**The Commission for the Supervision of Business Competition of the Republic of Indonesia**

# REGULATION OF THE COMMISSION FOR THE SUPERVISION OF BUSINESS COMPETITION OF THE REPUBLIC OF INDONESIA NUMBER 5 YEAR 2010

**CONCERNING**

**GUIDELINES ON IMPLEMENTATION OF ARTICLE 14 CONCERNING VERTICAL INTEGRATION BASED ON LAW NUMBER 5 YEAR 1999 CONCERNING PROHIBITION OF MONOPOLISTIC PRACTICES AND UNFAIR BUSINESS COMPETITION**

**THE COMMISSION FOR THE SUPERVISION OF BUSINESS COMPETITION**

Considering : that to implement the provisions of Article 14 of Law Number 5 Year 1999, it is deemed necessary to enact a Regulation of the Commission for the Supervision of Business Competition concerning Guidelines on Implementation of Article 14 concerning Vertical Integration based on Law Number 5 Year 1999 concerning Prohibition of Monopolistic Practices and Unfair Business Competition;

In view of :

1. Law Number 5 Year 1999 concerning Prohibition of Monopolistic Practices and Unfair Business Competition (State Gazette of the Republic of Indonesia Year 1999 Number 33, Supplementary State Gazette of the Republic of Indonesia Number 3817);
2. Decree of the President of the Republic of Indonesia Number 75 Year 1999;

3. Decree of the President of the Republic of Indonesia Number 59/P Year 2006;

Bearing in mind : The Resolutions of the Commission's Meeting dated April 7th, 2010.

**HAS DECIDED:**

TO ENACT : REGULATION OF THE COMMISSION FOR THE SUPERVISION OF BUSINESS COMPETITION CONCERNING GUIDELINES ON IMPLEMENTATION OF ARTICLE 14 CONCERNING VERTICAL INTEGRATION BASED ON LAW NUMBER 5 YEAR 1999 CONCERNING PROHIBITION OF MONOPOLISTIC PRACTICES AND UNFAIR BUSINESS COMPETITION

**Article 1**

In this Regulation of the Commission, referred to as:

1. Guidelines on Article 14 of Law Number 5 Year 1999 concerning Vertical Integration, hereinafter referred to as the Guidelines, shall be the document of the guidelines on the implementation of Article 14 in relation to Vertical Integration.
2. Commission shall be the Commission for the Supervision of Business Competition as stated in Law Number 5 Year 1999.

**Article 2**

(1). The Guidelines constitute the explanations to the basic principles, limitation and samples of the implementation of the provisions of Article 14.

(2) The Guidelines are intended for:

a. Business actors and other parties who have an interest in understanding the provisions of Article 14 concerning the Implementation of Law Number 5 Year 1999 on Vertical Integration;
b. The Commission in performing its tasks and authorities as set out in Article 35 and Article 36 of Law Number 5 Year 1999 in conjunction with Article 4 and Article 5 of the Presidential Decree Number 75 Year 1999 concerning Commission for the Supervision of Business Competition.

**Article 3**

(1). The Guidelines are as contained in the Appendix to this Regulation.

(2) The Guidelines as stated in paragraph (1) shall be minimum standard for the Commission in performing its tasks, which shall form an integral part of this Regulation and bind all parties.

**Article 4**

(1). Decision and policies in relation to Article 14 concerning Vertical Integration as decided and enacted by the Commission prior to the issuance of this Regulation shall remain enforceable.

(2). This Regulation shall take effect as of the date of its stipulation.

Enacted in : Jakarta

On : April 9th, 2010

COMMISSION FOR THE SUPERVISION OF BUSINESS COMPETITION

CHAIRMAN,

Prof. Dr. Tresna P. Soemardi

## Forewords

As mandated in Article 35 point (f) of Law Number 5 Year 1999 concerning Prohibition of Monopolistic Practices and Unfair Business Competition, the Commission for the Supervision of Business Competition has a task to prepares the guidelines and/or publication in relation to the implementation of Law Number 5 Year 1999.

