



Capita and IBS

A report on the completed acquisition by Capita Group plc
of IBS OPENSsystems plc

© Competition Commission 2009

Website: www.competition-commission.org.uk

Members of the Competition Commission who conducted this inquiry

Christopher Clarke (*Chairman of the Group*)

Dr Diane Coyle

Barbara Donoghue

Professor Stephen Wilks

Chief Executive and Secretary of the Competition Commission

David Saunders

The Competition Commission has excluded from this published version of the report information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by ✂. Some numbers have been replaced by a range. These are shown in square brackets. Non-sensitive alternative wording is also indicated in square brackets.

Capita/IBS software and related services merger inquiry

Contents

	<i>Page</i>
Summary.....	4
Findings	7
1. The reference.....	7
2. The companies, the products and the customers	7
Capita.....	7
IBS	7
The overlap products and services	8
Terminology	8
Software licences	9
Related services.....	10
Customers.....	10
R&B software	10
SH software.....	11
Procurement.....	11
3. The transaction and the relevant merger situation.....	12
The transaction	12
The rationale for the transaction	12
IBS's reasons for selling.....	12
Capita's reasons for buying IBS.....	13
Valuation of IBS	13
Jurisdiction	13
4. The counterfactual	14
Capita's view	14
Our assessment.....	15
If Capita had not bid successfully in the 2008 sale process.....	15
IBS's forecast financial performance and position	15
Strategic direction of IBS and Capita	16
Conclusions on the counterfactual.....	16
5. Market definition.....	17
Introduction	17
Product market definition	17
Are there separate product markets for the R&B and SH applications?	18
Is there a single system market for a bundle of software and/or services?.....	18
Is the product market segmented by customer type and/or size?.....	21
Conclusion on product market	21
Geographic market definition	22
Conclusion on geographic market.....	23
6. Pre-merger competition.....	23
Introduction	23
Pre-merger competition in the R&B market	24
Shares of supply	24
Total revenues from new contracts	26
The nature of pre-merger competition.....	27
Conclusions: pre-merger competition in the R&B market	34
Pre-merger competition in the SH market.....	35
Shares of supply	35
Total revenues from new contracts	37
The nature of pre-merger competition.....	37
Conclusions: pre-merger competition in the SH market.....	41
7. Market entry and expansion.....	41

Introduction	41
Capita's view	41
Our assessment: the R&B market.....	42
Past evidence of entry and expansion	42
Barriers to entry.....	43
Prospects for future entry and expansion	47
Our assessment: the SH market.....	47
Barriers to expansion	48
Barriers to entry.....	48
Conclusions on barriers to and likelihood of entry and expansion in the R&B and SH markets	49
8. Buyer power	50
Introduction	50
Constraints on local authorities' budgets and sophisticated purchasing staff	51
Selection of suppliers	53
Knowledge asymmetry.....	53
User groups.....	54
The merger of two-tier local authorities into unitary authorities and local authorities' ability to share services and form purchasing consortia	54
Wider relationships with suppliers	55
Sponsoring entry	56
Self-supply	56
Conclusions on buyer power.....	56
9. Assessment of the competitive effects of the merger	56
Theories of harm	57
Capita's views	57
Unilateral effects in the R&B market: our assessment.....	58
The size of the market.....	58
The Northgate–Anite merger.....	58
The conditions of the unilateral theory of harm	59
Effects of the merger on new customers, roll-over customers and mid-term customers	62
Conclusions on unilateral effects in the R&B market	63
Unilateral effects in the SH market: our assessment	63
Pre-merger competition and the constraint from existing suppliers	64
Effect of the merger on barriers to entry and expansion	64
Conclusions on unilateral effects in the SH market.....	65
Coordinated effects	65
10. Conclusion on SLC	67
11. Remedies	67
Introduction	67
Assessment of effectiveness of remedies options	67
Behavioural remedies	68
Structural remedies	68
Full divestiture	69
Partial divestiture.....	71
Proportionality and relevant customer benefits	77
Proportionality	77
Relevant customer benefits.....	78
Conclusion on remedies.....	78

Appendices

- A: Terms of reference and conduct of the inquiry
- B: Society of Information Technology Management data analysis
- C: Customer questionnaire responses
- D: The extent of stand-alone provision of software and service components

E: Customer base analysis
F: Background to the transaction and the valuation of IBS
G: The nature, size and requirements of customers
H: Capita and IBS financial information and IBS's likely strategy absent the merger
I: Shares of supply
J: Market entry supporting evidence
K: Pre-merger competition supporting evidence
Glossary

Summary

The following summary should be read in conjunction with the rest of this report from which it is derived.

1. On 19 November 2008, the Office of Fair Trading (OFT), in exercise of its duty under [section 22\(1\)](#) of the Enterprise Act 2002 (the Act), referred to the Competition Commission (CC), for investigation and report, the completed acquisition of IBS OPENSystems plc (IBS) by Capita Group plc (Capita).
2. We published our provisional findings on 1 April 2009. Following an extension to the original inquiry period ending on 5 May 2009, we are required to publish our final report by 30 June 2009.
3. Capita is a FTSE 100 company with operating activities which include professional support services and business process outsourcing solutions. In 2008, Capita's turnover was approximately £2 billion. Among its many activities, Capita supplies revenues and benefits (R&B) software systems to UK local authorities and social housing (SH) software systems to SH organizations, also known as 'registered social landlords' (RSLs).
4. Before its acquisition by Capita in June 2008, IBS was a public company trading on the Alternative Investment Market (AIM) with approximately £21 million turnover. Its primary business activity was the development, marketing and installation of software systems for local authorities and SH organizations in the UK. Its products included R&B and SH software systems.
5. Capita and IBS therefore overlapped in the supply in the UK of R&B software to local authorities and the supply of SH software to RSLs and we found that Capita's acquisition of IBS created a relevant merger situation within the meaning of the Act.
6. We examined what would have been likely to have happened in the absence of the merger (ie the 'counterfactual') against which we could assess the competitive effects of the merger. We found that it was likely that, if Capita had not acquired IBS, IBS would have remained an independent competitive constraint in the relevant markets.
7. We defined two markets as a framework for our assessment of the competitive effects of the merger: (a) the supply in the UK of R&B software and related services supplied by the same supplier as a single system (the R&B market); and (b) the supply in the UK of SH software and related services supplied by the same supplier as a single system (the SH market).
8. Public sector procurement procedures (governed by UK regulations implementing EU procurement directives) apply to public organizations purchasing R&B and SH software above a threshold value. Most new R&B software systems trigger such a public sector procurement requirement, although some SH software procurement may fall below this threshold. A tendering process is undertaken, in which customers invite potential suppliers to submit bids in a transparent process that is legally binding on the customer. These procurement processes do not apply to a customer 'rolling over' its existing contract with a current supplier at the end of an initial contract term.
9. We examined pre-merger competition, the potential for entry and expansion and the possibility of any countervailing buyer power in each relevant market.
10. In the R&B market, we found that there was close competition before the merger between Capita and IBS for both new customers and roll-over customers. In

particular, Capita and IBS bid against each other for a high proportion of contracts that had been available since 2003. We found that Capita, IBS, Northgate Information Solutions Ltd (Northgate) and Civica plc (Civica) monitored each other in this market for the winning and losing of software bids, new product offerings and customer satisfaction. Following Capita's acquisition of IBS, the only other supplier actively bidding for new contracts was Northgate, and only Capita, Northgate and Civica had existing contracts with customers. In contrast, in the SH market, we found that competition before the merger between Capita and IBS was not close.

11. We found significant barriers to entry in the R&B market: the market was mature with a stable customer base and a highly concentrated supplier base; there was no evidence of recent market entry; nor did entry or expansion in the next two to three years generally appear likely. Barriers to entry comprised: time required for and cost of market entry; switching costs and risks for customers; importance of supplier reputation to customers; cross-selling advantages for Capita and Northgate and current market conditions. Further, current market conditions did not support entry as the cost of entry was high relative to the low number of tenders and average contract revenues. Although we found it possible that the number of new tenders might increase, the current low number of tenders was not the only barrier to entry we identified. Therefore an increase in the number of tenders would be unlikely, by itself, to make entry more attractive to a prospective new entrant. In any event, there was no evidence that a substantial improvement in market conditions was likely in the foreseeable future.
12. We therefore concluded that neither entry nor expansion (nor the threat of them) would be likely to prevent Capita exercising any market power following the merger in the R&B market.
13. In the SH market, we found that the market was served by several software suppliers and the number of large customers had increased. Barriers to entry included the time required and cost to enter the market and switching costs and risks for customers. While we found evidence that RSLs regarded supplier reputation and installed base as important, this had not prevented suppliers of small add-on applications achieving sales.
14. We therefore found that it was possible that entry and expansion (and the threat of them) would be a competitive constraint on Capita in the SH market following the merger. However, we did not need conclude on this as we found that competition between Capita and IBS before the merger was not close and that other suppliers in the market would be sufficient to constrain Capita-IBS following the merger.
15. With regard to possible countervailing buyer power, we found that some customers might be able to achieve more favourable terms by employing better negotiators or by developing joint purchasing arrangements with other customers. It was also possible that some customers might attempt to develop their own software or sponsor new entry. However, we concluded that it was unlikely that any of these, individually or in combination, could provide Capita's and IBS's customers with sufficient buyer power to offset the increase in Capita's market power caused by the merger. We noted that the loss of IBS as an independent competitor might especially hamper the bargaining power of customers in the R&B market, where there were very few competitors before the merger.
16. Accordingly, in the R&B market, we found that the merger combined two closely competing bidders (whose bids were also the closest to each other's on some occasions) and that constraints from existing competitors, the threat of entry and

countervailing buyer power would be insufficient to prevent Capita–IBS exercising market power as a result of the merger.

17. However, in the SH market, we found that competition between Capita and IBS before the merger was not close and that the other suppliers in the SH market would be sufficient to prevent Capita exercising market power as a result of the merger.
18. In the R&B market (although not in the SH market) we found that market participants would have an increased ability to develop coordinated behaviour following the merger. However, we also found reasons why incentives for such behaviour might be limited.
19. We concluded that the merger may be expected to result in a substantial lessening of competition (SLC) in the R&B market on the basis of unilateral effects. We found that there were likely to be adverse effects on prices, service levels and innovation for both new and roll-over customers due to the loss of rivalry between Capita and IBS, as well as for mid-term customers when they reached the end of their initial contract term. Given that we found that the merger may be expected to result in an SLC in the R&B market on the basis of unilateral effects, we did not need to come to a conclusion on the likelihood of coordinated effects in this market.
20. We concluded that the merger may not be expected to result in an SLC in the SH market.
21. We examined several possible remedies. We found that the behavioural remedies Capita had proposed to the OFT would be complex, difficult to monitor, and not effective. We found that divestiture of either the entire IBS business or the R&B business of IBS could be effective structural remedies. Both had certain risks (in terms of finding a purchaser in the case of full divestiture, or in terms of asset risk in the case of partial divestiture), but we decided that such risks could be managed. Given that we found an SLC only in respect of the R&B market, we found that the partial divestiture of the R&B business would be less intrusive and so more proportionate to the SLC we had found. We did not find any relevant customer benefits within the meaning of the Act.
22. Accordingly, we concluded that Capita should be given the opportunity to sell the R&B business of IBS to a suitable purchaser. Should a successful divestiture of the IBS R&B division not be achieved by Capita within a reasonable period, we will review whether we need to widen the scope of the divestiture package to a full divestiture of the IBS business. We will also consider whether it would be appropriate to appoint a divestiture trustee at any stage in the process, taking into account the circumstances at the time.

Findings

1. The reference

- 1.1 On 19 November 2008, the OFT, in exercise of its duty under section 22(1) of the Act, referred to the CC for investigation and report the completed acquisition of IBS by Capita.¹
- 1.2 We published our provisional findings on 1 April 2009. We extended the original inquiry period ending on 5 May 2009 under [section 39](#) of the Act due to delays in the provision of information necessary to carry out the inquiry and the need to assess the effectiveness of both a full and a partial divestiture of the IBS business. We are required to publish our final report by 30 June 2009. Our terms of reference are in Appendix A, together with an explanation of how we have conducted our inquiry and the steps we took to ensure the separate and independent operation of the IBS business during the course of our inquiry.
- 1.3 This document (together with its appendices) constitutes the final report that we must publish under [section 38\(1\)](#) of the Act. Redacted versions of the main party and third party written submissions are on our website,² along with other documents relevant to this inquiry. We cross-refer to them where appropriate.

2. The companies, the products and the customers

Capita

- 2.1 Capita is a FTSE 100 company that supplies professional support services and business process outsourcing solutions. It provides a wide range of support services from customer contact services to property and infrastructure consultancy. A business division of Capita, Capita Software Services (CSS), supplies R&B, payment management, e-government and integrated housing management systems to public sector and SH organizations, also known as RSLs.³
- 2.2 In 2008, Capita's turnover was approximately £2 billion, of which CSS's turnover was approximately £[redacted] million. SH and R&B accounted for approximately £[redacted] million (about [redacted] per cent) and £[redacted] million (about [redacted] per cent) of CSS's turnover respectively. Further financial information for Capita is set out in Appendix H.

IBS

- 2.3 IBS was acquired by Capita on 26 June 2008. Further details of the transaction are set out in paragraph 3.2. Prior to its acquisition, it was a public company trading on AIM.
- 2.4 IBS's primary business activity is the development, marketing and installation of software and supporting services to more than 200 local authorities and housing organizations in the UK. Its products include systems for SH management, R&B, works management and finance.

¹In this report, we refer to Capita and IBS collectively as 'the main parties'.

²www.competition-commission.org.uk/inquiries/ref2008/ibs/index.htm.

³RSLs are independent housing organizations registered with the Housing Corporation under the Housing Act 1996. Since January 2009 this term has been replaced in England by the term Registered Provider (RP) following the abolition of the Housing Corporation and English Partnerships and the creation of the Tenant Services Agency and Communities England.

- 2.5 IBS has four primary business units (in declining order of turnover): (a) SH, ie provision of software and services to RSLs; (b) R&B, ie provision of software and services to local authorities for administration and payment of benefits and collection of council tax and commercial property rates; (c) Contractor (CON), ie provision of software and services for workforce and materials management to the SH sector as well as to local authorities and contractors; and (d) Services (SES), ie providing financial accounting and reporting systems.
- 2.6 In 2007, IBS's turnover was approximately £21 million. In 2008, IBS's turnover was approximately £[redacted] million, of which its SH business unit accounted for approximately £[redacted] million (about [redacted] per cent), its CON business unit (which also serves the SH sector) accounted for approximately £[redacted] million (about [redacted] per cent) and its R&B business unit accounted for approximately £[redacted] million (about [redacted] per cent). Further financial information for IBS is set out in Appendix H.

The overlap products and services

- 2.7 Before the merger, Capita and IBS both supplied software and related services for R&B functions within local authorities and for SH functions carried out by RSLs. This section describes these products and services⁴ and the related pricing structure.

Terminology

- 2.8 There is no standard industry terminology for the various elements of R&B and SH software or for the services that customers typically purchase alongside such software. Definitions of these products and services vary between suppliers. We have therefore defined certain key terms ourselves for the purposes of this inquiry:
- (a) 'application' refers to the overall software package designed to meet a specific business requirement (eg the R&B software application and the SH software application);
 - (b) 'component' refers to the various different items of software and services that together meet a customer's requirement for an R&B or SH software application; and
 - (c) 'module' refers to a self-contained software item within an R&B or SH software application.
- 2.9 We identified different types of customer, depending on the stage at which they were in their relationship with their R&B or SH supplier:
- (a) 'New customers' are customers that have just gone or are going out to tender for a new R&B or SH software contract (the tendering process is described in paragraph 2.26). Customers are considered 'new' as long as they are within the first year of their contract.
 - (b) Existing customers are customers that are in the second year or more of supply by their current R&B or SH software supplier, comprising:
 - (i) 'mid-term customers', which are existing customers in the middle of a contract period. For example, if the initial contract was for five years (the typical

⁴Capita and IBS confirmed that they had both only occasionally provided small amounts of hardware on an individual basis to customers. We therefore did not consider the supply of hardware further.

contract term), a mid-term customer may have acquired the software two, three or four years ago; and

- (ii) 'roll-over customers', which are existing customers that have reached the end of their initial contract term and have renewed their contract with their current supplier on an annual 'roll-over' basis. For example, if the initial contract was for five years, a roll-over customer will have had the software for more than five years.

2.10 A customer typically signs a contract covering two elements:

- (a) the software licence(s), which is usually paid for at the outset of the contract; and
- (b) related services including implementation (also paid for at the outset of the contract) and annual maintenance (payable annually from the second year of the contract onwards).⁵

We explain each of these below.

2.11 Customers set out the software and services they require when they issue tenders. Suppliers bundle software licences and related services in responding to those tenders. Contractually and practically, it is difficult to separate the two elements identified in paragraph 2.10, and the specific products and services included in each of them vary between contracts and, to some extent, also between suppliers. In the following paragraphs we describe each of these two elements in detail.

Software licences

2.12 We distinguish between software licences for 'core' and 'non-core' modules.

2.13 For R&B software, the core modules cover basic services the local authority has a statutory duty to provide, ie collecting revenue via council tax and non-domestic rates, and making certain benefit payments.

2.14 For SH software, the basic functions are housing management, housing repairs and rent and arrears collection. In contrast to R&B software, SH software is not based on a core package, but is entirely modular, with individual modules making up the software package.

2.15 For both R&B and SH applications, numerous other non-core modules may be added to those that provide the basic functions, either at the time of signing the contract or subsequently. Capita and IBS do not differentiate between types of non-core modules and definitions of what might constitute a non-core module differ among other suppliers and customers.

2.16 We distinguish between the following types of non-core module to enable us to analyse any potential competitive constraints:

- 'Add-on' modules. These modules are specific to the software application concerned, that is, they can only be used with the R&B or SH applications. These

⁵A licence fee may also be charged annually, covering renewal of the initial software licence and/or licences for subsequent upgrades and new modules.

modules give additional functionality⁶ around the core modules, such as mobile working, fraud detection and management information.

- ‘Horizontal’ modules. These modules are not application-specific. For example, local authorities have a wide range of other software applications including Customer Relationship Management software (to enable more ‘joined-up’ provision of services across multiple departments); workflow software (to manage business processes across multiple departments); and document management software (to streamline the processing of incoming documents).

2.17 There are many different R&B and SH modules. Capita currently has [X] R&B modules (including add-ons and horizontal modules) while IBS has [X]. For SH, Capita has [X] modules (including add-ons and horizontal modules) while IBS has [X].

Related services

2.18 Implementation services include managing the installation of the R&B or SH application, including establishing interfaces (some standard, some bespoke) with the customer’s existing software. Implementation will also include initial customer training.

2.19 From the second year of the contract onwards, when the software has been implemented, customers require maintenance services which could include, among other things:

- (a) telephone-based helpdesk support services;
- (b) post-implementation training;
- (c) remote monitoring and database support; and
- (d) other support and maintenance, eg regular updates and software revisions to take account of changes in legislation.⁷

Customers

R&B software

2.20 The customer base for R&B software comprises the 408 local authorities in England, Wales and Scotland that are responsible for the collection of revenue and distribution of benefits plus a further two public bodies in Northern Ireland with similar responsibilities.⁸

2.21 The number of local authorities with billing responsibilities reduced between 1995 and 2008 from 420 to 408 due to the replacement of some district councils by unitary authorities, and, as set out in Appendix G, this process is expected to reduce the number of customers by a further 22 over the 2009/10 period. However, the creation of new unitary authorities will also result in a small number of tendering opportunities in 2008/09 as software requirements of each new authority are assessed. Overall we

⁶We use the term ‘functionality’ to describe the capabilities of an R&B or SH software system.

⁷The products and services included as part of annual maintenance arrangements depend on the particular supplier–customer agreement. For example, Capita told us that post-implementation training was not included in the annual fee it charged.

⁸Northern Ireland Housing Executive and Land and Property Services Northern Ireland.

found that the sale of R&B software and related services to local authorities was likely to be a low growth area in revenue terms.

- 2.22 We found that, rather than purchasing new R&B software to a regular timetable, local authority R&B departments undertook periodic assessments of their business requirements to determine whether or not their R&B software should be replaced. We also found that there were other procurement trends that may affect how local authorities purchase R&B software, including 'shared services' strategies, strategic service delivery partnerships (SSPs) and outsourcing. These are defined and their likely limited effects are discussed in Appendix G. We noted in particular that outsourcing would not reduce the number of potential customers for R&B software, but it might transfer the responsibility for the selection of software to the outsourcing supplier in certain cases.

SH software

- 2.23 We identified 2,141 RSLs in the UK. We also commissioned a report from Tribal Consulting Ltd⁹ (the Tribal Report), which concluded that RSLs with fewer than 2,500 housing units to manage would in general not be customers for the type of software sold by Capita and IBS (with the exception of local authorities that had no housing stock of their own to manage but needed to maintain a waiting list and which would purchase that module of SH software only). Based on our analysis set out in Appendix G, we identified 569 large RSLs (ie managing at least 2,500 housing units) and a further 187 local authorities that manage their own stock.
- 2.24 The number of large RSLs increased between 1998 and 2008 from 122 to 569 as legislation enabled the creation of new organizations and group structures for SH management and an inflow of private capital. Overall, we found that the sale of SH software and related services to RSLs was likely to be a higher growth area in revenue terms than the sale of R&B software and related services to local authorities.
- 2.25 The process of SH stock transfer from local authorities to RSLs (described further in Appendix G) had increased the customer base between 1988 and 2008 (eg at least six were newly created in 2007/08¹⁰), and may have created tendering opportunities. However, the increasing concentration of SH stock in the hands of the largest groups may partly offset the creation of new RSLs in terms of the size of the addressable customer base.

Procurement

- 2.26 Public sector procurement procedures (governed by UK regulations implementing EU procurement directives) apply to public organizations purchasing R&B and SH software above a threshold value (which for local authorities' procurement of supplies or services is €206,000 (£139,893¹¹)). A tendering process is undertaken, in which customers invite potential suppliers to submit bids in a transparent process that is legally binding on the customer. An overview of relevant public sector procurement regulations is provided in Appendix G. Based on Capita's estimates of average

⁹Tribal Consulting Ltd (Tribal Consulting) is a leading supplier of consultancy services to SH landlords in the UK. It also works with Housemark, the SH benchmarking club, to produce annual statistics on the systems in use within the sector. Its January 2009 report for the *CC Housing Management System Suppliers 2005–2008* is available on our website at www.competition-commission.org.uk/inquiries/ref2008/ibs/pdf/tribal_consulting_report.pdf.

¹⁰*Social Housing*, Vol 20, No 9, September 2008.

¹¹Council Regulation 1422/2007 (L317/34 5/12/07). Sterling equivalent is as published in C301/07 13/12/07, ie it is based on the exchange rate prevailing at that time.

contract revenues,¹² the procurement of a brand-new R&B software system would trigger an EU procurement requirement.¹³ Some SH software procurement may fall below the threshold.

- 2.27 All R&B customers and the majority of SH customers already have the necessary R&B or SH software in place. The demand for both R&B and SH software is primarily driven by external factors such as new legislation (setting out, for example, new policies on the payment of benefits), technological changes, the amalgamation of customers and the availability of central government funding for renewing or updating the software. These factors are not within the control of the software suppliers themselves, making demand unpredictable and the planning of market entry difficult —see Section 7.

3. The transaction and the relevant merger situation

- 3.1 This section describes the transaction and its rationale, and sets out our assessment of whether the CC has jurisdiction in relation to this transaction.

