THE COMMISSION FOR THE SUPERVISION OF BUSINESS COMPETITION

GUIDELINES ON ARTICLE 20

CONCERNING PREDATORY PRICING

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PREFACE

As mandated in Article 35 sub-article (f) of Law No. 5 of 1999 concerning the Prohibition of Monopolistic Practice and Unfair Business Competition (Law No. 5/1999), Commission for the Supervision of Business Competition (KPPU) has the duty of preparing Guidelines and or publication related to the implementation of Law No. 5/1999. These guidelines are prepared so that KPPU may properly perform its supervisory function on the implementation of Law No. 5/1999. It is also expected that these guidelines may provide a clear understanding for business actors and parties on the definitions and purposes of Articles included in Law No. 5/1999.

Under such consideration, KPPU prepares Guidelines on predatory pricing or low price fixing as included in Article 20 of Law No. 5/1999. These guidelines highly necessary bearing in mind that **predatory pricing** can result in monopolistic practices and or unfair business competition. However, the foregoing terms are occasionally used in parallel or as a substitute.

With respect to business activities which are very dynamic and always developing, continuous revision possibly will be made to these Guidelines.

CHAPTER I. BACKGROUND

As a result of market-oriented economic development, competition arises in various activities in the national economy. Competition potentially promotes the increase in the number of business actor which in turn, it will raise the number of demand and the type of goods available in the market. In order to have a reasonable competition that generates a sound business growth and guarantees equal business opportunity, it is necessary to create fair business competition climate. It is expected that the creation of fair business competition will prevent the centralization of economic power in an individual or certain group. The centralization of economic power may initiate the abuse of position by business actors.

However in reality, the condition of business world is dominated with the unfair behavior of business actors. Business actors tend to collect incentive to gain market power so that they can have the freedom to control price and other determining factors in business transaction. To create such market power, business actors take unfavorable actions on their competitors such as, applying market restriction, creating barrier to entry, entering into collusive agreements to arrange price, limiting output, arranging market and performing other anti-competition practices.

Such market condition reflects a market failure which may result in an inefficient allocation of resources and has an adverse impact on the performance of industry and economic growth. Therefore, a dynamic and competitive environment in the era of business competition must be supported with legal instruments and a number of conductive policies on competition in order to encourage fair business competition and create an efficient market economy.

In the effort to guarantee a fair business competition, Law No. 5/1999 was issued. An effective implementation of Law No. 5/1999 may serve as the basis for driving economic restructuring and in turn, it will be able to create competition culture so as to continue encourage and increase the number of business actors.

One of the forms of anti-competition behavior which becomes the focus of Law No. 5/1999 is predatory pricing or low price fixing with the purpose of eliminating or terminating the business of its competitors in the relevant market. Predatory pricing is a pricing strategy adopted by business actors to eliminate its competitors in the relevant market in the effort to maintain its monopolistic or dominant position.

In short term, predatory pricing can be beneficial because consumers can enjoy low good or service price. However in the long run, after competitors are eliminated from the market, the predatory business actor will increase the good or service price again. Therefore, such predatory pricing practice may create monopolistic practice or unfair business competition.

In order to provide business actors with better explanation and understanding on predatory or low price fixing behavior as intended in Article 20 of Law No. 5/1999, it is necessary to draw up implementing guidelines for the provisions therein.

CHAPTER II. OBJECTIVES AND SCOPE OF GUIDELINES

In 2000, KPPU was established as an independent institution to which Law No. 5/1999 gives a mandate to supervise the implementation of such law. One of the duties of KPPU as provided in Article 35 is to prepare guidelines and or publication related to the implementation of Law No. 5/1999.

Several provisions in Law No. 5/1999 requires further elucidation to obtain clearer description on the definition and limit of such provisions. This elucidation is formulated in the form of implementing guidelines or provision guidelines.

II.1 Objective of Guidelines

The production of these implementing or provision guidelines is aimed at providing business actors, legal and economic practitioners, relevant institutions and public with an elucidation of Article 20 as well as describing matters categorized as potential violation to Article 20.

These guidelines are not intended to describe the procedures for examination on an alleged violation at KPPU, but more focus on providing further elucidation and understanding on as well as the scope and limit of the provisions of Article 20.

Therefore, these guidelines are aimed at:

a. Providing a clear and accurate understanding on Article 20,

b. Providing clear understanding and direction on the implementation of Article 20 so as to prevent broad interpretation beyond those described in these guidelines,

c. Serving as a foundation for all parties in conducting their activities so that no parties are harmed and subsequently, creating a condition where business competition indicates a reasonable growth.

Although these article guidelines provide an understanding and elucidation on provisions regarding the definition of predatory or low price fixing however, in the process of enforcing Law No. 5/1999, the view and decision of the Panel of Commission in conducting examination on alleged violation to Article 20 of Law No. 5/1999 still take the priority.

II.2 Scope of Guidelines

Guidelines on Article 20 include the philosophy, spirit and direction of the provisions in promoting fair competition. These guidelines also briefly describe the condition resulting from the lack of system which supports the upholding of the principle of fair competition, particularly with regard to the practice of unfair competition. Systematically, these guidelines comprise as follows:

Chapter I	Background
Chapter II	Objectives and Scope of Guidelines This chapter provides a description on the objectives of the guidelines and matters incorporated in the guidelines, benefits of regulation of Article 20 and the systematization of guidelines.
Chapter III	Definition and Elucidation This chapter provides a description on the elements contained in Article 20, including among other things, the definition of business actor, good and or service supply, predatory pricing, low price fixing.
Chapter IV	Economy of Predatory Pricing This chapter explains the concept and definition of predatory pricing or low price fixing along with theoretical description as well as the detection of behavior which violates Article 20.
Chapter V	Implementation of Predatory Pricing This chapter describes procedures for handling alleged predatory pricing behavior, including procedures for conducting examination on predatory pricing.
Chapter VI	Regulation on Sanction
Chapter VII	Closing Remarks

CHAPTER III. DEFINITION AND ELUCIDATION

III.1 Definition

In accordance with the objective of Law No. 5 of 1999 (Law No. 5/1999) namely to actualize a conducive business climate through the regulation of fair business competition in order to guarantee the certainty of equal business opportunity for small, medium and large-scale business actors, hence Law No. 5/1999 governs several behaviors and activities which are prohibited and potentially result in unfair competition.

