

February 22, 2007

**COMMENT ON DRAFT CONSOLIDATED JURISDICTIONAL NOTICE**

**Re: IT Service Outsourcing Arrangements**

This Note outlines several observations and suggestions concerning ¶¶22-25 and 136 of the Commission's Draft Consolidated Jurisdictional Notice under Council Regulation 139/2004 (the "Draft Notice"), which address issues that commonly arise in regard to outsourcing arrangements. While many of the issues raised apply equally to other forms of service and manufacturing outsourcing, our comments focus on the outsourcing of IT services.

We welcome the Commission's decision to provide guidance on the application of Council Regulation 139/2004 to IT service outsourcing arrangements -- not least because we hope that this may facilitate convergence among conflicting approaches currently adopted under national merger control laws within the EEA. Our comments and observations reflect experience in advising IT service providers in connection with outsourcing transactions, and with past Commission and national merger control practice as regards IT service outsourcing.

**I. Summary and Introduction**

**1. The Issue**

An IT service outsourcing arrangement essentially involves the conclusion of a supply arrangement with an outside vendor for IT services that were previously provided in-house (Draft Notice, ¶23). In many circumstances, the service contract will be accompanied by the ancillary transfer to the service provider of personnel (often including related office equipment, such as PCs, printers, screens, and mobile telephones) and/or other assets associated with the customer's in-house provision of the relevant services.

From the customer's perspective, such transfer frequently is a key part of the economic rationale for the outsourcing arrangement -- even if the service provider would gladly have accepted to provide the relevant services with its own existing staff and assets.<sup>1</sup> Importantly, the service provider generally does not acquire any brands or goodwill, third-party customer relationships, intellectual property, real estate, sales and marketing personnel, or other assets normally associated with a stand-alone IT service provider operating on the open market.

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<sup>1</sup> The transfer of personnel and assets associated with the in-house provision of IT services allows the customer to turn fixed costs into variable costs, and to benefit from the service provider's economies of scale and scope. Transfer of personnel may also be required under the EU Directive on the safeguarding of employees' rights in the event of transfers of undertakings (as defined for purposes of that Directive). The service provider, in turn, will almost invariably seek to rationalize the acquired assets and personnel, either by re-deploying or discarding at least part of those assets and personnel.

Both under EU and national merger control rules, the issue has arisen whether such IT service outsourcing arrangements involving the transfer of associated employees and/or assets should be characterized as a “concentration” and, if so, how the “market” turnover of the previously captive “business” should be calculated for purposes of applicable turnover thresholds.

## **2. EU and Local Precedent**

In a number of cases at the EU level, taking projected annual services fees as the most appropriate proxy for “market” turnover, the Commission has concluded that an IT service outsourcing arrangement involving the transfer of associated employees and/or assets did not constitute a “concentration with a Community dimension” (e.g., C.2003/459 *IBM/Nordea*; see also C.2003/9 *Sanmina-SCI/IBM*). In at least one case (C.2003/441 *IBM/Ericsson*), moreover, the Commission expressly took the view that an IT service outsourcing arrangement with ancillary transfer of employees (and minimal office equipment) did not constitute a “concentration”. In fact, outside the context of joint ventures (e.g., Case M.2478 *IBM/Fiat* or Case M.3571 *IBM/Maersk Data and DM Data*), we are aware of only a single published instance in which the Commission has reviewed an IT service outsourcing transaction as a “concentration” (Case M.3171 *CSC/Royal Mail*) – which decision lacks any reasoning on the issue and predates *IBM/Ericsson* (see above).

At the national level, while we believe the matter remains undecided in most jurisdictions, there have been conflicting approaches, with certain regulators taking the view that IT service outsourcing arrangements with ancillary transfer of employees do not constitute concentrations – for example, the Netherlands (current position; e.g., zaaknr. 5179 *IBM/ABN Amro*) and Sweden --, while others have taken the position that such transactions should be treated as concentrations under local merger control rules – for example, Italy (e.g., Case C6132 *IBM/Ericsson*), Germany (e.g., B 7 – 200/02 *IBM/Deutsche Bank*), Netherlands (past position; e.g., zaaknr. 3619 *IBM/Essent*). However, even in the latter jurisdictions, no clear rules exist as regards the calculation of the “market” turnover of the previously captive “business”, with only the Netherlands – to our knowledge – having expressly accepted that projected service fees under the outsourcing contract are an appropriate proxy for “market” turnover (e.g., zaaknr. 4001 *IBM/Delta Lloyd*).