The transaction

- 3.2 On 26 June 2008, Capita completed its acquisition of IBS following a recommended public offer.¹⁴ The 100 per cent cash consideration was 187.85p per IBS share (excluding 1.2 million treasury shares), valuing the fully diluted share capital of IBS at £77.7 million.
- 3.3 The sale process was conducted in a period when IBS's share price had fallen sharply following its trading update in January 2008, which stated that 2007 results were 'slightly short of analysts' formally published expectations'.¹⁵

The rationale for the transaction

IBS's reasons for selling

- 3.4 IBS had been a wholly-owned subsidiary of International Business Systems AB (Sweden) (IBS AB) from 1991 until 2005. In 2005, IBS AB decided to sell IBS (its UK subsidiary, known as IBS Public Services Ltd at the time) and had initial discussions with several interested parties, namely [REDACTED]. We understand that [REDACTED].
- 3.5 The 2005 sale process concluded with the decision to place the company on AIM. Numis Securities Ltd (Numis) briefly acquired the company, acting as a vehicle to facilitate the offering. The company re-registered as a public company on 15 March 2005 and IBS was admitted to AIM on 23 March 2005.

¹²New purchase: £[REDACTED] (comprising £[REDACTED] for the software licence and implementation and five years of annual maintenance at £[REDACTED] a year).

¹³The Office of Government Commerce (OGC) manages a list of contracts and Framework Agreements, known as Catalyst, all of which have already been let under the EU procurement process. If customers use suppliers from the Catalyst, there is no further need to advertise individual requirements. The aim is to speed up the procurement process and to achieve better value for money.

¹⁴Following Capita's acquisition of IBS, two other companies active in supplying R&B software to local authorities and SH software to RSLs also merged. In August 2008, Northgate announced its intention to acquire Anite Public Sector Holdings Limited (Anite), a wholly-owned subsidiary of Anite plc. This transaction was completed in October 2008, following clearance of the transaction by the OFT.

¹⁵IBS's pre-close trading update (17 January 2008).

- 3.6 In 2008, following the fall in IBS's share price described in paragraph 3.3 and two unsolicited approaches from potential buyers, the board of IBS decided to sell the business. IBS's remaining former management told us that the timing of the sale process was solely driven by the board's desire to maximize shareholder value in declining market conditions. This process was managed by Numis, IBS's financial advisers during the sale. [Several] companies expressed an interest to Numis during the sale process, of which Numis selected three offers for the board of IBS to consider: namely, [REDACTED]. IBS told us that its board ultimately chose to recommend to its shareholders that Capita's offer be approved as, although it was not the highest offer, it was an all-cash offer, no shareholder or bank approval was required and it offered the prospect of completion within a short time frame. Further details of the sale process are set out in Appendix F.

Capita's reasons for buying IBS

- 3.7 Capita told us that its key reason for buying IBS was to obtain a stronger SH software product. Capita also stated that acquiring IBS presented opportunities to cross-sell Capita's other products and services to IBS's customer base, for example R&B outsourcing capabilities, procurement services and treasury services, as well as to offer its own customers a selection of IBS's products.
- 3.8 We found that it was likely that, as Capita stated, its key rationale for purchasing IBS was to acquire IBS's SH product offering, capabilities and customer base, to which it could sell other Capita products. Based on a review of Capita's strategy for its R&B business prior to its acquisition of IBS and the evidence supporting Capita's stated rationale for the transaction in terms of the strengthening of its SH business unit, we also found that acquiring IBS's R&B business unit was not a key acquisition rationale for Capita.

Valuation of IBS

- 3.9 To help us understand whether Capita might have paid a premium for IBS because it anticipated unduly strengthening its market position, we assessed Capita's offer and valuation of IBS. Our analysis is set out in Appendix F. Based on this evidence, we found that the price paid by Capita for IBS was reasonable in the context of market conditions at the time.

Jurisdiction

- 3.10 Under [section 35](#) of the Act, and pursuant to our terms of reference (see Appendix A), we must investigate and report on whether a relevant merger situation has been created. Under [section 23](#) of the Act, a relevant merger situation is created if two or more enterprises have ceased to be distinct within the statutory period for reference and if either the share of supply test or the turnover test specified in the Act is satisfied.
- 3.11 We are satisfied that IBS and Capita are both enterprises for the purposes of the Act, and that they have ceased to be distinct as a result of the transaction described in paragraph 3.2.
- 3.12 Under section 23(3) of the Act, the share of supply test is met if, as a result of the merger, Capita increased its share of supply of goods or services of any description in the UK, or in a substantial part of the UK to at least one-quarter, or if it already supplied at least one-quarter, it must have increased its share as a result of the merger.

- 3.13 Before the merger, Capita and IBS both supplied (among other things) R&B software to UK local authorities. On the basis of the figures set out in paragraphs 6.12 and 6.15, we estimate that, as a result of the merger, Capita will increase its share of supply of R&B software from [20–40] per cent to [approaching 50] per cent (based on the number of contracts as at 2008) and from [25–45] per cent to [well over 50] per cent (based on the number of new contracts won from 2005 to 2008). In either case, the Capita–IBS merger satisfies the share of supply test.
- 3.14 We therefore conclude that a relevant merger situation had been created. As the share of supply test is satisfied, we need not consider the application of the turnover test.

4. The counterfactual

- 4.1 We assessed what was likely to have happened in the absence of the merger (the counterfactual).¹⁶
- 4.2 We assessed whether it was likely that the pre-merger competition between Capita and IBS would not have continued if the merger had not taken place. In particular, we examined, whether, absent the merger:
- (a) IBS would have remained an independent competitive constraint in the relevant markets (as defined in paragraph 5.26) (either because it would have remained unsold or would have been sold to an independent third party not already active in the relevant markets either during the 2008 sale process described in paragraph 3.6 or subsequently);
 - (b) IBS’s viability as a stand-alone entity would have materially deteriorated;
 - (c) the strategies IBS and Capita would have pursued would have been materially different (in terms of the competitive conditions generated) from those pursued by them in the past; and
 - (d) there would have been any other developments in the relevant markets that would have altered competitive conditions.

Capita’s view

- 4.3 Capita told us that the growth in IBS’s margins had reached a maximum in recent years and margins were now expected to decline. Capita argued that, absent the merger:
- (a) IBS would be ‘ill-equipped to survive’ in the R&B market, given its lack of scale and the propensity of customers to choose bigger players such as Capita and Northgate;
 - (b) IBS would be at a competitive disadvantage as local authorities moved towards outsourcing and shared services; and

¹⁶The CC’s merger guidelines (*Merger references: Competition Commission Guidelines, CC2, June 2003: www.competition-commission.org.uk/rep_pub/rules_and_guide/pdf/cc2.pdf*) (CC2) state in [paragraph 1.22](#) that: ‘[i]n applying the SLC test, the CC will evaluate the competitive constraints on firms with the merger compared to the situation that would have been expected to prevail without the merger (sometimes referred to as the “counterfactual”). The counterfactual will be that situation which the CC expects to arise in the absence of the merger under consideration.’

- (c) IBS would have become a less important competitive constraint in the R&B market for new tenders for R&B software, based on Capita's assessment of IBS's pre-merger plans for advertising, marketing and research and development (R&D) expenditure.

Our assessment

If Capita had not bid successfully in the 2008 sale process

- 4.4 As set out in paragraph 3.6, Capita was one of three potential bidders for IBS. The others were [redacted] and [redacted]. We noted that neither [redacted] nor [redacted] were active in the relevant markets.¹⁷
- 4.5 Two other companies also expressed interest in IBS to Numis but did not submit bids. We reviewed the extent of the interest expressed by these other companies and concluded that it did not alter our analysis of the counterfactual.
- 4.6 IBS told us that [redacted] and [redacted] were both credible bidders. Had either [redacted] or [redacted] bid successfully for IBS, the competitive outcome would have been the same, namely IBS would have remained an independent competitive constraint in the relevant markets.
- 4.7 Northgate's acquisition of Anite was completed in October 2008, after Capita's acquisition of IBS (26 June 2008). We assessed whether, absent the Capita-IBS merger, Northgate would still have acquired Anite or whether it might have purchased IBS instead. Northgate told us that it had been in discussions with Anite over the sale of Anite's public sector and Secure Information Solutions businesses [redacted]. It then recommenced discussions in 2008. At the time of the IBS sale announcement, discussions between Northgate and Anite were at an advanced stage. [redacted] We concluded that, absent the merger, Northgate would have completed its acquisition of Anite and it was unlikely that it would have acquired IBS.

IBS's forecast financial performance and position

- 4.8 We reviewed IBS's financial forecasts for 2009 and 2010 to assess whether they demonstrated any signs of a significant deterioration in its ability to compete effectively in the relevant markets (as suggested by Capita). We also reviewed IBS's historic cash flows to determine whether there were any potential liquidity issues that could have had an impact on IBS.
- 4.9 Based on our analysis of IBS's forecast financial performance, as a stand-alone entity (that is, excluding any synergies arising from the merger with Capita), IBS's forecast operating profit margins would have continued to be under pressure and might have fallen further, but IBS would still have been profitable (see Appendix H). We noted that declining margins were a feature of the industry as a whole.
- 4.10 We saw no evidence to suggest that IBS was losing contract tenders because of its smaller size compared with Capita as a whole or Northgate as a whole.¹⁸ IBS and Northgate told us that IBS was able to compete for and win tenders with larger local authorities. IBS's remaining former management also stated that IBS benefited from

¹⁷We noted, however, that [redacted].

¹⁸In any event, we found that it was not particularly meaningful to compare IBS with Capita or Northgate as a whole. A more meaningful comparison would be between IBS and Capita's R&B and SH activities (see paragraphs 2.1 and 2.5) and between IBS's and Northgate's equivalent activities.

a loyal customer base, which was committed to IBS as a business, and that it believed that the majority of its customers were focused on IBS's reputation, product offering and capabilities, rather than its smaller scale relative to its competitors. We also saw no evidence to support Capita's statement that IBS would be at a competitive disadvantage as customers moved towards outsourcing and shared services. IBS told us that outsourcing had not historically been an important consideration for customers in the bid processes in which IBS had been involved; and that IBS, prior to its acquisition by Capita, had already begun to sell to local authorities setting up shared services arrangements.

- 4.11 We concluded that as a stand-alone entity, IBS's forecast financial performance demonstrated a healthy profit (albeit declining alongside those of other industry participants). IBS's remaining former management told us that it expected that IBS would have continued to be a profitable business in future (whether or not it had been acquired by Capita). While organic growth would likely have been limited given current market conditions, IBS showed no signs of a significant deterioration in its competitive position in the short to medium term (ie during the next two to three years) absent the merger.

Strategic direction of IBS and Capita

- 4.12 We examined IBS's likely business strategy absent the merger (see Appendix H). IBS told us that maintaining its historic organic growth rates would have been challenging in current market conditions and that most of its future growth would have been likely to have come through acquisitions of other software services businesses serving the public sector (though not necessarily within the R&B and SH markets). Nonetheless, we found that it was likely that IBS would have continued its operations within the R&B and SH markets, whether under new (non-Capita) ownership or under its previous status as a publicly-listed company. We saw no evidence to suggest that, whatever strategy IBS pursued absent the merger, IBS would have competed less vigorously in the relevant markets in the short to medium term.
- 4.13 We found it likely that, absent the merger, Capita would also have continued to operate within the R&B and SH markets. Capita told us that, had it not been successful in acquiring IBS, it would have [✂].

Conclusions on the counterfactual

- 4.14 We conclude that it was likely that, if Capita had not acquired IBS, the pre-merger competition between Capita and IBS would have continued. In particular, we expected that:
- (a) IBS would have remained an independent competitive constraint in the relevant markets (either as a result of not being sold, or of being sold to a party not already active in the relevant markets);
 - (b) IBS would have remained financially viable as a stand-alone entity; and
 - (c) both IBS and Capita would have continued to operate within the R&B and SH markets, and IBS's competitive position would not have significantly deteriorated.

5. Market definition

Introduction

- 5.1 CC2 states that the key to market definition is substitutability.¹⁹ In defining the market, we seek to identify the extent to which customers can readily switch between products (known as demand-side substitution), or suppliers can readily switch between the supply of alternative products (known as supply-side substitution) in response to a change in price imposed by a hypothetical monopolist of the relevant product in the manner envisaged in the ‘SSNIP’ test.²⁰ CC2 notes that market definition is not an end in itself, but rather a framework within which to analyse the effects of a merger on competition. As such, market definition is a useful tool for identifying the competitive constraints that affected Capita and IBS before the merger, and that would affect the merged Capita–IBS business following the merger.
- 5.2 Capita argued that it was appropriate to consider the relevant product markets to be the markets for a particular software application (ie R&B or SH), including all relevant core and non-core modules and related support, maintenance and training services, since these together enable the customer to automate its business processes. Capita further argued that the geographic scope of both the R&B software and related services market and the SH software and related services market was UK-wide.
- 5.3 In this section, we first assess the relevant product market(s) and we then assess the geographic scope of those market(s).

Product market definition

- 5.4 We structured our analysis of the product market as follows:
- (a) we first examined whether there were separate product markets for the R&B and SH software applications;
 - (b) we next examined whether there were single system markets²¹ for customers at different stages of their contracts (ie new customers, mid-term customers and roll-over customers) for each of the R&B and SH software applications. We looked at:
 - whether there were single markets for either (i) a bundle of core software; (ii) a bundle of core and non-core software; (iii) a bundle of core software and related services; or (iv) a bundle of core software, non-core software and related services; and
 - whether the third-party provision of certain stand-alone components, that would otherwise be part of the bundle, constrained the bundle, ie whether a hypothetical monopolist of the bundle could not profitably increase the price of

¹⁹Paragraph 2.1.

²⁰The SSNIP test (also known as the hypothetical monopolist test) is an economic test for market definition. SSNIP stands for a small but significant non-transitory increase in price. The SSNIP test involves considering whether a hypothetical monopolist of a certain product or set of products which might constitute a market could profitably impose a SSNIP.

²¹A system market is a unified market for a primary product and a secondary product (a product which is purchased only as a result of buying the primary product). In this case, the core R&B and SH modules can be defined as primary products, while the non-core R&B and SH modules and the related services can be defined as secondary products. A system market definition may be appropriate where, for example, customers view the purchase of the primary and secondary products as a unified deal, engaging in whole-life costing (ie the customers correctly anticipate the cost of future necessary purchases of the secondary product when buying the primary product). See OFT, Market Definition—Understanding Competition Law, 2004, section 6, paragraphs 6.1 to 6.6, www.of.gov.uk/shared_of/business_leaflets/ca98_guidelines/oft403.pdf.

one component of the bundle without customers turning to third-party suppliers of such a component;²² and

- (c) we then examined whether the relevant product market(s) should be segmented by type of customer.

Are there separate product markets for the R&B and SH applications?

- 5.5 R&B and SH software applications address specific functionality needs for customers and serve fundamentally different purposes. As a result they are not demand-side substitutes.²³ The profitability of a price rise (of the type envisaged in the SSNIP test) by a hypothetical monopolist of, for example, R&B software applications would therefore not be constrained by customers switching to SH software applications, and vice versa. On the supply side, some non-trivial investment (in terms of software development costs) is required to switch between producing and supplying each application (see paragraph 7.13). The conditions for supply-side substitution are therefore also not satisfied.
- 5.6 The lack of substitutability between R&B and SH software applications is supported by the fact that customers who purchase both R&B and SH applications do so through separate procurement teams within their own organizations, often from different suppliers. R&B applications are sold to R&B procurement teams within local authorities while SH applications are sold to RSLs and SH procurement teams within local authorities.²⁴ When we compared the suppliers of housing stock management software with those supplying benefits software to the same customers using data from the Society of Information Technology Management²⁵ (SOCITM) (see Appendix B), we found that two-thirds of customers source the two applications from different suppliers.
- 5.7 On the basis of our conclusions on the absence of demand- and supply-side substitutability between R&B and SH software applications, we find R&B and SH applications to be in separate markets. In the next section, we examine whether there is a further distinction within each application between core modules, non-core modules and related services, ie whether such complementary products and services should be assessed individually or together as a system.

Is there a single system market for a bundle of software and/or services?

- 5.8 As set out in paragraph 2.11, customers of R&B and SH software typically issue a tender for a bundle of (a) licence(s) for core and non-core software and (b) related services including implementation and annual maintenance. Suppliers submit bids for the complete bundle rather than for individual components of the tender. This is

²²In other words, we examined whether bundles of products and services competed with other such bundles or whether customers considered each component of their requirements separately and would be able to switch to stand-alone providers of individual components in the event of a price rise for the system by a hypothetical monopolist. We carried out this analysis taking into account whether customers at different stages of their contracts (ie new customers, mid-term customers and roll-over customers) faced the same options in terms of products/services and suppliers and were subject to the same potential constraints.

²³Northgate told us that financial software might be substitutable with SH software, thus arguing for a wider market definition. However, this point was not raised by any other third party.

²⁴As set out in paragraph 2.25, the transfer of SH stock from local authorities to RSLs means that the number of local authorities that need SH software is diminishing.

²⁵SOCITM is the professional association for information and communication technology managers working in and for the public sector.

supported by customer responses to our questionnaires²⁶ (see Appendix C) and from an examination of a sample of customer contracts.

- 5.9 We asked customers²⁷ whether they considered the ‘core software/non-core software /related services’ combined price or the price of each component of the bundle separately. The results are presented in Appendix C. For R&B software and related services, responses show that the majority of respondents considered the initial licence fee, implementation fee and annual maintenance fee as a combined price. For add-on and horizontal modules (the example given in the questionnaire was workflow software), the percentage of respondents that said they considered the combined price with the core modules was lower. The majority of SH respondents also considered implementation and annual maintenance fees as a combined price.
- 5.10 The evidence from a selection of customer bid evaluation documents provided to us by local authorities also indicated that customers consider the overall price of the bundle rather than the prices of the individual components separately. Price is only one factor in the customer’s decision; other factors include functionality and quality (see paragraph 6.30). Customers appear to evaluate the bid on the basis of the terms and conditions offered for the whole bundle.

Core software

- 5.11 As set out in paragraphs 2.13 and 2.14, the core modules for the R&B application are (a) council tax, (b) benefits and (c) non-domestic rates. The core modules for the SH application are not so well defined. The main modules for the SH application include housing management, housing repairs and rent and arrears collection.
- 5.12 For each of the R&B and SH software applications, the same suppliers provide all core modules for the particular application in question. For both R&B and SH, the majority of customers we spoke to told us that they bought all core modules at the same time and considered the combined price bid in the response to their tender.²⁸ This is consistent with responses from suppliers.
- 5.13 Treating the individual R&B core modules as within one market or as in separate markets will not materially affect our analysis of the competitive effects of the merger, because the same set of suppliers would be active in the resulting market(s) either way, and the same applies to the SH core modules. Therefore, for simplicity, we consider the core R&B modules to be in a single market and the core SH modules to be in another single market.

Non-core software

- 5.14 For reasons similar to those set out in paragraph 5.12, we found that non-core software appeared to belong to the same markets as core software for each of the R&B and SH applications.

²⁶During our inquiry, we sent questionnaires to competitors, potential competitors and customers. A variety of new, mid-term and roll-over customers responded to our questionnaire, and the responses we received were similar across these customer groups. However, the number of responses to these questions was low, particularly from SH customers, and respondents were unlikely to be using standardized terminology. We therefore treated this evidence with caution.

²⁷We asked customers which components were included in their latest contract with their software supplier in addition to the software application. The data presented in Appendix C includes percentages of respondents. However, the counts of those responding are small, especially for SH, so the percentages are indicative of customers’ opinions rather than necessarily reflecting the opinions of all customers.

²⁸Although customers told us that they purchased the core modules at the same time, this in general does not establish the substitutability of these products and so is not a necessary condition for there to be a single market for all the core modules.

- 5.15 We consider further the constraints imposed by third-party providers of individual non-core software modules after we have assessed whether core software and related services are in the same market.

Related services

- 5.16 There is a strong system link between core software and related services. This is because related services such as implementation, training and maintenance (eg upgrades) are typically after-market services to a great extent essential to the functionality of the core software. Even when services do not require the knowledge of the source code of the software and hence third-party provision of such services is theoretically possible,²⁹ customers are likely to have much greater confidence if such services are undertaken by their main software supplier, whose expertise in the software in question is certain. We found that such services are almost always negotiated by customers with the suppliers of the core R&B and SH modules themselves, at the very beginning of the contract in the case of mid-contract customers or annually in the case of roll-over customers. Some considerations relating to the independent provision of these services are discussed in paragraphs 5.18 to 5.21.
- 5.17 We therefore find that related services belong to the same market as core software for each of the R&B and SH applications.

Does stand-alone provision of components constrain the bundle?

- 5.18 Having defined a single market for R&B software (including core and non-core modules) and related services and for SH software (including core and non-core modules) and related services, we asked whether these markets should be considered as system markets, or should be widened to include stand-alone individual components (ie non-core software and related services provided by non-system providers). The question we examined was whether a hypothetical monopolist of the bundle could profitably impose a SSNIP on an individual component of the bundle (and hence also increase the price of the overall bundle) without a sufficient proportion of customers turning to third-party suppliers of such individual components to render the SSNIP unprofitable.
- 5.19 We noted that both new and existing customers could obtain some non-core modules and some elements of R&B and SH related services (eg training and consultancy services) from third-party suppliers.
- 5.20 Appendix D sets out the detail of our analysis of the extent of stand-alone provision of software. In terms of non-core modules, we could not reach a definitive conclusion on third-party provision given the lack of clarity in the evidence received.³⁰ Capita told us that [below one-third] of R&B and [below a half] of SH non-core modules were sourced from third parties; however, it also told us that there was a growing need for Capita to bundle non-core modules into its initial contract with its customers, leaving less scope for subsequent non-core sales to those customers. On the other hand, IBS told us that there was a lower level of third-party provision. IBS told us that [a small percentage] of R&B and SH non-core modules were purchased from third parties. Evidence from other suppliers also indicated that the market presence of

²⁹Maintenance and repair can only be provided by the software supplier because knowledge of the source code of the software is required. Training or consultancy services could in principle be supplied by third-party providers.

³⁰Third-party provision of non-core modules is much more common than third-party provision of core modules (ie customers multi-sourcing their core module requirements). However, the extent of third-party provision of non-core modules is difficult to determine and measure as the definition of such modules varies between suppliers—some will include what we term ‘add-on’ non-core modules, and others will include what we term ‘horizontal’ non-core modules (see paragraph 2.16).

third-party providers was limited. As for related services, the evidence we collected indicated that third-party provision was limited in scope.

- 5.21 Overall, in light of the available evidence (for example, as to market shares, prices charged and ease of switching for each component) we found that such third-party provision should not be taken into account in defining the relevant markets for the inquiry, nor that it created additional competitive forces on the relevant markets. The same conclusion held for both new and existing customers (whether mid-term customers or roll-over customers). Given the evidence we received about the likely magnitude and scope of third-party provision, we found that, irrespective of where third-party provision is taken into account in the analysis (ie in defining the relevant markets or in the competitive assessment), this would not have materially altered our conclusions on the effect of the merger on competition.

Conclusion on system market

- 5.22 On the basis of paragraphs 5.8 to 5.21, we found there to be a single system market for R&B software (including core and non-core modules) and related services and a separate single system market for SH software (including core and non-core modules) and related services.

Is the product market segmented by customer type and/or size?

- 5.23 We next assessed whether the relevant markets should be segmented by customer size or customer type or both. We examined whether different sizes of customer (in terms of population base for local authorities and volume of housing stock managed for RSLs) might be in separate markets, in the case of both R&B software and SH software, and whether local authorities and RSLs might be in separate markets, in the case of the SH software.³¹
- 5.24 We noted that price discrimination by size of customer was possible in these markets since R&B and SH software contracts are individually negotiated and suppliers know the size and type of customer they are dealing with.³² Further, licence agreements of the specialist R&B and SH software prevented resale by purchasers. However, we found that Capita and IBS did not appear to sell to particular sizes or types of customer³³ and that different customers were likely to be harmed by a price increase in a similar way because they would all be served by the same suppliers and would be affected by potential constraints (such as entry) in the same way.
- 5.25 The analysis above indicates that subsets of customers with different demand elasticities do not exist, and therefore that segmentation of the relevant market by customer size or type is not appropriate. We found different customer groups and sizes to be part of the same market, whether for R&B software or for SH software.