In respect of prohibition on monopolistic practice and unfair business competition, one of activities prohibited are the supply of goods and or services by way of predatory pricing or determining very low price with the purpose of eliminating or terminating its competing business actors in the relevant market so as to result in monopolistic practice and or unfair business competition.

The practice of

- ***predatory pricing, or***
- ***low price fixing***

with the purpose of eliminating or terminating the business of its competitors in the relevant market in Article 20 of Law No. 5/1999 is referred to as predatory pricing.

The practice of predatory pricing with the purpose of eliminating or terminating its competing business actors in the relevant market in the context of business competition is the behavior of business actors who generally assume dominant position in the market or act as incumbent business actors fixing an economically adverse price for a relatively long period of time. This strategy can cause its competitors to be eliminated from the relevant market and or create barrier to market entry for other business actors.

In short term, consumers can benefit greatly from predatory pricing however, after the competitors are eliminated from the market and barrier to market entry is created for new potential competitors, the dominant or incumbent business actor may significantly increase the price. In general, the price fixed to cover such loss is monopolistic (higher) price so that it potentially incurs loss to the consumers. This practice is an effort to maximize and cover the loss resulting from predatory pricing or low price fixing.

Low price fixing strategy included in Limit-Pricing Strategy is identified with monopolistic or dominant business actors who desire to protect their position by way of substantial price cut or significant production increase. This behavior is intended to close the opportunity for new business actors to enter into the industry or to make them lose interest in entering into the industry so that the monopolistic business actors can continue maintaining their position.

Although consumers can benefit from low price fixing, the benefit is only in short term because after certain period of time when a number of competing business actors are eliminated from the market, consumers will in fact suffer from loss as the business actors set an extremely high price directed toward or potentially constituting a monopolistic price. This kind of business activity needs to be reviewed under Article 20 of Law No. 5/1999 based on the framework of economic analysis and consideration.

In addition to Article 20, a prohibition against price fixing is also set forth in Article 7 of Law No. 5/1999 concerning the prohibition of below market price fixing. However, KPPU will apply Articles 7 and 20 differently depending on the fact found on a case by case basis. Article 7 requires an agreement between its competing business actors in fixing the price below the market while Article 20 does not indicate any requirement of agreement.

III.2 Description of Elements

Article 20 of Law No. 5/1999 states that:

Business actors shall be prohibited from supplying goods and or services at a price below cost or by setting extremely low prices with the aim of eliminating or ruining the business of their competitors in the relevant market which may cause monopolistic practices and or unfair business competition.

The foregoing Article 20 may be described into several elements as follows:

1. **Element of Business Actor**

   The definition of business actor as intended in Article 1 sub-article 5 is any individual or business entity, incorporated or not incorporated as legal entity, established and domiciled or conducting activities within the jurisdiction of the Republic of Indonesia, either independently or jointly based on agreement, conducting various business activities in the economic field.

2. Element of Supply

The definition of supply as intended in the elucidation of Article 15 is to provide supply of either goods or services for sale and purchase, lease, lease and purchase as well as leasing activities.

3. Element of Goods

The definition of goods pursuant to Article 1 sub-article 16 is any physical objects, either tangible or intangible, movable or immovable, which may be traded, used, utilized or exploited by consumers or business actors.

4. Element of Services

The definition of services pursuant to Article 1 sub-article 17 is any services in the form of work or performance traded in society to be utilized by consumers or business actors.

5. Element of Predatory Pricing

Predatory pricing is the sale price set by business actor below the costs discussed in these guidelines.

6. Element of Very low price

Very low price is the price set by business actors which is unreasonably low.

7. With the aim

'With the aim' means that the activity is conducted with an intention or purpose.

8. Element of Eliminating or ruining

Eliminating or ruining means to remove or eliminate competing business actors from the relevant market or to shut down its business.

9. Element of Competitor

Competitor is the business of other business actors in the same relevant market.

10. Element of Market

Pursuant to Article 1 sub-article 9, the definition of market is be an economic institution in which sellers and buyers, either directly or indirectly, can conduct trading transactions of goods and or services.

11. Element of Relevant Market

The definition of relevant market is the market related to certain marketing scope or area by business actors for goods and or services of the same or similar type or substitute of such goods and or services.

12. Element of Monopolistic Practices

The definition of monopolistic practices pursuant to Article 1 sub-article 2 is the centralization of economic power by one or more business actors, resulting in the control of the production and or marketing of certain goods and or services thus resulting in unfair business competition and potentially harmful to the interests of the public.

13. Element of Unfair Business Competition

The definition of unfair business competition pursuant to Article 1 sub-article 6 is competition among business enactors in conducting activities for the production and or marketing of goods and or services in an unfair or unlawful or anti-competition manner.