## **3. The Draft Notice**

The Draft Notice states that an outsourcing arrangement with associated transfer of assets qualifies as a “concentration” only if “*the assets constitute the whole or part of an undertaking, i.e., a business with access to the market.*” The difficulty, clearly, is in distinguishing between mere assets and a business. To that end, the Draft Notice explains that the existence of a business “*requires that the assets previously dedicated to in-house activities [...] will enable the outsourcing service supplier to provide services not only to the outsourcing customer but also to third parties, either immediately or within a short period after the transfer.*” The Draft Notice distinguishes the following three scenarios:

- The customer does not transfer assets or employees to the IT service supplier – in this circumstance, no concentration will arise (Draft Notice, ¶23).
- The customer transfers an internal business unit or subsidiary that, in addition to in-house provision, was already engaged in the provision of services to third parties – in this circumstance, a concentration will arise (Draft Notice, ¶24). (Although the Draft Notice does not specify this, it would seem reasonable in

such circumstances to have regard only to the external “market” turnover generated with third parties in assessing the presence of a “Community dimension”.)

- The customer transfers associated personnel and/or assets that were employed exclusively in the in-house provision of IT services – in this circumstance, a concentration will arise if the transferred assets include “*at least those core elements that would allow a market presence.*” This could be the case if the transferred assets include “*the required know-how (e.g., the relevant personnel and intellectual property) and those facilities which allow market access (such as, e.g., marketing facilities).*” Alternatively, and more troublesome, the Draft Notice states that a concentration may also arise if “*the acquiring undertaking [is] able to complement [the transferred assets] with its own assets to build up a market presence*” (Draft Notice, ¶24).

Finally, as regards turnover calculation, the Draft Notice states that the “market” turnover of a previously captive business should “*normally be calculated on the basis of the previously internal turnover [...].*” Alternatively, “*where the previously internal turnover does not appear to correspond to a market valuation of the activities in question (and, thus, to the expected future turnover on the market), the forecasted revenues to be received on the basis of an agreement with the former parent may be a suitable proxy*” (Draft Notice, ¶136).

The remainder of this Note is structured as follows. Section II explains that, as a policy matter, there are good reasons narrowly to construe the type of IT service outsourcing arrangements that are characterized as “concentrations.” Against that background, Section III suggests that, as a practical matter, several amendments to the current Draft Notice appear necessary to avoid that all IT service outsourcing arrangements involving the transfer of employees automatically qualify as “concentrations”. Finally, Section IV argues that, in the context of outsourcing arrangements, the projected service fees under the outsourcing contract are almost always the best proxy for the “market” turnover that can properly be attributed to the captive business – it is the essence of outsourcing that the service can be provided cheaper externally (on the open market) than in-house.

## **II. As A Policy Matter, IT Service Outsourcing Arrangements Typically Do Not Warrant Merger Control**

As a general matter, IT service outsourcing arrangements are pro-competitive. They enable customers to (1) benefit from high-tech services provided by specialized providers; (2) rationalize their cost structure, by transforming fixed costs into variable costs and reducing capital invested; and (3) use their own resources more efficiently by focusing on their core business, thus enhancing their product and service offerings to final consumers.

Against this background, several policy considerations militate against characterizing IT service outsourcing arrangements that involve the transfer of associated employees and/or assets as “concentrations” subject to Council Regulation 139/2004.

- First, the key objective and point of gravity of an IT service outsourcing transaction is the provision of services to the customer that were previously sourced internally. The transfer of employees and assets is very much secondary, as reflected by the disproportionate relationship between the value of the assets purchased (most often little, very little, or no value) and the value of the service contract (most often high value). In fact, the transfer of employees and assets is

ancillary to the services agreement, rather than the other way round. “Ancillary” clauses should be held to the same test and should be reviewed according to the same procedure and same substantive standard as the main transaction to which they relate. Since the main transaction is a non-structural service contract susceptible to review under Articles 81 EC, the employee/asset transfer element should follow the same procedure and analysis.

- Second, provided the outsourcing customer was not itself engaged in the provision of IT services to third parties, the competitive issues that might be raised by IT service outsourcing arrangements involving the transfer of associated employees/assets do not justify the transaction costs involved in mandatory merger control notifications.

Since transactions of this kind merely involve the transfer of employees/assets that were not previously active on the open market, there is no aggregation of market shares and no restriction of actual or potential competition between IT service provider and outsourcing customer (note that the customer’s decision to outsource implies that it cannot be viewed as a realistic potential competitor in the external provision of IT services) -- there can therefore be no horizontal or conglomerate competitive concerns.

Indeed, especially in the IT services sector, there can be no structural concerns since employees with the relevant skills can easily be recruited by any IT services provider and the transferred assets are widely available on the market. The IT service provider might well prefer to provide the service without having to take-over employees and assets, and acquires them in part because the customer wishes to offload the associated liabilities and cost.