Conclusion on product market

- 5.26 We concluded that, for the purposes of this inquiry:

³¹For R&B software, all customers are local authorities. For SH software, major customer groups comprise local authorities and RSLs.

³²Capita and IBS told us that one factor they both used in setting their prices was the population of the local authority area.

³³Capita told us that, in the R&B market, it tended to sell to medium- to large-size customers while IBS tended to sell to small- to medium-size customers. We reviewed each supplier's customer base in relation to the size of its customers to understand whether the supplier's customer base was centred on different size groupings. We found that Capita and IBS did not appear to sell to particular sizes of customer (see Appendix E).

- (a) R&B and SH applications were in separate markets;
- (b) for each of R&B and SH, core modules, non-core modules and related services supplied by the same supplier as a single system were part of the same market; and
- (c) it was not appropriate to segment the market by customer type or customer size.

5.27 We use the terms ‘the R&B market’ and ‘the SH market’ to refer to these system markets from this point on.

Geographic market definition

5.28 The geographic market is the area over which a hypothetical monopolist could profitably increase prices by 5 per cent in the manner envisaged in the SSNIP test without losing customers to suppliers outside that geographic area.³⁴

5.29 In assessing the geographic scope of the market, we first assessed whether there were separate markets for different regions within Great Britain. R&B and SH software and processes are designed to suit legal and regulatory requirements. While customer requirements sometimes differ according to local regulatory regimes across the UK (ie in England, Wales, Scotland and Northern Ireland), UK R&B and SH software suppliers told us that they satisfied the requirements of these regimes and served the whole of Great Britain.³⁵ Further, Capita and IBS told us that there was no material difference in the applications, types of customer or supply between the regions and that there was limited price variation between them. On the basis of this evidence, we found that the relevant market was no narrower than Great Britain.

5.30 We then examined whether the market should include Northern Ireland. Capita is not active in Northern Ireland while IBS only serves some SH customers there. As set out in Appendix G, Northern Ireland does not have a council tax system but has a more centralized system of local taxation and benefits. We did not identify any R&B and SH software suppliers based in Northern Ireland. In light of this, we found that the prices of R&B and SH software in Northern Ireland were unlikely to be a constraint on prices in Great Britain, which suggested that Northern Ireland did not form part of the relevant market for supply in Great Britain.

5.31 However, although Northern Ireland did not appear to form part of the relevant market for supply in Great Britain, we noted that treating the market as if its geographic scope were the UK would not make any difference to our analysis of the competitive effects of the merger, and would simplify our analysis in some respects. We therefore refer to the UK from this point onwards.

5.32 Finally, we examined whether imports from outside the UK were part of the relevant market. Customers gave mixed responses as to whether their suppliers needed a UK presence (see Appendix C). Suppliers’ views were also mixed. Some suppliers told us that a UK presence was typically required³⁶ while others³⁷ told us that it was not essential. We did not identify any customers that had purchased R&B or SH software from an overseas supplier. Further, Capita and IBS were not aware of any non-UK

³⁴CC2, paragraphs 2.24 and 2.25.

³⁵For R&B software: Capita, IBS, Northgate and Civica; and for SH software: Capita, IBS, Consilium Technologies Ltd (Consilium), Orchard, Civica and Northgate.

³⁶For R&B: Capita and IBS; and for SH: Capita, IBS, Consilium and Orchard.

³⁷For R&B: Northgate; and for SH: [REDACTED].

R&B and SH supplier operating in the UK. We noted that, for SH software, while Aareon was German owned, it had a UK subsidiary.

Conclusion on geographic market

- 5.33 On the basis of this evidence, we found it likely that a UK hypothetical monopolist of R&B or SH software would be able profitably to increase prices by 5 per cent in the manner envisaged in the SSNIP test without losing customers to suppliers outside the UK.
- 5.34 We concluded that the geographic scope of the R&B and SH markets was no wider than the UK.

6. Pre-merger competition

Introduction

- 6.1 To find an SLC in either the R&B or SH markets, we needed evidence that the main parties had been exerting a competitive constraint on one another which would be removed by the merger.
- 6.2 As set out in paragraph 2.13, due to the common statutory requirements that each customer's R&B software must be capable of performing, there is limited variation between customers in terms of the functionality they require of their R&B software applications.
- 6.3 There is greater variation in the type and size (defined in terms of housing stock size) of customers in the SH market than in the R&B market (see paragraphs 2.23 to 2.25). Further, the functionality requirements of an SH software system are not as strictly defined by legislation as they are in the R&B market. These factors combine to make module requirements vary more significantly between customers in the SH market than in the R&B market.
- 6.4 We saw evidence that IBS considered Capita to be a main competitor in both the R&B and SH markets, and that it also considered Northgate (as Sx3³⁸) a main competitor for R&B software and Northgate (as Sx3) and Orchard as main competitors for SH software (see Appendix K).
- 6.5 As defined in paragraph 2.9, we identified different types of customer to help us with our assessment of competition: (a) 'new customers'; and (b) 'existing customers', comprising: (i) 'mid-term customers'; and (ii) 'roll-over customers'.
- 6.6 We looked at the relative sizes of these different groups of customers. In the R&B market, we estimated that about 75 per cent of 'existing customers' were roll-over customers and about 25 per cent were mid-term customers.³⁹
- 6.7 We noted that, if the number of new tenders (and hence 'new customers') continued to be small or declined further (see paragraph 6.17), the proportion of roll-over customers would increase as contracts aged and were not retendered. It was difficult to

³⁸Northgate acquired Service and Systems Solutions Ltd (Sx3), an IT services and business process outsourcing business, in 2005.

³⁹To make this estimate, we looked at the length of time since a customer signed its R&B contract with its current supplier. If this was over five years ago, we assumed that the customer was a roll-over customer. Data from the SOCITM survey broadly supported this estimate as it showed that around half of the respondents had systems that were six or more years old.

estimate precisely the proportion of R&B contract revenue derived from such new contracts and from existing contracts for each supplier and to compare these estimates across suppliers, due to the lack of detail in the data provided to us by parties and variability in accounting practices. In general, new contract revenue arises in proportion to the number of new contracts awarded each year. Evidence showed that the vast majority of revenue comes from existing customers. Data from IBS showed that in 2007, when there were only six new contracts put out to tender, new contract revenue accounted for [3] per cent of all IBS R&B revenue. Capita submitted that [3] per cent of its turnover in R&B came from existing customers and data from Northgate showed a similar picture between 2005 and 2007. If the current trend for relatively few new contracts per year were to continue, we would expect to see new contract revenue accounting for a similar small proportion of all R&B revenue in future years and the proportion of revenue (and profits) coming from existing customers increasing.

- 6.8 In the following sections we first examine pre-merger competition in the R&B market and then in the SH market. For each market, we examine market structure, and then assess the degree of rivalry and the evidence on customer switching behaviour before the merger.

Pre-merger competition in the R&B market

Shares of supply

- 6.9 As part of the assessment of the competitive constraint the main parties imposed on one another pre-merger, we looked at shares of supply.⁴⁰
- 6.10 Although Northgate and Anite merged after Capita and IBS had merged, because the Northgate merger had been cleared by the OFT and subsequently completed, we combined the shares of supply of Northgate and Anite when considering the current shares of existing (including mid-term and rolled-over) contracts in both the R&B and SH markets.
- 6.11 We examined shares of supply of existing contracts and shares of supply of new contracts. The former provided both an indication of historic rivalry between the main parties (and other suppliers) and an estimate of the main parties' more secure business (represented by the existing customer base), while the latter was an important indicator of more recent rivalry in tender processes between the main parties (and other suppliers). However, we note that market shares do not shed light on competition between suppliers during each individual bidding process, and so should be treated with caution. Our analysis of the available bidding data is presented in paragraphs 6.39 to 6.45.

Shares of existing contracts

- 6.12 Table 1 shows that Capita's share of supply of existing contracts in 2008 was [20–40] per cent and IBS's share was [10–20] per cent. Other players in this market are Northgate/Anite (combined [40–60] per cent) and Civica ([5–10] per cent).

⁴⁰We looked at shares of supply of existing contracts and new contracts rather than market shares, given that customers in both the R&B and SH markets purchased their R&B and SH software via long-term contracts.

TABLE 1 R&B share of supply of existing contracts, 2008

	Number of contracts	Share %
Capita	[X]	[X]
IBS	[X]	[X]
Combined	[X]	[X]
Northgate	[X]	[X]
Civica	[X]	[X]
All local authorities	439	100

Source: CC analysis based on data from the main parties 2008.

Note: Total of local authorities supplied = 439. The difference between the total number of UK local authorities (408) and the total in this table is likely to be due to customers multi-sourcing.

6.13 Estimates of shares of supply of existing contracts from other sources were consistent with the figures in Table 1—see Appendix I. Table 2 shows the estimated share of supply of existing contracts for the period from 2004 to 2008. IBS’s share of supply has increased since 2004. Northgate’s share also increased following its acquisition of Anite in 2008.

TABLE 2 R&B share of supply of existing contracts, 2004 to 2008

Year	Total	Capita		IBS		Combined		Northgate		Anite	
		No	%	No	%	No	%	No	%	No	%
2004	-	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	-
2005	359	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
2006	377	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
2007	394	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
2008	414	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]

Source: CC estimates based on data and information provided by the main parties and by Northgate.

Note: The small difference in the 2008 data between Tables 1 and 2 is due to the different data sources used.

Shares of new contracts

6.14 Table 3 shows the total number of contracts awarded to each supplier as a percentage of the total new contracts awarded in each year. For ease of comparison, the table presents percentages of wins, but the base counts are small.

6.15 Our key findings from this data were:

- (a) the number of contracts awarded had declined between 2005 and 2008;
- (b) [X]; and
- (c) on the basis of the combined data [35–55] contracts were issued between 2005 and 2008⁴¹ of which Capita won [X] ([25–45] per cent) and IBS won [X] ([20–40] per cent).

⁴¹Capita and IBS told us that their bidding data before 2005 had significant gaps due to [X].

TABLE 3 R&B share of supply of new contracts—combined data from main parties and Northgate

Year	Total contracts	Capita		IBS		Combined		Northgate		Anite	
		No	%	No	%	No	%	No	%	No	%
2003*	40–43	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
2004*	43–46	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
2005	22	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
2006	16	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
2007	6	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
2008	8	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Total (2005–2008)	52	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]

Source: CC analysis of data provided by the main parties and Northgate.

*The datasets provided by Northgate and the main parties do not contain exactly the same list of issued tenders. This table presents data that has been created by combining the contracts that each of the main parties and Northgate indicated they had won in the data they provided.

6.16 Civica also supplies R&B software to [X] local authorities in the UK. However, it has not bid for any new core R&B software contracts in the last two and a half years and has not won any of the contracts on which we have been provided data by Capita, IBS or Northgate. Consequently Civica does not appear in Table 3. Civica’s position in the R&B market is discussed further in paragraphs 7.6 and 7.7.

Total revenues from new contracts

6.17 Table 3 shows a decline in the number of tenders available. Internal documents provided by Capita and IBS also highlight this decline and forecast that this trend will continue into 2009. This pattern is also discussed in an analyst’s report dated March 2008 which expects that there will be fewer new tender opportunities in the next three years than there have been in the last five years.

6.18 Looking forward, IBS’s 2009 business plan estimates that there will be [X] new issued tenders in 2009 and forecasts IBS will win [X]. Capita’s 2009 business plan cited [X] to [X] new named sales. Capita also subsequently estimated that no more than [X] tenders per year would be put out in the next two to three years, and that the average revenues from software licences and implementation services had declined to approximately £[X] per contract in 2008 (with annual maintenance fees of around £[X] payable after the system has gone live, usually starting in year two of the contract⁴²). Capita told us that the five-year value of new contestable business in the R&B market in 2009 was unlikely to exceed £[X] million a year, and might be considerably less in future years.

6.19 However, our analysis of the average revenue from R&B software contracts, and hence of the revenue likely to arise from new contracts, produced higher estimates than those provided by Capita. We estimated that the total revenue from new contracts in 2009 would be higher than Capita’s calculation of a five-year value of £[X] million a year. In particular, we estimated the average contract revenue to be in the region of £400,000 to £600,000 (and the corresponding total revenues from new contracts per year to be between about £2 million and £3 million, assuming five new contracts a year) depending on the supplier (see Appendix K).⁴³

⁴²This implies that for a five-year contract the annual renewal fee will be paid for four years only.

⁴³We did not agree with Capita’s calculation of the value of new contracts as we did not agree with its exclusion of certain contracts in making this calculation. Further details are set out in Appendix K.

The nature of pre-merger competition

- 6.20 To establish the nature of pre-merger competition between Capita and IBS, we first examine the product ‘offer’ of each supplier. We then review evidence on: (a) trends from bidding data; (b) the ability of customers to switch; (c) the extent of such switching; and (d) the use of threats to switch during negotiations. Finally, we assess evidence of the degree to which software suppliers monitor each other.

Product offering

- 6.21 Customers consider a range of factors in their commercial negotiations. We received mixed evidence on the weights placed on price and non-price factors. Capita and IBS told us that value for money, functionality, supplier reputation and customer relationships were key. Our analysis of customer responses to our questionnaire and OJEC contract notices indicated that functionality and value for money were the most important aspects. An analysis is provided in Appendix K.

Price competition

- 6.22 According to our review of contract data provided by Capita and IBS, contracts typically include a one-off cost at the start of the contract and an annual fee payable from the second year of the contract onwards (see paragraph 2.10).
- 6.23 The data on contract prices and revenues did not provide a detailed breakdown between different contract components, and so did not allow an analysis of different suppliers’ pricing strategies. Further, given the large variability of contracts and the lack of detail in contract pricing data (see paragraph 8.17), a comparison of prices between customers would not be meaningful. We therefore reviewed customer evaluation documentation and tender data to determine the comparability of Capita, IBS, Northgate and Anite prices (see Appendix K). We do not have data relating to Civica’s prices as (with one exception) it has not bid for a new core R&B contract since 2005.
- 6.24 The main parties provided us with information about bids that they had made from 2005 to 2008 for R&B software contracts. A comparison of initial bid prices where both Capita and IBS bid for the same contract showed that [REDACTED].
- 6.25 There is evidence that suppliers do agree to price reductions during tender negotiations. However, the extent of these price reductions is difficult to assess given the individual negotiation of contracts. Capita, IBS and Northgate all told us that price reductions are negotiated on an [REDACTED].
- 6.26 We also saw evidence of reductions in the previous contracted charge for annual maintenance negotiated when customers threatened to issue a tender at the end of their initial contract period with their incumbent supplier. [Evidence from several parties showed]⁴⁴ that at the end of an initial contract period, roll-over customers would negotiate for reductions in the size of their ongoing annual maintenance fees. In order to obtain such price reductions, customers would often threaten to retender

⁴⁴Although [REDACTED] initially stated that customers did not normally negotiate on price and non-price factors when renewing their contracts, it subsequently clarified that customers reaching the end of their initial contract and entering the roll-over period would often ask for price reductions in their ongoing annual maintenance fee. [REDACTED] provided us with two specific examples of price reductions that had been achieved during renegotiations of existing contracts ([REDACTED]).

their R&B software contract instead of rolling over with their existing supplier.⁴⁵ [The evidence also showed] that customers may communicate with other suppliers, and use any pricing information obtained as a bargaining tool during negotiations with their existing suppliers. Threats to switch suppliers are discussed in more detail in paragraphs 6.56 to 6.59.

- 6.27 The information reviewed suggests that suppliers compete on price both during the tender process and during negotiations when contracts are rolled over.

Non-price competition

- 6.28 Much of the product specification for R&B core software is driven by legislative requirements in R&B processing and Capita and IBS told us that all providers had products which would achieve these core legislative functions.
- 6.29 However, there is some evidence to suggest that suppliers attempt to differentiate their products along some non-price lines. Capita told us [redacted]. IBS told us that it promoted [redacted]. Northgate told us that it had a more up-to-date underlying database than IBS or Capita.⁴⁶
- 6.30 In addition, the evidence also shows that customers evaluate contracts on a range of factors (including price, functionality, quality, reputation etc), and suppliers' scores vary (evidenced by customer evaluation forms analysed in Appendix K). This suggests that products are not homogenous across suppliers.
- 6.31 On the basis of the evidence above, we found that competition in the R&B market involves different dimensions (price and non-price factors) and differentiated products. In particular, the exact package of products and services offered by different suppliers in a given tender differs, eg in terms of the mix of non-core modules and services (excluding implementation), database and non-core module functionality

Product portfolio

- 6.32 In addition to the supply of R&B software services, some suppliers also offer a range of additional products and services. While IBS is active only in R&B and SH software and related services, Capita provides a range of other services to local government. However, we noted that customers procured software systems in isolation to satisfy specific business objectives. We were told that attempts to procure jointly across different teams within the same local authority broke down due to the different paces of change within the business teams using the software, and hence different requirements in terms of the frequency of upgrades. Capita told us that its various divisions were managed separately and that it was primarily concerned about longer-term development of its brand reputation (because purchasing an R&B system might be the first contact a local authority had with Capita⁴⁷) rather than always seeking immediately to cross-sell other products and services to its existing customers.

⁴⁵[redacted] submitted that local authorities would threaten to retender an existing contract that was due to expire, although they would often roll over the contract, because renewing the contract was cheaper and carried considerably less risk to the local authority than retendering the entire contract.

⁴⁶Each R&B software product is written to function with a specific database. Northgate uses Oracle, Capita uses Ingres and IBS uses Progress. Databases are provided by third-party software suppliers, are bundled with the R&B software and are installed during the installation project by the supplier of the R&B system. The process of data migration requires careful management to preserve the data integrity of underlying records.

⁴⁷Capita gave us as an example its relationship with [redacted], which had purchased Capita's R&B software several years ago. Building on a very positive experience with Capita in relation to that software, [redacted] had subsequently entered into a much larger and broader partnership arrangement with Capita.

Therefore, although it was possible for them to do so, we did not find that suppliers took advantage of wider product portfolios.⁴⁸

- 6.33 The evidence suggested that the SH and R&B products offered by all suppliers were very similar. Furthermore most customers appeared to evaluate suppliers' bids according to broadly similar criteria.

Innovation

- 6.34 The importance of product development in providing a competitive advantage implies that suppliers need to invest in product and process innovation.
- 6.35 Innovation can occur on both core and non-core modules, and may entail a product development such as an upgrade or the introduction of a new product. Appendix K contains a summary of data provided by the main parties on R&D expenditure levels, as well as R&D expenditure as a proportion of total revenue. It is difficult to make comparisons between Capita's and IBS's R&D expenditure because their definitions of R&D expenditure differ.⁴⁹ Capita spent £[redacted] on [redacted] in 2004 and £[redacted] in 2008, which includes not only R&D but the entire core product development.⁵⁰ [redacted], IBS spent £[redacted] in 2004 and £[redacted] in 2008 [redacted].⁵¹
- 6.36 Northgate has also been investing in R&D, [redacted].
- 6.37 We saw evidence of this R&D expenditure in relation to non-core (add-on and horizontal) modules. Both Capita and IBS envisaged developing new add-ons in their annual product development plans and many new products have been introduced in the last five years. IBS's business plans noted that a number of small modules were constantly being developed, [redacted].⁵² Northgate also told us that it was continuously updating its modules in order to ensure that it had the best product offering for its customers.
- 6.38 However, we did not find evidence that new products were being developed for the core functionalities. [redacted] told us that such a major product rewrite would only be precipitated by a substantial legislative or technological change, which had not occurred in the last five years and which they did not envisage in the near future.⁵³

Bidding analysis

- 6.39 To understand the extent of rivalry between Capita and IBS for new contracts, we examined: (a) the number of bidders for each new contract that is awarded; (b) the identities of competing bidders; and (c) how often suppliers bid against each other. The data did not contain values of bids submitted by different suppliers within an

⁴⁸Nevertheless, we considered that the scope for Capita and Northgate to exploit cross-selling advantages (whether or not they actually do so at present) would act as a barrier to new entry to the R&B market (see paragraph 7.29) and that this barrier would increase as result of the merger (see paragraph 9.26).

⁴⁹Indeed, we found that, in some cases, what was termed R&D expenditure in this industry appeared to be devoted to activities that in other industries would constitute general operating expenses.

⁵⁰[redacted]

⁵¹However, the above figures for IBS represent only the R&D costs that have been treated as an expense in IBS's profit and loss statement, ie treated as a cost item in the calculation of IBS's profit. We note that approximately 80 per cent of IBS's development costs are capitalized, ie treated as an asset on IBS's balance sheet (based on IBS's 2005 to 2007 annual reports). Therefore, the above figures significantly understate IBS's total development expenditure. Our analysis is set out in Appendix K.

⁵²According to the main parties, a major input to such development processes came from customers' requests, but another driver had also been responding to competitors' product offers.

⁵³[redacted] told us that the last substantial technology shift had been the move from mainframe systems to PC-based systems in the 1990s.

individual tender process, which would have provided further insights as to the closeness of pre-merger competition for new contracts between Capita, IBS and Northgate. As a result, our analysis of the bidding data largely refers to how many times suppliers bid against each other, which in itself does not demonstrate fully the competitive constraint imposed by software suppliers.⁵⁴ Nonetheless, we noted that it was costly for suppliers to participate in a tender process, and so evidence of a supplier being active in a large number of bids could be reasonably taken as evidence that the supplier at least viewed itself as able to compete for those contracts. In addition, we noted that the data we received was not sufficient to allow any price concentration analysis (ie an examination of any relationship between the final prices of contracts and the number of different competing bidders for a particular contract), which may have allowed us to assess the competitive constraint in the bidding process derived from an additional independent software supplier.

- 6.40 The main parties argued that Northgate was a stronger competitor than IBS prior to the merger. They stated that the number of times Capita and Northgate were selected to bid against each other was greater than the number of times Capita and IBS were selected to bid against each other, and as such that Northgate rather than IBS was the most important competitive constraint on Capita. Capita emphasized this point in its response to our provisional findings.
- 6.41 We received bidding data from the main parties on all of the contracts for which either Capita or IBS had bid since 2005 and bidding data from Northgate on all contracts for which either Northgate or Anite had bid since 2003. We used this data to evaluate the extent to which the main parties acted as competitive constraints on one another when bidding for new contracts.
- 6.42 The details of our analysis are set out in Appendix K, but our key findings were:
- (a) [X] bid for the majority of issued tenders, but [X] bid for a much lower proportion in most years;⁵⁵ and
- (b) since the beginning of 2005 there have been [30–50] issued tenders of which Capita and IBS have bid against each other in [20–40] cases and Capita and Northgate in [25–45]. [X]
- 6.43 The data therefore verified the main parties' claim that Capita and Northgate bid against each other more frequently than Capita and IBS did. However, this difference was small, and the more general observation from the data was that Capita, IBS and Northgate all bid against each other for the majority of contracts each year. The main parties were bidding against each other in [60–80] per cent of the contracts that were awarded⁵⁶ before the merger.
- 6.44 In addition to the bidding data provided by the main parties and Northgate, some customers provided information on the latest contracts they awarded, and who bid for

⁵⁴For example, if the bids submitted by two particular suppliers were not constraining each other (ie they were not close to each other) in those tenders where both suppliers bid, calculating the proportion of occasions on which both suppliers bid may overstate the actual closeness of competition.

