears to be the supply of software systems to the relevant hospital users within the UK.

COMPETITION ASSESSMENT

The main suppliers of secondary healthcare software currently installed in UK hospitals are iSOFT, Torex/IBA, McKesson and Siemens. The parties' share of installed (“legacy”) systems is significant, with the parties supplying 44 per cent of EPRs and 56 per cent of LIMS to the UK public sector. They are key suppliers in each country of the UK, particularly in the supply of LIMS (where in Scotland and Wales, their legacy systems will account for 100 per cent of the installed base). The pace of innovation in healthcare IT systems and changes to the procurement process suggest, however, that the installed base is not the best guide as to whether the parties will have market power in the future.

Since most public sector contracts are awarded following a competitive tender, a better measure of potential market power may be the parties' success in winning competitive bids in the past few years. While the existence of an installed base may give incumbent bidders reputational or informational advantages in bidding for new contracts, if the system required is substantially different from existing systems these advantages are unlikely to be significant. The presence of other bidders should act as a competitive

constraint on the parties as they bid for new contracts, requiring them to put forward innovative solutions at competitive prices.

The effect of the NPfIT

The NPfIT has attracted bids from two major US players, Cerner and IDX, who have adapted their US EPRs for use in the UK and who have been selected as preferred sub-contractors (by 3 and 2 respectively) of the 10 short-listed LSPs. The effect of this selection process, which has already taken place, will be to displace other suppliers of EPR systems who currently hold a share of the installed base, from the future NPfIT. Within England, it is uncertain whether NHS Trusts will have the funds or autonomy to be able to purchase IT software and systems independently of the NPfIT. Any such purchases are likely to be of limited value and may have to be funded directly by the NHS Trust so that there is unlikely to be sufficient incentive to behave autonomously outside of the NPfIT.

iSOFT's EPR system has been selected by 5 of the 10 short-listed LSPs, unlike Torex's which has not been selected by any of the LSPs. iSOFT considers that this is due to its superior product, reflecting its investment in product development to meet the needs of the NPfIT. The parties consider that Torex is no longer a viable competitor in the supply of PAS/EPR systems as it has neither developed nor innovated its existing software and, as a result, has not won any new contracts in the past three years nor been selected as a preferred supplier/sub-contractor for any of the LSPs for the supply of EPR systems. A review of information available on OJEC decisions for the past three years shows that Torex has, in fact, been short-listed on a number of occasions and was selected as the preferred supplier on three occasions but these projects were cancelled because they were incompatible with the NPfIT.

The parties consider that Torex's strength lies in its implementation and services capabilities while iSOFT's lie in product development, and the rationale for the merger is to bring together the parties' complementary strengths. As noted above, EPRs can be built up module by module or can be developed as an integrated system. The two US companies, Cerner and IDX, offer an integrated system so that any LSP that has chosen these companies as its preferred sub-contractor, may be less inclined to invite tenders for LIMS or other departmental systems. iSOFT has built up its system on a modular basis so that its LSP partners may invite bids for LIMS projects. The parties argue, once again, that Torex's LIMS module is unlikely to be selected because it has not been developed to meet the requirements of the NPfIT. They point to OJEC tender data for the past few years which reveal that Torex has not been successful in winning recent LIMS contracts.

Barriers to entry and expansion

The increasing sophistication of healthcare IT systems and the need to meet the particular requirements of the NHS would suggest that barriers to entry are likely to be high because of the cost of developing systems and bidding for contracts. However, the policy focus on NHS IT modernisation in England means that HM Treasury has made available significant funding to spend on updating IT systems and this has attracted bids from major US suppliers keen to win contracts with the LSPs. Smaller

companies also have opportunities to enter as suppliers (either of systems or technical support) to the nominated sub-contractors.

The presence of international EPR suppliers in England is likely to have a knock-on effect on competition elsewhere in the UK. Annual IT expenditure in England is worth £850 million a year (with a further £2.3 billion allocated under the NPfIT in the next three years). In each of Northern Ireland and Wales, annual expenditure is worth some £25 million while in Scotland it is worth some £125 million. Smaller scale contracts elsewhere in the UK may allow more opportunity for smaller suppliers to enter the market with innovative solutions.

Buyer power

Under the NPfIT, five LSPs (rather than 177 NHS Trusts) will purchase IT requirements in England and this is likely to increase their buyer power, so long as there are alternative competing suppliers of EPRs and LIMS. EPR suppliers will have competed actively against each other to win preferred supplier status with the LSPs and this will have given the LSPs buyer power in deciding who to appoint.

