OFFICE OF FAIR TRADING

Completed acquisition by International Business Machines Corporation of Candle Corporation

The OFT's decision on reference under section 22(1) given on 13 July 2004

Please note square brackets indicate figure excised at the request of the parties or paragraph excised at the request of the parties.

PARTIES

International Business Machines Corporation (IBM) is a global developer and supplier of information technology (IT) products and services, including hardware and software. In the fiscal year ending December 2003, IBM's worldwide turnover was approximately $89 billion.

Candle Corporation (Candle), based in California, is active in the developing and marketing of system infrastructure software, which allows customers to track and maximize return from IT investments. In the fiscal year ending June 2003, Candle's UK turnover was £ [ ] million.

TRANSACTION

IBM agreed to acquire the stock of Candle for $[ ] million on 12 March 2004. The transaction closed on 7 June 2004. The OFT's respective administrative and statutory deadlines for this case are 13 July 2004 and 6 October 2004.

JURISDICTION

As a result of the transaction, IBM and Candle have ceased to be distinct. The parties overlap in certain systems management software and it appears the share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met. The OFT believes that it is or may be the case that a relevant merger situation has been created for the purposes of section 22(1)(a) of the Act.

RELEVANT MARKET

Product market

Systems Management Software

Systems management software (SMS) is a class of middleware, described by the parties as a software layer between the operating system and software applications. In essence, SMS monitors and manages customers' IT systems, by providing services relating to identification, communication, database facilities, web application support, authentication, authorization and security. The parties overlap in the following three SMS segments, as defined by IDC:[1]

- *Performance Management Software* (PMS) monitors the performance of IT operations and reports any anomalies or 'events'. For example, PMS may warn that the server's processing unit exceeds 90 per cent utilization, thus enabling appropriate action by IT administrators to prevent users from experiencing degraded performance.
- *Event Automation Software* (EAS) offers predetermined and automated actions either to correct anomalies or events reported by PMS, e.g. automatic server restart to resolve a recurrent problem; alternatively, EAS can also be set to recommend manual action.
- *Change and Configuration Software* (CCS) is used in conjunction with PMS to make changes to an IT system (such as deploying the latest releases of software, allocating a new server into a configuration, or changing the way security is handled by servers). CCS may thus facilitate resolution of performance problems.

Distinctions by functionality. While various SMS products are often used together, third party responses confirm that the segments identified offer distinct functionality that – while in some cases complementary (e.g. PMS and EAS) – are not substitutable on the demand side. Customers are able to mix-and-match different SMS products from multiple vendors, though some customers observed that it may be desirable to limit suppliers to reduce overheads and ensure interoperability.

IBM has argued that the SMS sector is characterized by supply-side substitutability, and some vendors do offer a portfolio of such products. As the speed and extent to which vendors could offer each relevant functionality appears open to question, however, it is appropriate to base the OFT's frame of reference exclusively on demand-side factors, and each of PMS, EAS and CCS are considered separately.

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[1] IDC (International Data Corporation) provides IT market research. The collective term for the first two segments listed is Performance Availability and Management. IDC's other SMS categories are Job Scheduling, Output Management, and Problem Management.

Distinctions by platform. IBM submits that SMS distinctions by type of platform have over time become largely meaningless, because (i) a vast majority of today's customers run heterogeneous environments incorporating a mix of mainframe (e.g. IBM z/Series) and distributed (e.g. Windows, UNIX, Linux) platforms; (ii) demand is thus for SMS that can manage a multiplicity of platforms and other middleware; and (iii) most SMS vendors have responded by offering mainframe and distributed versions of their product with similar functionality. Various other factors, however, militate in favour of distinguishing by platform. For a customer to use the 'monitoring' functions of SMS, the product must (unlike its 'management' functions) contain platform- or middleware-specific code: hence, SMS dedicated to e.g. IBM's z/Series platform could not monitor a different platform or vice versa. Moreover, competitors have cast doubt on supply-side substitutability between SMS for different platforms; indeed, some have raised foreclosure concerns in SMS based on IBM's alleged market power in respect of its own mainframe platforms, addressed below.

The appropriate frame of reference for the purposes of this inquiry thus distinguishes within SMS functionality (PMS, EAS, CCS) by the type of platform it is designed to monitor.

Security Software

Security software ensures the integrity and confidentiality of data when transferred electronically. The parties overlap in the IDC category 'security 3A software' (3A is short for authentication, authorisation and administration). As Candle's presence is *de minimis*, however, this segment is not considered further.

Geographic market

The majority of evidence tends to suggest the relevant geographic frame of reference for each product at issue is worldwide: leading SMS suppliers are U.S.-based competitors distributing software on a global basis, often to globally-active customers; SMS can be transported easily and cheaply by portable disk or electronic delivery; and significant trade barriers appear to be absent.

Although IBM maintains that most support is delivered remotely, some customers implied a European-wide market by noting that it was preferable to deal with a supplier with support functions located domestically or regionally. [ ]

As the competitive assessment does not materially differ under either a global or European-wide frame of reference, both have been considered for the purposes of this inquiry.

