
Completed acquisition by Francisco Partners L.P. of G International Inc

The OFT's decision on reference under section 22(1) given on 22 March 2005.
Full text of decision published 28 April 2005

Please note square brackets indicate figures or information excised at the request of the parties for reasons of commercial confidentiality.

PARTIES

1. **Francisco Partners L.P. (Francisco Partners)** is a technology-focussed investment firm. It controls Global Exchange Services Inc (GXS). GXS operates a secure global network platform for business to business (B2B) communication, in particular via Electronic Data Interchange (EDI) services.
2. **G International Inc (G International)** consists of assets formerly owned by the Application Hosting Business Division of International Business Machines Corporation (IBM).¹ It provides a secure global network platform for B2B communications, including EDI services. In 2003, G International's UK turnover was [less than £70 million].

TRANSACTION

3. On 21 October 2004, Francisco Partners announced its intention to acquire G International. The transaction completed on 30 November 2004. The extended deadline for consideration of the transaction by the OFT expires on 23 March 2005.

JURISDICTION

4. As a result of this transaction Francisco Partners and G International have ceased to be distinct. GXS and G International overlap in relation to the supply of EDI Value Added Networks (EDI VANs).

¹ [] Post-merger IBM continues to supply the merged entity with the technical infrastructure for the VAN services on an out-sourced basis.

5. The parties' estimate that their combined UK share of supply of EDI VANs is [more than 25] per cent. The share of supply test in section 23(2)(b) of the Enterprise Act 2002 (the Act) is therefore met. The OFT therefore believes that it is or may be the case that a relevant merger situation has been created.

RELEVANT MARKETS

Product markets

6. The parties both operate in the area of B2B communications, in particular the provision of EDI VANs. EDI VANs enable and facilitate supply chain transactions such as ordering and invoicing between trading partners. There are a number of different forms of B2B communication, the key ones being:
- post, telephone and fax, which remain popular with a substantial range of UK businesses
 - e-mail
 - private network point-to-point, which allows electronic exchange of data in a standardised format between two parties (or 'trading partners') over a leased telephone line: each party requires EDI interface (or 'translation') software and a modem to enable such information to be sent and received in a mutually understandable format
 - traditional EDI VANs which work on a similar basis to private network point-to-point systems in that information is transmitted between parties in a standardised format by means of interface software and a modem over a telephone line.² However, instead of being sent directly between trading partners, the messages are first routed to a VAN which acts as an electronic 'sorting office' to forward messages to the correct recipient mailbox. This allows for multilateral communication between multiple trading partners. VANs also provide additional features such as audit facility (allowing the effective delivery of messages to be confirmed). EDI VAN via the internet is a variant of this which relies on the internet rather than telephone lines to transmit information
 - internet VAN which involves the routing of electronic information entirely over the internet: an EDI VAN is therefore not required

² The telephone line connection may be obtained by the customer on a leased line basis, or it may rely on a standard dial-up modem for connectivity over the telephone line.

- internet point-to-point connections which allow information to be sent between two or more parties directly, without the need for an intermediary VAN. Internet point-to-point connections make use of a standard protocol to ensure that information is mutually intelligible. One of the most common protocols is AS2. This protocol effectively provides a wrapper around EDI files which enables them to be sent securely over the internet. To make use of this system each party needs EDI software, security software and an internet connection to send and receive information. The information is then sent directly over the internet. Setting up an AS2 community – where all users communicate with each other in this way – effectively involves conducting some VAN service elements in-house; and
- internet-based private exchanges and public electronic market places, which are essentially electronic meeting places for exchange of purchase and supply information.

7. The parties have argued that all of the options set out above are substitutable for one another. We examine the substitutability of each of these options with EDI VANs below.

Post, telephone and fax

8. Third party enquiries suggest that post, telephone and fax are not substitutes for EDI, as they are slower, not very secure and subject to re-keying errors. In terms of functionality, they are very different in nature from EDI VANs.

E-mail

9. E-mail is an increasingly popular form of B2B communication, but has very different functionality from EDI VANs. Similar concerns with regard to security and re-keying errors arise here as in relation to post, telephone and fax.

Private network point-to-point

10. Private network point-to-point communications have markedly different functionality from EDI VANs in that they do not allow multiple parties to communicate with one another over the same network. Third party comments also suggest that private network point-to-point communications networks are prohibitively expensive.

