

Outsourcing deals in the EU

The antitrust implications

by *David Wood**

Outsourcing arrangements are increasingly common, particularly in high-volume industries where returns to scale are important, such as IT and data-processing. They have also recently come to the fore in online advertising markets. In competition law terms, the key questions are: (1) whether the arrangements give rise to a concentration falling within the scope of the EU Merger Regulation (merger issues); (2) whether in-sourced supply should be regarded as part of the relevant market for the purposes of determining the competitive effects of any outsourcing arrangements (market definition issues); and (3) whether outsourcing arrangements between direct competitors raise different competition concerns to vertical outsourcing arrangements (market sharing issues).

Merger issues

As is clear from the Commission's 2007 consolidated jurisdictional notice on the control of concentrations between undertakings, where assets and employees are transferred to the contractor, a concentration falling within the scope of the EU Merger Regulation may arise if the transaction can be said to have created "a business with access to the market". This will occur if the contractor can use the transferred assets and employees to provide services to third parties, either immediately or within a period probably not exceeding three years.

Where the business in question relates to the manufacture of products, it may be necessary to transfer production facilities. In relation to services, the contractor may need only the relevant knowhow (from the transferred employees and intellectual property) and the means for achieving market access (for example, marketing facilities).

Market definition issues

As regards market definition issues, in the IBM Italia/Business Solutions decision, the Commission considered an arrangement whereby IBM Italia combined its businesses supplying IT services to third parties (outsourced activities) with Fiat's in-house IT services business (previously in-sourced activities). The Commission considered outsourcing from the demand side and found that there were many potential outsourcing customers for IT services "due to both technological innovation and the development of e-business" (at para 21).

In its assessment of the horizontal impact of the transaction, the Commission found (at para 32) that:

"In the market investigation, the Commission has noticed some divergences in public independent reports, and above all in the parties and competitors' estimates concerning the 'expansion potential' in Italy of outsourcing demand especially as far as IT management services are concerned. This is due mainly to a different consideration given in these reports and by the parties to 'captive outsourcing'. This is represented by the IT services (and/or IT

management services), which are provided within the same corporate entity by separate companies belonging to the same group, as opposed to IT services (and/or IT management services) which are instead provided by personnel devoted to IT services within the same company (captive tout-court). In particular, according to the parties, the latter would represent the vast majority of the IT services (and/or IT management services) which are provided 'captive'. Considering only 'captive outsourcing' as a source for new demand would of course result in much lower 'potential expansion' estimates than the ones stemming from an overall consideration for IT management services satisfied 'captive'."

In its assessment of the vertical impact of the transaction, the Commission found (at para 37) that "...Fiat's share of demand for IT services, including its current captive demand, represents less than [<1]% and [0-5]% of total European and Italian demand, respectively".

Although the Commission did not need to reach a final determination as to the precise scope of the relevant market in that case, two conclusions can be drawn concerning how "captive demand" should be treated for the purposes of market definition in service sectors.

The first conclusion is that services which are provided within the same corporate entity by separate companies belonging to the same group should be included in the definition of the relevant market, at least from a demand-side perspective. As can be seen from the Commission's assessment of Fiat's share of demand for IT services, Fiat's captive demand was included in the definition of the relevant market.

The second conclusion is that in sectors such as IT services, there is an increasing tendency towards outsourcing. In these sectors, it is at least possible that all or some of the services which are provided by personnel devoted to IT services within the same company should also be included in the definition of the relevant market.

Since this was not the case for Fiat, the Commission did not need to reach a final determination. Nevertheless, it was satisfied that sufficient evidence had been presented for the point to be left open.

From the supply side perspective, the Commission accepted the principle that in-house captive capacity (in-sourcing) should be included in the definition or assessment of the relevant market if: (1) in-sourcing can be switched to non-captive supply; or (2) if the potential customers are highly sophisticated with significant in-house production capabilities providing them with an effective competitive alternative to outsourcing. In particular, in the Hutchison/RCPM/EC decision, the Commission found that: "If captive production can be switched to non-captive production within the short-to-medium term, it may constitute potential competition" (at para 71).