HORIZONTAL ISSUES

Shares of supply

The data presented focuses on mainframe platforms, the only platform area within SMS for which IDC data[2] reports an overlap, and the area of rivals' concerns.

Principal Suppliers	PMS – Mainframe		EAS – Mainframe		CCS – Mainframe	
	Global	W. Eur.	Global	W. Eur.	Global	W. Eur.
IBM	13.6	17	41.5	54.1	24.3	38.4
Candle	18.9	22.2	4.9	5.9	1.6	2.4
Post-merger	**32.5**	**39.2**	**46.4**	**60**	**25.9**	**40.8**
Computer Assoc.	18.6	13.3	23.4	19.0	33.2	32.5
BMC	15	14.1	2.4	2.1	-	-
Allen Systems	5.3	3	-	-	-	-
Compuware	4.6	5.5	-	-	-	-
Software Eng.	-	-	10.6	7.3	-	-
Hitachi	-	-	5.7	-	-	-
Isogon	-	-	-	-	7.8	4.9
NEC	0.9	0.1	1.1	0.2	5.1	1.1
All others	23.1	24.8	10.4	11.4	35.8	25.6

Source: IDC data for 2002; supplied by IBM

Any prima facie concerns raised by the share data are dispelled by the absence of third party concerns at the horizontal level. Customers confirmed that they have sufficient alternative supply sources, and barriers to expansion appear low. Moreover, IBM's documents support its view that the parties' products offer largely complementary functionality, this being one rationale for the transaction.

[2] IDC data does not provide SMS category data in respect of individual mainframe platforms such as those of IBM; accordingly, the IDC 'mainframe' category has been taken as the best-available proxy (IBM mainframe platforms account for the majority (IDC: 55 per cent in 2002) of total mainframe platform revenue, ahead of Hitachi, Fujitsu, Unisys, NEC, Siemens, with shares ranging from 2-14 per cent).

Barriers to entry and expansion

While barriers to *de novo* entry into SMS categories appear significant (access to human capital, need to develop an innovative product), barriers to expansion by existing players appear to be largely absent, as this represents merely increased licensing and maintenance and support functions.

Buyer power

Third parties shared the view that customers have significant negotiating strength due to the scale of their requirements and the choice of suppliers available.

VERTICAL AND CONGLOMERATE ISSUES

Certain independent software vendors (ISVs) competitors raised two foreclosure concerns based on IBM's alleged dominant market power in respect of its mainframe platforms (z/Series and earlier).

Foreclosure through withholding of APIs

Rival ISVs argued that SMS is the principal remaining area of competition in mainframe software and that by acquiring Candle's software portfolio, the merger would create or increase IBM's incentives to withhold or delay release of its application programming interfaces (APIs) to rival ISVs, thereby impairing their ability to offer IBM mainframe-compatible SMS, and ultimately harm consumers in the form of higher prices or less innovation.

However, the parties' UK customers variously supported IBM's contentions that IBM mainframes compete with distributed (e.g., UNIX, Linux) solutions; that its continued competitiveness relies on continued supply of compatible software from ISVs, and that IBM has no incentive – or certainly no increased incentive, post-merger – to withhold APIs because it would harm the competitiveness of IBM mainframes and/or customer relationships across IBM's wider business.

Other factors suggesting that this merger will not harm UK consumers include (i) IBM's internal documents, which suggest a pro-competitive rationale for the transaction [ ] and (ii) insufficient countervailing evidence that IBM has hitherto engaged in exclusionary practices in the SMS area in terms of API access. Finally, it does not appear that such foreclosure could be targeted at or limited to the UK, and in the U.S. – where the relevant suppliers are based and where the scale of any harm, given the size of the marketplace, is likely to be most acute – the Department of Justice did not conduct an in-depth inquiry (i.e. extend the statutory waiting period) and the transaction has closed.

Foreclosure through bundling

The other foreclosure concern related to IBM's alleged post-merger ability and incentives to bundle its mainframe products with complementary products acquired from Candle, and thus exclude rivals. Although IBM is already active in SMS, the merger may give it a wider range of complementary products, which may provide customer benefits; in any event, customers maintain that no Candle product is a 'must-have' and that they will have continued ability to multi-source for IBM-compatible products. Overall, for reasons similar to those discussed under APIs, the weight of evidence does not suggest the merger will enhance the ability or incentives of IBM to bundle SMS with other products to exclusionary effect.

THIRD PARTY VIEWS

Customers were unconcerned. Certain (but not all) competitors contacted raised foreclosure concerns addressed above.

ASSESSMENT

On the basis of the share of supply data given above, the OFT has reason to believe that the transaction may satisfy the share of supply test in relation to categories of SMS for mainframe platforms in the UK. Although the transaction gives rise to significant combined shares of supply in these sectors on a global and European basis, market participants raised no horizontal concerns.

Certain ISV competitors submitted that the merger would lead to their foreclosure in providing IBM mainframe-compatible software in Candle's product areas, either through denial of access to APIs or through product bundling. The weight of evidence, however, suggested that the merger will not create or increase the ability or incentives of IBM to engage in exclusionary conduct and harm consumers.

Consequently, the OFT does not believe that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

DECISION

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