CHAPTER IV. ECONOMY OF PREDATORY PRICING

IV. 1 Definition and Indication of Predatory Pricing

Based on economic theory, predatory pricing is a condition where a business actor sets the sale price of goods and or services produced under the average total cost. A business actor can only gain profit if it can set the sale price of goods and or services produced above the average total cost or it can only reach break even if it sets the price exactly the same as the average total cost.

However the price set below the average total cost (ATC) is still considered as reasonable price if it is higher than the average variable cost because in such condition, business actor still can benefit from the manufacturing, although there is no use to replace the damaged capital equipment. Meanwhile if a business actor sets the price below the average variable cost (AVC), the price can be regarded as unreasonable price and we can allege that such business actor has a specific intention by conducting the predatory pricing.

IV. 2 Purpose of Predatory Pricing

First, we need to understand that the predatory pricing strategy is not necessarily intended to terminate the competing business actors. Therefore, a thorough consideration, research and review must be conducted on the purpose of business actor performing predatory pricing practice.

Generally, the predatory pricing practice has 5 (five) main purposes, namely:

1. To terminate the competing business actors in the relevant market,
2. To limit any competitors by applying predatory price as entry barrier,
3. To earn substantial profit in the future,
4. To reduce loss in the past, or
5. To serve as promotional price in the effort to introduce new product as a tool of marketing strategy.

In accordance with the purposes of business actor, the behavior prohibited in Article 20 of Law No. 5/1999 is the supply of goods or services by means of predatory pricing with the purpose of eliminating or terminating the business of its competitors in the relevant market so as to result in monopolistic practices or unfair business competition. Business actors performing the aforementioned predatory pricing practice will at least achieve the first three purposes at the same time.

On the other hand, business actor usually achieves the fourth purpose when it goes on sale to prevent higher loss if the supply of goods available is no longer saleable or to take out the supply of out-of-date goods or which are almost expired.

IV. 3 Definition and Indication of Predatory Pricing

A business actor can be deemed to supply goods and or services by way of fixing a very low price if the price is set at a much lower level if compared to the price sets by several other business actors. This requires a horizontal comparison. It may be suspected that a business actor supplying goods and or services by way of fixing a very low price has the intention of eliminating or terminating the business of its competitor in the relevant market if the level of profit gained from the price set by the business actor is lower than the applicable rate of interest.

In a market with perfect competition, the price rate applicable in the market is determined by the supply and demand of goods and services in which the price is established at the equilibrium between the quantity of consumer demand and manufacturer supply. However often in specific goods or services market, there are price setters or price leaders who are generally large-scale business actors adopting the lowest price structure. Therefore, the scale of production of such business actors must be reviewed in order to identify their purpose of fixing a very low price.

The larger the scale of production of a business actor, the lower the production cost paid by the business actor. As the production cost is lesser, the price rate which can be offered to the relevant market becomes lower.

With regard to this scale of production, a business actor supplying goods and services by fixing a very low price does not necessarily have the intention of eliminating or terminating the business of its competitors if such business actor has a large scale of production.

IV. 4 Market Share

In relation to the scale of production of a business actor, it is really necessary to observe the market share of a business actor allegedly conducting predatory pricing or fixing a very low price with the purpose of eliminating or terminating the business of its competitors.

The larger the market share of a business actor, the more dominant the business actor is in controlling the relevant market. As a dominant business actor, often it can act as price setter or leader.

IV. 5 Cost Structure

The pricing of a good or service supplied by a business actor is not only affected by its position in a market (market share), but also highly determined by the cost structure applicable to such business actor.

Since predatory pricing requires the amount of Average Variable Cost (AVC), it is crucial to make a comparison between the Average Variable Cost (AVC) and Fixed Cost (FC). Business actor with high fixed cost usually has low average variable cost. On the contrary, business actor with low fixed cost generally has a higher AVC.

In addition it is also very important to provide distinct criteria for the types of components included in the fixed cost and those of the variable cost, although economic-wise, they have relatively clear definitions.

IV. 6 Definition of Cost

Considering that a complete knowledge on production cost incurred by a business actor to produce goods or services is required to identify any predatory pricing, it is necessary to have a clear definition of such cost.

For business actors engaging in goods or services manufacturing activities, cost is the value of supply (input) used to produce output. In corporate economics, cost comprises direct or explicit cost and implicit cost. Explicit cost is the explicit expenses from the cash of a business actor which are allocated to purchase or hire the services for production factors required while implicit cost is the manufacturing cost which estimates the factors inherent in the company and used in its own production process.

IV. 7 Short run Cost

Predatory pricing practice is usually performed in short term to earn long term profit. Therefore to identify any indication of predatory pricing conducted by a business actor, it would be more appropriate if we take into account the cost in short-term equilibrium.

Fixed cost, total variable cost and total cost are present in short term. Total fixed costs (TFC) are costs incurred by a business actor in short term for fixed input. These costs are constant and independent and are not affected by the total input or production or the manufacturing activity of the business actor concerned. One of the examples of TFC is fixed lease payable to manufacturer for factory building during the term of lease agreement.

Total variable costs (TVC) are the costs incurred by a business factor for the variable input used. These costs vary according to the total output produced. The example of TVC is raw material cost and specific labor cost. On the other hand, total cost (TC) is equal to total fixed cost plus total variable cost.

IV. 8 Short run Cost Per Unit

Although the total amount of cost is very important, cost per unit or average cost is more crucial for conducting short term analysis on a business actor. Short run costs per unit taken into account are average fixed cost, average variable cost, average cost and marginal cost.

Average fixed cost (AFC) is the total amount of fixed cost per unit of output or the total fixed cost divided with the total output produced. The average fixed cost (AFC) is the variable cost per unit of output or the total variable cost divided with the total output produced. Average cost is the total amount of cost per unit of output. Therefore, AC is equal to AFC plus AVC.

