

NON-CONFIDENTIAL VERSION

**CAPITA GROUP PLC
COMPLETED ACQUISITION OF IBS OPENSYSTEMS PLC**

Response to provisional findings and remedies notice

Introduction and summary

1. This paper sets out the response of Capita Group plc ("**Capita**") to both the provisional findings report (the "**PFR**") and the remedies notice (the "**RN**") sent by the Competition Commission (the "**CC**") to the main parties on 31 March 2009 with a request for responses by 20 and 27 April, respectively. By email dated 7 April, Capita offered to submit its combined response to the PFR and RN by 20 April.
2. A summary of Capita's response to the PFR and RN is as follows:
 - (a) Capita does not agree with the findings in the PFR and considers that the CC fails to take account of, or give sufficient credit to, a number of competitive factors. Capita invites the CC to re-consider its provisional conclusion that Capita's acquisition of IBS OPENSystems plc ("**IBS**") may be expected to result in a substantial lessening of competition ("**SLC**") in the market for revenues and benefits ("**R&B**") software and related services.
 - (b) If the CC nevertheless concludes in its final report that the acquisition of IBS will result in an SLC in the R&B market, Capita considers that the most appropriate divestiture package to address the SLC comprises the IBS R&B business unit only.
 - (c) A requirement to divest the whole of IBS in these circumstances would be entirely disproportionate: the IBS R&B business represents [**CONFIDENTIAL**] of IBS' revenues, the remainder of which are accounted for by businesses whose acquisition by Capita presents no competition concerns; and there are no practical, legal or commercial obstacles to separation of the IBS R&B business from the remainder of IBS.
 - (d) There is therefore no compelling reason why potential purchasers should be given an option to bid for either the whole of IBS or part thereof.
 - (e) There are also no grounds for appointing a divestiture trustee at this stage.
3. These points are discussed in turn below. References in brackets are to the relevant paragraphs of the PFR and RN, unless otherwise stated.

The Provisional Findings Report

4. Capita submits that the CC's analysis of the impact of the acquisition on the R&B market as set out in the PFR fails to take account of, or to give sufficient credit to, a number of factors which indicate that the lessening of competition the CC finds may result from the merger in relation to the R&B market is not substantial, as the PFR suggests.
5. The PFR is unduly simplistic, lacks logic or is contradictory in relation to the following points:
 - (a) *Bidding analysis:* The PFR gives more weight to the fact that, in the R&B market, “the main parties were bidding against each other in [60-80] per cent of the contracts that were awarded before the merger” than the fact that “Capita and Northgate bid against each other more frequently than Capita and IBS did” (PFR, paras. 6.42(b) and 6.43). The PFR fails to explain why it is appropriate for the CC to do so in these circumstances and in particular why the close competitive constraint exercised by Northgate on Capita and IBS pre-merger has been marginalised. An absence of further evidence on competitive constraints exercised by Northgate pre-merger (PFR, para. 6.39) does not entitle the CC to conclude that Northgate has not exercised a competitive constraint in the R&B market that is stronger, or at least as strong, as that exercised by Capita and IBS. The low number of customer responses to the CC’s questionnaire makes the CC’s findings on this issue (PFR, paras. 6.44 and 6.45) unreliable (see also paragraph 5(e) below).
 - (b) *Switching:* The PFR (i) finds that customer switching is rare, because switching costs and risks are material (PFR, paras. 6.47, 7.17 to 7.22); (ii) cites [CONFIDENTIAL] in which threats to switch have resulted in any reductions in maintenance fees (PFR, para. 6.56 and 6.57); and (iii) finds that, in the majority of other cases, contracts have simply rolled over (PFR, para. 6.54). A logical conclusion to draw from these three factors would be that customers tend to be "captive", unless switching is prompted by external factors, such as a major change in legislation or technology or a major failure in the existing software. Nevertheless, the PFR reaches the unsupported conclusion that: “there was evidence that competition between suppliers allowed roll-over customers to negotiate price reductions on their annual fees when renewing contracts” (PFR, para. 9.28). The PFR fails to identify the evidence on which the CC is seeking to rely in order to reach such a general conclusion in the face of the above facts.
 - (c) *Monitoring and internal review:* The PFR finds that “an extract from an Ovum report provided by Capita described IBS as a key pre-merger rival to Capita in the R&B and housing sector” (PFR, para. 6.62). First of all, it is insufficient for the PFR to rely on the Ovum report to support an argument that Capita and IBS are close competitors in R&B, because the report describes IBS as a key pre-merger rival to Capita in *both* R&B *and* Social Housing ("SH"). Second, in quoting this extract, the PFR “cherry picks” from the Ovum report, without giving due consideration to other parts of the same report or other analysts'

reports. The PFR fails to explain the basis upon which the CC selects certain passages of the Ovum report and disregards others.¹ Third, the PFR accepts evidence that Capita, IBS, Northgate and Civica monitor each other in the R&B market (PFR, para. 6.59) but again it fails to take adequate account of the competitive constraints exercised by Northgate in particular.