⁵⁵The bidding data from the main parties listed Civica as bidding for a number of contracts between 2007 and 2008. However, Civica told us that it had not tendered for any R&B applications for the last two and half years. [X] mentioned that Civica was seeking to retain its customer base and was not active in bidding for new business. [X] did not list Civica as a bidder for any of the contracts.

⁵⁶The main parties estimated that they were the final two bidders in the second stage of a tender process in only 20 per cent of opportunities since 2005. However, the main parties also told us that, although they did not believe there was more than one round of bidding in relation to each tender, they were uncertain of this and as such were unable to provide data illustrating whether they were successful in any subsequent (and indeed the last) bidding round. Therefore, we did not attach much weight to this evidence and we were unable to verify the main parties' 20 per cent assertion.

them (see Appendix K). We found that almost every customer who responded approached both Capita and IBS, and that they were the top two bidders for nine out of the 15 respondents who listed the top two bidders.

- 6.45 In summary, our bidding analysis showed that Capita, IBS and Northgate bid for the vast majority of issued tenders, with Anite having a weaker presence. The customer responses we received listed Capita and IBS as the top two bidders in their most recent R&B tenders more than any other pair of software suppliers. As set out in paragraph 6.43, we accept that Capita and Northgate bid against each other more frequently than Capita and IBS did (as Capita notes in its response to our provisional findings), but we found there was also significant bidding rivalry between IBS and Capita that the merger removed.

Switching

- 6.46 We assessed the ability of customers to switch between R&B software suppliers, the extent of such switching, and the use of threats to switch during negotiations.
- 6.47 The ability of R&B software customers to switch between suppliers will be lower if the costs or risks associated with switching are high relative to the potential gains from switching. Switching in the middle of a contract appeared to be rare. Therefore the evidence below refers to switching at the end of a contract term. Factors that inhibit switching are discussed in detail in paragraphs 7.17 to 7.22. Software suppliers and customers agreed that switching costs and risks were material, and data migration was widely cited as the main switching risk. Further detailed evidence on switching costs is presented in Appendix K.

• *Evidence on extent of switching*

- 6.48 The annual number of new contracts awarded has been relatively low in recent years. The initial contract period does not appear to represent the full lifespan of a product. Capita and IBS both told us that in theory there was no time limit to their R&B software products as they provided product updates four times a year to cover minor legislative changes and to fix 'bugs'. Northgate also told us that, once a contract was obtained and the client was happy with the product, it might be maintained for a substantial length of time.
- 6.49 Circumstances that could cause a customer to switch include:
- a supplier leaving the market, eg Group Steria SCA left the market in 2003;
 - weaknesses in the product, eg [REDACTED];
 - the product being too expensive or a desire for greater cost efficiencies;
 - changes in local government structure, eg the formation of shared services or unitary trusts;
 - the breakdown of the supplier/local authority relationship or outsourcing; and
 - major legislative changes.
- 6.50 Customers responded to our questionnaire as to the reasons why they had switched in the last five years. Of the 22 customers that have switched, ten did so because their previous product was no longer supported or became obsolete (or was still a

mainframe product in the case of Bury), two because they became part of a new shared services agreement, and a further three customers switched from an in-house system. Only six customers indicated that they switched for the simple replacement of an existing system. An analyst report into the market found that in 2007 there were only two new customers gained by simple replacement of existing systems, while we estimated that there were six new contracts tendered overall in that year.

6.51 We concluded that switching appeared largely driven by an 'external' impetus, such as the discontinuation of a product or the merger of several customers, rather than the simple replacement of existing systems. Northgate and Civica responses support this finding.

- *SOCITM survey results*

6.52 We compared the 2008 SOCITM survey⁵⁷ to a similar survey conducted by SOCITM in 2003 (see Appendix B). We looked at the suppliers reported in 2003 and those reported in 2008 by the same local authorities.

6.53 Overall, 29 per cent of customers switched supplier (we consider Northgate and Anite as one entity following their merger) between 2003 and 2008 which corresponds to an average rate of 6 per cent a year among these customers.⁵⁸ If this pattern were replicated over all local authorities (and so all customers of R&B software), this would correspond to a switching rate of 24 authorities a year.

6.54 Another way of interpreting this result is that the local authorities surveyed replaced their software systems about every six years but tended to retain the same supplier.⁵⁹ We noted that, in the SOCITM data, retention of the same supplier might be due either to a customer 'rolling over' its contract with its existing supplier or to the incumbent supplier winning a competitive tendering process. The SOCITM data does not distinguish between these two possibilities.

6.55 Overall, we found that there were factors that inhibited switching, stemming from costs and risks associated with data conversion and software implementation. Switching since 2005 has been relatively rare, particularly switching for the simple replacement of an existing system (although we saw evidence that the threat to switch was more common—see paragraphs 6.56 to 6.59). Switching does not occur at a regular yearly rate but rather appears to follow 'waves'; the evidence suggests that the switching rate in 2003 and 2004 was relatively high (which we understand to be due to [X]) (see paragraph 7.25) and the availability during this period of Department for Work and Pensions (DWP) funding to local authorities' benefits departments—see Appendix G), and that switching in 2007 and 2008 was less widespread than in previous years. This may have several implications for competition. In the face of switching costs (which make the threat to switch less credible), suppliers may be able to charge higher prices to existing customers. However, given the limited number of new contracts, competition for those that appear may be fierce, as Capita noted in its response to our provisional findings.

⁵⁷The SOCITM survey lists the R&B software installed in over 200 local authorities.

⁵⁸The switching rate estimated here should not be directly compared with the number of customers switching presented in paragraph 6.50, as the latter is based on a small sample from a group of customers primarily targeted because they had gone out to tender relatively recently.

⁵⁹The turnover period corresponding to a rate of 6 per cent a year is about 17 years and since the average lifetime of software was shown to be about six years, the time to replace suppliers is greater than that to replace software.

- *Threats to switch*

- 6.56 Capita told us that customers often used the threat of switching to negotiate price reductions during the roll-over period after an initial contract term. [REDACTED]
- 6.57 [We also saw other evidence] that when some local authorities came to the end of their initial contract term with their existing suppliers, they negotiated with their suppliers to minimize the ongoing maintenance costs, for example by telling their suppliers of an intention to carry out 'market testing', ie to issue a tender for a new contract, inviting bids from any supplier in the market. Such market testing would impose a cost on the incumbent, ie the cost of managing the tender process. [This evidence showed that], having threatened to 'test the market', local authorities would invite their incumbent supplier to make reductions in their annual maintenance fee to avoid the risk of losing the business altogether, and to avoid the costs associated with managing the tender process.
- 6.58 However, we also received some evidence that such threats to switch may not always be successfully used as a bargaining tool. [REDACTED] told us that it [REDACTED]. Similarly, [REDACTED] said that [REDACTED].
- 6.59 Capita stated in its response to our provisional findings that the limited extent of switching we found showed that 'customers tended 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'. While we accepted that actual switching may have been limited in recent years, the evidence of switching and threats to switch show that these are both sources of competitive pressure on competitors in the R&B market.

Monitoring and internal review

- 6.60 We found evidence that Capita, IBS, Northgate and Civica monitored other suppliers. Such information is available to suppliers via feedback from customers, EU contract award notices (which give the contract winner and often the weighting for each award criterion), government agencies and market surveys.
- 6.61 Internal documents from Capita indicated that it monitored Northgate, IBS, Civica and Anite in the R&B market. [REDACTED],⁶⁰ and business plans provide a general overview of which companies Capita views as competitors, and the strength of this competition. Capita also told us that it monitored DWP data on the efficiency of each local authority's R&B processing, which, combined with information on who provided the local authority's software, could allow some inferences to be drawn as to the efficiency of rival software suppliers' products.
- 6.62 Internal documents from IBS indicated that it also monitored its competitors in the R&B market. [REDACTED] Further, IBS provided us with its business plans and budgets, which demonstrated that [REDACTED]. The sort of information that IBS obtained included [REDACTED]. IBS's 2008 business plan also discusses [REDACTED].
- 6.63 We found further evidence that the main parties considered each other to be close rivals:

⁶⁰For example, [REDACTED].

- an extract from an Ovum report provided to us by Capita described IBS as a key pre-merger rival to Capita in the R&B and housing sectors,⁶¹ and
 - the 2007–2009 IBS business plan described Capita as being IBS’s main rival over the last two years, and expected to remain a tough competitor in future years.
- 6.64 [redacted] Capita’s and IBS’s business plans and budgets [redacted] propose [redacted]. Capita’s business plans highlighted [redacted], while IBS suggested [redacted].
- 6.65 Northgate told us that it monitored the winning and losing of software bids. It monitors [redacted]. It provided us with its internal documents including [redacted]. Northgate told us that it would use such information [redacted].
- 6.66 Civica told us that it actively monitored competitors in the R&B sector, and reviewed the annual SOCITM ratings to understand local authorities’ perception of its products. It said that all other monitoring was anecdotal.

Conclusions: pre-merger competition in the R&B market

- 6.67 In the R&B market, we found that there was close competition between Capita and IBS for both new customers and roll-over customers. In particular, we found that:
- (a) Capita’s share of supply of existing contracts in 2008 was [20–40] per cent and IBS’s share was [10–20] per cent. Between 2005 and 2008, Capita’s share of supply of new contracts was [25–45] per cent and IBS’s share was [20–40] per cent. The other main competitor in the market was Northgate which, since its merger with Anite in 2008, had a share of supply of [40–60] per cent of existing contracts. Civica supplied R&B software but had R&B contracts with only [redacted] out of 408 local authorities. With one exception, it had not bid for any new core R&B contracts in the last two and a half years but before the issue of our provisional findings told us that it might begin bidding more regularly for new contracts in two to three years’ time when it had completed the migration of its existing customers to its new R&B software.
 - (b) Most customers assessed suppliers along similar lines when awarding a new contract, namely on price and functionality. The evidence from notices of award and from customers suggested that price was, on average, the most important feature of a bid when customers were selecting a new R&B software supplier, and we found evidence that Capita and IBS competed on price when submitting bids for new contracts.
 - (c) We saw evidence of expenditure on R&D (since 2004). As there had not been a new product introduction involving the core R&B modules in the last five years, expenditure appeared to have been focused on regular product upgrades and non-core module innovation, bringing benefits for both new and existing customers.
 - (d) There were factors that inhibit customer switching but these were not insurmountable. Switching since 2005 had been low but we observed relatively high levels in 2003 and 2004. Switching appeared often to be driven by external factors such as new legislation, technological changes, problems with a specific product, and

⁶¹Capita argued that other extracts from analysts’ commentaries indicated that Northgate would be the key competitor to Capita and (in its response to our provisional findings) that we had ‘cherry picked’ the Ovum report in relying on certain extracts more than others. However, the extracts Capita had previously referred us to related to the competitive situation following the merger and so were not relevant to competition between Capita and IBS before the merger.

central government funding, and as such did not occur at a regular frequency. There was also some evidence that threats to switch suppliers would be used by customers during negotiations at the end of their initial contract period, even if the customer did not end up issuing a formal tender for a new system.

- (e) The main parties both bid against each other for a high proportion of the contracts that were available since 2003 and there was also evidence that all suppliers in the market could be involved in price negotiations at the end of a customer's initial contract period. We found that Capita, IBS, Northgate and Civica monitored each other in this market for the winning and losing of software bids, new product offerings and customer satisfaction.

Pre-merger competition in the SH market

Shares of supply

- 6.68 According to the Tribal Report, the major suppliers in this market are Aareon, Capita, Civica, IBS, MIS Active Management Systems Ltd (MIS), Northgate and Orchard. Smaller suppliers, often providing more basic systems, include CHICS, Kypera, OmniLedger, Paloma and SDM, and are generally grouped under 'other supplier' in the share of supply data presented below.
- 6.69 The shares of supply presented here include only those customers with a housing stock of at least 2,500 units. This is due to a problem with the reliability of the customer base data for smaller customers.⁶² However, we had minimal concerns about smaller customers because Tribal Consulting told us that at the lower end of the market there were a number of smaller suppliers providing SH software systems with sufficient capabilities for these smaller customers' generally less complex needs. Again, we present shares of supply of existing contracts and new contracts, but as noted in paragraph 6.11, these may not be particularly representative of the extent of competition between suppliers during the bidding process.

Shares of existing contracts

- 6.70 Table 4 shows the shares of supply of SH software suppliers in the UK according to their current number of contracts. After its merger with Anite, Northgate currently has [X]. Before its merger with IBS, Capita had a share of supply of existing contracts of [10–20] per cent and IBS had a share of [10–20] per cent.

⁶²At the lower end of the market, some of the leading suppliers have local authority customers with no housing stock using the 'Housing Needs' part of the system only, to manage waiting lists. These may skew the figures indicating that a supplier has a reasonable base at the lower end of the market. Furthermore, not all of the software suppliers offer such a Housing Needs only system.

TABLE 4 Shares of supply of existing contracts 2008, by customer housing stock

Supplier	Number of contracts					All with at least 2,500 units	Share of supply (%)				All with at least 2,500 units
	Housing units managed in 2008						Housing units managed in 2008				
	2,500–4,999	5000–9,999	10,000–19,999	20,000 or more			2,500–4,999	5000–9,999	10,000–19,999	20,000 or more	
Capita	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
IBS	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Parties combined	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Northgate	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Orchard	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Civica	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Aareon	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
MIS	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
In-house	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Other supplier	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Total	164	176	106	67	513	100	100	100	100	100	100

Source: Tribal Consulting estimates as at December 2008.

Notes:

1. All customers with at least 2,500 units of housing stock.
2. Customers in the UK include RSLs, Arm's-Length Management Organizations (ALMOs) and local authorities.
3. Excluding organizations managing fewer than 2,500 units.
4. SH organizations with fewer than 2,500 units generally require simpler software than that provided by the main suppliers listed in the table.
5. Figures are Tribal Consulting's best estimates as at December 2008 and may differ from other sources such as the Housemark survey.
6. We combine the shares of supply of Northgate and Anite, following their merger.
7. Percentages shown in table may not sum to 100 due to rounding.

6.71 We received various estimates from other parties of the shares of supply of existing contracts (see Appendix I). The majority of these estimates placed the main parties' combined share between 20 and 30 per cent. We consider the estimates presented by Tribal Consulting to be the most reliable source, as it is an independent consultant.

6.72 Appendix I sets out the shares of supply of SH software suppliers from 2006 to 2008 and shows that the main parties' shares have been stable over the last three years.

Shares of new contracts

6.73 Table 5 shows the number of new contracts won by SH software suppliers from 2006 to 2008.⁶³

⁶³Capita, IBS and Northgate all provided estimates that indicated that the main parties had won more contracts than reflected in Table 5. This may be explained by the fact that, whereas the software suppliers' data includes all new contracts for SH software, the Tribal Consulting data includes only contracts for customers with more than 2,500 units of housing stock. We consider the Tribal Consulting data to be reliable.

TABLE 5 Housing stock management software contracts won 2006 to 2008, for customers with housing stock greater than 2,500 units

Supplier	Number of contracts won		
	2006	2007	2008
Capita	[REDACTED]	[REDACTED]	[REDACTED]
IBS	[REDACTED]	[REDACTED]	[REDACTED]
Parties combined	[REDACTED]	[REDACTED]	[REDACTED]
Aareon	[REDACTED]	[REDACTED]	[REDACTED]
Orchard	[REDACTED]	[REDACTED]	[REDACTED]
Civica	[REDACTED]	[REDACTED]	[REDACTED]
MIS	[REDACTED]	[REDACTED]	[REDACTED]
Northgate	[REDACTED]	[REDACTED]	[REDACTED]
In-house	[REDACTED]	[REDACTED]	[REDACTED]
Other supplier	[REDACTED]	[REDACTED]	[REDACTED]
Total	9	16	15

Source: Housemark survey of suppliers' customer lists; Tribal Consulting analysis.

6.74 Table 5 shows that the total number of new contracts was higher in 2007 and 2008 than in 2006. Pre-merger Aareon was [REDACTED]. Northgate has [REDACTED]. Between 2006 and 2008, Capita's share of supply of new contracts was [15–25] per cent and IBS's share was [15–25] per cent. Capita estimated that approximately [REDACTED] customers would issue tenders in 2009.

Total revenues from new contracts

6.75 As set out in Appendix K, our estimates of the revenue likely to arise from new contracts ranged from about £1.8 million to about £5.9 million, depending on the assumptions we made about the number of new contracts per year and the average contract revenue.

The nature of pre-merger competition

6.76 We considered the same dimensions of competition in the SH market as we did for the R&B market (see paragraph 6.20).

Product offering

6.77 We were told that SH software customers considered a range of factors in their commercial negotiations, although there was mixed evidence on the weight placed on price and non-price factors. The main parties told us that value for money and functionality were key.

6.78 We reviewed contract award notices in the *Official Journal of the European Union* (OJEU) and customer responses on the relative weightings of award criteria. Both sets of evidence (see Appendix K) suggested that functionality was generally the most important aspect of a product offering, followed by price.⁶⁴

⁶⁴This is in contrast to the R&B software market where price appears to be the most important criterion, a difference which is perhaps explained by customers having more dispersed core functionality requirements for SH software than they do for R&B software.

Price competition

- 6.79 As in the R&B market, contracts typically involve a one-off cost at the start of the contract followed by an annual fee agreed for the following five⁶⁵ years. Software suppliers told us that they took into account a range of factors when setting their bid price, including customer size in terms of volume of housing stock managed, the value of the contract as a reference for future sales to other customers, competition and general market conditions.
- 6.80 As noted in paragraph 6.23 in relation to the R&B market, the data was not sufficient to allow a formal analysis of pricing strategies. However, although there is some variation, the information we saw suggested that suppliers compete on price:
- (a) the main parties provided us with internal documentation which stated that price competition had been increasing in the last few years as the number of new contracts had declined;
 - (b) Civica made similar comments and also argued that the similarity between suppliers in terms of core functionality had contributed to increased price competition; and
 - (c) we received some anecdotal evidence from another supplier and a customer of recent price competition.
- 6.81 The evidence on whether suppliers will offer price reductions is mixed, and difficult to assess given the individual negotiation of contracts. Most software suppliers told us that price reductions, like overall prices, would be negotiated on an individual basis.

Non-price competition

- 6.82 Although according to the Tribal Report all SH software suppliers have products that will meet the core SH requirements, we were also told that suppliers attempted to differentiate their product by some non-price features. However, this appeared to be relatively limited. Analysts of this industry tend to view Northgate, IBS and Orchard as generally having better SH software products than Capita.
- 6.83 We also received some limited evidence that suppliers offered non-price incentives to customers such as free service days and additional software. Capita and IBS [REDACTED]. Orchard told us that it would [REDACTED] Northgate told us that it would [REDACTED].
- 6.84 The evidence on product differentiation and non-price incentives is limited and as such it appears that the products offered by all suppliers are similar. Furthermore, most customers appear to evaluate suppliers' bids according to broadly similar criteria. This would suggest that, absent switching costs, competition pre-merger is close between all suppliers.

Innovation

- 6.85 As in the R&B market, innovation can occur on both core and non-core modules, and may entail a product development such as an upgrade, or may entail the introduction

⁶⁵The initial contract term varies across suppliers and customers, but five years is the most common.

of a new product. Appendix K contains a summary of the data we received regarding R&D expenditure⁶⁶ in this market. The data shows that [X].

- 6.86 We saw evidence of R&D expenditure in relation to add-on modules, such as financial management systems and managed services. The main parties also told us that they regularly provided product updates. Several software suppliers told us that recent innovation had focused on mobile and portable technology.
- 6.87 However, we did not see evidence of new products being developed for the core functionalities. Indeed [X] told us that such a major product rewrite would only be precipitated by a substantial legislative or technological change, which had not occurred in the last five years and which they did not envisage in the near future.

Bidding analysis

- 6.88 As for the R&B market (see paragraph 6.39), the data was not sufficient to compare bids within an individual tender nor to perform any price-concentration analysis. The analysis presented here largely focuses therefore on the overlap of suppliers in the bidding process.
- 6.89 We asked customers which suppliers they approached for tenders, proposals or quotations and a summary of their responses is set out in Appendix K. The limited evidence from seven customers suggested that [X] was approached most frequently, but that there were a number of other software suppliers, including [X] which were approached relatively often. However, of these seven responses, Capita and IBS were approached only once for the same contract (for which they were the top two bidders).
- 6.90 Competing software suppliers told us that IBS bid on almost all contracts, whereas Capita bid somewhat less frequently.
- 6.91 The main parties each provided us with data on the winning bidders for some tenders between 2005 and 2008. We combined these two data sources to produce a bidding dataset of 108 tenders, of which IBS had won [X] and Capita had won [X]. This data again suggested that IBS had bid on and won SH software contracts more frequently than Capita.
- 6.92 Northgate also provided us with internal bidding data for all [X] tenders in which it participated between April 2007 and April 2008 (see Appendix K). This data also indicated that [X] participated in most tenders, but a number of other suppliers, including [X], bid less often but not infrequently.⁶⁷ Capita and IBS were shortlisted for the same contract only twice.
- 6.93 Overall, we found evidence that IBS was the most frequent bidder in SH tenders and that Capita and IBS had bid against each other on occasion. However, a considerable number of other suppliers also bid regularly.

⁶⁶Indeed as noted in paragraph 6.35 in relation to the R&B market, in some cases what was termed R&D expenditure in this industry appeared to be devoted to activities that in other industries would constitute general operating expenses.

⁶⁷The data shows that [X] was shortlisted eight times, [X] was shortlisted seven times, [X] was shortlisted five times, and [X] and [X] were each shortlisted four times. We noted that since these tenders were just those in which Northgate participated, this figure might over-represent Northgate's bidding position.

Switching

6.94 As in the R&B market, we found that the costs and risks associated with tendering, data conversion and software implementation were likely to inhibit switching in the SH market (as shown in Appendix K).

- *Evidence of past switching*

6.95 The annual number of new contracts is relatively low and, as for R&B software, the initial contract length does not appear to represent the total lifespan of an SH software product.

6.96 Circumstances cited that might cause a customer to switch SH software supplier included:

(a) a supplier ceasing to support a product;

(b) weakness of the supplier in keeping up with legislative changes in its upgrades;

(c) a change of circumstances such as a merger of several housing organizations; or

(d) a technology change.

6.97 We asked customers that had switched their supplier of SH software in the last five years why they had switched. The limited responses we received are summarized in Appendix K. Only a minority of customers responded that they had switched for the simple replacement of an existing system, rather than as a result of external driving factors such as the merger of several customers or the discontinuation of a product.

6.98 As in the R&B market, we used SOCITM surveys⁶⁸ to compare the suppliers' installed customer base as of 2008 with that in 2003. The details of our analysis are set out in Appendix B. Overall, 38 per cent of customers in the survey switched supplier (we consider Northgate and Anite as one entity), which corresponds to an average rate of 8 per cent a year for 2003 to 2008. If replicated across all local authorities, this would correspond to 31 authorities switching supplier each year. However, only 15 new contracts were won across all SH software customers, including RSLs and ALMOs, in 2008 (and only nine and 16 in 2006 and 2007 respectively). Therefore, the observed number of new contracts has been lower in recent years than would be inferred from the SOCITM survey, probably because there were more new contracts and more opportunities for switching prior to 2006.

6.99 In summary, we found that there were factors that inhibited switching by customers but these were not insurmountable, as shown by the degree of switching that occurred between 2003 and 2008. By looking at the overall number of customers that switched between 2003 and 2008 we inferred that, while switching has been relatively low since 2006 (as shown by the lower number of new tendered contracts in these years), it was more common between 2003 and 2005.

Monitoring

6.100 There is evidence that Capita, IBS, Northgate, Orchard and Civica monitor each other. As with the R&B market, information is available via feedback from customers,

⁶⁸For SH software, SOCITM lists the SH software installed in over 200 local authorities and a small number of housing associations.