In this opportunity, the Commission prepares the Guidelines on Implementation of Article 14 concerning Vertical Integration based on Law Number 5 Year 1999 concerning Prohibition of Monopolistic Practices and Unfair Business Competition. The Guidelines are prepared in a view that the Commission is able to performing its supervisory function on the implementation of Law Number 5 Year 1999 appropriately. In addition, the guidelines is expected to provide complete explanation, but easily understood by the parties who indirectly involve in the efforts of creating fair business climate, among others, business actors, government, law enforcement bodies and the public in general.

In line with very dynamic and fast growing business activities, this Guidelines might need an improvement in the future.

Chairman of the Commission

Appendix to the Regulation of the Commission for the Supervision of Business Competition
Number : 5 Year 2010
Date : April 9th, 2010

## TABLE OF CONTENTS

## CHAPTER I
## BACKGROUND

In a production process, there are some phases to be passed, starting from the acquisition of the raw materials to the processing to be half-finished goods and then processing to be finished goods. The production process is then continued with the distribution of the goods and/or services from distributor to the end consumers. The phases to be passed constitute a production chain which covers business units at the upstream to the downstream. Every phase to be passed in the production process and distribution contain a margin between the price and production cost. Therefore, the end consumers will pay for a product with the price which is an accumulation of the production cost and margin of every phase from the production process to the distribution.

Vertical Integration is an agreement with an objective to control some business units which are included in the production chain of certain goods and/or services. Vertical Integration can be conducted by the strategy of controlling of the production business units to the upstream in which the company owns the business units for the procurement of the raw materials and the downstream with the ownership of business unit for the distribution of goods and/services to the end consumers.

Vertical Integration can reduce the negative effect of the monopolistic market structure at every production and distribution phase. Vertical Integration can limit the multiple margin, the consumers can therefore benefit from the lower price of the product. A company can also benefit this strategy by utilizing the technical and transaction cost efficiency; therefore, the total profit to be earned can be higher than the condition in which they have to procure raw materials from other companies or distribute its products through other companies.

Nevertheless, vertical integration can also inhibit competition as it can increase the cost to be borne by the competitors to access the raw materials or distribution channel required to sell their products. In addition, vertical integration can also reduce the availability of raw materials and increase the amount of capital required to get entry to the market. In other words, vertical integration can produce an obstacle to get entry to a market.

Law Number 5 Year 1999 concerning Prohibition of Monopolistic Practices and Unfair Business Competition ("Law Number 5 Year 1999") provides for the vertical integration agreements in Article 14 which is read as follows:

*"Business actors shall be prohibited from entering into agreements with other business actors with the intention of controlling the production of several goods which are products included in the production chain of certain related goods and or services where each product link is the end product of the production process or of further processing, either in one direct link or indirect link, which may potentially result in unfair business competition and or be harmful to society".*

If we pay attention to the contents of the provisions of Article 14 of Law Number 5 Year 1999, it can be clearly seen that the principle used to analyze this article is the need for evidences that unfair business competition or be harmful to society has occurred. Vertical integration has the pro-competitive and anti-competitive effects effect and only vertical integration that results in unfair business competition and be harmful to society will be therefore prohibited.

# CHAPTER II
# OBJECTIVES OF FORMULATION OF GUIDELINES CONCERNING VERTICAL INTEGRATION

## 2.1. Objectives of Formulation of the Guidelines

The Commission for the Supervision of Business Competition (Commission) was established to supervise the implementation of Law Number 5 Year 1999. The tasks of the Commission are as mandated in Law Number 5 Year 1999. One of the tasks of the Commission is to prepare guidelines and/or publications in relation to Law Number 5 Year 1999 (article 35 point f). The guidelines are required to explain in details concerning the articles and other matters which have not been explained in Law Number 5 Year 1999. With the guidelines, it is expected that business actors and other stakeholders can adjust themselves with the guidelines in a view that they will not violate the business competition as regulated in Law Number 5 Year 1999. Therefore, the formulation of the Guidelines on Implementation of Vertical Integration (hereinafter referred to as the Guidelines) is one of the efforts to provide a clearer picture concerning the provisions of Article 14 of Law Number 5 Year 1999.