On the other hand, marginal cost (MC) is the additional total cost (TC) resulting from the change of cost of output per unit.

IV. 9 Sunk Cost

To start the activity of good or service manufacturing, particularly in the industry sector, a business actor will incur a number of costs which may be recovered if a the industry suffers from a failure. These costs are known as sunk cost. The costs included in sunk cost generally constitute an initial investment required by any new business actor.

The amount of sunk cost often creates a barrier to market entry for new competitors for at least two reasons. First, the amount is quite relatively significant if compared to the total amount of cost or to the estimated profit gained. Secondly, the amount of sunk cost affects the business decision that needs to be made to reduce the scale of its production in the effort to minimize the financial risk of a business actor. Considering the small scale of production, it prevents the competitive and effective business actor from participating in the market.

IV. 10 Unreasonable Price

With respect to predatory pricing or low price fixing, it is necessary to adopt a rational approach to identify the reasonability of pricing conducted by a business actor. Such approach includes the need for:

1. Analysis on the capability of such business actor to cover losses in a relatively long term

2. Financial analysis on such business actor in relation to the ratio of revenues to costs incurred for manufacturing. This analysis is conducted to identify whether the low price is set at a reasonable level.

It is also necessary to consider the potential unreasonable price resulting from market expansion. In general, the larger the scale of production of a business actor, the bigger opportunity that the business actor has for minimizing its manufacturing cost so as to allow lower price fixing if compared to other business actors.

CHAPTER V. IMPLEMENTATION OF PREDATORY PRICING

V.1 Predatory pricing

In general, predatory pricing is a business strategy adopted to set a very low price for goods and or services produced within a relatively long period of time to eliminate other competing business actors from the market or to create a barrier to market entry for other business actors. In short term, consumers greatly benefit from predatory pricing. However if the competing business actors are already being eliminated from the market, such business actor will act as a monopolist increasing price to a very high level to cover the losses previously suffered.

Business actors applying predatory pricing is usually incumbent business actors who do not want to have any competing business actors in their businesses. In order to eliminate their competing business actors from the market or to prevent new competitors from entering the market, an incumbent business actor will set the price of good or service produced below the costs incurred by the business actor so that its competing business actors would not survive in the same business. In short term, consumers greatly benefit from predatory pricing because of the inexpensive good price. However if all competitors could not engage in their business activities, the incumbent company will raise the price to a high level to cover the losses suffered during the period of very low price fixing.

Furthermore if there is a new business actor who wishes to gain benefit from such high price, the incumbent business actor will reduce the price to a very low level again in order to eliminate the new business actor from the field of its business. The impact is no business actor will be able to enter the market and the incumbent business actor is free to raise the price to a monopolistic level without having any concern about other business actors intending to enter the relevant market.

In several cases, predatory pricing behavior does not necessarily reflect in a monopolistic or incumbent business actor. In fact, it is not always concerned with a dominant business actor, but it is rather involving one of the oligopolistic business actors. Furthermore, a predatory business actor does not necessarily attempt to eliminate its competing business actors from the market, but rather prevent new and potential competitors from entering the relevant market.

V. 2 Consequence of Predatory Pricing

In reality, it is difficult for the incumbent business actor to adopt predatory pricing behavior. Therefore, it is necessary to understand the characteristics of business actor acting as the predator. The **first** reason is that when a business actor performs the predatory pricing practice, it will suffer a significant loss. The fact is the incumbent business actor will suffer a greater loss if compared to the loss suffered by competing business actors at the equal level of efficiency.

This is because the incumbent business actor must meet the needs of all market demands for the low price level it applies. On the other hand, the competing business actors are not required to meet such obligation so that they can organize their production to minimize loss. In fact, the incumbent business actor will suffer greater losses if it must also meet the remaining total production that is not met by the competing business actors or if the market continues to increase. Therefore, predatory pricing will highly affect business actors intending to apply predatory pricing practice.

The **second** reason, if the nature of the industry allows business actors to enter and leave the market without any difficulties, no predatory pricing practice will occur. When the predatory pricing is applied, the competing business actors will leave the relevant market and invest their assets in another industry. When the incumbent business actor raises the price, the competing business actors will enter the industry again. This condition will continue until no predatory pricing practice is performed which ultimately will incur losses to consumers.

The **third** characteristic, the absence of sunk cost will also prevent predatory pricing practice. As the sunk cost is not present, the incumbent business actor has no means of raising the price toward the competing business actors so that it would not be effective to apply a price lower than the cost.

The **fourth** reason is because it is difficult to apply predatory pricing. A business actor performing such practice is usually a large-scale or dominant business actor in the goods or service market. This argument arises because unlike small-scale business actors, only large-scale business actors who is able to overcome losses.

V. 3 Dominant Business Actor

A dominant business actor and several business actors on a smaller scale will always present in any industry. Dominant business actor (dominant firm) is business actor having large market share which can affect the market price by increasing its production. This business actor often takes the role as price setter than price taker. Therefore, it has significant market power. On the contrary, business actors on a smaller scale play minor role and will act as price taker.

A business actor assumes a dominant position for the following reasons:

1. The dominant business actor applies the structure of lower production cost if compared to other business actors due to the following:

    - The dominant business actor is more efficient if compared to its competitors. This business actor has better managerial capacity and more advanced technology application so as to allow lower production cost. This technology advantage may in fact be protected as patent.

- As the pioneer in an industry, the dominant business actor has learned about a more efficient method of production (learning by doing).