- (d) *Market expansion or entry:* The PFR is inconsistent with the OFT's findings in its decision of 16 May 2005 on the merger of Northgate and Sx3, in which the OFT noted that barriers to entry were not insurmountable. Market liquidity issues aside, the OFT has not suggested that barriers to entry are insurmountable in subsequent R&B cases (Capita's Main Submissions, para. 92). The CC completely disregards the evidence provided by Capita in relation to past entry and potential new entry (Capita's Main Submissions, para. 96), without explaining its reasons for doing so (PFR, para. 7.38). Moreover, the PFR is inherently contradictory and illogical in its analysis of market entry and alleged unilateral effects arising from the merger, for the following reasons. It accepts that Civica and Northgate do not face insurmountable barriers to expansion (PFR, para. 7.7 and para. 7.8, respectively). It concludes that the only difference between the barriers to entry identified by the CC in the R&B market (PFR, para. 7.51) and those identified in the SH market (PFR, para. 7.53), respectively, is the number of prospective new tenders. It considers that an increase in the number of new tenders would be unlikely (PFR, para. 7.51(d)). Despite having concluded that an increase in the low number of tender opportunities is unlikely in the foreseeable future, the CC finds that the merger would likely result in a *substantial* lessening of competition in relation to *new* tenders (PFR, para. 9.27). This puts disproportionate weight on the small number of new customers that will be affected by the merger (see paragraph 7(c) below). The PFR also ignores the strong incentives of the remaining suppliers post-merger to compete for the low number of tender opportunities (PFR, para. 6.55 and paragraph 7(a) below).
- (e) *Buyer power:* the PFR concludes that "there was no reason that buyer power held by some customers (if any) would necessarily affect the price (and non-price) terms available to other customers" (PFR, para. 8.3). While Capita accepts that some customers may have more buyer power than others, because of their larger requirements and higher level of sophistication as purchasers, it does not follow that other customers do not possess buyer power. The fact that only a small number of new contracts is available in the R&B market (PFR, para. 6.55) confers significant buyer power on any local authority that goes out to tender. Moreover, the PFR is inherently contradictory in relation to the CC's own evidence. On the one hand, the CC dismisses the fact that the most common response from customers to a 10 per cent price increase was to seek to purchase collectively, on the ground that the CC received a "low response rate" to its questionnaire (PFR, para. 8.23). On the other, the CC

¹ In particular, Ovum indicates that: "IBS faces significant challenges as an independent company. And like other mid-sized players in the market, it lacks the scale to compete or partner significantly in the major transformation programmes where the majority of money is now being spent. For IBS therefore the options are limited: scale up or lose out" (Annex C.30.4).

relies on its questionnaire, despite the low response rate, to argue that only a minority of respondents would use their wider relationships with suppliers as a bargaining tool (PFR, para. 8.24(c)). Capita requests that the CC explains on what basis it chooses the evidence it seeks to rely on.

6. Additionally, the PFR under-plays the likely extent of competition in the R&B market post-merger. This merger is not a “three-to-two” merger as alleged by the CC (PFR, para. 9.45), but a “three-to-three” merger, with a repositioning of all market players, whereby Northgate [CONFIDENTIAL], Capita, and Civica will expand its position, thus replacing IBS (PFR, paras. 7.6 and 7.7). This view is supported by the analysts' reports contained in Annex C.30.4 and Civica's own evidence to the CC.
7. The PFR fails to take account of, or give sufficient credit to, the following factors which suggest that there will not be a *substantial* lessening of competition:
 - (a) First, the PFR fails to recognise the competitive strength of Northgate and the increasing competitive constraint which Northgate will continue to exert, with increased power following its merger with Anite, on Capita post-merger. The CC erroneously focuses its analysis on whether the R&B market is an ideal bidding market or not (PFR, paras. 9.17 to 9.20). This issue is irrelevant – the market does not possess the characteristics of a bidding market and Capita has never suggested that it does. The key issue is that Northgate will constrain Capita's behaviour post-merger (Capita's Main Submissions, para. 111-127), particularly in light of the small number of contracts coming out to tender in the R&B market (PFR, para. 6.55).
 - (b) Second, the PFR does not give sufficient weight to the fact that Civica has told the CC that it intends to begin bidding regularly for new contracts in two to three years' time (PFR, para 7.7) and that, were there to be an increase in the number of new contracts coming out to tender, Civica would bid and compete on those it felt were attractive (PFR, para 7.6).
 - (c) Third, the CC's analysis of the likely effects of the merger on different types of customers is inconsistent and results in the CC failing to draw the logical conclusion that the merger is unlikely to affect the vast majority of customers (PFR, para. 9.27 to 9.33). As regards "new customers", it is common ground that there are very few new contracts and the CC considers it unlikely that the number of new tenders will increase in the foreseeable future (PFR, paras. 6.7 and 7.51(d)). It follows that the merger will potentially affect only a minute proportion of customers.² As regards "installed base" customers, the PFR finds that 75 per cent of customers are roll-over customers and 25 per cent are mid-term customers. The CC finds elsewhere in the PFR that there is no evidence of successful price negotiation for roll-over customers (except for