EU contract award notices (which detail the contract winner and weightings for each award criteria) and market surveys. The detailed evidence we received on competitor monitoring in the SH market is set out in Appendix K.

Conclusions: pre-merger competition in the SH market

- 6.101 In the SH market, we found that competition before the merger between Capita and IBS was not close:
- (a) before the merger, the market for SH software was less concentrated than the R&B software market. Capita's share of supply of existing contracts was [10–20] per cent and IBS's share was [10–20] per cent. Between 2006 and 2008, Capita's share of supply of new contracts was [15–25] per cent and IBS's share was [15–25] per cent. However, in this market, these share of supply figures did not themselves provide evidence on the closeness of competition between Capita and IBS as our limited bidding data suggested that IBS and Capita did not compete very frequently for the same contracts. The other major SH software suppliers are Northgate, Aareon, Orchard, MIS and Civica;
 - (b) most customers assessed suppliers along similar lines when awarding a new contract, namely on price and functionality. Suppliers' product offerings might differ in terms of non-core module provision but were similar in terms of core functionality;
 - (c) there were factors that inhibited switching by customers but these were not insurmountable. Switching since 2006 had been relatively low. There was evidence that IBS had been more active than Capita in competing for new contracts, and there were several other competitors that regularly submitted tenders for new contracts, and consequently with whom IBS regularly competed; and
 - (d) there was evidence that the main parties and their competitors monitored each other for the winning and losing of bids, product offerings and customer satisfaction.

7. Market entry and expansion

Introduction

- 7.1 In this section, we set out our analysis of the potential for entry and expansion in the R&B and SH markets. We assess whether the threat of entry by a new competitor or expansion by an existing competitor would be sufficient to constrain price rises or reductions in service levels by the merged Capita–IBS, if the merger were to increase Capita–IBS's market power.

Capita's view

- 7.2 In the R&B market, Capita argued that:
- (a) there were unlikely to be any insurmountable barriers to entry, as several parties possessed the technical ability, production capacity and sufficiently strong reputation required to compete;
 - (b) barriers to expansion were low, involving only the recruitment of additional sales and technical staff; and

- (c) barriers to entry would be significantly reduced should the market become more active through significant legislative or technological changes or product failure by an existing supplier.

7.3 Capita argued that barriers to entry and expansion in the SH market were low.

Our assessment: the R&B market

7.4 Our analysis of the potential for market entry and expansion comprised an examination of:

- (a) past evidence of entry and expansion;
- (b) barriers to entry (including the costs and timing of entry and expansion and current market conditions); and
- (c) prospects for future entry and expansion.

Past evidence of entry and expansion

7.5 According to evidence received from third parties, the suppliers active in bidding for tenders in the R&B market immediately prior to the merger were Capita, IBS, Anite and Northgate. Capita and IBS told us that, in addition to these suppliers, Civica had also been active in bidding for new R&B contracts in the recent past. As described in paragraph 4.7, Northgate has subsequently acquired Anite.

7.6 Civica told us that it had not recently tendered for new R&B contracts.⁶⁹ This was because it had undertaken a significant product rewrite, using funding from the DWP (see Appendix G), and had developed a new version of its core R&B software system. Civica told us that it was currently in the process of moving its existing customers on to the new product, a process which it hoped to complete in two to three years' time. This would allow Civica to establish the reputation of the new version of its core R&B system before selling it more widely. Civica also told us that the main area of growth was in non-core rather than core modules, and as such this was where its strategic focus had been. However, it also told us 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.

7.7 We concluded that Civica did not face insurmountable barriers to expansion in the R&B market now that it had redeveloped its core product. We note that it told us it had taken a commercial decision not to pursue such a strategy in the next two to three years.

7.8 As Northgate had recently acquired Anite and we were examining Capita's acquisition of IBS, we concluded that there would therefore only be two active market participants for new business post-merger (namely Northgate and Capita-IBS). As in the case of Civica, we did not consider that Northgate would face any insurmountable barriers to expansion in the R&B market.

7.9 Since the introduction of the council tax in 1993, the number of suppliers has reduced due to exit from the market and merger activity. The key entry and exit events are set out in Appendix J.

⁶⁹With the exception of a tender for Mid Lothian District Council, where Civica was the incumbent supplier and no further action was taken after the tender submission.

- 7.10 We also considered the history of ‘self-supply’ entry by local authorities (ie local authorities developing systems themselves) and entry by providers of non-core modules. While we recognized that self-supply entry had occurred in the past,⁷⁰ and Capita told us that a small number of existing in-house applications survived, we noted that most had been replaced by one of the current suppliers since 2005. There are also several other suppliers of non-core modules (for example, SunGard Public Sector Ltd (SunGard), which provides a benefits risk analysis tool). However, these do not compete with the core R&B package.

Barriers to entry

- 7.11 This section contains an analysis of the barriers to entry we identified:

- (a) the cost of and time required for market entry;
- (b) switching costs faced by customers;
- (c) the importance of supplier reputation and installed base to customers;
- (d) the existence of cross-selling advantages for certain incumbent suppliers; and
- (e) effect of prevailing market conditions.

Cost of and time required for market entry

- 7.12 Potential market entry strategies include: development of a new application; extension of the functionality of software products supplied to local authority customers in different service areas (eg social care); broadening of functionality (eg document management); acquisition of an in-house (ie local authority-developed) application as a development platform for third-party sales or adapting software used in other sectors such as utility billing or invoicing and cash collection.
- 7.13 A software supplier planning to enter the market must develop a software package capable of supporting the core R&B modules, ie council tax, non-domestic rates and benefits. This requires an understanding of the underlying business logic and business processes involved and, in particular, the details of the relevant legislation. A new entrant would also need a sales capability to engage with potential customers during the tendering process, and a customer support function to provide user training, product maintenance and updates (including dealing with changes in legislation). The software supplier would also have to maintain investment in ongoing R&D to avoid obsolescence. The cost of fulfilling these requirements would depend on the overlap, if any, with the new entrant’s existing activities, and the extent to which the new entrant could therefore share its existing resources and expertise with its new R&B business.
- 7.14 Several parties provided estimates of the cost and time for a software vendor to enter the market. These estimates ranged from £0.5 million to £10 million, and from one to three years.⁷¹ Details of these estimates are set out in Appendix J. We considered that the wide range of estimates for the cost of entry was likely to arise because costs would depend strongly on the market entry strategy pursued. These estimated

⁷⁰For example, Capita told us that West Wiltshire District Council developed its own R&B system which eventually became the Academy system that Capita purchased.

⁷¹Capita estimated that the cost of entry would be in the region of £[redacted]–£[redacted], depending on the identity of the new entrant (the [lower] estimate would apply to an existing supplier of software to the local government sector). Capita also estimated that entry would take [redacted] to [redacted] assuming a sufficient number of contracts were available.

costs of entry may be compared with estimated total revenues from new contracts a year of between about £2 million and £3 million (assuming five new contracts per year, as set out in Appendix K).

- 7.15 However, even taking into account the full range of entry cost estimates we received, we found that the costs would still be high relative to the size of the total revenue from new contracts a year and that costs would be front-loaded, ie they would almost entirely be incurred at the outset.
- 7.16 Further, based on the range of estimates supplied to us, the time required to achieve market entry significantly exceeded the notice period for tenders (see Appendix G). A potential new entrant would not be eligible to participate in bids for contracts without first having invested in developing a working product, and would face additional uncertainty because of the infrequency and unpredictability of tenders in current market conditions.

Switching costs faced by customers

- 7.17 We found that local authorities faced considerable costs and risks in changing their R&B software supplier, as set out in paragraphs 7.18 to 7.22 and Appendix K.
- 7.18 A local authority may decide to replace its R&B software on expiry of an existing supply arrangement.⁷² Local authorities must follow EU tendering rules if the likely cost of a replacement system exceeds the European threshold value (see paragraph 2.26). If, following a tendering process, an alternative supplier were to be selected, the local authority would need to pay an initial licence fee for the new software and undertake an implementation project, which would result both in fees payable to the software supplier and additional internal costs for the customer (eg project management and training), to remove the old system and configure the new system.
- 7.19 The costs of tendering,⁷³ initial licence fees and implementation would not be incurred if a local authority decided to retain the existing software without going out to a formal tender, but annual maintenance charges would still be payable.⁷⁴ We were told that a typical implementation phase for R&B software lasts [redacted] (see Appendix J).
- 7.20 In any event, we considered that every R&B tender would not necessarily represent a genuine market entry opportunity. This was because [we saw evidence] that, after a contract expired and entered the roll-over period, local authorities negotiated with the supplier to minimize the ongoing maintenance costs, in some cases by telling the supplier that they intended to carry out 'market testing'. [The evidence showed] that [redacted]. [redacted] Capita, [redacted] said that, [redacted].⁷⁵
- 7.21 The principal risk of migration is that of potential disruption to the day-to-day operation of a local authority's R&B services, which are vital statutory responsibilities.
- 7.22 A further risk arises if changing R&B software necessitates replacement of a local authority's database that holds personal and property records for the residents and

⁷²We understand that it is extremely rare for a customer to retender before the end of a contract term due to the significant risk of disruption. We were told by [a third party] that a local authority would only consider switching supplier during the life of the contract in catastrophic circumstances, such as insurmountable technical problems or supplier bankruptcy.

⁷³We obtained two separate estimates for tendering costs: £30,000 and £71,000. (Kensington & Chelsea estimated that the procurement process would cost it £71,000. Derby City Council estimated that the procurement process cost around £30,000.)

⁷⁴It is customary for annual maintenance to be purchased for a fixed period (eg five years) following initial implementation, and then continued on an annual basis following the expiry of the initial contract term.

⁷⁵Capita also told us that it assessed the profitability of tendering across an overall product line.

businesses in its geographic boundary. The need to change the database stems from the software architecture.

Importance of supplier reputation and installed base to customers

- 7.23 We found evidence that it would be difficult for a new entrant to compete with the incumbent suppliers without a good reputation and a working installation to serve as a customer reference.
- 7.24 Capita told us that the ability to reference existing installations of R&B software was an important factor in securing new contracts, and that the importance of such benchmarking might increase in the future.
- 7.25 Northgate told the OFT that [redacted]. Northgate stated [redacted].
- 7.26 [A third party] said that, due to the importance of the R&B function of a local authority, it could not think of any local authority selecting a software system that had not been proven in an existing installation.

Cross-selling advantages for certain incumbent suppliers

- 7.27 A supplier of R&B software may have cross-selling advantages with respect to the sale of other non-R&B software and professional services that were not specified within a tender process, if it has a portfolio of such products and services to offer. For example, the supplier may use its existing customer relationship to make sales of stand-alone products and services that do not exceed the public sector procurement thresholds. Both Capita and Northgate sell a range of products and services to local government customers.⁷⁶ Capita told us that it appointed account managers for important customers with responsibility for managing and optimizing such relationships. By the same token, incumbent suppliers of non-R&B professional services to local government may enjoy cross-selling advantages with respect to R&B software. However, we did not find evidence that bundles consisting of R&B software and other non-R&B products and services were put out to tender by customers, nor that suppliers offered such bundles to their customers. Cross-selling advantages therefore appeared to us to arise mainly in terms of the scope for enhancing a supplier's reputation through having multiple areas of contact with the same customer.
- 7.28 A local authority's strategy for procuring its R&B system (see paragraph 2.22) may create additional scope for suppliers to exploit cross-selling advantages. Vertical integration between the provider of outsourcing services (or the lead contractor in the case of an SSP) and the provider of R&B software may create a barrier for new entrants. This is because the vertically-integrated business may sometimes (depending on the terms of the outsourcing arrangement) be in a position to select its own supplier for R&B software and therefore reduce the number of sales opportunities available to the new entrant. Both Capita and Northgate are vertically integrated in this respect.
- 7.29 We found that, while cross-selling advantages enjoyed by some incumbents were a barrier to entry for prospective entrants into the R&B software market that do not have a suitable portfolio of products and services to offer, this was not an

⁷⁶Capita provided details of spend by its top ten R&B customers on other non-R&B Capita products. These customers purchased an average of [redacted] other Capita products. The proportion of total Capita spend going on R&B software ranged from [redacted] to [redacted] per cent.

insurmountable barrier because local authorities were prepared to procure from a variety of suppliers.

Effect of prevailing market conditions

- 7.30 Capita stated that the market was mature and that both the volume and value of contracts had fallen since a peak in 2003/04, and was not expected to recover in the next two to three years. As set out in paragraph 6.18, Capita estimated that the number of contracts for R&B systems likely to be put out to tender in the next two to three years would be no more than four a year. However, Capita also argued that a new entrant would need to win only [§] contracts in order to recoup its investment and make a profit.
- 7.31 We considered that a prospective entrant would be likely to perform an assessment of potential commercial returns to justify entering the market. An analysis of potential commercial terms would require assumptions for many variables, and the output would be sensitive to those assumptions. We identified the following variables as important in such an analysis:
- market size, represented by expected contract volume and revenues;
 - profitability, at a contract level (direct costs, including R&D) and at an overall corporate level (indirect costs, taxes etc);
 - bidding success rates;
 - cost of capital; and
 - timing.
- 7.32 We observed that any attempt to produce a quantitative analysis of potential returns to a new entrant would exhibit a high degree of sensitivity to the input assumptions. However, we also concluded that current market conditions do not support market entry. We identified changes in legislation, technology changes or dissatisfaction with a current supplier as potential trigger events for an increase in the number of tenders. We did not rule out the possibility of an increase in the number of tenders, but we concluded that existing customers, suppliers or government departments do not expect trigger events to occur in the foreseeable future.
- 7.33 However, a low number of tender opportunities is only one factor that might deter market entry. Even if the number of such opportunities were to increase, there would still be other barriers to entry as discussed in paragraphs 7.11 to 7.32. Further, we found that there were barriers to exit which a prospective new entrant would need to take into account in deciding whether or not to enter the market.⁷⁷ We concluded that, while neither the barriers to entry nor the barriers to exit would, by themselves, be sufficient completely to prevent market entry, these factors would deter entry.

⁷⁷Leaving the market would require discussions with existing customers to achieve a smooth exit without causing business disruption to the customer or reputational damage to the supplier. A supplier may decide to cease marketing a product to new customers, but will need to continue to support existing installations in return for annual fees. Given that customers have long-term contracts with a range of expiry dates, and the tendency for customers to renew support on a perpetual basis, the ongoing support may continue for an indefinite period of time.

Prospects for future entry and expansion

- 7.34 The market for R&B software is mature. All existing 408 local authority customers have previously purchased R&B software and the number of customers is expected to fall slightly (see paragraph 2.21).
- 7.35 Capita submitted that several companies such as SAP AG (SAP), SunGard, [redacted], Fujitsu Europe Ltd (Fujitsu) and IBM (UK) Ltd (IBM) had experience of tax and revenue collection systems in other countries. However, both IBM and [redacted] confirmed to us that they had no plans to enter the R&B application software market.⁷⁸ [redacted] SAP and Fujitsu did not respond. We found no evidence that any companies not currently supplying R&B software had plans to enter the UK market.
- 7.36 Capita also argued that companies that provided software for use in social care had much of the necessary expertise. For example, companies such as OLM Systems Ltd, CareWorks Ltd (CareWorks) and Liquidlogic Ltd (Liquidlogic) provide software which enables social care users to collate information and process calculations and payments in the same way as R&B software. CareWorks and [redacted] told us that they had no plans to enter the R&B market.⁷⁹
- 7.37 We found evidence of market expansion in the provision of non-core R&B modules.⁸⁰ However, for the suppliers concerned, this did not appear to entail expansion into the provision of the core R&B modules.
- 7.38 We carefully considered Capita's arguments about future entry and expansion in its submissions to us, including in its response to our provisional findings. While we found that there were companies who had the resources necessary to enter or expand in the market, they had not done so, and confirmed that they had no plans to do so in the future. We concluded that prospects for future entry or expansion into the R&B market were limited.

Our assessment: the SH market

- 7.39 We noted the following key differences in the customer and supplier base between the R&B and SH markets:
- (a) the SH customer base is larger in terms of customer numbers than the R&B customer base (see paragraph 2.23);
 - (b) despite variations in size of local authorities (measured by number of dwellings or population), R&B software requirements are very similar as statutory responsibilities do not vary between customers.⁸¹ SH software requirements vary to a greater extent between SH landlords. This is due to variations in: size of SH organization (measured by number of housing units managed); operating strategy (eg whether they carry out repairs in-house or contract this activity to a

⁷⁸These responses from potential competitors were in reply to our questionnaire, in which we asked: 'Have you considered and would you consider entering/expanding into the following sectors? If not, why not and by how much would the price have to increase for you to consider entering in the future?'

⁷⁹These responses from potential competitors were also in reply to the same question in our questionnaire as set out in the previous footnote.

⁸⁰For example, we were told by the local authority performance division at the DWP that SunGard had developed a tool to perform risk analysis on benefits claims, and that the DWP was not aware of current plans for full market entry by SunGard or other software vendors. Civica told us that its strategy for the time being was to defend its installed base for R&B and to increase sales of workflow and electronic document management products, which it described as horizontal applications that could be deployed by a local authority for use in several different departments.

⁸¹Except in Northern Ireland, which operates rates, not council tax.

third party); and the extent of standardization of business processes and automation;

- (c) the transfer of SH management to RSLs has led to an expansion of the addressable customer base (see paragraph 2.25); and
- (d) unlike R&B software suppliers, SH software suppliers may be divided into those selling to large customers and those selling to small customers. There are a larger number of suppliers active in the market for all categories of customer. According to Tribal Consulting,⁸² the companies selling to the upper end of the market include Aareon, Capita, Civica, IBS, MIS and Northgate and companies selling to the lower end include Orchard, CHICS Ltd (CHICS), Kypera Ltd (Kypera), OmniLedger Ltd (OmniLedger), Paloma Systems Ltd (Paloma) and SDM.

Barriers to expansion

7.40 Before the merger, Capita and IBS sold to large social landlords. However, we found no evidence of insurmountable barriers to expansion for a small supplier seeking to start selling to larger customers:

- SDM targets small to medium customers (many with fewer than 1,000 units). It told us that the barrier to expansion for a small vendor seeking to move 'up-market' in terms of size of customer was the ability to convince a customer of its capacity to provide customer support to a larger organization, which required investment in sales and marketing to achieve commercial success, rather than technical changes to its software.
- Northgate echoed this view, stating that the customer perception of suppliers to small organizations in both R&B and SH software would need to be overcome before the supplier could sell into larger organizations.

This evidence indicates that barriers to expansion in the SH market are not insurmountable, but would require investments to support new customers, and would take time to be realized.

Barriers to entry

7.41 In common with the R&B market, barriers to entry to the SH market include (a) costs of entry, (b) customer switching costs, and (c) the importance to customers of reputation and installed base.

Cost of entry

7.42 As in the case of R&B software, it is difficult reliably to estimate the cost of market entry, and costs would depend on the market entry strategy pursued. Capita estimated that the cost would start from £[£] in respect of key modules. Market entry strategies include development of a new product or investment to extend the customer reach of a product currently aimed at small RSLs to cover the large RSLs targeted by the main parties. The cost of entry was estimated to be around a few million pounds (see Appendix J).

⁸²Tribal Group, Housing Management System Suppliers 2005–08. December 2008.

Customer switching costs

- 7.43 As with local authorities and R&B software, RSLs would incur costs in switching SH software supplier (see Appendix J). These would include implementation fees payable to the new supplier and an RSL's internal costs.⁸³ We were told by [X] that implementation of a new SH system would take 12 to 18 months.

Importance to customers of reputation and installed base

- 7.44 As with R&B software, the reputation and installed base of an SH software supplier is an important part of customers' selection criteria. However, we noted evidence that customers might be more willing to consider small suppliers for some aspects of their software needs. For example, Wakefield and District Housing explained that it would be prepared to consider small software suppliers for new software, eg 'mobile working'.⁸⁴ It stated that there was a risk as to whether a supplier with a track record with smaller customers was capable of replicating this success on a larger scale. Despite this reservation, it told us that it had awarded a payroll system to a supplier with a track record with smaller customers. In the case of the core SH system, however, it said that track record in terms of size of customer was one of the key supplier selection criteria.
- 7.45 We concluded that there were some prospects for entry or expansion into the SH market because of the variation in customers' software requirements, the expansion of the addressable customer base and the ability of existing smaller suppliers to expand over time to serve larger customers.

Conclusions on barriers to and likelihood of entry and expansion in the R&B and SH markets

- 7.46 In the R&B market, we found that:
- (a) the R&B market was mature with a stable customer base and a highly concentrated supplier base;
 - (b) there was no evidence of recent market entry, nor did entry or expansion in the next two to three years appear likely (except in the case of Northgate if there were to be an increase in the number of tender opportunities). Those companies that might be capable of entering indicated that they had no plans to do so;
 - (c) barriers to entry existed in the form of: time required for and cost of market entry; switching costs and risks for customers; the importance of supplier reputation to customers; cross-selling advantages for certain incumbents and current market conditions; and
 - (d) current market conditions did not support entry as the cost of entry was high relative to the low number of tenders and average contract revenues. Although we considered it possible that the number of new tenders might increase, the current low number of tenders was not the only barrier to entry we identified. Therefore an increase in the number of tenders would be unlikely, by itself, to

⁸³[X] told us that typically the software companies charged 'significant amounts for implementation costs'. In the year of implementation of its new system, 2005/06, it incurred costs of £2.6 million, whereas the ongoing fee was about £100,000 per year.

⁸⁴'Mobile working': providing a field worker, eg maintenance operative, with a mobile device that is linked to the SH software system to improve productivity.

make entry to a market that we found to be mature and stable more attractive to a prospective entrant. In any event, there was no evidence to lead us to conclude that a substantial improvement in market conditions was likely in the foreseeable future.

- 7.47 As a result, we concluded that neither entry nor expansion (nor the threat of them) would be likely to be sufficient to prevent Capita–IBS exercising any market power following the merger in the R&B market.
- 7.48 In the SH market, we found that:
- (a) the SH software market was served by a number of different software suppliers and the number of large customers had increased. The customer base consists of both large and small customers, and Capita (and others) sell to the largest RSLs. However, there are no insurmountable barriers to expansion preventing a smaller supplier from moving up-market; and
 - (b) barriers to entry included the time required for and cost of entry to the market and switching costs and risks for customers. While we found evidence that RSLs regarded supplier reputation and installed base as important, this had not prevented suppliers of small add-on applications achieving sales.
- 7.49 We identified several differences regarding barriers to entry and expansion in the SH market compared with the R&B market, as set out above. We concluded that it was possible that entry and expansion (and the threat of them) would be a competitive constraint on Capita–IBS in the SH market following the merger. However, we did not need to come to a conclusion on this point as we concluded that competition between Capita and IBS before the merger was not close (see paragraph 6.101) and that other suppliers in the market would be sufficient to constrain Capita–IBS following the merger (see paragraph 9.43).

8. Buyer power

Introduction

- 8.1 Countervailing buyer power exists when ‘buyers, either because of their size or commercial significance to their suppliers ... have the ability to prevent the exercise of market power by suppliers’.⁸⁵
- 8.2 Unless stated otherwise, our analysis of possible buyer power in this case applies to the different forms of negotiations in the relevant markets (whether formal tendering processes or informal discussions) and applies to both R&B and SH markets.
- 8.3 Capita argued that, in the R&B market, it would be constrained following the merger by the countervailing buyer power of its customers. According to Capita, customers’ buyer power in the R&B market originated from the following sources:
- (a) local authorities having sophisticated purchasing staff with strong motivation to negotiate low prices, based on constraints on their budgets and their obligation to account publicly for their expenditure;
 - (b) the way in which local authorities select their suppliers and negotiate purchase terms;

⁸⁵CC2, paragraph 3.58.