- A predecessor business actor having dominant position has more opportunity to increase the scale of its production to an optimum level so that it benefits from the economies of scale. If the fixed cost is divided with the total amount of output, this business actor has lower average production cost if compared to new business actors on a smaller scale of production.

2. Dominant business actor usually has a superior product in the relevant market. This superior product is created by the reputation it achieve either through advertising or the quality established after controlling the market for a long period of time.

3. Dominant business actor may be created due to the merger between several business actors. The merger of business actors in a type of industry often provides an incentive to coordinate their activities with the purpose of increasing profit.

V. 4 Dominant Position

Pursuant to Article 25 of Law No. 5/1999, a business actor assumes dominant position in the following events:

1. A business actor or a group of business actors controls over 50% (fifty percent) of the market share of a certain type of goods or services; or

2. Two or three business actors or a group of business actor control over 75% (seventy-five per cent) of the market share of a certain type of goods or services.

V. 5 Indication of Predatory Pricing

Before making any accusation on business actor allegedly performing predatory pricing practice, we should first complete the 2 (two) phases of analysis related to the application of unreasonable price by predatory business actor.

First, to consider the market characteristics, such as seller concentration and condition for entering such market as indicated by the existence of market power.

Second, to ensure that the level of price applied is highly unreasonable by conducting an evaluation on the ratio of price set by predatory business actor to the production price.

V. 6 Test to Detect Predatory Pricing

There are several tests which may be conducted to detect whether a business actor commits a predatory pricing practice. The following are several tests commonly used to assist competition authority in verifying the existence of predatory pricing practice committed by a business actor.

- Price-Cost Test
- Areeda-Turner Test
- Average Total Cost Test (ATC Test)
- Average Avoidable Cost Test (AAC Test)
- Recoupment Test

V. 6. 1 Price-Cost Test

This test is performed to determine whether the predatory pricing conducted by a business actor constitutes a part of predatory pricing strategy it adopts. By comparing the date on price and cost objectively, this test is not directly aimed at verifying that a business actor has committed predatory pricing practice, but rather providing information that such condition is in fact directed toward a predatory price.

In this case objectivity is very crucial because the predatory pricing behavior reflected in a business actor is possibly only limited to achieve or maintain its position as dominant business actor without any intention to becoming a monopolistic business actor. With its level of efficiency, such business actor forces the competing business actors to remain under the control of the price it sets so that these competitors have to operate at loss and finally, be eliminated from the market. This condition will also prevent new competitors from entering the market.

Insofar as the price set by the dominant business actor can cover the production cost, the applicable price may be regarded as the equilibrium price in a perfectly competitive market. On the other hand, if the price is set below the production cost, the process of fair competition has been violated. The predatory pricing committed by such business actor could possibly eliminate a more efficient competing business actor.

The majority of competition authorities use the price-cost test to analyze predatory pricing problem and there are several types of costs generally utilized by the competition authority. The following are the types of costs commonly used as reference in detecting predatory pricing:

1. Marginal Cost (MC) is the additional cost for producing an additional unit of final output.
2. Average Variable Cost (AVC) actually depicts the behavior of MC on average of a number of outputs. AVC is calculated by identifying all variable costs with additional output. All of these costs are totaled up and the result is divided with the total output produced.
3. Average Avoidable Cost (AAC) is the total amount of costs avoidable by a business actor if it does not produce a number of certain outputs divided with the total output that is not produced. Avoidable cost is defined as the addition of variable cost and fixed cost of certain products, but it is not sunk cost. In other words,

average avoidable cost is the cost required to produce outputs in certain quantity.

The amount of Average Total Cost (ATC) is obtained by dividing the total amount of cost borne by business actor (variable cost, fixed cost, including other common costs) with the total amount of goods and services produced. Common cost is fixed cost supporting several activities of the business actor.

V. 6. 2 Areeda-Turner Test

According to Areeda and Turner, the pricing of a good and or service may be regarded as predatory if it is set below the short run marginal cost. On the other hand, any price above the marginal price of short run cost is not of predatory nature. This test is in line with the theory of perfectly competitive market which equates market price with Marginal Cost (MC) and Marginal Revenue (MR). At this price level, any competing business actor would not leave the market insofar as its efficiency is at least similar to the incumbent business actor.

Considering the difficulty to determine Marginal Cost, Areeda and Turner recommend the use of AVC as its substitute. However several criticisms arise on the use of this test. Criticisms on this test may be divided into 2 (two) categories, **first**, short run marginal cost is not an appropriate test because several costs above the short run marginal cost are in fact of predatory nature. **Second**, if the short run marginal cost presents an appropriate test tool, AVC is not a suitable substitute because this cost tends to be below MC at the higher level of output (therefore indicating an under-estimate trend).

The basic criticism is that the use of AVC is not suitable for business actors with high fixed cost and low variable cost, such as business actors in transportation sector and software industry. These types of business actors face relatively no difficulties in fixing price above the variable price so that the use of AVC Test will prevent the incumbent business actor from entering the market.

However this test is the most common test and allows the most practical application by competition authority handling predatory pricing case. The use of this test is not without an appropriate material. Business actors fixing prices below AVC are almost certain practicing predatory pricing because price fixing below average variable cost in a long run usually incurs significant loss (because the price fixed is only able to cover variable cost without taking into account of fixed cost). This is only conducted by a predatory business actor.

V. 6. 3 Average Total Cost Test (ATC Test)

As we know, one of the weaknesses of AVC Test is its failure to detect price that is actually below the actual level of cost. As a result of the use of this test, the determination of marginal cost (MC) will not only be underestimated, but the condition of price above AVC and below AC will also be overlooked. In fact, if the price is within the range of both types of cost, only variable cost that may be covered, rather than the entire fixed costs. Therefore, price fixing in such price range is not entirely able to cover the cost components, such as lease cost, interest payment and depreciation.