² In the course of two to three years, a total of only 3-4.5% of customers will have been affected, corresponding to 1.5% per year, not the 6% per year cited by the CC in PFR, para. 6.53, which reflects wholly exceptional activity in 2003-4, created by the failure of Anite's Pericles software - the CC concedes in any event that switching since 2005 has been rare (PFR, para. 6.55). Within those two to three years, Civica will have repositioned itself as an alternative to IBS in the R&B market.

[CONFIDENTIAL] – see paragraph 5(b) above).³ It follows that there is no material possibility of switching by roll-over customers, and, even if there were some limited possibility, the merger is unlikely to reduce the scope of such competition, because there would continue to be three suppliers, namely Northgate, Capita and Civica, which – according to the CC's own analysis – monitor each other in relation to existing contracts that are due to expire (PFR, para. 6.59) and target each other's existing customers. These considerations hold true *a fortiori* in relation to competition for mid-term customers (PFR, para. 9.31).

- (d) Fourth, the CC has adopted an unnecessarily narrow understanding of countervailing buyer power. It implies that the number of switching alternatives available to customers is the only source of buyer power. This is wrong in law and in fact.⁴ Capita has provided evidence that local authorities' buyer power depends on a number of factors that are independent of the number of switching alternatives available to customers. However, the PFR materially fails to give sufficient consideration to the evidence provided by Capita. Capita asks the CC to re-consider the wider issues. During the course of the CC's inquiry, Capita offered to facilitate meetings with clients for the CC, in order to test Capita's submissions on buyer power, and this offer remains open.
- (e) Finally, the PFR relies on information and documents submitted by third parties on a confidential basis, on which Capita has been unable to submit its observations, because key information was excised from the working papers that were put back to it and Capita's requests for non-confidential summaries of third party submissions have not been met by the CC. It follows that since Capita has been unable to acquaint itself sufficiently with the tenor of the confidential information in question, the CC cannot rely on it for the purposes of the PFR.⁵

- 8. Without prejudice to Capita's position in relation to the above points and in relation to the remainder of the CC's analysis and conclusions in the PFR, Capita will now address the issues identified by the CC in the RN. The next section of this paper therefore sets out Capita's response to the RN.

³ In respect of [CONFIDENTIAL] mentioned in the PFR, moreover, the CC fails to establish [CONFIDENTIAL].

⁴ *CC 2 Merger References: Competition Commission Guidelines*, June 2003, paragraph 3.59.

⁵ See, by analogy, Case C-413/06 P, *Bertelsmann AG and Sony Corporation of America v Independent Music Publishers and Labels Association (Impala)*, Judgment of the European Court of Justice of 10 July 2008 (not yet reported in ECR), para. 100-102.

The Remedies Notice

9. The RN invites views on whether the following remedies would be effective in addressing the expected SLC in the R&B market:
 - (a) divestiture of the entire IBS business to a suitable purchaser; or
 - (b) divestiture of the R&B business unit of IBS to a suitable purchaser.
10. In summary, although divestiture of the entire IBS business might be effective in addressing an SLC in the R&B market, it would be entirely disproportionate for the CC to require this in the absence of any finding of a SLC in the SH market. In these circumstances, divestiture of the R&B business of IBS would be the least costly and least intrusive remedy and therefore the most appropriate remedy.
11. The CC invites views on a number of issues relating to a possible divestiture of the IBS R&B business, to which Capita responds at paragraphs 15 et seq. below.