At most, transactions of this kind could raise vertical issues related to the terms of the service arrangement. Although unlikely in practice (since IT service outsourcing contracts are typically non-exclusive, subject to termination by the customer at relatively short notice, and the result of a competitive bidding process), any vertical issues that might arise are better addressed under Article 81 EC than under merger control rules. IT service providers engage in many transactions of this type that might meet EU or national merger control thresholds – and mandatory notification would imply significant transaction costs and unnecessary delays. This is not warranted by the competition issues that such transactions might exceptionally raise, which can be dealt with outside merger control.

- Third, the *reductio ad absurdum* of applying Council Regulation 139/2004 (or national merger control rules) to transactions of this kind would be to require, in the entirely hypothetical example of a firm with a dominant position in the relevant IT service outsourcing market, that the IT service provider withdraw from the market until it is no longer “dominant” or that it spin off one or more existing outsourcing contracts as a condition for entering into a new one.

Since even dominant firms are entitled to continue to offer their services on competitive terms and conditions, the application of merger control rules in such a case would be inconsistent with the fundamental rationale of merger control and would reduce competition by lessening customer choice. The impact of a

prohibition order would be to reduce efficiency of the outsourcing customer, and thus to reduce competition in its market. A customer would understandably be upset if, after a drawn-out tender process, merger review suggests that it cannot use the selected IT service provider, but must choose a less preferred (more expensive or less efficient) alternative one. This confirms that merger review is not appropriate for IT service outsourcing arrangements involving the transfer of associated personnel/assets (without third-party business).

In sum, as a policy matter, there are good reasons narrowly to construe the type of IT service outsourcing arrangements that are characterized as “concentrations” -- and to limit those to transactions where employees/assets are transferred and, cumulatively, where the outsourcing customer was already engaged in the provision of IT services to third parties.<sup>2</sup> Only in those circumstances would it appear warranted to subject IT outsourcing arrangements to the transaction costs and delays associated with merger control.

### **III. As A Practical Matter, The Draft Notice Risks Drawing The Net Too Wide – Not Every Transfer Of Employees Should Give Rise To A “Concentration”**

We consider the Draft Notice’s starting point appropriate, where it states that an outsourcing arrangement with associated transfer of assets qualifies as a “concentration” only if “*the assets constitute the whole or part of an undertaking, i.e., a business with access to the market.*” To be notifiable as a concentration, the assets transferred in connection with an outsourcing arrangement must, in other words, function as an autonomous undertaking in its own right, or be capable of doing so independently upon transfer of control. This is consistent with the notion of an “undertaking”, which is defined for purposes of EC competition law as “*an economic entity made up of a collection of physical and human resources capable of independently carrying out economic or commercial activities.*”<sup>3</sup> (Emphasis added)

The notion that a collection of assets must qualify as a stand-alone economic entity with access to a market in order to constitute an “undertaking” also finds support in the provisions of Regulation 139/2004 concerning full-function joint ventures – which must on a lasting basis perform “*all the functions of an autonomous economic entity.*” (Emphasis added.) The Commission has made clear that joint ventures are not notifiable under Council Regulation 139/2004 if they do not “*operate on a market, performing the functions normally carried out by undertakings operating on the same market.*”<sup>4</sup>

Problems arise, however, when the Draft Notice attempts to translate the general rule into more concrete, practical guidance. Two main points are of concern.

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<sup>2</sup> No concentration should be deemed to arise, however, if the outsourcing customer was merely engaged in the transitional supply of IT services to divested entities.

<sup>3</sup> Cf. Case T-6/89, *Enichem v. Commission*, [1991] ECR II-1623, para. 235; Case C-41/90 *Hoefner and Elsner v. Macrotron*, [1991] ECR I-1979. The competition law concept of an “undertaking” is not necessarily the same as that of a ‘businesses or parts of an undertaking or a business’ under the EC Directive on the safeguarding of employees’ rights in the event of transfers of undertakings, since that Directive deals with protection of employees’ rights, not with the protection of competitive market structures.

<sup>4</sup> Commission Notice on the Concept of full-function joint ventures, para. 12.

- First, when “*third parties are not yet supplied*”, the Draft Notice advises that a concentration will arise if the transferred assets include “*at least those core elements that would allow a market presence.*” It specifies that this could be the case if the transferred assets include “*the required know-how (e.g., the relevant personnel and intellectual property) and those facilities which allow market access (such as, e.g., marketing facilities).*”

This is likely to be insufficiently clear in practice. Which facilities allow a “market presence” or “market access”? What constitute “marketing facilities” in the context of IT services? Would it not be reasonable to assume that a group of employees and assets that were used exclusively for in-house provision of IT-services will not have “*those facilities which allow market access*”? They certainly will not have marketing facilities – no marketing is required for a captive customer. In other words, also in view of the policy considerations outlined above, we believe it would be reasonable to assume that “*facilities which allow market access*” will normally be present only when there was already a third-party business. If the Commission believes it appropriate to go beyond circumstances involving existing third-party business, further clarification – notably confirming the exceptional nature of that scenario -- would be welcome.