Internet VANs

11. There seems to be a greater degree of substitutability between EDI VANs and internet VANs, although the extent of that substitutability is not clear. On the whole, in terms of functionality, there appears to be little difference between EDI VANs and internet VANs: they both involve EDI delivered by an intermediary and offer a similar range of services, including mailbox facilities, various security features and end-to-end audits.
12. Notwithstanding the apparent common functionality and the fact that internet VAN services appear to be substantially cheaper than EDI VANs, the extent of switching from traditional EDI VAN services has been low. The absence of publicly-available data in the industry has made it difficult to determine the extent of actual switching. The parties have pointed to the following evidence to support the proposition that internet VANs are a strong competitive constraint on EDI VANs.
 - GXS's growth rate has slowed significantly in the past two years: this is said to be because switching from traditional EDI has been significant as newer technologies have become available. However, this evidence does not on its own show that GXS's slowing growth is due to the competitive constraint from internet VANs and internet point-to-point connections.
 - The parties provided International Data Group (IDG) data showing that internet-enabled EDI is forecast to grow, while traditional EDI is forecast to decline in the next few years. However, certain literature on EDI suggests that switching has been limited and certainly much lower than expected; for example, Forrester Research argues that 'the use of electronic data interchange (EDI) standards and value-added network (VAN) based document transport continues to expand and will be the mainstay of commercial B2B activity for the foreseeable future'.³
 - The parties argue that the posited decline in GXS's volume growth coincides with a period of price reductions by GXS in the UK []. GXS states that it has in the same period increased the functionality of its offering. However, the OFT has not seen sufficient evidence to determine whether these falls in prices are attributable to constraints from internet VANs rather than competing EDI VANs, or more general cost reductions in the technology sector.
 - The parties have provided a number of examples of instances where it is said a customer preferred an internet VAN to an EDI VAN, and certain situations where they retained an EDI contract in the face of competition from an internet VAN. This evidence is said to show that the primary competitive constraint faced by

³ Forrester Research Inc: '*Trends 2005: Electronic Data Interchange – The More Things Change, the More they Stay the Same*'.

the merged entity would be from internet VANs and, as discussed below, internet point-to-point connections. However, there are few examples of such switching or competition; and the evidence that is available is not without question.

- Finally, the parties have provided evidence as to the relationship between EDI and internet VANs in the United States. While such evidence may provide some guide to the future development of the sector in the UK, it is difficult to be precise about the weight that should be placed on it.

13. The arguments advanced by the parties are plausible. However, the modest level of up-take for these services in the UK in spite of large differences in price between EDI VANs and internet VANs suggests that the degree of constraint on EDI VANs provided by internet VANs is still limited. In view of the lack of objective evidence on switching in this sector – and the amount of conflicting evidence that we have received from the parties and third parties – it has not been possible to reach a firm conclusion on whether the relevant product scope extends beyond traditional EDI VANs to include internet VANs.

Internet point-to-point connections

14. The OFT's inquiry has revealed little evidence that internet point-to-point connections at present provide a significant constraint on traditional EDI VANs. The set up of internet point-to-point connections is very different in nature from the set up of EDI VAN systems. Many of the functions which in the context of an EDI VAN would be carried out by the VAN (and are therefore effectively outsourced by users) are, in the context of an internet point-to-point connection, carried out instead at each end of the communication process. Although the transaction costs of AS2 are much lower than in the case of EDI VAN systems, third parties have told us that companies using AS2 will need greater internal IT support services. A switch from an EDI VAN or internet VAN system to an AS2 system would require each trading partner to have access to such internal IT support systems. This may not be possible in many cases.

15. The parties have provided estimates by IDG which suggest that non-EDI internet B2B commerce will grow globally from US\$0.98 trillion in 2003 to no less than US\$5.18 trillion in 2007 – an increase of 429 per cent. At the same time data supplied by the parties suggests that EDI will grow at a much slower rate. As noted above, though, in relation to internet VANs there is a variety of data projections and care is needed in interpreting this data as evidence that internet point-to-point connections act as a constraint on traditional EDI VANs and internet VANs.

16. The parties have provided a number of examples of internet point-to-point connections based on protocols such as AS2 being introduced in the UK and in other parts of Europe. However, the number of such examples is relatively small. In addition, most customers who expressed a view said that they did not consider AS2 to be a viable option for them at the current time.
17. Although the parties have provided evidence that the price of EDI VAN services has fallen over the last six years, it is not clear that this has happened as a consequence of competition from internet point-to-point connections.

Internet-based private exchanges and public electronic market places

18. These methods of B2B commerce do not appear to have taken off as expected. Third parties did not mention them as a competitive constraint on EDI VANs.