These guidelines is intended for business actors, legal and economic practitioners, government and society in order to be able to easily and clearly understand what are meant by:

1. Vertical integration
2. Vertical integration practice which is considered to violate Law Number 5 Year 1999
3. Approach method in law enforcement which regulates about vertical integration.

Vertical integration can improve the management efficiency and effectiveness, manufacture and/or operation process as well as the product and/or services distribution or marketing to the end consumers. Nevertheless, vertical integration can also create anti-competition and monopolistic practice which will in turn create inefficiency and market failure. These guidelines will provide explanation concerning vertical integration which can result in monopolistic practice and unfair business competition and/or be harmful to society, it is therefore expected that the guidelines can give assurance of the business competition law enforcement, especially concerning vertical integration.

### 2.2. Scope of Guidelines

These guidelines explain the general principles and basic standards used by the Commission in conducting an analysis to assess a vertical integration agreement as regulated in Article 14 of Law Number 5 Year 1999.

These guidelines also explains the concept and definition of vertical integration, impacts of vertical integration and measuring the impacts of vertical integration.

Systematically, these Guidelines cover:

| | |
|---|---|
| Chapter I | Background |
| Chapter II | Objectives and Scopes of Guidelines<br>This chapter explains the objectives of the formulation of the Guidelines and matters included in the Guidelines |
| Chapter III | Definition and Explanation of Article 14 concerning Vertical Integration<br>This chapter explains the scope of vertical integration, explanation of the relevant elements in article aforesaid and correlation between Article 14 and other articles in Law Number 5 Year 1999. |
| Chapter IV | Vertical Integration and Sample Cases<br>This chapter explains the concept of vertical integration, reasons of business actors in conducting the vertical integration, impacts of vertical integration, assessment of impacts of vertical integration, things to be considered in relation to the analysis of prohibition of vertical integration and some sample cases. |
| Chapter V | Rules of Sanction<br>This chapter states some sanctions which may be imposed by the Commission against the violation of article 14 concerning vertical integration. |
| Chapter VI | Closing |

# CHAPTER III
# DEFINITION AND EXPLANATION OF ARTICLE 14 CONCERNING VERTICAL INTEGRATION

## 3. 1. Definition and Scope

Articles 14 of Law Number 5 Year 1999 stipulates that “Business actors shall be prohibited from entering into agreements with other business actors with the intention of controlling the production of several goods which are products included in the production chain of certain related goods and or services where each product link is the end product of the production process or of further processing, either in one direct link or indirect link, which may potentially result in unfair business competition and or be harmful to society”.

Article 14 only regulates the prohibition to business actors in controlling (through ownership and/or agreements) the production/operation included in a production/operation chain. The explanation to the production/operation chain which is the results of processing and/or further process definitely explains the characteristics of the vertical operation/production chain, either at upstream level (production/operation process of goods and/or services) or at the downstream level (distribution and marketing of goods and/or services). Nevertheless, the scope of vertical integration based on article 14 does not include the distribution process from retailers to the end consumers.

In implementing the provisions of article 14, not only the elements of article 14 shall be fulfilled, but it shall be also proven whether the consequences or impacts of the vertical integration agreement has caused unfair business competition or be harmful to society. Bearing in mind that vertical integration agreements can result in harmful impact, the proofing process of unfair business competition and/or be harmful to society is very important in deciding whether or not the vertical integration agreement has barred the competition .