The LSP contracts will be in place until 2010. The DoH, in appointing LSPs, has given them incentives to reduce costs and control risks while EPR and LIMS suppliers who do not meet their contractual obligations to the LSPs can be replaced. The effect of the NPfIT may be that some suppliers will exit the market – there is already evidence that this is occurring as companies lay off staff. However, this is not an unnatural consequence of competition for the market, and it seems likely that as contracts come up for renewal, this may provide entry opportunities for other providers of sufficient scale.

Elsewhere in the UK, contracts are largely awarded on a national basis, which raises the prospect that awarding bodies are likely to possess and exercise buyer power. Again, this requires that there are alternative suppliers of EPRs and LIMS.

Vertical issues

There appear to be no vertical concerns raised by this merger. One issue (mentioned in more detail in the third party views below) over the distribution of competitor products is best addressed as part of the overall competition assessment.

THIRD PARTY VIEWS

A number of third parties were very concerned. They considered the merger would substantially lessen competition because the parties' incumbency (providing knowledge of existing systems) and increased portfolio would make it very difficult for competitors to compete with the merged firm and limit the choices available to purchasers. LIMS suppliers were particularly concerned that the EPR suppliers would be able to specify (or bundle) their departmental module in preference to independent suppliers.

One concerned competitor was IBA, who as noted at paragraph 1 above are also active in IT solutions to the healthcare industry. IBA believes that the proposed merger would be anti-competitive due to the combined group's high market share in the sector. IBA

also allege that the close links between IBA and Torex resulting from the InHealth acquisition means that IBA would be unable to act as an effective constraint on the merged group and that the merged group would concentrate on sales of their own products to the detriment of IBA's.

Several hospitals responded to the Office's Invitation to Comment, expressing their concern that the merger would lead the parties to abandon some of their systems and this would increase hospitals' costs in migrating to new systems or decrease the usefulness of the system (if it was not well supported). This was a particular concern for hospitals which had recently purchased systems from IBA and Torex. This appears to be a contractual issue between hospitals and the parties rather than a competition concern. Several hospitals commented that the merger was consistent with the aims of the NPfIT and would be of benefit in terms of system development.

The relevant national health authorities outside England were generally unconcerned. While acknowledging that the parties would 'own' a significant proportion of the legacy contracts, they considered that there was sufficient competition (see note 2). This view was not necessarily shared by the Northern Ireland authority who felt that the merger could potentially lead to a loss of competition for contracts.

ASSESSMENT

In terms of their legacy contracts to the UK public sector, iSOFT and Torex are clearly the two leading suppliers of IT software to the healthcare sector in the UK. In a bidding market, competition is *for* the market rather than *in* the market so that the competitive advantage acquired from the legacy base is unlikely to be strong, especially where a new procurement strategy is being introduced.

The NPfIT has created five LSP regions, and bidders for the five regions have pre-selected their preferred sub-contractors. Torex's products have not been selected (although in line with its claim that its strengths lie in this area it has been selected as a service provider providing support and installation services) (see note 3). Absent the merger, this means that Torex is likely to face significantly reduced opportunities to sell its products (or those of IBA) to hospital users in England. Expenditure elsewhere in the UK is significantly lower and may not justify the costs involved in updating Torex's existing portfolio of products.

The NPfIT is a high profile strategy, supported by government, which gives effect to a commitment to increase spending on updating IT healthcare systems in England. The increase in funding has attracted international LSP bids from well known and established global companies and has allowed for partnerships between the LSPs and US IT healthcare providers, Cerner and IDX, as well as iSOFT. The presence of these international competitors makes it likely that competition for future contracts will remain active. There is a reasonable prospect that international competitors with a UK base will bid for contracts in the regions with the likely effect of increased competition for contracts in Northern Ireland, Scotland and Wales.

CONCLUSION

iSOFT and Torex have been the two leading suppliers of IT software to the healthcare sector in the UK. While a strong legacy base may give the parties a large presence it is unlikely, in itself, to confer significant market power in view of the changes being brought about by the NPfIT. Such a fundamental change has altered the future competitive landscape with the effect that competitive constraints must be viewed under a new scenario.

For these reasons, the OFT does not believe that it is or may be the case that, if carried into effect, the creation of this relevant merger situation may be expected to result in a substantial lessening of competition within any market or markets in the United Kingdom for goods and services.

DECISION

This merger will therefore **not be referred** to the Competition Commission under section 33(1) of the Act.

NOTES

1. Outlined in the Department of Health's "Delivering 21st Century IT Support for the NHS".
2. Text removed at third party request for reasons of commercial confidentiality.
3. Torex has requested that it is noted that in the primary care sector, Torex's IT software solutions for use by GPs in the primary sector have been accredited by LSPs under the NPfIT programme.