- (c) knowledge asymmetry between suppliers and local authorities;
 - (d) the existence and behaviour of user groups;
 - (e) the merger of two-tier local authorities into unitary authorities and local authorities' ability to share services and form purchasing consortia;
 - (f) wider relationships between suppliers and local authorities such that suppliers do not wish to jeopardize larger deals for relatively small R&B deals; and
 - (g) the potential for local authorities to induce new entry.
- 8.4 Capita stated in its response to our provisional findings that we had limited our consideration to sources of buyer power that depended on the number of switching alternatives available to customers. However, we particularly sought sources of buyer power that were independent of the number of competitors.⁸⁶ We assessed each source proposed by Capita.
- 8.5 We considered whether buyer power held by some customers in the relevant markets might protect all customers from any adverse effects of the merger. Our analysis indicated that prices for R&B and SH software were negotiated individually and so there was no single price in the market. Further, while an entrant sponsored by one customer might help constrain the prices charged by existing suppliers to all customers, we found it unlikely that customers would sponsor new entry in the R&B and SH markets (see paragraphs 8.27 and 8.28 below). As a result, there was no reason that any buyer power held by some customers would necessarily affect the terms available to other customers. We therefore found that all customers would need to enjoy countervailing buyer power in their own right in order for us to conclude that buyer power would be sufficient to mitigate any adverse effects of the merger.
- 8.6 To examine how customers could influence their own terms of supply, we considered each of Capita's arguments in turn.

Constraints on local authorities' budgets and sophisticated purchasing staff

- 8.7 Capita and IBS pointed out that, particularly as a result of a recent report by Sir Peter Gershon, the government Efficiency Review expected local authorities to make efficiency savings of 3 per cent a year. Further, local authorities had an obligation to account publicly for their expenditure and had sophisticated purchasing staff. According to Capita, these factors would give local authorities both the ability and incentive to negotiate price reductions. IBS also told us that some of its customers had used efficiency targets to negotiate year-on-year price reductions. Capita provided the following detailed information in support of its argument:
- (a) a statement from a local authority indicating that budget restrictions were one of two particular factors (the other being the information it gathered from other local authorities—see paragraph 8.19) which enabled it to negotiate successfully with Capita to reduce its R&B costs;
 - (b) correspondence between Capita and another local authority showing that the local authority had been able to win a reduction in [X]; and

⁸⁶The number of competitors represents the switching alternatives available to customers.

- (c) an analysis of average prices bid by Capita for R&B contracts over the last four years, showing an apparent decline over time. Capita argued that one of the two plausible reasons for this decline was the improvements in local authorities' performance in controlling their spending⁸⁷ (the other being the reduction in the number of tenders for new contracts).
- 8.8 We considered that budgetary restrictions would increase local authorities' incentives to obtain price reductions but any concessions won (even if ostensibly as a result of quoting such restrictions) would be a result of market conditions, including the supply alternatives available to customers. The evidence provided by Capita did not show that any R&B price reductions achieved prior to the merger would be achievable post-merger, when market conditions will have changed (ie it will no longer be possible for customers to switch, or threaten to switch, to IBS). We noted that the removal of IBS as an independent switching alternative might especially affect the R&B customers' ability to achieve such price reductions given the limited number of competitors before the merger. Evidence of negotiated price reductions was therefore insufficient, in itself, to establish countervailing buyer power (see paragraph 8.14).
- 8.9 We did not find that employing sophisticated buyers could confer countervailing buyer power on customers. Buyers' differing skills might explain some of the variability in prices. However, in the R&B market, we noted that an R&B system would not represent a particularly large purchase for a local authority⁸⁸ and may not justify deploying high levels of management skill. We found that in both the R&B and SH markets, the ability of buyers to negotiate price reductions depended largely on the availability of alternatives. If the merger reduces the availability of such alternatives (by, say, removing an independent IBS), we did not find that buyer's skills could offset the resulting decline in their bargaining power.⁸⁹
- 8.10 We looked at what appeared to be a declining trend in Capita's average R&B bid prices over the last five years. We found that this trend could be explained by either competitive pressure on Capita's bid prices or variation in contract sizes (or a combination of both). Given that the data we received was based only on averages, we could not reach reliable conclusions on the reasons behind any trend in such bid prices. To the extent that this decline reflected competitive pressure on Capita's bid prices, we found that this was again a function of market conditions, and did not imply that such prices were independent of the alternatives available to customers. Further, we considered that this was more likely to be due to fiercer competition for a declining number of new tenders than a result of increasing buyer power.⁹⁰
- 8.11 Overall, we found that budgetary restrictions and the employment of sophisticated buyers would be unlikely to confer countervailing buyer power on customers.

⁸⁷Capita offered an analysis of local authority performance against an internal financial control measure in the Audit Commission Comprehensive Performance Assessment in 2007 as compared with 2002 as evidence of this improved performance.

⁸⁸Capita argued, however, that the indirect costs and risks to a local authority (in terms of both its reputation and its operations) associated with changing its R&B system were substantial.

⁸⁹Capita suggested that sophisticated buyers could constrain suppliers by delaying purchases. We noted that delaying purchases might be part of a customer's negotiating strategy, but that it was unlikely to override the shift in bargaining power away from customers as a result of the reduction in alternative suppliers available.

⁹⁰Capita argued that the reduction in the number of contracts available under current market conditions increased buyer power (and reiterated this point in its response to our provisional findings). However, we considered that any bargaining strength conferred on customers as a result of the decline in tendering activity would depend on the number of switching alternatives available to customers. Following the merger, there will be fewer competitors for the contracts that are available.

Selection of suppliers

- 8.12 Capita told us that the tendering process for new contracts allowed customers to compare different offers over several rounds of bidding and to negotiate very strongly.
- 8.13 However, the existence of the tender process (whether or not it is carried out under EU guidelines) does not guarantee that customers will be able to get competitive terms from their suppliers,⁹¹ nor does it confer any buyer power.
- 8.14 Capita also provided evidence of customers obtaining reductions from the prices initially offered to them by Capita both for new contracts and when renewing their existing contracts. However, we considered that such price reductions were simply market outcomes that reflected pre-merger market conditions. Capita itself noted that it offered [X] to one customer after the end of a first tender process because the customer threatened to switch to another supplier. As explained in paragraph 8.8, this evidence provided by Capita did not show that price reductions would be similarly achievable post-merger following the removal of IBS as an independent competitor. Therefore, in itself, this evidence is insufficient to establish countervailing buyer power.
- 8.15 Overall, we did not find that the way in which suppliers were selected and negotiations took place before or during the tender process demonstrated that customers enjoyed countervailing buyer power.

Knowledge asymmetry

- 8.16 Capita argued that customers derived buyer power from their ability to gain knowledge of prices from other customers while suppliers had no knowledge of their customers' budgets.
- 8.17 We found that, while customers may have more information than suppliers in some respects, suppliers have more information than customers in others. Customers may gain knowledge from other customers, but suppliers also have certain key information not available to their customers regarding costs. For example, only suppliers could estimate the resource required for (and hence the costs associated with) product installation and development.⁹² Further, the benefit of sharing price information with other customers appears limited since customers have individual requirements which vary and hence are likely to have difficulty in making price comparisons. We tried to make price comparisons using the contract-by-contract data available to us. However, this data was insufficiently detailed for us to make price comparisons in a way that adequately took into account variation in contract terms between individual customers. Neither Capita nor IBS offered us any equivalent analysis of its own.
- 8.18 Overall we did not find that knowledge asymmetries were a source of countervailing buyer power.

⁹¹See, for example, Paul Klemperer, *Bidding Markets*, CC working paper, 2005, www.competition-commission.org.uk/our_role/analysis/bidding_markets.pdf.

⁹²The information Capita supplied to us in relation to price reductions showed that, in at least one case, Capita had declined a customer request to provide a breakdown of Capita's costs to justify the proposed charge.

User groups

- 8.19 Capita suggested that the presence of user groups created greater buyer power in two ways. First, customers' can communicate and share knowledge through these groups and such groups act as conduits for any negative views of a supplier. As noted in paragraph 8.7, Capita provided evidence that one of its local authority customers considered information sharing to be key to its ability to negotiate lower R&B prices with Capita. However, each user group relates to a single supplier and so cannot facilitate comparisons between competing suppliers. Further, even if pricing information were shared in these groups, we did not find that such information sharing would translate into bargaining strength (see paragraph 8.17).
- 8.20 According to Capita, user groups made 'demand more concentrated than supply', since there are two main user groups for Capita customers (for the northern and southern parts of the UK). However, given that there are over 400 customers for R&B software and over 700 customers for the type of SH software sold by Capita and IBS (see paragraphs 2.20 and 2.23), and given that Capita's user groups do not purchase as one entity,⁹³ we did not find that user groups would make demand more concentrated than supply in either the R&B or SH markets.
- 8.21 We therefore did not find that user groups conferred countervailing buyer power on Capita's and IBS's customers.

The merger of two-tier local authorities into unitary authorities and local authorities' ability to share services and form purchasing consortia

- 8.22 Capita suggested that local authorities could increase their buyer power by purchasing together in various different ways, all of which would help local authorities share information with each other.
- 8.23 CC2 states that 'the fact that the market is characterized by buyers that are large relative to the size of the suppliers does not necessarily mean that there is countervailing buyer power'.⁹⁴
- 8.24 We noted that larger customers, purchasing consortia and shared services arrangements⁹⁵ exist in the relevant markets, and that these may theoretically achieve more favourable terms. However, we did not consider that information sharing across customers would translate into bargaining strength for the reasons set out in paragraph 8.15. Further, as already noted, we considered that the terms obtained by larger customers would not necessarily constrain the prices faced by the smaller customers.
- 8.25 Capita argued that, among respondents to our customer questionnaire, the most common response to a 10 per cent price rise was to seek to purchase collectively. However, as shown in Appendix C, we note that this corresponds to only 20 per cent of respondents and multiple responses were allowed. In addition, given the low response rate, this proportion is indicative of customer views only and should not be

⁹³Capita told us that user groups often negotiated purchases for and on behalf of their members, particularly the pricing of add-on modules and that user groups also influenced the development of the core software modules. However, we considered that such negotiations (for example, relating to the sharing of costs for upgrades needed as a result of minor legislative changes and required by all R&B customers of a given supplier or the relative priority to be given to different core module developments) were fundamentally different from joint purchasing arrangements for the core R&B modules. We saw no evidence that user groups participated in the latter. Purchasing consortia are considered in paragraph 8.24.

⁹⁴CC2, [paragraph 3.59](#).

⁹⁵For example, the South Worcestershire Revenues and Benefits Shared Service Partnership, which covers Wychavon District Council, Malvern Hills District Council, Worcester City Council and Worcestershire County Council.

generalized across the entire customer base. Capita also argued that IBS was ill-suited as a supplier to unitary authorities or shared services arrangements. However, IBS's remaining former management told us that its software was suitable for shared services arrangements and that some customers used its software in this way.

Wider relationships with suppliers

8.26 Customers may be able to constrain R&B software prices if they are able to impose substantial costs on the merged Capita–IBS in relation to sales of other products. As set out in paragraph 7.27, both Capita and Northgate sell a wide range of non-R&B, non-SH software and services to their public sector customers. Capita argued that such customers might respond to an increase in the price of R&B or SH software by reducing purchases of other products from the same supplier, which would make such price increases unfeasible. Capita pointed out that R&B revenues represented only a small part of Capita's overall revenue, and that therefore Capita would have a strong incentive to grant a price reduction for R&B software in order not to lose greater revenues elsewhere. We were not persuaded by this argument for the following reasons:

- (a) If a software supplier increased its R&B software prices post-merger to a given customer and this supplier was the lowest-priced competitor in another service to the same customer, by penalizing the supplier in this other service, the local authority would incur two losses instead of just one: the loss in R&B software and the loss in the other service. This in our view does not make the threat of 'punishing' software suppliers in other markets a credible one, and hence not one that can operate to constrain any post-merger price increases.
- (b) We received evidence that separate teams in local authorities typically make separate—rather than collective—purchasing decisions to meet their individual business objectives.⁹⁶
- (c) We did not find any examples in which this strategy was successfully implemented by a customer and resulted in lower prices for R&B or SH software, nor any examples of customers using this strategy as a threat against suppliers as part of their negotiations. Appendix C contains an analysis of R&B customer responses to our customer questionnaire regarding likely customer behaviour in the event of price increases. The customers that responded to our questionnaire appeared unlikely to consider punishing suppliers in an unrelated software market in response to an increase in price in the R&B or SH market. Further, only a minority of respondents indicated that they would consider pursuing any of the strategies we proposed in response to a small price increase (ie of 10 per cent or less). We note that, given the low response rate to our customer questionnaire, this evidence indicates the views of certain customers only and should not be generalized across the entire customer base. Nevertheless, it indicates that those customers that responded to our questionnaire would not have sufficient countervailing buyer power to prevent small price increases post-merger.

⁹⁶Capita argued that separate purchasing teams nevertheless talked to each other and shared views on the reputation of suppliers. However, in our view, customers might not necessarily recognize modest changes in a supplier's behaviour in the R&B market as being sufficient to justify a poor reputation, especially if the prices offered by the supplier in other areas were attractive. We did not therefore find that the risk of reputational damage jeopardizing wider relationships was sufficient to contribute to the case for countervailing buyer power.

Sponsoring entry

- 8.27 We examined whether large buyers could sponsor new entry by virtue of their size. Their size might allow them to offer a large enough order for a supplier (not usually tendering for such contracts) to invest a small amount in developing a suitable alternative to the main parties' products. The evidence we received from customers and other suppliers suggested that sponsoring entry along these lines had not occurred in the past, would not generally be in customers' interests and would in any case be extremely difficult.⁹⁷
- 8.28 Capita also argued that smaller local authorities might be able to sponsor a supplier to produce a particular bespoke element of its R&B software. According to Capita, over time the supplier would be able to build a full core package by adding third-party modules or developing its own modules. We did not receive evidence that sponsored entry into the relevant markets had occurred by this route in the recent past. In any event, we found that the time that sponsored entry would take (whether by small or large local authorities) meant that the threat of such sponsorship would not act as a constraint on suppliers in the context of a particular tender or renewal negotiation.

Self-supply

- 8.29 We were aware of a small number of examples of self-supply. However, the evidence we received indicated that, as for sponsored entry, it was not attractive to customers.⁹⁸

Conclusions on buyer power

- 8.30 We found that in principle some local authorities might be able to achieve more favourable terms by employing better negotiators or by joining in shared service agreements. It was also possible, albeit unlikely, that some customers might be able to attempt to self-supply or to sponsor new entry. However, we concluded that it was unlikely that any of these, individually or in combination, could provide Capita's and IBS's customers with a significant degree of countervailing buyer power sufficient to compensate for any increase in Capita's market power as a result of the loss of IBS as an independent alternative supplier. We noted that the loss of IBS as an independent competitor might especially hamper the bargaining power of customers in the R&B market, where there were very few competitors before the merger.

9. Assessment of the competitive effects of the merger

- 9.1 In this section we assess the competitive effects of the merger in each of the relevant markets in comparison with the counterfactual. First, we review the theories of harm set out in our issues statement.⁹⁹ Second, we set out the main parties' views on the likely effects of the merger. Third, we assess the effect of the merger on competition.

⁹⁷Civica, SDM, [a local authority], SWRBSS and Northgate.

⁹⁸[A local authority] told us that it previously developed an in-house system which [redacted]. [The local authority] told us that the level of resources needed to operate the system was very significant. It also said that it would not advise any local authority to do it. It said that, although the system was good, it was very expensive; that there was a risk associated with losing resources and a risk associated with keeping it maintained. Furthermore, the lead-in investment cost would also be very significant.

⁹⁹www.competition-commission.org.uk/inquiries/ref2008/ibs/pdf/issues_statement.pdf.

Theories of harm

- 9.2 Our issues statement identified two theories of harm:
- (a) *Unilateral horizontal effects*: the reduction in the number of suppliers of R&B and SH software and related services in the UK as a result of the merger creates or increases (or might be expected to create or increase) market power in the relevant markets, leading to higher prices, or lower levels of service or innovation than would otherwise be the case; and
 - (b) *Coordinated effects*: the merger creates or increases (or might be expected to create or increase) the scope for coordinated effects (that is, market participants recognizing their interdependence, leading to them anticipating competitors' responses to their own actions and taking this into account in their own decisions, for example, in relation to pricing or customer allocation), leading to higher prices, lower levels of service, or less innovation than would otherwise be the case.
- 9.3 We examined both these theories of harm in assessing the competitive effects of the merger.¹⁰⁰

Capita's views

- 9.4 Capita argued that we should judge the merger against two scenarios: (a) current market conditions, and (b) a market in which conditions might eventually change, creating a need for investment and innovation.
- 9.5 Capita submitted that the impact of this merger on competition in the R&B market should be viewed in the context of 'a mature market which has very few new tender opportunities and is therefore effectively in run-off', meaning that very few new tender opportunities could be expected in future and that demand for new R&B software was diminishing. Capita told us that activity was now focused on maintaining existing systems, and selling add-ons and other service upgrades that enhanced the functionality of, but did not fundamentally change, the existing software system to existing customers. Capita argued that IBS was a weak competitor and Northgate provided a competitive constraint. Capita considered that customers enjoyed countervailing buyer power and that a change in market dynamics such as a major technological development would facilitate entry. Capita also argued that the small size of the market (particularly in terms of the low number of new contracts coming up for tender) should be taken into consideration when judging whether there was an SLC.
- 9.6 Capita told us that the SH market was relatively fragmented and it was unlikely to give rise to material competition concerns since: (a) there were at least five other strong players; (b) the main parties' combined share of existing customers had been below 25 per cent in the last five years; and (c) barriers to entry and expansion in this market were low.
- 9.7 Capita stated that, taken together, these factors meant that the merger might not be expected to result in an SLC in either of the relevant markets when compared with the counterfactual.

¹⁰⁰Portfolio effects do not appear to be a potential theory of harm in this case. The merger does not increase Capita's product portfolio as it already had R&B and SH products prior to the merger. Further, Capita told us that its various divisions were managed separately and Capita was primarily concerned about brand reputation rather than always seeking to cross-sell other products and services to its existing customers. Further, the evidence suggests that customers procure R&B, SH and other products separately to satisfy different business objectives, and that attempts to procure jointly break down due to the different paces of change within the customer's different business teams.

Unilateral effects in the R&B market: our assessment

9.8 In this section, we first examine Capita’s argument that the small size of the R&B market should be taken into account when determining whether there is an SLC in this market and second, explain how we have factored the Northgate–Anite merger into our analysis. Although Tables 1 and 3 show that the merger created a combined Capita–IBS share of supply [approaching 50 per cent] for existing contracts and [well over 50 per cent, although estimates varied], for new contracts, an analysis of shares of supply alone is not sufficient to establish that the merger is likely to enhance the ability of the merged Capita–IBS to exercise market power independently of its competitors. Accordingly, third, we examine whether the conditions necessary for the unilateral effects theory of harm to be established (whether in the R&B market or the SH market) are met, ie:

- (a) Capita and IBS were close competitors pre-merger and would have continued to compete absent the merger;
- (b) existing competitors are insufficient to mitigate the effects of any increased market power;
- (c) the threat of entry by a new competitor is insufficient to mitigate the effects of any increased market power; and
- (d) countervailing buyer power is insufficient to mitigate the effects of any increased market power.

9.9 Fourth, we examine the effect of the merger on new customers, mid-term customers and roll-over customers (as defined in paragraph 2.9).

The size of the market

9.10 We were not persuaded by Capita’s argument (repeated in its response to our provisional findings) that the size of the R&B market (particularly in terms of the low number of new contracts coming up for tender) should be taken into account when deciding whether there was an SLC. First, once a merger has been referred to the CC by the OFT, the CC must determine whether or not the merger results in, or may be expected to result in, an SLC, irrespective of the market size. Second, in this case, any adverse effects of the merger would not be confined to new customers, but could also affect existing customers, both mid-term and roll-over (see paragraphs 9.30 to 9.35). Therefore we did not accept that any SLC would only affect a small proportion of customers.

The Northgate–Anite merger

9.11 In our assessment of the unilateral effects of the Capita–IBS merger, we took into account the merger of Northgate and Anite. We recognized that the combined Northgate–Anite share of supply might not be a particularly accurate indication of Northgate’s strength in the R&B market in future.¹⁰¹ However, the conclusions relating to Northgate’s future ability to constrain a merged Capita–IBS are more important than its precise share of supply, an issue discussed in paragraph 9.15.

¹⁰¹The combined Northgate–Anite share may overstate Northgate’s position because [§<]. On the other hand, the combined Northgate–Anite share may underestimate Northgate’s position, given that a larger firm may be able to compete more effectively against Capita and IBS than either Northgate or Anite would have been able to on its own.

The conditions of the unilateral theory of harm

Competition between Capita and IBS prior to the merger

- 9.12 As set out in paragraph 6.67, we found that Capita and IBS were close competitors in the R&B market before the merger, based on our assessment of their shares of contracts, the direct evidence of pre-merger rivalry and an analysis of bidding data.

Ability of existing suppliers to constrain the merged Capita–IBS

- 9.13 Capita told us that the merged Capita–IBS would continue to offer both Capita and IBS R&B products to customers in future until such time as there was a technological or major legislative change. However, we considered that such a strategy would not mitigate any anti-competitive effects that might arise from the merger. Prior to the merger, Capita and IBS’s products were in competition with each other, whereas following the merger there would simply be different product offerings under the control of Capita.
- 9.14 Capita argued that Northgate was its main competitor pre-merger and would continue to be an effective competitive alternative, and that there would also continue to be competition from Civica.
- 9.15 We noted that Northgate was not facing any insurmountable barriers to expanding its activities in the R&B market (see paragraph 7.8). Following the merger, we thought that any expansion by Northgate was more likely to occur through product development and associated organic growth in Northgate’s customer base rather than through acquisition, given the small number of remaining suppliers in the R&B software market and the resulting possible competition concerns were Northgate to acquire one of its competitors. However, as further explained in paragraphs 9.17 to 9.20, we found that the constraint on Capita from Northgate alone would not replicate the pre-merger constraint on Capita from both IBS and Northgate acting independently.
- 9.16 While it did not appear that Civica was facing any insurmountable barriers to expanding its activities in the long term, we found that it might face some barriers to expansion in the short to medium term and that over this time period it would be a weak constraint on Capita. As set out in paragraph 7.6, Civica had not recently tendered for new R&B contracts and was in the process of moving its existing R&B customers to a new version of its core R&B software system, a process that would be completed in the next two to three years. Given the resources likely to be employed in this migration process and given that Civica told us it had taken a commercial decision not to pursue an expansion strategy based on bidding for new customers in the next two to three years, we found that Civica’s ability and incentives to expand organically through competing for and winning new customers in the short to medium term might be limited. In addition, although we did not rule out the possibility that Civica might compete more strongly for new customers in the future, we found that, given the lengthy migration process from its old to its new software and the current lack of a substantial track record for its new product, there remained uncertainty surrounding Civica’s new product offering and hence about its ability to act as a competitive constraint on the merged Capita–IBS in the short to medium term.¹⁰²

¹⁰² Accordingly, we do not share Capita’s view (expressed in its response to our provisional findings) that Civica would be able to exercise a sufficient competitive constraint on a merged Capita–IBS through its future expansion to replace the competitive constraint from an independent IBS.