Conclusion

19. It is undoubtedly the case that there is a spectrum of B2B communications solutions, ranging from post and fax at one end, through to internet point-to-point communications at the other. The parties' EDI VAN services lie in the middle of this spectrum. While this is a sector characterised by innovation and technological development, the pace and impact of that development is difficult to predict. The parties' arguments that their EDI VAN services have been overtaken and that newer B2B solutions (such as internet VANs and internet point-to-point) pose a significant competitive constraint looking forward are plausible. But the available evidence is at present mixed, especially from third parties.
20. On balance therefore, the OFT considers that the appropriate frame of reference for considering the competitive effects of this merger is EDI VANs. This approach does allow for recognition that the emergence of internet VANs and internet point-to-point communications will have some – albeit uncertain – competitive impact.

Software service provision

21. Traditional EDI VAN services consist of two elements – the communications infrastructure (sometimes referred to as the 'backbone') and the 'translation' software that customers use to access the service. GXS provides an integrated service, where these two elements are sold together. It also provides the two elements separately. G International has tended to provide only the backbone and – while it has some application software – has relied heavily on resellers of its EDI VAN to provide the software. The fact that the software vendors choose to resell the EDI VANs could suggest that the customers may view the backbone and the software as a single product. On the other hand, the parties told us that in [] per

cent of the cases where GXS is the provider, users also buy software from another source. This would suggest that, from the demand and supply side, software provision should be considered separately from backbone provision.

22. Neither GXS nor G International is a particularly important provider of EDI software. Perhaps most importantly, as noted above, even where customers have purchased the EDI VAN service from GXS, [] per cent of customers do not purchase software from GXS and, of those that do, a further [] per cent do not use GXS software. This is because GXS offers its own proprietary software as well as third-party software.

Geographic scope

23. The majority of the providers in the sector are global companies. All traditional VAN providers except for BT have their central information databases outside the UK. In addition, customers in the UK may have international trading partners.
24. However some of GXS and IBM's traditional VAN competitors in the US – where the supply of traditional VAN services is much more fragmented than in the UK – took the view that there are strategic barriers to entry in the UK that account for the low shares of supply that GXS and IBM's US competitors have in the UK. This seems to be in the main a result of GXS's first mover advantages resulting from the existence of network externalities. The lack of penetration in the UK by big global EDI VANs – even though they have attempted entry – suggests that the geographic market is the UK.
25. We have also been told by third parties that EDI services are much more developed in the UK than in the rest of the EU, with EDI transactions in the UK accounting for the majority of EDI transactions in the EU. Customer evidence did not suggest that there was much demand for transferring to suppliers based outside the UK.

HORIZONTAL ISSUES

Shares of supply

26. A lack of industry wide data has meant that we have not been able to use an objective measure of shares of supply and have instead had to rely on the estimates of various industry participants. The table on page 8 shows the various estimates of shares in the UK, for traditional EDI VAN only.

UK shares of supply of EDI VANs

	Share of supply of EDI VANs in the UK			
	[third party]	[third party]	GXS	[third party]
BT			[]%	
G Int'l	20%	c. 6%	[]%	33%
GXS	50%		[]%	50%
Others			[]%	
Combined GXS and IBM	70%		[]%	83%

27. On any view, the merged entity will clearly have a substantial share of the EDI VAN sector. The situation is even more marked in the specific business sectors where GXS or G International have a stronger presence; in the retail sector, one third party estimated that the merger resulted in GXS's market share increasing to 97 per cent, with an increment of 17 per cent. And in insurance and financial services – where G International's EDI VAN is particularly strong – one third party estimated that the merged entity will have 100 per cent of traditional EDI VAN services (with an increment of 20 per cent).

28. While the parties' share of supply is difficult to estimate with any level of certainty, it seems likely that the parties may, post-merger, have a substantial position in relation to the supply of traditional EDI VANs, and possibly also if internet VANs were included in the analysis.

Unilateral price increases

29. GXS and G International are, on any view, close competitors in the provision of EDI VANs. The only other significant UK supplier of EDI VAN is BT. The extent to which BT alone, or in combination with the fringe of smaller EDI VAN suppliers, could act as a competitive constraint on the merged entity is unclear. Third parties have identified GXS and G International as the two main EDI VAN providers.