## 3.2. Explanation of Elements

Vertical Integration in Law Number 5 Year 1999 is regulated in article 14 as follows:

> *"Business actors shall be prohibited from entering into agreements with other business actors with the intention of controlling the production of several goods which are products included in the production chain of certain related goods and or services where each product link is the end product of the production process or of further processing, either in one direct link or indirect link, which may potentially result in unfair business competition and or be harmful to society".*

The explanation of elements contained in article 14 of Law Number 5 Year 1999 are as follows:

1. Business actors

   Business actors according to article 1 point 5 shall be any individual or business entity, either 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. Agreement

   Agreement according to article 1 point 7 shall be the action of one or more business actors for binding themselves to one or more other business actors under whatever name, either in writing or not in writing.
3. Other business actors

   Other business actors shall be the business actors who are in a production/ operation chain, either at upstream or downstream.
4. Control of Production

   Control of raw materials, production/operation and market share conducted by a business actor in a production chain.
5. Goods

   Goods according to article 1 point 16 shall be any physical objects, either tangible or intangible, movable or immovable, which may be traded, used, utilized or exploited by consumers or business actors.
6. Services

   Services according to article 1 point 17 shall be services in the form of work or performance traded in society to be utilized by consumers or business actors.
7. Unfair business competition

   Unfair business competition shall be competition among business actors in conducting activities for the production and or marketing of goods and or services in an unfair or unlawful or anti-competition manner.

8. Harmful to society

   Harmful to society shall be a condition in which the public shall bear the cost as a result of unfair competition, such as unreasonable price, lower quality of goods/services, limited options/scarcity and lowered welfare (welfare loss).

### 3.3. Other Relevant Articles

Regulation on vertical integration can also be found at other articles of Law Number 5 Year 1999, namely:

1. Article 15 concerning Closed Agreements. Vertical Integration can be considered to violate Law Number 5 Year 1999 if the agreements results in the violation of article 15 which provides for the closed agreements. Closed agreements aforesaid contain provisions that the party receiving the goods is limited in the distribution of goods and/or obligated to buy certain goods. The regulations concerning Article 15 will be described in detail in the Commission's Explanation concerning Article 15.
2. Article 19 concerning Market Control. Vertical Integration can be done with an objective to control the product, as stated in Article 19, i.e. to bar other business actors to conduct the same activities at the relevant market, to bar consumers or customers of their competitors from engaging in a business relationship with such business competitors; or limit the distribution of goods and/or services in the relevant market; or engage in discriminatory practices towards certain business actors.
3. Article 26, where vertical integration can be conducted through multiple positions (holding the position as a director or a commissioner) at two companies or more that are in one vertical production chain.
4. Articles 28 and 29, where vertical integration can be conducted through the process of merger, consolidations and acquisitions. Regulations concerning these articles will be described in detail in the Commission's Explanation concerning the subject matter.

## CHAPTER IV
## VERTICAL INTEGRATION AND SAMPLE CASES

### 4.1. Concept and Definition of Vertical Integration

Vertical Integration means the agreements entered into by some business actors who are in the different production/operation phase and/or distribution, but inter-related one another. The forms of agreements may be an integration of some or the whole consecutive operational activities in a production/operation chain.

Mechanism of the relationship between a business activity and other business activities is vertical interaction in nature in the perspective of competition law, especially Law Number 5 Year 1999 is described as a production/operation chain which is the results of processing or further process, either in a direct or indirect chain (including the substitute or complementary goods and/or service production chain).

The mechanism of relationship of the vertical integration business activities can be seen in the following production scheme which describes the relationship from upward to down, which is commonly called as from the upstream to the downstream.