By taking the aforementioned matters into consideration, several competition authorities, such as those in European Union indicate a trend toward using ATC Test in determining predatory pricing. In this case, combined approach of AVC-ATC Test is often adopted where any price below AVC will surely be considered as predatory price while any price above AVC and below ATC may also be regarded as predatory price, unless the competition authorities have reasonable reasons.

Although ATC measurement is more practical, however it is very difficult to be applied on business actors manufacturing multi-product. In fact, to a certain extent it is impossible to obtain accurate calculation result on multi-product business actors.

V. 6. 4 Average Avoidable Cost Test (AAC Test)

AAC Test is one of the variations of Areeda-Turner Test. In AAC Test, price is compared with AVC plus variable cost, excluding sunk cost or in other words, the cost incurred to produce a specific number of outputs.

The benefit of the use of this test is that it is considered to present a better estimation if compared to AVC on business actor allegedly committing predatory pricing. Predatory pricing practice often forces business actor to add several components to its fixed cost in the effort to increase the production capacity in order to absorb all market demand.

Since this test also calculates fixed cost for a certain number of outputs, it can address the criticisms assuming that Areeda-Turner Test is too easy for industries with high fixed cost.

However in calculating avoidable cost, it is also necessary to take into account duration problem. Usually, the longer the duration of calculation is, the higher value of avoidable cost would be, both in total or in average. This makes sense because in long run, the element of sunk cost would become avoidable cost. Therefore it is clear that it would be more difficult to conduct AAC Test in a longer period of time. Thus it is necessary to consider the most appropriate and reasonable duration to calculate avoidable cost, namely during the predatory pricing practice.

V. 6. 5 Recoupment Test

Recoupment Test is not use to verify whether a business actor commits predatory pricing, but rather to evaluate whether the business actor committing such practice has successfully achieved its purpose, namely to eliminate its competitors from the market and to prevent other competitors from entering the market. Furthermore, this test is also performed to identify whether predatory business actor would be able to gain more profit than the existing competitive advantage to cover the losses it suffers during predatory practice.

Recoupment Test is based on the rationale that competition law is aimed at improving consumers' welfare. This is based on the assumption that after its competitors leave the market, business actor will set a high price to cover the losses suffered during predatory pricing practice. The price is estimated to be above the price in perfect competition which surely will harm consumers.

Recoupment Test is intended for preliminary investigation. If the business actor allegedly committing predatory pricing practice is not proven to have eliminated or prevent its competitors from entering the market or the effort to cover the losses is eventually impossible, this test allows the competition institution to release the alleged business actor from the charge of being predatory business actor without having to perform price-cost test. This is the advantage of Recoupment Test because it is difficult to determine predatory pricing through Price-Cost Test. On the contrary, if this test ultimately indicates that the alleged business actor indeed raises the price to cover its losses, Price-Cost Test must be performed to prove that the foregoing business actor commits predatory pricing practice.

The use of Recoupment Test is relatively common in various countries and it appears that it is the most practical and appropriate test to be performed in Indonesia. In addition considering that predatory pricing practice in Indonesia has not reached an alarming level for fair business competition.

However there are 2 (two) key factors presenting the most appropriate reasons for the difficulty in implementing Price-Cost Test. First, the data required to determine Short-Run Marginal Cost, moreover Average Variable Cost, are often difficult to obtain. Second, there are several explanations which can be used to justify the application of predatory price. For example, the application of promotion price by a new business actor to attract consumers' attention. As an initial step in business, it is common and ordinary thing for business actor to give a reward in the form of discount price below the marginal cost. This is not wrong if the decision on price fixing is intended as promotion activity which can be regarded as future investment.

Another example of price fixing below Marginal Cost is related to learning by doing. Learning by doing with respect to price decrease by increasing the number of output is usually directed at learning about a more efficient production. Based on the experience and experiment, the business actor applying learning by doing is often able to gain profit at low price level.

It is important to note that the allegation of predatory pricing practice is often made by a business actor feeling threatened by its competitors. Allegation of predatory pricing against a business actor can also be made as inefficient strategy adopted by business actor in the effort to maintain its market position. This allegation is made because there is a growing concern that the efficient business actor will reduce the price of goods and services produced by them. With regard to such matter, the allegation of predatory pricing eliminating a business actor should not be made prematurely. If the business actor is actually proven to have eliminated another equally efficient or more efficient business actor and then proven to have made a significant price increase, such allegation requires a follow-up.

Recoupment Test will consider various conditions which play a vital role for the success of predatory pricing strategy. However it does not necessarily mean that these conditions have to be met at once. A number of conditions which are often taken into account in the Recoupment Test are among other things:

- domination or market power,
- barriers to entry and re-entry,

- relative financial power,
- price elasticity against low demand,
- over capacity,
- trend of market share,
- relative efficiency,
- impact of reputation
- price discrimination,
- cross subsidy

V.6.5.1 Domination or market power

Competition authorities should give serious consideration to the dominant position or market power of a business actor in addressing a predatory pricing problem, although they do not apply Recoupment Test. As previously described, the condition of dominant position or significant market power often serves as one of the important requirements to be met by a business actor intending to adopt predatory pricing strategy. The dominant position of business actor will provide a predatory business actor a good opportunity to conduct recoupment on the losses it suffers when applying a predatory price.