- 9.17 We considered carefully whether Northgate’s presence in the R&B market would be sufficient to constrain Capita following the merger, as Capita claimed. We considered that the most likely way in which just two firms could be sufficient to preserve competition in the R&B market would be if the R&B market could be characterized as a ‘bidding market’ as defined in the next paragraph.¹⁰³ In most markets, a reduction in the number of competitors from three to two¹⁰⁴ would be considered, all else being equal, as likely to lead to a significant lessening of competition. However, it is often argued that in ideal bidding markets the existence of two firms is sufficient to imply perfect competition.
- 9.18 An ideal bidding market is characterized by the following structural features: (i) competition results in the winner taking all (ie each supplier wins all or none of the order); (ii) competition is ‘lumpy’ (ie each contest is large relative to a supplier’s total sales in a period); and (iii) competition begins afresh for each contract and for each customer (ie there are no incumbency advantages by which the outcome of one contest importantly determines another),¹⁰⁵ However, we considered that, while the R&B market displays the first of these characteristics, it does not display either of the other two characteristics,¹⁰⁶ and therefore the R&B market is not an ideal bidding market.
- 9.19 As discussed in paragraphs 6.22 to 6.31, competition in the R&B market appears to occur on the basis of price and non-price factors and on the basis of differentiated products. In addition, given the evidence analysed in paragraphs 6.39 to 6.45 we considered that Capita and IBS were close competitors to each other (as well as to Northgate) in general and that Capita and IBS’s bids were the closest to each other’s on some occasions.
- 9.20 Therefore the reduction in the number of software suppliers and the resulting increase in market concentration in the R&B market is likely to cause a lessening of competition for new customers going out to tender as well as for roll-over and mid-term customers. (We consider the effect of the merger on roll-over and mid-term customers in paragraphs 9.30 to 9.35.)
- 9.21 We also considered the ability of existing suppliers to constrain the merged Capita–IBS in terms of innovation rivalry. Innovation is another important dimension over which firms can compete in this market and may potentially affect both new customers and existing customers (whether mid-term customers or roll-over customers).
- 9.22 As set out in paragraphs 6.34 to 6.38, innovation in the R&B market can occur in relation to new core products, new non-core modules and existing product refinements. R&D expenditure by market participants appears to have been focused on the latter two dimensions.¹⁰⁷
- 9.23 The evidence we received as to the degree and nature of innovation competition prior to the merger varied across the different products in the market. In particular:

¹⁰³We note that Capita did not make this argument itself, and indeed thought it irrelevant.

¹⁰⁴Following the merger, only Northgate and Capita remain active in bidding for new contracts in the R&B market.

¹⁰⁵See Paul Klemperer *Bidding Markets*, op cit.

¹⁰⁶We found that competition in the R&B market is not lumpy, given that the scale of any individual contract is small relative to a supplier’s total revenue from other R&B customers in a given period (see paragraph 6.7). We also found that there are incumbency advantages in the R&B market (for example, see paragraphs 7.21 and 7.22).

¹⁰⁷As already noted, however, definitions of R&D expenditure differ between suppliers and, on the basis of the data provided to us, it is unclear what specific items are included under the R&D label by each supplier.

- (a) we did not see any evidence of competition through innovation in relation to new core products;¹⁰⁸
- (b) there was evidence of competition to develop new non-core modules involving both Capita and IBS.¹⁰⁹ Although third-party providers are active in this area (see paragraph 5.19), we received limited evidence on the extent of their involvement;¹¹⁰ and
- (c) although only the incumbent supplier has the source code for the software and therefore only the incumbent supplier can provide refinements for existing products (ie upgrades and enhancements such as mandatory legislative upgrades and fixes to ‘bugs’), the supplier has an incentive to make such refinements to maintain customer satisfaction. We saw evidence that functionality was one of the most important aspects of product offering for customers (see paragraph 6.21). If a product becomes less up-to-date than competing products, customers may well be pushed to incur the switching costs to replace their existing system with a system from a different supplier and get a better product.

9.24 Overall, we found that Capita and IBS competed on innovation pre-merger, at least in terms of existing product refinements and new non-core modules, and that, as for other dimensions of competition (such as service levels), following the merger Capita might be able to reduce its level of innovation in relation to these aspects of its products without triggering customers to switch suppliers in response.

The threat of entry by a new competitor

- 9.25 The effect of the merger is to reduce the number of suppliers from which a potential customer could solicit responses to a new contract tender or which an existing customer could play off against each other in negotiations to ‘roll-over’ an existing contract. Given the recent merger of Northgate and Anite and Civica’s recent lack of interest in bidding for new R&B contracts, the merger of Capita with IBS leaves only two companies actively competing for new business.
- 9.26 Both incumbent suppliers that remain (Capita and Northgate) will have certain cross-selling advantages (see paragraphs 7.27 to 7.29), whereas, prior to the merger, there was at least one company active in the market that did not enjoy such advantages (IBS). Therefore we found that the merger would raise the cross-selling barrier to entry for a prospective new entrant.
- 9.27 Accordingly, as set out in paragraph 7.49, we concluded that neither entry and expansion nor the threat of entry and expansion would be likely to be sufficient to prevent Capita exercising any market power (arising from increased concentration and loss of rivalry in the R&B market) as a result of the merger.

Countervailing buyer power

- 9.28 As set out in paragraph 8.30, we found that it was unlikely that Capita’s and IBS’s customers had countervailing buyer power sufficient to compensate for the loss of IBS as an independent alternative supplier as a result of the merger.

¹⁰⁸In the R&B sector a new product introduction involving core R&B software has not occurred in the last five years.

¹⁰⁹Capita and IBS also told us that they attempted to differentiate their products along non-core lines and we saw evidence that non-core product introductions had arisen in response to competitors’ offerings.

¹¹⁰We thought it unlikely that we would obtain definitive evidence on this point, given that such activity would be dispersed across many different suppliers and subject to relatively rapid change.

Effects of the merger on new customers, roll-over customers and mid-term customers

New customers

- 9.29 We considered the likely effects of the merger on new customers¹¹¹ (ie those customers that have just gone or are about to go out to tender for a new R&B contract):
- (a) As set out in paragraphs 9.12 to 9.28, we found that the merger combined two closely competing bidders (whose bids were also the closest to each other's on some occasions). We also found that constraints from existing competitors, the threat of entry and countervailing buyer power would be insufficient to prevent Capita exercising any market power as a result of the merger.
 - (b) By acquiring IBS, we considered that Capita would face a significantly reduced constraint on its competitive behaviour such that it would be likely to be able profitably to raise prices or otherwise offer less favourable terms, for example, on non-price factors (such as service quality), in relation to those contracts that come up for tender in the future.

Roll-over customers

- 9.30 As noted in paragraph 6.6, we estimated that approximately 75 per cent of existing customers were roll-over customers (ie customers that had reached the end of their initial contract term and had renewed their contract with their current supplier on an annual roll-over basis). As noted in paragraph 6.26, there was evidence that competition between suppliers allowed roll-over customers to negotiate price reductions on their annual fees when renewing their contracts.
- 9.31 The merger is likely to reduce the scope for such negotiations because it reduces the number of alternative suppliers, which in turn makes the threat of switching supplier at the roll-over stage less credible. The decreased credibility of switching, both as an explicit threat made by customers and as part of more general ongoing negotiations, would, in our view, be likely to curtail the negotiating strength of roll-over customers, and make incumbent suppliers more able to resist pressure for reductions in customers' ongoing annual payments to them.

Mid-term customers

- 9.32 We also considered the impact of the merger on mid-term customers (ie existing customers in the middle of a contract period).
- 9.33 Capita and IBS told us that prices for software, services and annual maintenance (support) are set on contract signature for the duration of the contract. Any year-on-year changes in the annual maintenance fee during the contract term are usually linked at the outset to changes in the RPI, AEI or a similar index. There therefore appears to be limited scope for competition during the contract term.
- 9.34 We considered whether mid-term customers might benefit from competition through:
- (a) threatening to switch mid-contract to prevent any deterioration in their service levels. We found no evidence that this happened in practice;

¹¹¹This was only part of our analysis. We did not place disproportionate weight on the effect on these customers, contrary to Capita's argument in its response to our provisional findings.

- (b) incentives on suppliers to maintain good levels of service during the term of a customer's contract to enhance their reputation and therefore increase their prospects of winning new tenders (both from new customers and from their existing customers coming out of contracted periods). Although theoretically plausible and although customers appeared to exchange experiences, we found no evidence to indicate that competition for new customers did in fact serve to protect service levels for mid-contract customers in this way; and
- (c) competition to supply additional non-core modules that are bought during the life of a contract. Our analysis of the extent of competition for non-core modules is set out in paragraphs 5.18 to 5.21.

9.35 Overall, we concluded that there was limited scope for mid-term customers to benefit from competition in the R&B market. However, we noted that mid-term customers would in due course become new customers or roll-over customers when their initial contract term expired, and, as such, they too would be adversely affected by the merger in the manner set out in paragraphs 9.29 to 9.31.

Conclusions on unilateral effects in the R&B market

- 9.36 As set out in paragraphs 9.12 to 9.28, we found that the merger combined two closely competing bidders (whose bids were also the closest to each other's on some occasions) and that constraints from existing competitors, the threat of entry and countervailing buyer power would be insufficient to prevent Capita exercising market power as a result of the merger. We concluded that the merger may be expected to result in an SLC in the R&B market. We found that there were likely to be adverse effects on prices, service levels and innovation for both new and roll-over customers due to this loss of rivalry, as well as for mid-term customers when they reached the end of their initial contract term.
- 9.37 We considered whether a change in market conditions (such as a significant technological or legislative change, or an increase in government funding for new core product developments) would alter our view that the merger may be expected to result in an SLC in the R&B market. We noted the possibility that, at some time in the future there could be a step change in market conditions that resulted in more contracts coming up for tender. However, we considered that any such changes were too speculative to be taken into account in our conclusions. In addition, even if such changes were to occur, market entry would not necessarily follow¹¹² and, in any case, there would be more competition in the R&B market with IBS as an independent competitor than without. The possibility of such future changes in market conditions did not therefore alter our view that the merger may be expected to result in an SLC in the R&B market.

Unilateral effects in the SH market: our assessment

9.38 In this section we consider whether the conditions for an SLC finding on the basis of unilateral effects (as set out in paragraph 9.8) are met in the SH market.

¹¹²As set out in paragraph 7.11, there are several other barriers to entry in addition to the current limited number of tender opportunities and we therefore did not expect that market entry (or the threat of market entry) would become sufficient to offset any SLC in the event of a significant change in market conditions.

Pre-merger competition and the constraint from existing suppliers

- 9.39 As set out in paragraph 6.101, we found that the SH market was less concentrated than the R&B market. The figures in Table 4 show that, following the merger, Capita–IBS will have [20–40] per cent of the share of supply of existing contracts overall and, in the period 2006 to 2008, Capita–IBS would have had a share of supply of [30–50] per cent of new contracts. Our analysis of shares of supply, direct evidence of pre-merger rivalry, and our analysis of bidding data suggested that Northgate, Orchard, Civica and Aareon were all important competitors to the main parties.
- 9.40 Bidding data indicated that IBS bid more frequently than Capita for new contracts and had been more successful in winning contracts. The data also suggested that IBS competed as often against Northgate, Orchard or Civica as it did against Capita. This data supported the view that IBS and Capita were not competing any more closely with each other than they were with several other software suppliers. Some of the data we reviewed suggested that IBS competed more often with other software suppliers than it did with Capita, although we noted that this was based on a very small sample, so we treated it with caution.
- 9.41 Capita argued that Capita and IBS were not close competitors pre-merger, as IBS’s SH product was superior. The view that Capita’s SH product was comparatively weak was echoed in third-party responses from both customers and suppliers, and supported by Capita’s internal documentation.
- 9.42 Our assessment of the other factors relevant to assessing the ‘closeness’ of pre-merger competition between Capita and IBS is set out in paragraphs 6.76 to 6.100.
- 9.43 Overall, we concluded that, while Capita and IBS were competing with each other in the SH market prior to the merger:
- (a) they were also competing at least as closely with Northgate, Orchard, Civica and Aareon;
 - (b) Northgate, Orchard, Civica and Aareon would remain important competitive constraints on Capita following the merger; and
 - (c) the merger would not create the opportunity for Capita to exercise market power independently of its competitors, since the remaining suppliers would be sufficient to prevent Capita doing so.

Effect of the merger on barriers to entry and expansion

- 9.44 The Tribal Report provided data which showed seven different software suppliers serving 546 large SH customers in 2008. The report also identified an additional five software companies targeting smaller SH customers. These were not marginal suppliers: seven separate suppliers were identified as having between 43 and 139 installations each. [REDACTED], Northgate–Anite, had [REDACTED] installations. Capita had [REDACTED] installations and IBS had [REDACTED] installations. Based on the information in the Tribal Report, there would still be at least six direct competitors for large customers following the merger.
- 9.45 We identified barriers to entry and expansion in the SH market, including the costs of market entry, switching costs for customers and reputational barriers. However, we found no evidence to indicate that these barriers would increase materially as a result of the merger.

Conclusions on unilateral effects in the SH market

9.46 We found that competition between Capita and IBS before the merger was not close and that the other suppliers in the SH market would be sufficient to prevent Capita exercising market power as a result of the merger. The merger would not increase barriers to entry or expansion. Accordingly, we concluded that the merger may not be expected to result in an SLC on the basis of unilateral effects in the SH market.

Coordinated effects

9.47 We considered whether there would be any coordinated effects arising from the merger in the R&B and SH markets. In order to determine this, we looked first at whether coordination was likely to have existed before the merger. We found no evidence of such effects in either market.¹¹³ Bearing in mind the reduction in the number of market participants already resulting from the Northgate–Anite merger (see paragraph 4.7), we then considered whether the Capita–IBS merger would increase the likelihood of coordinated effects so as to give rise to an SLC.

9.48 We examined whether the three conditions necessary for coordinated effects identified in CC2 would be satisfied following the merger,¹¹⁴ namely:

- (a) the market has to be sufficiently concentrated for firms to be aware of the behaviour of their competitors, and for any significant deviation from the prevailing behaviour by a firm to be observed by other firms in the market;
- (b) it must be clear that it will be costly for firms to deviate from the prevailing behaviour; so costly that it will be in a firm's interests to go along with the prevailing behaviour rather than seek to deviate from it; and
- (c) competitive constraints in the market (such as the threat of entry) must be relatively weak.

9.49 In the R&B market we found that there were some factors that were likely to increase the ability of market participants to establish and monitor the terms of coordination:

- the Capita–IBS merger is essentially a ‘three-to-two’ merger¹¹⁵ that will lead to a highly symmetric market structure;¹¹⁶ and
- before the merger, we considered that there was some limited transparency in the market in that, although market participants were not aware of customer-specific prices or other terms and conditions, they sometimes knew which other suppliers

¹¹³We concluded that there was no evidence of past coordination in the R&B market based on the following considerations: (i) while shares of supply of existing contracts were reasonably stable in the period 2005 to 2008, shares of supply of newly-tendered contracts (the number of which has declined significantly in recent years) were more volatile, indicating a competitive dynamic not typically consistent with coordinated behaviour; (ii) the bidding data we analysed did not show any alignment in the values of bids, nor did the data imply any clear allocation of customers by geographic area, by incumbent supplier or by a bidding rota; and (iii) customers did not express concerns to us about coordinating behaviour in tenders. Similar arguments applied in relation to the SH market, except in respect of bid values on which we had no data.

¹¹⁴CC2, paragraphs 3.37 to 3.39.

¹¹⁵In terms of the number of active bidders for new contracts.

¹¹⁶Post-merger Capita–IBS will have a combined share of supply [approaching 50] per cent of existing contracts and its main competitor, Northgate, will have a share of supply of [40–60] per cent. Capita–IBS's combined share of supply in terms of newly-awarded contracts is somewhat higher, being [well over 50] per cent between 2005 and 2008, compared with Northgate's share of supply of [20–40] per cent (see paragraphs 6.12 to 6.16). We recognize that the Capita–IBS merger in June 2008 was closely followed by the Northgate–Anite merger (announced in August 2008 and completed in October 2008—see paragraph 4.7). It is therefore only possible for us directly to observe the effects of the change from four market participants active in bidding for new tenders (prior to the Capita–IBS merger) to two market participants active in bidding for new tenders (following the Northgate–Anite merger).

were bidding for contracts, which supplier ultimately won the contract and which suppliers were negotiating with roll-over customers. However, we found that the degree of market transparency would be significantly increased following the merger, given the repeated interactions between just two market participants through the tendering process (each market participant would know with certainty the identity of the other competing supplier and of the supplier which won the tender).

- 9.50 The factors highlighted above imply that market participants would be able easily to reach a coordinated outcome and to detect any deviation from the coordinated behaviour. We considered the terms of coordination in the R&B market as likely to be around market sharing mechanisms, for example market sharing by (i) geographic area; (ii) incumbent supplier; or (iii) a bidding rota.¹¹⁷ In particular, in a situation of just two active bidders for new contracts each with strong market positions, an outcome in which each company did not compete for a contract for which the other is the incumbent cannot be ruled out. Such a market-sharing mechanism would cover both tenders for new contracts and negotiations at the end of a local authority's initial contract period, when the local authority was informally seeking to apply pressure to its incumbent supplier to lower its ongoing annual charges if the existing contract were to be rolled over.
- 9.51 There was some evidence from market participants that supported our concerns about the risk of market sharing following the merger [REDACTED]:
- Northgate told us that it [REDACTED]; and
 - Capita said that [REDACTED].
- 9.52 However, we also found that there were other factors, not affected by the merger that would limit incentives for coordinated behaviour in the R&B market. In particular, in relation to new contracts coming up for tender, there are (i) infrequent competitive interactions, that is there are a small number of new contracts that come up for tender; (ii) uncertainty over the frequency of interaction, that is contracts come up for tenders at irregular and unknown intervals; and (iii) the size and content of contracts coming up for tender varies greatly. Together, these factors suggest that the incentives to cheat on any collusive outcome in relation to new contracts are high,¹¹⁸ given the potential benefits arising from a deviation (in terms of the lifetime value of the new customer) and the potential low effectiveness of the punishment mechanism, ie it could take a long time before an opportunity to bid aggressively against the deviator arose, and then it might only be a small contract.¹¹⁹
- 9.53 In addition, as set out in paragraphs 9.27 and 9.28, we considered that other competitive constraints in the R&B market such as the threat of market entry and buyer power were relatively weak and the merger does not change (and may in fact exacerbate) such weakness.
- 9.54 Another factor limiting the incentives for coordinated behaviour between Capita–IBS and Northgate would be the uncertainty over the timing and extent of Civica's future involvement in bidding for new contracts (see paragraph 7.6).

¹¹⁷We did not consider that coordination on contract terms (either on price or on non-price factors) was plausible due to the lack of comparability in such terms between contracts, which reflect the individual requirements of customers.

¹¹⁸We noted that the same arguments would not necessarily apply to roll-over negotiations, which arise more frequently and with greater predictability.

¹¹⁹However, it should be noted that any punishment mechanism need not be limited to new contracts but could involve other markets or other customers. Its overall effectiveness could then be improved. For example, the punishment mechanism might entail negotiating aggressively with the other supplier's roll-over customers.

- 9.55 On the basis of our analysis, we found that in the R&B market, market participants would have an increased ability to develop coordinated behaviour following the merger. However, we also found reasons why incentives for such behaviour might be limited. Overall, given that we expected the merger to have unilateral effects in this market (see paragraphs 9.36 and 9.37), we did not need to come to a conclusion on the likelihood of coordinated effects.
- 9.56 In the SH market, while noting that a degree of market transparency existed, we found that there was a sufficiently large number of suppliers¹²⁰ remaining in the market after the merger to make coordination more difficult to sustain and that the same factors limiting the incentives to coordinate in the R&B market also applied. On this basis, we therefore expected that the merger would not increase the likelihood of coordinated outcomes in the SH market.

10. Conclusion on SLC

- 10.1 As set out in paragraph 9.36, we conclude that the merger may be expected to result in an SLC in the R&B market leading to higher prices, lower service levels and/or lower levels of innovation than would otherwise be the case in that market.
- 10.2 On the basis of paragraphs 9.46 and 9.56, we conclude that the merger may not be expected to result in an SLC in the SH market.

11. Remedies

Introduction

- 11.1 We found an SLC in the R&B market. Under [section 35](#) of the Act, we must have regard to the need to achieve ‘as comprehensive a solution as is reasonable and practicable to the substantial lessening of competition and any adverse effects resulting from it’.¹²¹
- 11.2 We first identify remedies that are effective in addressing the SLC and its resulting adverse effects. We then consider proportionality, seeking to ensure that no remedy is disproportionate in relation to the SLC and its adverse effects. We also have regard to any relevant customer benefits arising from the merger.¹²²

Assessment of effectiveness of remedies options

- 11.3 In general, the CC prefers one-off remedies that restore or maintain the structure of the market (structural remedies) to remedies designed to regulate or constrain the behaviour of the parties (behavioural remedies). This is because structural remedies are likely to deal with the SLC or consequent adverse effects at source by restoring rivalry in a horizontal merger and do not normally require ongoing monitoring and enforcement. Behavioural remedies, on the other hand, may be difficult to specify or easy to circumvent; may lead to market distortions; and are likely to require significant monitoring and enforcement.

¹²⁰In terms of mid-term and rolled-over contracts as well as of newly-awarded contracts.

¹²¹[Section 35\(4\)](#).

¹²²[Section 35\(5\)](#).

- 11.4 With this approach in mind, we assessed the effectiveness of the remedy proposals that we identified in, or received in response to, our Remedies Notice (the Notice). We consider behavioural remedies before addressing structural remedies.

Behavioural remedies

- 11.5 In response to the Notice, no third party proposed any behavioural remedies to address the SLC. Capita recognized that the CC generally preferred structural remedies, but drew our attention to the behavioural remedies that it had offered to the OFT as undertakings in lieu of reference. These remedies comprised a continuation of a choice of IBS and Capita R&B software, continued investment in both systems, price controls, external monitoring, and waiving fixed terms in its supply agreements.
- 11.6 We considered these behavioural remedies but found that they were unlikely to be effective in addressing the SLC. The remedies proposed whereby Capita would, for example, maintain a choice of the IBS or Capita software systems for existing and new customers, continue to invest in both software systems, or waive any fixed term in any existing contract, would not restore rivalry in the R&B market and so would not address the SLC.
- 11.7 Further, remedies in the form of a price control (eg a reduction in fees charged to new customers to a specified percentage below the average of historical fees) would not address the reductions in service levels identified as part of the adverse effects of the SLC. Price control remedies would also not be practicable to implement because contracts with each customer are unique with different service requirements, such that prices are individually negotiated. There is a range of prices that would need to be regulated (including initial licence fees, implementation fees and annual maintenance fees) that would make a price control extremely complex and costly to design and monitor in a market characterized by extensive information asymmetries between customers and suppliers.
- 11.8 Accordingly, we concluded that behavioural remedies would not be effective in addressing the SLC identified.

Structural remedies

- 11.9 We identified two possible structural remedies: (i) divestiture of the whole of the IBS business (full divestiture), or (ii) divestiture of only the R&B business unit of IBS (partial divestiture). In this section we examine the likely effectiveness of each, having regard to three broad categories of risk set out in our guidelines:¹²³
- (a) *composition risks*, ie risks that the scope of the divestiture package may be too constrained or not appropriately configured to attract a suitable purchaser or may not allow a purchaser to operate as an effective competitor in the market;
 - (b) *purchaser risks*, ie risks that a suitable purchaser is not available or that the merger parties will dispose to a weak or otherwise inappropriate purchaser; and
 - (c) *asset risks*, ie risks that the competitive capability of a divestiture package will deteriorate before completion of the divestiture, for example through loss of customers or key members of staff.

¹²³ CC8, *Merger Remedies: Competition Commission Guidelines, November 2008*, paragraph 3.3.

11.10 We used this framework to assess the effectiveness of full and partial divestiture in turn. As stated in our merger guidance,¹²⁴ the CC generally prefers divestiture of an existing business that can compete effectively on a stand-alone basis independently of the merger parties, to divestiture of part of a business or a collection of assets. By 'stand-alone', we mean competing as an independent operating entity rather than as part of any wider organization. Divestiture of a complete, stand-alone business is less likely to be subject to purchaser and composition risk and can generally be achieved more rapidly.