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These issues have also been addressed by a number of regulatory authorities as well as by the International Competition Network (ICN). According to the ICN:

“There are three options [in relation to the inclusion of captive production in the relevant market]. The first is to adopt a general rule excluding captive production on the grounds that companies engaged in self-supply are generally unwilling to sell in the market because doing so may leave unsatisfied internal demand and may require investment in distribution and marketing systems. Arguably, such an approach involves an arbitrary disapplication of the SSNIP test in cases involving self-supply. The second is to include such sales to the extent that they would be diverted to third party sales in the event of a SSNIP. The third is to include self-supply in the market to the extent that such inclusion accurately reflects its competitive significance (which might arise if captive production would be diverted to third party sales in the event of a SSNIP or if captive producers might influence market operation by increasing production both of the relevant product and the downstream output).”

Similarly, the UK Office of Fair Trading merger guidelines state that “the extent to which ‘captive’ capacity or production is likely to be released onto the open market will be taken into account in assessing the competitive constraint.”

Finally, according to a well-established principle in US competition law and practice where the “customer can replace the services of [an external product] with an internally-created [...] system, this ‘captive output’ (ie the self-production of all or part of the relevant product) should be included in the same market” (see *Sungard Data Systems* case).

Market sharing issues

The analysis outlined above for identifying whether or not to include any given demand or supply on the relevant market is one element to take into account in analysing the competitive effects of any outsourcing arrangement. The other main element is whether the parties to the arrangement are actual or potential competitors on that relevant market, not least because “agreements between competitors pose a greater risk to competition than agreements between non-competitors” (Commission technology transfer guidelines, para 26).

Vertical outsourcing arrangements concern services which, instead of being in-sourced, are acquired from a third party and which are used in the production or distribution of goods or services at a different level of the supply chain. The input is the outsourced service and the output is the good or service incorporating that input.

Such arrangements do not generally give rise directly to antitrust concerns, provided they are not too long in duration and that the supplier of the input does not have a sufficiently high share to foreclose access to that market to its competitors. Concerns may also arise if either of the parties has a high market share and is party to a number of similar arrangements. Concerns may arise indirectly if the parties are also competitors in the output market and the outsourcing arrangements lead to an alignment of prices in that market or otherwise to a reduction in competition between the two.

Horizontal outsourcing arrangements would appear to raise

concerns of a different magnitude altogether. First of all, since the input and the output are not at different levels of the supply chain but at the same level, the arrangements in question take place between actual or potential competitors. Although, under Community competition law, this does not give rise to per se illegality, it does raise a presumption that the arrangements in question restrict competition: “Negative effects on competition within the relevant market are likely to occur when the parties individually or jointly have or obtain some degree of market power and the agreement contributes to the creation, maintenance or strengthening of that market power or allows the parties to exploit such market power” (see Commission article 81(3) guidelines).

As a result, it is necessary to carry out a detailed assessment of the likely harm and alleged efficiencies of the arrangement as well as of the parties’ general ability to raise prices or reduce service quality. This will include an assessment of the relative strengths of the parties to the arrangements as well as that of their other competitors. Furthermore, it is necessary to ascertain whether other contracts are available for (potential) competitors to offer services at or above their minimum efficient scale of production.

Where benefits other than purely financial ones cannot be shown, it is doubtful whether the parties to a horizontal outsourcing agreement would be able to satisfy the burden of proof that the procompetitive benefits of the arrangement are greater than the probable harm to competition. This doubt would seem likely to increase commensurately with the combined market shares of the parties to the arrangements. It would also increase where one or more of the parties was party to a number of similar arrangements.

Conclusions

Outsourcing arrangements are increasingly common but do raise evidential issues in terms of market definition and the identification of all correct sources of actual and potential competition. They may also have sufficient “structural” elements to qualify as concentrations for merger control purposes.

Horizontal outsourcing arrangements would appear to be relatively rare. Where the parties to them have large market shares, they would appear to give rise to prima facie competition concerns. In such cases, it may be difficult to satisfy the burden of proof that the likely harmful effects of the arrangements are outweighed by any efficiencies. High markets shares particularly on the supply side would also increase this difficulty.

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