As it assumes a dominant position, a business actor has greater capacity to act as a predator by using 2 (two) methods, namely **first**, to decrease price to the lowest possible extent while increasing output to absorb market demand for the low price. It is impossible for a business actor to apply price reduction without having to take over the market share of its competing business actors. If a predatory business actor could not increase its production to absorb the market demand met by its competitors up to now, the surplus of market demand will cause the price set by the predator to be ineffective. Moreover, this also applies for sole manufacturer committing predatory pricing practice for the purpose of preventing any competitors from entering the market.

Price reduction requires the manufacturer not only to meet the existing demand, but also the increasing demand due to the price reduction. If the manufacturer does not have significant market power to meet all these demands, its competitors which can cover the surplus of demand will be able to set the price higher than the price set by the predator, thus preventing the predator from achieving its purpose.

Second, to apply barriers to enter and re-enter the market.

V.6.5.2 Barriers to Enter and Re-enter Market

It is crucial for predatory business actor intending to conduct recoupment on the losses it suffers from adopting predatory pricing strategy to create barriers to enter and re-enter the market. If the competitors are already eliminated and potential competitors have been successfully prevented from entering the market, the predatory business actor will raise the price of goods and services it produces in order to gain supra competitive profit to cover the losses intentionally incurred by such business actor. This high price certainly will attract competing business actors to re-enter the market which as a consequence, the price will be reduced to a competitive level. In the market with a high level of barrier to entry, predator would be protected from the competing business actors so as to continue enjoying the benefit of the high price level.

In general, barriers to re-entry imposed on business actors who had been eliminated from the market are related to the reputation of such business actor that had been damaged by bankruptcy and the difficulty to re-hire expert staff whose employment has been terminated when the business actor ceases its activities or to find their replacement. Therefore to determine the existence of predatory pricing, we need to focus our attention not only to the potential barriers to re-entry, but also to the time required by business actors who had been eliminated to re-enter the market. If it requires years to re-enter the market, the predatory pricing strategy will continue benefit the predatory business actor.

V.6.5.3 Relative Financial Capacity of Business Actor

Successful implementation of policy on predatory pricing strategy does not only require the financial power of business actor as a whole, but also stronger financial condition if compared to that of counter business actors. If the predatory business actor has more cash reserve funds and easy access to capital if compared to other business actors, it would be easier for such business actor to successfully perform predatory pricing practice.

V.6.5.4 Price Elasticity against Demand

Although this condition is not too crucial, price elasticity against demand may determine whether or not the predatory pricing strategy would be successfully adopted by using two methods.

First, by reducing the total over capacity required in predatory practice. In this case, we can determine whether predatory pricing practice is able to absorb all market demand arising from price reduction. The lower the price elasticity against demand is, the lesser excessive capacity to be met by the predator due to new market demand resulting from the predatory price.

Second, low price elasticity also facilitates recoupment as it lowers the possibility for reduction of demand due to price increase. On the contrary, high price elasticity will reduce market demand so as to cut the profit gained by predatory business actor to cover the losses resulting from predatory pricing practice.

V.6.5.5 Over Capacity

Over capacity is an essential prerequisite for predatory pricing practice because business actor must be able to absorb all new market demand arising due to price reduction and to also absorb the market share controlled by the competitors up to now. If not, the surplus of market demand will again result in price increase and relieve the pressure against the competitors so that they are able to survive, at least for a longer period of time.

V.6.5.6 Relative Efficiency

If the incumbent business actor is more efficient, it is more cost-effective and easier for such business actor to apply predatory pricing practice. On the contrary, if a business actor has low efficiency, it is more costly and difficult for such business actor to apply predatory pricing practice. However, business actors often do not realize that they do not have the advantage of relative efficiency against competing business actors so that when they apply predatory pricing practice, predatory business actors have to continuously lower the price level to eliminate their competitors who turn out to be more efficient.

V.6.5.7 Price Discrimination

Price discrimination occurs when the incumbent business actor is able apply predatory price only to specific consumers who give serious consideration before purchasing the product from its competitors. Therefore, the predatory price fixing is not applied to all outputs. If this occurs, the predatory cost will be lowered to a minimum extent because not only that it facilitates financing, but also it requires lower cost to achieve break even point in the recoupment process.

V.6.5.8 Cross Subsidy

Cross subsidy may initiate predatory pricing practice because the losses resulting from predatory pricing in a market are often covered by supra competitive profit in another market. This condition allows predatory pricing practice to be applied for relatively long period of time to eliminate the existing competitors or prevent new competitors from entering the market.

V. 7 Indication of Predatory Pricing

In addition to comparing the profit gained with the applicable rate of interest, there are several tests which can be used to determine whether unreasonably low price fixed by a business actor is intended to eliminate or terminate its business competitors in the relevant market, namely as follows:

- Above-Cost Test
- Limit-Pricing Strategy

V.7.1 Above-Cost Test

We still can assume that a business actor has the intention to eliminate or terminate its business competitors although it sets the selling price for the goods and services above the average total cost (ATC). However, the price is usually set at an unreasonable level so as to reduce the maximum profit in the short term.

Business actors usually will select production level that leaves other business actors intending to enjoy such profit with only insignificant amount of demand. In fact, no new business actors will be able to cover their average total cost at the applicable price level.

By sacrificing a part of its profit, the incumbent business actor generally will let its competing business actors to stay outside the market. If this is achieved, the incumbent business actor will subsequently attempt to gain higher profit that earned on a perfectly competitive market. This strategy will harm consumers if the followers of such business actor eventually can improve their efficiency to at least, an equal level as the incumbent business actor. However this can only be achieved if the followers of such business actor is able to secure their position in the market, to increase the volume of goods and frequently, to reduce their operating cost.