Divestiture of the entire IBS business

12. As the CC states in paragraph 6 of the RN, divestiture of the entire IBS business would remedy the expected SLC in the R&B market.
13. However, the CC states in its Merger Remedies Guidelines⁶ that it will seek remedies that are effective in addressing the SLC and its resulting adverse effects and will then select the least costly and intrusive remedy that it considers to be effective. It will seek to ensure that no remedy is disproportionate in relation to the SLC and its adverse effects.
14. Divestiture of the entire IBS business would be more costly and intrusive than is required to remedy any perceived SLC in the R&B market. Divestiture of the R&B business is entirely feasible and would be a sufficient and effective remedy (see paragraphs 15 et seq. below). It would therefore be disproportionate to require divestiture of the whole IBS business.

Divestiture of the R&B business unit of IBS

15. As the CC itself states in paragraph 7 of the RN, when defining a divestment package, it will normally seek to identify the smallest viable, stand-alone business that can compete successfully on an ongoing basis.⁷ Capita submits that IBS's R&B unit meets these criteria and would therefore be the most appropriate remedy to address the expected SLC in this case.
16. In response to paragraph 8 of the RN, in which the CC invites views on how a divestiture package comprising only the R&B business of IBS could be effective in addressing the SLC, **[CONFIDENTIAL]**.
 - (a) **[CONFIDENTIAL]**

⁶ CC8. *Merger Remedies: Competition Commission Guidelines*, November 2008, paragraph 1.9

⁷ Ibid, paragraph 3.7

- (i) **[CONFIDENTIAL]**
 - (ii) It is therefore entirely feasible to establish an independent R&B business unit **[CONFIDENTIAL]**.
 - (iii) **[CONFIDENTIAL]**. In any event, Capita has the necessary experience in business/contract exit management to guarantee that the new owner will receive all the data and information required for a smooth transfer of the business.
 - (iv) **[CONFIDENTIAL]**
 - (v) **[CONFIDENTIAL]**
 - (b) The R&B business unit of IBS could compete effectively in the market, including in terms of customer perceptions, on a stand-alone basis. In particular, the R&B business unit would have a number of "selling points", as a stand-alone business, such as:
 - (i) brand focus in the R&B market;
 - (ii) R&B customer focus;
 - (iii) Standalone product development, in terms of database and applications, which would also not have to be compromised to take into effect the needs of other business areas, such as SH; and
 - (iv) good "referenceability" from its installed customer base;
 - (v) a sound revenue stream: **[CONFIDENTIAL]** of IBS R&B's revenues are generated from annually recurring fees, representing a strong and reliable return on investment for acquiring the R&B business.
 - (c) A divestiture package comprising only the R&B business unit would attract suitable purchasers, such as companies with a sufficient footprint in local government outsourcing and local government (Capita's Main Submissions, para. 96).
17. Based on the above observations, **[CONFIDENTIAL]**, Capita submits that the divestiture of IBS's R&B unit is entirely feasible and would be the most appropriate remedy to address the alleged SLC in this case.
- [CONFIDENTIAL]**
18. **[CONFIDENTIAL]**
19. **[CONFIDENTIAL]**
20. **[CONFIDENTIAL]**

Alternative divestiture packages

21. At paragraph 10 of the RN, the CC invites views on whether purchasers should be given an option to bid as they wish for either the whole of IBS or the R&B business only. Capita strongly submits that they should not be given this option, because it would run against the interests of a swift and efficient divestiture process. Keeping the divestiture to the smallest legitimate business unit [CONFIDENTIAL] will ensure that the divestiture process is completed rapidly and effectively.

Divestiture trustee

22. At paragraph 11 of the RN, the CC suggests that it may need to consider whether to appoint a divestiture trustee at an early stage in the process. [CONFIDENTIAL] Accordingly, there is no reason for appointing a divestiture trustee before the end of the initial divestiture period.
23. This case is moreover different from other cases, in which an up-front divestiture trustee was appointed. In its decision on Tesco's acquisition of a Co-op store in Slough, for example, the CC ordered Tesco to appoint a divestiture trustee from the beginning of the divestiture period, alongside the monitoring trustee. However, this case was unusual because although the CC indicated in its decision that divestiture was its preferred remedy, the CC recognised that it might not be possible to implement the remedy and therefore provided for the possibility of implementing fallback remedies. The CC considered that the 'fallback option' should be conducted by a divestiture trustee from the outset. In the present case, IBS' R&B unit is the appropriate divestiture package [CONFIDENTIAL]. Accordingly, there is no need for a fall back option nor for a divestiture trustee.

[CONFIDENTIAL]

24. [CONFIDENTIAL]

25. [CONFIDENTIAL]

26. [CONFIDENTIAL]

27. [CONFIDENTIAL]

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