30. The parties have principally pointed to the competitive constraint posed by newer technologies, as discussed above. They have rightly noted that predicting post-merger outcomes is particularly difficult in rapidly-evolving technology sectors. While this should imply caution in identifying adverse competitive effects from a merger, it also implies a degree of care in correctly predicting the outcome of those technology changes.

31. In this regard, the evidence as to the impact and speed of technology change in this sector is mixed. While the parties have advanced plausible arguments as to the likely outcome of that development and its competitive effects, third party evidence

is much more mixed. Although some customers with access to more than one form of EDI would be able to switch in response to an increase in price by one of their providers, it is unclear how many customers have this facility and difficult to determine the extent of the constraint this would provide.

32. In these circumstances, absent new EDI entry or buyer power (discussed below), there is a realistic prospect that post-merger, the merged entity will be in a position to increase charges to its customer base, or to slow the rate of decline in EDI VAN prices: in other words, post-merger prices may be higher than they would have been absent the merger. The likelihood of this is difficult to establish without a clearer idea of customers' willingness to switch to other forms of EDI.

Barriers to entry

33. The fact that the UK traditional EDI VAN sector is much smaller and more concentrated than US EDI VAN supply, together with a lack of significant switching to cheaper internet-based alternatives, suggests the existence of significant entry barriers in this sector in the UK.
34. One key barrier to entry into the EDI VAN sector appears to be consumer inertia. Some of this inertia may be due to the fact that users tend to attribute EDI costs to (internet) telephony charges and therefore do not review them as frequently as they might other charges. Consumer inertia can be further strengthened by strategic barriers placed by the incumbent providers, such as charges for sending information.
35. The lack of ability to gain interconnection – or the risk that such an interconnection could be cut – could also impact on the costs of entry, and on the likelihood of its success. In this regard, third parties have raised the prospect that the merged entity would have a strong post-merger incentive to end interconnection between its VAN and others. The competitive threat to EDI VANs posed by internet VANs will depend on the availability of interconnection with EDI VANs in the short-term. It has been suggested that the merged entity could mute the competitive threat from internet VANs by cutting off the interconnection between its EDI VAN and internet VANs. To the extent that internet VANs pose a current competitive constraint (however limited), this action might dull that threat. To the extent that the competitive impact of internet VANs is yet to be felt, it might be further muted or its emergence materially delayed. While the evidence in this regard is mixed, the evidence does suggest that the merged entity may have an incentive post-merger to cut interconnection. Evidence as to whether this action alone would allow GXS to raise prices is mixed.

Buyer power

36. There is no clear evidence that buyer power would act as a constraint on the merged entity.

VERTICAL ISSUES

37. Third parties have also expressed a concern that post-merger, GXS could foreclose the market for supply of EDI VAN software, by not allowing resellers to sell GXS mailboxes with their own software. Currently, GXS operates a model whereby it provides its own proprietary software together with its EDI VAN and does not offer the latter service separately.
38. However, it is not clear whether, even if GXS were to stop reselling its EDI VAN, this would foreclose the downstream market for software. First, in the absence of GXS cutting its interconnection with BT, resellers still have the option of selling their software with a BT connection. Second, GXS has told us that [] per cent of their customers also buy software from another source. This suggests that customers may well be prepared to buy the software separately from EDI VANs.

Third party comments

39. Concerns were expressed by a significant proportion of the parties' EDI VAN competitors, by EDI VAN resellers and by internet VAN providers. EDI VAN and internet VAN providers were most concerned about the provision of interconnection, while resellers were in the main concerned about vertical issues.
40. The main concerns expressed by customers related to the fact that GXS had traditionally been more expensive than IBM and that the charges imposed on former IBM customers might be brought into line with those charged by GXS as a consequence of the merger. One customer was concerned that GXS would use its strong position in traditional EDI VANs to move customers from traditional EDI VAN onto new GXS internet-based services.

ASSESSMENT

41. A large range of B2B communications solutions is available. The parties are leading suppliers of one such solution – EDI VANs. Looked at narrowly, the merged entity would have a very substantial proportion of sales in the relevant sector. A key question is the pace and impact of technological change in this sector. The parties have advanced some plausible views as to the effect that such technology will have in the sector in which the merged entity operates. However, the evidence on the pace and impact of technological change in this sector is unclear and the views

expressed by third parties are such that the OFT has concerns as to the competitive impact of the transaction. On balance, considering all the available evidence, there is a realistic prospect that the merger may result in a substantial lessening of competition.

42. Consequently, the OFT believes that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom

DECISION

43. This merger will therefore **be referred** to the Competition Commission under section 22(1) of the Act.