V.7.2 Limit-Pricing Strategy

A pricing strategy known as Limit-Pricing Strategy is identified with the desire of monopolistic or dominant business actor to protect its position by way of making substantial price deduction or significantly increasing its production. This is conducted to prevent new business actors from entering into the industry or to make the industry less attractive to them so that the monopolistic business actor can continue maintaining its dominant position.

This strategy is usually adopted by showing to newcomer business actors that with the participation of these new business actors, additional outputs will result in the reduction of price to an equal level with the total average cost. As zero profit condition may occur, new business actors often choose not to enter the relevant industry.

CHAPTER VI. REGULATION ON SANCTION

Pursuant to Article 47 of Law No. 5/1999, KPPU is authorized to impose administrative sanction on business actors violating the provisions of Article 20 in the form of:

3. ordering business actors to stop activities proven to have been causing monopolistic practices and or unfair business competition and or being harmful to society (Article 47 paragraph (2) sub-paragraph c); and or

4. ordering business actors to stop the misuse of dominant position (Article 47 paragraph (2) sub-paragraph d); and or

5. imposition of a minimum fine of Rp.1,000,000,000,- (one billion Rupiah) and a maximum fine of Rp.25,000,000,000,- (twenty-five billion Rupiah) (Article 47 (2) sub-paragraph g).

Violation of Article 20 may also subject to primary criminal sanction as set forth in Article 48 of Law No. 5/1999 in the form of:

1. Criminal sanction of a fine of minimum Rp.5,000,000,000,- (five billion Rupiah) or maximum Rp.25,000,000,000,- (twenty-five billion Rupiah), or a criminal sanction of imprisonment as replacement of fine for no longer than 5 (five) months (Article 48 paragraph 2)).

2. A fine of minimum Rp.1,000,000,000,- (one billion Rupiah) and maximum Rp.5,000,000,000,- (five billion Rupiah) or the criminal sanction of imprisonment as an alternative to fine for maximum 3 (three) months (Article 48 paragraph 3)), if the business actors and or refuse to submit evidence required in the investigation and or examination or refuse to be examined, provide information required in the investigation and or examination or impede the process of investigation and or examination as intended in Article 41 paragraphs (1) and (3).

With regard to the foregoing primary criminal sanctions as set forth in Article 49 of Law No. 5/1999, violation of Article 20 may be subject to additional criminal sanctions in the form of:

a. revocation of business license; or

b. prohibition for business actors proven to have violated this law from filling the positions of director or commissioner for at least 2 (two) years and for no longer than 5 (five) years; or

c. cessation of certain activities or actions resulting in losses to other parties.

CHAPTER VII. CLOSING REMARKS

In short term, predatory pricing greatly benefits the consumers, however if all competitors cannot conduct their activities again, the incumbent company will raise the price to a high level to cover the losses suffered during unreasonably low price fixing. Predatory price or unreasonably low price fixing is a prohibited activity in Law No. 5/1999 because it may impede business competition and harm public welfare.

In the effort to clarify the foregoing regulation, both business actors and consumers can use one of these guidelines to identify the background, economic and business theories, study as well as the application of predatory pricing or unreasonably low price fixing included in Article 20 of Law No. 5/1999.

In its implementation, investigation will commence as from KPPU receives a report on alleged predatory pricing committed by a business actor. The duration of investigation will start as of the reported business actor commits the alleged predatory pricing practice up to and including the reporting party reports the alleged predatory pricing.

With respect to business activities which are very dynamic and always developing, continuous revision possibly will be made to these Guidelines.

After considering a number of strengths and weaknesses of various tests to detect predatory pricing practice, KPPU will begin the following phases of test:

Phase I. Conducting Review on Unreasonably low price

In this phase, a review will be conducted to identify whether or not the low price set by a business actor allegedly committing predatory pricing practice is an unreasonable price. As the first indication, the review will be first conducted on the market power of the business actor. The business actor is deemed to have a market power if it controls at least 35% (thirty-five percent) of the market share. If such business actor indeed has market power, the test will proceed to identify the relationship between the price and costs incurred for production.

If the price of goods is set above average total cost (ATC), it is almost certain that the price is not an unreasonable price. We may suspect that the price set is an unreasonable price if it is below average variable cost, except for certain reasons. On the other hand, if the price is between average total cost (ATC) and average variable cost (AVC), we need to consider various factors, including among other the strength of market demand, over capacity and the purpose of win the competition in the market.

Phase II. Recoupment Test

Recoupment Test is intended for preliminary survey. If the business actor allegedly committing predatory pricing practice is not proven to have eliminated or prevented its competitors from entering the market or if it is impossible to finally make any effort to cover any losses, this test allows the competition authority to release the business actor allegedly applying predatory pricing from any charge without having to perform price-cost test.

However if the Recoupment Test indicates that the alleged business actor indeed raises the price to cover its losses; price-cost test must be conducted to verify whether such business actor has committed predatory pricing practice.

Phase III. Price-Cost Test

The recommended price-cost test is Areeda-Turner Test. According to Areeda and Turner, the price fixing of a good and or service may be considered as predatory if it is lower than the short run marginal cost. Bearing in mind that it is not difficult to determine marginal cost, according to the recommendation of Areeda and Turner, Marginal Cost will be replaced with Average Variable Cost.

In compliance with the applicable laws and regulations, anyone perceiving that it has been harmed and knowing that a predatory pricing or unreasonably low price fixed is or allegedly has occurred, he/she may file a written report to KPPU with accurate information on the violation by attaching the identity of the reporting party to the address below. KPPU will keep the identify of the reporting party perceiving that it has been harmed and knowing that a predatory pricing or unreasonably low price fixed is or allegedly has occurred as confidential.

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