Full divestiture

11.11 Under this option, the entire IBS business, IBS OPENSystems (UK) Ltd, would be divested by Capita to a suitable purchaser. A successful full divestiture could address the SLC by restoring the R&B market to the pre-merger competitive conditions. We assess the composition, purchaser and asset risk of full divestiture in turn.

Composition risks

- 11.12 The IBS business contains all the relevant capabilities, assets and personnel to compete effectively in the R&B market, as it did before its acquisition by Capita. We noted that the IBS business had a track record of competing effectively both on a stand-alone basis and as a wholly-owned subsidiary of Capita.
- 11.13 Before its acquisition by Capita, IBS operated as a stand-alone business, trading on AIM. Since the acquisition, IBS continued to trade with no changes to its range of business activities but Capita had replaced some of IBS's back-office functions with services supplied by Capita. As set out in paragraph 4.9 and Appendix H, IBS was a profitable business. It enjoyed a stable reputation with customers, secured by long-term contracts with its customers for the provision of software and services. There was no evidence of significant loss of customers since the acquisition by Capita. IBS told us that, despite some changes in the market since the acquisition by Capita, it could operate as a stand-alone business as it had done in the past. It considered that divestiture of the whole of the IBS business should result in no major adverse effects on its trading position.
- 11.14 Against this financial background, we noted that Capita had stated that IBS would be 'ill-equipped to survive' in the R&B software services market, given it 'lacks the scale to compete' as customers would 'tend to choose bigger players such as Capita and Northgate'. [§] However, we concluded in paragraph 4.14 that IBS would have continued to be an effective competitor in the absence of the acquisition, and Capita accepted this conclusion.
- 11.15 Following the acquisition by Capita, some support functions¹²⁵ had been replaced by services provided centrally by Capita. The interim undertakings agreed during the CC inquiry were designed to prevent further integration of IBS into Capita. As a result, the IBS business operated independently of Capita during the inquiry.
- 11.16 To complete a full divestiture, some of these support functions would need to be recreated by a purchaser. Such circumstances commonly arise in divestitures, and there is no reason to believe that in this case any such arrangements would create composition risks, or compromise the ability of IBS to compete effectively either as a stand-alone entity or as part of another business.

¹²⁴CC8, paragraph 3.9.

¹²⁵Including treasury, payroll, human resources, business insurance, fleet car management and property management.

- 11.17 In response to the Notice, no third parties questioned the ability of IBS to compete effectively as a stand-alone entity if it were divested as a complete business from Capita.
- 11.18 Accordingly, we concluded that IBS could compete as a stand-alone business and that full divestiture of the whole of IBS would not give rise to material composition risks.

Purchaser risks

- 11.19 During the sales process in 2008, several parties expressed interest in acquiring IBS. Capita told us that, if it were required to divest the whole of IBS, it would [X].
- 11.20 During the third-party remedies hearings, we received evidence that several parties might be interested in acquiring the entire IBS business from Capita. [Third parties] told us that they might be interested in acquiring the whole of IBS, although noted that they were unaware of the current trading position of the IBS business. [A third party] suggested that, due to the specialized nature of the market, there might be around three or four trade buyers with both a strategic interest and the necessary financial capability and possibly 12 financial buyers interested in acquiring the whole of IBS.
- 11.21 We noted that there might be some potential purchasers interested in the whole of the IBS business which might give rise to further competition issues in one or more of the markets in which IBS participated, in particular in the SH software market.
- 11.22 We noted that, since the acquisition of IBS in 2008, financing conditions have become more difficult. However, the outlook for R&B and SH software had remained relatively stable. In the prevailing economic conditions, potential purchasers were cautious in their approach to acquisitions and it was more difficult to obtain acquisition funding than it had been in 2008. We considered that the financing arrangements for potential bidders would need to be considered on a case-by-case basis.
- 11.23 Capita also told us that, as IBS operated in several product areas, purchasing the whole IBS business could prove to be a more complex integration challenge than purchasing just one business (such as IBS's R&B business) as the latter could be integrated into a single business unit of a potential purchaser. Against this we noted that IBS as a self-contained operating unit would present fewer immediate integration challenges as it could continue to operate as a self-managed unit (as it did within Capita). On balance, we did not find that these integration risks identified by Capita were likely to be material, particularly given that Capita itself had not considered integrating the whole of the IBS business to be an insurmountable issue.
- 11.24 We concluded that, although there appeared to be several parties that had expressed an interest in acquiring the whole of IBS, there remained some purchaser risk given the prevailing financing conditions.

Asset risks

- 11.25 A lengthy or uncertain divestiture process, or the failure of a potential purchaser to complete the acquisition, would increase asset risks. In these circumstances, it is possible that customers and staff might be lost due to the uncertainty of the future of the business. These risks were, however, no higher than for any divestiture of a whole business at the end of a merger inquiry.

- 11.26 Any potential purchaser must perform due diligence to satisfy itself and potential finance providers of the merits of a transaction. In terms of financial due diligence, Capita expected [REDACTED]. We noted that despite the changes to the ownership of IBS, the historical audited accounts would provide several years of trading history for a potential purchaser. We thought that this could represent a starting point for financial due diligence. However, a potential purchaser would need to form a view about the adjustments it may need to make to the financial information based on its plans for the business.
- 11.27 Although some asset risks existed in relation to a full divestiture, should the process become drawn out or the due diligence process raised issues, we concluded that these asset risks were not material.

Conclusion on full divestiture

- 11.28 We concluded that full divestiture would be an effective remedy. Full divestiture would address the SLC, could be completed in a reasonable time, and would be practicable in terms of implementation. It would have an acceptable risk profile in terms of composition and asset risks. There remained some purchaser risk in the prevailing economic conditions.

Partial divestiture

- 11.29 Under this option, Capita would divest only those assets and intellectual property relating to R&B software and related services. A successful partial divestiture would address the SLC we identified. In this section we consider:
- (a) whether the R&B business unit would be capable of competing effectively on a stand-alone basis (as defined in paragraph 11.10);
 - (b) the composition risk;
 - (c) the asset risk; and
 - (d) the purchaser risk of a partial divestiture.

R&B division as a stand-alone business

- 11.30 Capita said that the R&B business could compete on a stand-alone basis, given its: (a) brand focus in the R&B market; (b) R&B customer focus; (c) stand-alone product development capability; (d) good 'referenceability' from installed customer base; and (e) a sound revenue stream, [REDACTED] is from annually recurring fees. We found that these represented necessary, but not sufficient conditions for the R&B division to compete effectively on a stand-alone basis.
- 11.31 Capita also stated that a stand-alone R&B business would be commercially viable, capable of sustaining product development for existing customers, but that it would be unlikely to attract new customers.
- 11.32 IBS told us that the R&B business unit of IBS could compete effectively on a stand-alone basis in the short term (given adequate protection from Capita to ensure an effective divestiture). However, in the longer term it would need to expand its service range to be able to compete.

- 11.33 We noted that there was no history of stand-alone operation by the R&B division and that no other R&B competitors existed as independent operating entities.¹²⁶ Any stand-alone operation would suffer from lack of scale and product diversification in relation to other R&B providers such as Capita and Northgate. Based on the evidence we received, we found that the uncertainty of the likely competitiveness of a stand-alone R&B division outweighed the factors put forward by Capita in paragraph 11.30.
- 11.34 We therefore concluded that the R&B division could not compete effectively on a stand-alone basis, and that a partial divestiture could only be an effective remedy if the divested R&B division was bought by a suitable purchaser. This placed greater importance on the capability and commitment of any potential purchasers, and is discussed in paragraphs 11.55 to 11.59.

Composition risk

- 11.35 As summarized in paragraph 11.10, the CC generally prefers the divestiture of a complete business to a collection of assets.¹²⁷ Our guidelines state¹²⁸ that ‘where a package of assets is proposed for divestiture, the CC will require the merger parties to specify the composition and operation of the package in detail’.
- 11.36 In light of these possible difficulties, we considered in detail the separation issues that would need to be overcome within IBS. Capita identified several such issues within IBS, examined below:
- (a) intellectual property (IP), including shared software code and know-how in relation to the core database and add-on modules;
 - (b) joint IBS customers, ie those customers that purchase both R&B and SH products from IBS;
 - (c) staff performing multiple functions within IBS, ie allocation of personnel between divisions, and the potential need for replication of some roles; and
 - (d) other shared IBS facilities and assets, including a shared customer helpdesk.

- *Intellectual property*

- 11.37 In relation to IP, we examined the extent of shared IP and know-how, and the separation proposals, particularly in relation to software code, in order to conclude whether the R&B business could compete effectively, independent of Capita and to confirm that there would be no need for ongoing links or monitoring requirements between Capita and the purchaser.
- 11.38 Capita identified several IP rights that would be required by any acquirer of the IBS R&B business. These rights related to: (a) the software code for databases used in providing IBS’s R&B products; (b) the software code for producing user screens for the IBS R&B products; and (c) the software code for a wide range of add-on modules. Capita noted that there were currently shared Intellectual Property Rights (IPRs) between the R&B and SH businesses in relation to the first two areas and for one particular add-on module.

¹²⁶Indeed IBS itself always had an SH business as well as an R&B business.

¹²⁷CC8, paragraph 3.10.

¹²⁸CC8, paragraph 3.10.

11.39 For the first two areas, Capita considered that the software code could be split by an assignment to any purchaser of all rights to use the code save in relation to the retained SH business. Capita would be assigned rights to use the code for the SH business only. As staff of IBS's SH business were able to maintain and develop the code independently of the R&B business, Capita submitted that these IP arrangements would ensure that there would be no need for any continuing links between Capita and a purchaser. Capita noted that there would need to be a short transitional period in the case of the software code for the databases, where those databases required replication (see paragraph 11.43(c)).

11.40 With regard to the add-on module which was also used by a small number of customers for IBS's SH product, Capita told us that it would offer options (such as obtaining a licence from the R&B business on commercial terms, replacing the module with one of Capita's own add-on modules, or replacing the module with a third-party add-on module) to those few IBS SH customers affected.

11.41 We concluded that all potential purchasers would need to be assigned the IP necessary for R&B in order to be able to compete effectively. However, we accepted, based on the evidence received, that the process of identifying and separating IP within IBS would not create significant composition risks. In particular, we found that there was no need for any continuing links between Capita and any purchaser in relation to IPRs and that any transitional period would be short.

- *Joint IBS customers*

11.42 We noted that some customers purchased both R&B and SH products from IBS, ie 'joint IBS customers'. IBS told us that there were a small number ([REDACTED] joint IBS customers out of [REDACTED] IBS R&B customers). To achieve a partial divestiture it would be necessary to separate the customer relationships so that the R&B and SH divisions could operate and compete independently. We assessed what costs this could impose on both the customers affected and on the R&B division itself.

11.43 With regard to joint IBS customers, three issues were apparent:

- (a) Of the [REDACTED] joint IBS customers, [REDACTED] had a single joint contract with IBS covering both R&B and SH systems, which would need to be separated for the respective IBS products and services. However, Capita proposed that these separate contracts would be on terms no less favourable than those currently enjoyed by these joint customers.
- (b) For those customers with a single joint contract, Capita also told us that it would need to enter into new licensing arrangements with Progress¹²⁹ on their behalf. Although revised licensing arrangements introduced an element of risk, we did not consider this to be material because the Progress sub-licences either were already split between R&B and SH products or were capable of being split.
- (c) [REDACTED] customers had a single 'core' database¹³⁰ installed at the customer site and accessed by both the R&B and SH systems.¹³¹ For each of these customers, this

¹²⁹Progress is an independent supplier of database software on which the IBS applications are based. In order to operate IBS software, a customer requires a licence for the Progress database software.

¹³⁰This database consisted of an individual record for each person liable for council tax, each person entitled to receive housing benefit and each property subject to non-domestic rates.

¹³¹One customer [REDACTED] told us that it had a single installation of the IBS core database, and that if the systems were supplied by independent companies, the information in the database would need to be replicated and interfaces would need to be developed to ensure that the newly-independent systems could continue to function.

database would need to be replicated so that it could continue to be accessed by the R&B and SH products separately. Capita told us that this was technically feasible and would only take a matter of days to complete. It was not aware of any contractual restriction preventing this. We recognized that this could create a potential cost for customers but Capita submitted that it would ensure no financial detriment was incurred by customers in relation to this issue.

11.44 We concluded that, with regard to the affected customers, a partial divestiture could give rise to costs in relation to each of the three areas above. However, Capita proposed to resolve these technical and commercial issues at no cost to the affected customers.

11.45 We noted that there may be several potential financial adjustments to the R&B division that would stem from the divisional separation, for example: (a) the retained proportion of business from joint customers; (b) negotiation with customers to split contracts; (c) performing the process of database replication at customer installations; and (d) loss of cross-selling benefits or savings from shared customer support for joint customers. We concluded that, in the event that the R&B division was combined with another business, these matters would be taken into account in the negotiation between Capita and the purchaser (and so might affect the price agreed, rather than the viability of the separation).

- *Staff*

11.46 Capita told us that the divestiture package would include all staff required by a purchaser. It identified those it thought necessary, including certain 'joint staff'.

11.47 There were [X] staff performing functions in both R&B and SH divisions in [X] functional areas including the Managing Director. We noted that IBS employs a total of [X] staff such that the number of joint staff was therefore [X] per cent of total.

11.48 Capita stated that the divestiture package would include all those 'joint staff' that the purchaser required. IBS told us that the issue of joint staff would depend on the identity of the buyer, but that a majority of the posts were in support roles. IBS told us that the separation of personnel by division would not be insurmountable.

11.49 We noted an additional asset risk during a partial sale from the uncertainty in relation to the future of employees, especially those that were currently working across the R&B and SH business units.

11.50 We also noted that decisions with respect to staff could have a material financial effect on the acquired entity, but this would be specific to any individual purchaser. We concluded that, in the event that the R&B division was combined with another business, these matters would be taken into account in the negotiation between Capita and the purchaser (and so might affect the price agreed, rather than the viability of the separation). We found that the separation between divisions would be clear cut for a majority of employees. For those employees performing functions in multiple IBS divisions, there could be some risks arising that may affect the division's ability to compete effectively in future, but a purchaser would be likely to pay close attention to staff allocation during due diligence.

11.51 Accordingly, we concluded that staffing issues did not produce a material composition risk.

- *Shared facilities*

11.52 We identified some assets and facilities that were common to R&B and SH. However, Capita and IBS provided us with evidence that such assets and facilities could be allocated between the two business units. Capita also provided a proposed divestiture package from which we were able to satisfy ourselves that the assets and facilities required for a purchaser to compete effectively would be transferred should that purchaser require them.

11.53 We concluded that the shared facilities issues identified would not represent an insurmountable problem for purchasers, and that the risk of customer problems in relation to customer support services could be effectively managed with appropriate preparation.

- *Conclusion on composition issues of partial divestiture*

11.54 A partial divestiture is likely to have a greater composition risk than a full divestiture. However, in this case, we concluded that such risks could be mitigated sufficiently so that a partial divestiture should not be precluded on this count.

Purchaser risks

11.55 For the reasons set out in paragraphs 11.30 to 11.34, we concluded that the R&B division would not be an effective competitor on a stand-alone basis, but a partial divestiture could be an effective remedy if the R&B division were combined with an existing business. In examining a partial divestiture, the capabilities and resources of prospective buyers are therefore relevant.

11.56 Capita told us that [✂].

11.57 We were told by [third parties] that they might be interested in acquiring the R&B division.

11.58 We noted that, in contrast to paragraph 11.21, as the R&B division would be active in fewer markets than the whole of IBS, there might be less chance that a potential purchaser would give rise to subsequent competition issues. We also noted that the smaller size of the transaction could result in a larger number of potential purchasers having the financial capability to complete the acquisition, particularly given the current financing conditions.

11.59 We therefore concluded that there were likely to be a number of suitable purchasers for the R&B division.

Asset risks

11.60 We considered the extent of asset risks in the case of a partial divestiture. A short sales process with a high degree of certainty of completion reduces the likelihood of asset risks arising. The duration of a sales process cannot be reliably predicted, but we identified several relevant considerations which we divided into three categories examined below:

(a) divisional separation during a sales process;

(b) size and complexity of the transaction; and

(c) purchaser motivation.

- *Divisional separation issues*

11.61 With respect to divisional separation issues during a sales process, an important difference between a full and partial divestiture is the need to complete the divisional separation of IBS in order to achieve a partial sale.¹³² In addition to the composition risks highlighted in paragraphs 11.35 to 11.54, the initial steps towards divisional separation during a sales process themselves create asset risks.

11.62 We noted that during the sales process, it might be necessary to inform staff and customers¹³³ and discuss various alternative approaches to divestiture, some of which might be purchaser-specific. This would create a degree of uncertainty for a significant number of staff and for customers, and could lead, for example, to staff resignation or loss of business.

11.63 We were particularly concerned by the possibility that actions taken by Capita during the exploration of the partial divestiture with any potential purchaser might preclude a subsequent sale of the whole of IBS, or a partial sale to a different purchaser.

- *Size and complexity of the transaction*

11.64 With respect to the size and complexity of the transaction, we noted that a sale of the R&B division would be a smaller transaction than a sale of the whole of IBS, but the divisional separation could add to its complexity and so slow the divestiture. A potential purchaser would need to conduct due diligence on the R&B division to satisfy itself of the merits of a transaction, and potentially secure financing from third parties.

11.65 Capita considered that more due diligence would be needed for a full divestiture than a partial divestiture, due to the greater size of the transaction.

11.66 [Third parties] each stated that the due diligence timetable would depend on the availability of financial information at a divisional level. [A third party] told us that a partial sale would require a longer due diligence process because of separation and employment issues. [A third party] told us that it thought it would need to conduct significantly more due diligence on a partial sale than a full sale, in order to understand the separation process and implications, including impact on customers, product development and sales.

11.67 We noted that a smaller transaction size might require less financing, but that the information on which to form a financing decision may be different. IBS had a trading history as a self-contained business which could inform any possible purchaser of a full divestiture, whereas for the R&B division, financing providers must form a judgement about the financial viability of the IBS assets following a major change in the scale and scope of the business.

11.68 With regard to financial information available to a potential acquirer, there were historical management accounts as well as audited financial statements for IBS prior to its acquisition by Capita, and [redacted].¹³⁴ In contrast, for the R&B division alone, the

¹³²Separation from Capita is required for both a full and partial divestiture.

¹³³See paragraph 11.43 in relation to joint customers.

¹³⁴Although we note that IBS has changed from an independent, listed company to a wholly-owned subsidiary of Capita.

available financial information consisted of unaudited management accounts from 2002 to 2008.

- *Purchaser motivation*

11.69 With respect to purchaser motivation, we noted that [REDACTED].

11.70 We also noted that [REDACTED]. We found that there was a potential asset risk arising in the due diligence phase should a potential purchaser fail to transact.

11.71 We found that a due diligence process for a partial sale would involve a number of practical steps, particularly in relation to technical separation, but there was insufficient evidence for us to conclude whether this would be a more or less complex or time-consuming exercise than for a full divestiture.

Conclusion on asset risk of partial divestiture

11.72 We found that there were some asset risks associated with a partial divestiture, principally around the need to 'carve out' part of the IBS business. However, taken as a whole, we found that these risks were not substantially higher than those arising in the case of a full divestiture. We also found that purchaser risks (which themselves affect the speed of the process and hence the asset risks) were higher for a full divestiture than for a partial divestiture.

Conclusion on partial divestiture

11.73 For the reasons given above, we concluded that a partial divestiture would be an effective remedy.

11.74 We next assessed the proportionality of remedies and relevant customer benefits.

Proportionality and relevant customer benefits

Proportionality

11.75 Our guidance states that '[i]n order to be reasonable and proportionate the CC will seek to select the least costly remedy, or package of remedies, that it considers will be effective. If the CC is choosing between two remedies which it considers will be equally effective, it will select the remedy that imposes the least cost or that is least restrictive'.¹³⁵

11.76 We consider both full divestiture and partial divestiture to be effective remedies. While we considered that a partial divestiture might impose some costs on third parties (ie the joint customers), we were satisfied that such costs would be met by Capita. In line with our guidance, for this completed merger, we did not take into account any costs of divestiture that might fall on Capita.¹³⁶

11.77 We noted that the SLC we had identified related to only the R&B market and that R&B revenues represented approximately [REDACTED] per cent of the IBS revenues. We therefore concluded that a partial divestiture is the less intrusive of the two remedies.

¹³⁵ CC8, paragraph 1.9.

¹³⁶ CC8, paragraph 1.10.

Relevant customer benefits

- 11.78 In deciding questions of remedies, the CC is permitted to have regard to the effects of any (remedial) action on any relevant customer benefits in relation to the creation of the relevant merger situation concerned.¹³⁷ Relevant customer benefits are limited by the Act to benefits to relevant customers in the form of lower prices, higher quality or greater choice of goods or services in any market in the UK, or greater innovation in relation to such goods or services.¹³⁸
- 11.79 The Act provides that a benefit is only a relevant customer benefit if it accrues from or is expected to accrue to relevant customers within the UK within a reasonable period from the merger and would be unlikely to accrue without the merger or a similar lessening of competition.¹³⁹
- 11.80 Capita suggested to us that there were two relevant customer benefits from the merger. It would be able to offer (a) SH customers an enhanced suite of SH products; and (b) an improved range of services to IBS's Local Authority customers, which pre-merger were not on offer from IBS.
- 11.81 We found that both of the claimed benefits amounted to improvements to Capita's own product range rather than any improvement to the range of products available generally to customers pre-merger. In addition, given that both Capita and IBS were profitable businesses with independent track records of funding product development, we thought that improvements to each of Capita and IBS's product ranges could have been made absent the merger or a similar lessening of competition.
- 11.82 Further, with respect to the first claimed benefit, we noted that under the partial divestiture remedy, Capita would retain IBS's SH activities. With respect to the second claimed benefit, we concluded that Capita had a longstanding track record of selling a range of products and services to local authorities, independent of whether or not a specific local authority was also a customer of the IBS R&B product, and that Capita's sales capability in this respect could be enhanced independent of the merger.
- 11.83 We therefore concluded that these claimed benefits should not be treated as relevant customer benefits for the purposes of our decision.

Conclusion on remedies

- 11.84 We concluded that both a full divestiture of IBS and a partial divestiture of the IBS R&B business would be an effective remedy to the SLC that we identified.
- 11.85 Since we identified two remedies that could be effective if successfully implemented, we considered their proportionality. We concluded that a partial divestiture would be the less intrusive of the two remedies, given that our SLC only relates to the R&B market, in which IBS earns only [%] per cent of its revenues. We did not find any relevant customer benefits within the meaning of the Act.
- 11.86 Accordingly, we concluded that in order to address the SLC, Capita should be given the opportunity to divest only the IBS R&B division to a suitable purchaser. To

¹³⁷ Sections 35(5) and 36(4).

¹³⁸ Section 30 of the Act. See also CC8, paragraph 1.14.

¹³⁹ Sections 30(2) and 30(3).

minimize asset risk we require that a partial divestiture is completed before Capita can progress with further integration of the rest of the IBS business.

- 11.87 Capita told us that in its view a partial divestiture could be completed within [X] months of due diligence commencing, with a further [X] months to allow all customer separation issues to be completely resolved. Following publication of this report, we will agree with Capita undertakings which will include specification of a reasonable period within which to achieve a partial divestiture.
- 11.88 During the divestiture process and given the asset risks identified, we will need to pay particular attention to mitigating asset risks that might arise. Should a successful divestiture of the IBS R&B division not be achieved by Capita within a reasonable period, we will review whether we need to widen the scope of the divestiture package to a full divestiture of the IBS business. We will also consider whether it would be appropriate to appoint a divestiture trustee at any stage in the process, taking into account the circumstances at the time.