- Second, and more troublesome, the Draft Notice states that a concentration may also arise if “*the acquiring undertaking [is] able to complement [the transferred assets] with its own assets to build up a market presence*” (Draft Notice, ¶24). With this sentence, the Draft Notice introduces the notion that it is not only what the purchaser acquires that is important, but also what the purchaser “can do” with such assets in view of its existing resources. On an expansive reading, this might imply that any assets transferred - regardless of their importance or size – could always be viewed as complements to an existing business and therefore give rise to a “concentration.”

This risks undermining the Commission’s past practice – also followed by certain national regulators – of considering that the transfer of primarily employees (with associated office equipment) did not amount to a concentration. Indeed, any IT service provider, whatever its size, will be able to complement the transferred employees and assets with its own resources and employ them in the servicing of third parties. In other words, any IT service outsourcing transaction involving the transfer of employees risks being characterized as a concentration. This would clearly be undesirable, and negate previous guidance on this matter both in the Draft Notice itself and in the Commission’s existing practice (*e.g.*, C.2003/441 *IBM/Ericsson*). We would therefore suggest deleting the reference to the IT service provider’s own complementary assets or, at least, clarifying that this criterion is not met by the simple transfer of employees and associated office equipment.

In closing on this topic, we note that IT service outsourcing will increasingly involve “2<sup>nd</sup> generation” outsourcing, where the customer changes its external IT service provider. It is not unusual, in these circumstances, that the outgoing IT service supplier transfers to the new IT service supplier the employees and other assets associated with the service provision to the customer (which may, initially, have come from the customer itself). Indeed, as mentioned in footnote 1, this may be required by labor law considerations. Transactions of this kind, then, involve the transfer between competitors of assets and

personnel previously employed in the external provision of services to the customer (although most often not organized as a separate business unit). While the transferred employees/assets were not involved in captive service provision, transactions of this kind should in our view not normally be considered “concentrations” – put somewhat colloquially, the incoming IT service provider is not acquiring a third-party business, it has won a customer in conducting its own business. It would in our view be appropriate for the Draft Notice also to address this type of transaction.

#### **IV. Projected Annual Service Fees Under The Outsourcing Contract Are Almost Always The Best Proxy For “Market” Turnover**

If, as this Note favors, “concentrations” would be limited to IT service outsourcing transactions where employees/assets are transferred and, cumulatively, where the outsourcing customer was already engaged in the provision of IT services to third parties, the issue of turnover calculation is simple. The relevant “market” turnover would be the external revenues generated from the provision of IT services to third parties.

When the transfer of a previously captive “business” can qualify as a “concentration”, however, the issue becomes more complex. At ¶136, the Draft Notice seems to give priority to “internal revenues” in the calculation of the “market” turnover that can properly be attributed to the captive “business”. This seems a step backwards from existing Commission practice (see C.2003/9 *Sanmina-SCI/IBM* and C.2003/459 *IBM/Nordea*), which had acknowledged that the projected annual service fees under the outsourcing contract are almost always the best proxy for the “market” turnover that can properly be attributed to the captive business. IT service outsourcing transactions are based on the very premise that more efficient external service providers can supply the outsourced service at a lower fee than the in-house IT unit. This often implies that the in-house IT unit would not have been able to sell its services on the open market for the internally invoiced amount, which therefore does not reflect “market” turnover.<sup>5</sup>

Looking at the forecasted annual service fee to be paid under the outsourcing contract for the first full year, agreed pursuant to arm’s length negotiations, is less artificial and less complicated than calculating turnover based on extrapolations from internal transfer pricing or cost allocation. (There may in some cases be a need to adjust the fee upwards if any transferred assets are acquired at a price below market value, but this likely to be the exception.)

Accordingly, we suggest that the Draft Notice be amended to delete the reference that turnover should “*normally be calculated on the basis of the previously internal turnover [...]*.” Instead, in the case of IT service outsourcing (or, indeed, other forms of outsourcing), we submit that “*previously internal turnover*” will almost always “*not appear to correspond to a market valuation of the activities in question (and, thus, to the expected future turnover on the market)*”. The Draft Notice should therefore clearly indicate that turnover should “*normally be calculated on the basis of the forecasted annual service fee to be paid under the outsourcing contract for the first full year.*”

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<sup>5</sup> Note also that the Commission has in the past relied, for purposes of examining whether a transaction has a Community dimension, on the current turnover of an undertaking rather than its turnover in the preceding financial year, where this reflected more accurately the value of the financial resources transferred, see Case IV/M.588, *Ingersoll-Rand/Clark Equipment*, Commission decision of May 15, 1995.