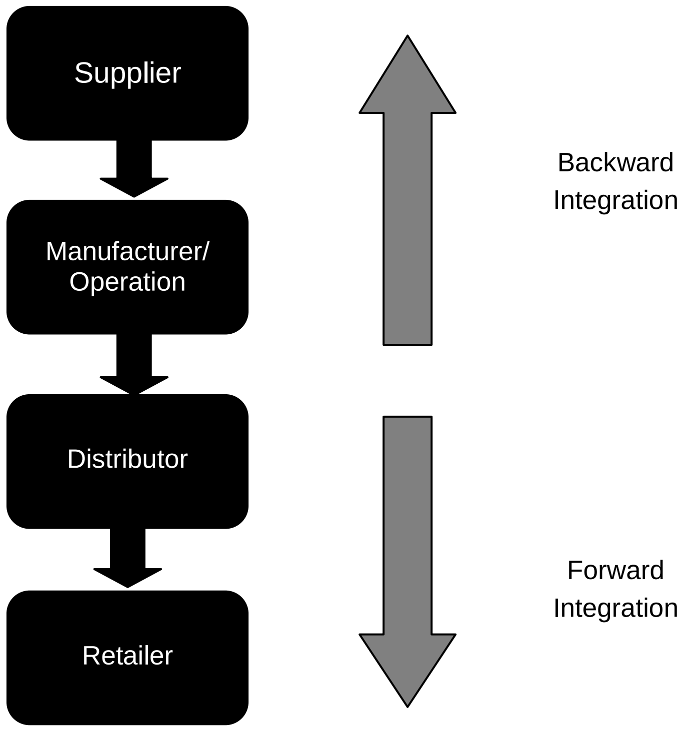


**Figure 1. Diagram of Vertical Correlation**

Based upon the diagram above, it appears that a vertical integration exists:

a). between a business actor and another business actor who acts as the supplier,

b). between a business actor and another business actor who acts as the buyer.

A business activity that is categorized as a backward or upstream vertical integration is that when the activity integrates a number of activities that lead to the provision of raw materials for main products.

For example, when a business actor that produces palm oil expands its business scope by integrating the supply of crude palm oil (CPO) as the main raw material of palm oil production. Such a palm oil producing company shall decide to enter into a binding agreement with the CPO producer. This action taken by the palm oil producing company is called a backward or upstream vertical integration.

In the meanwhile, the business activity that is categorized as a downstream vertical integration is that when the activity integrates a number of activities that lead to the provision of end-products.

For example, when the business actor that produces the palm oil decides to expand its business scope by integrating the supply of palm oil (CPO) and a supermarket sells the palm oil directly to the end-consumers. Such a palm oil producing company shall decide to enter into a binding agreement with the said CPO producer. The agreement that binds both the palm oil producer and its distributors is classified as downstream vertical integration.

The agreement that binds the business actors existing in the sequential production chain may take some forms. In the midterm, the vertical integration may be undertaken by the business actors by binding themselves to: a) long-term lease, b) joint venture, and c) partnership.

The long-term vertical integration agreement is made through the transfer of ownership that occurs through Merger and Acquisition. The ownership or acquisition of corporate assets may be classified into two types as follows:

1) vertical integration through ownership or acquisition of all corporate assets, and
2) vertical integration through acquisition of part of corporate assets,

The above chart of Figure 1 shows that the business actors that undertake vertical integrations do not compete with one another in the same relevant market; thereby the vertical integration agreement does not have a direct anti-competitive effect that result in the decreased number of horizontal competitors. In the above example of palm oil producer, in case a palm oil company applies a downstream vertical integration with the CPO producers, it is clearly recognized that the palm oil company and the CPO producers are not competing business actors, since they are not in the same relevant market. Therefore, the number of competitors against the palm oil companies in palm oil market does not change due to direct effect of the vertical integration.

Conversely, based upon the basic principles of competition theory and economic impacts, the vertical integration in general is aimed at increasing efficiency that gives rise to increased welfare of end-consumers. Yet, this does not mean that the vertical integration by business actors will always create efficiency and consumer welfare, but conversely it create high-cost economy/efficiency, unreasonable prices and profits by means of anti-competitive/monopolistic practices.

The rational considerations of the business actors to carry out vertical integration practices, both pro-competitive and anti-competitive reasons, are detailed in the following sub-sections:

## 4.2. Reasons of Business Actors Conduct Vertical Integration

There are some reasons why a business actor decides to carry out vertical integration, namely:

### 1. Efficiency

The goal of each business actor in doing efficiency through vertical integration is to attain competitive prices of the products or services offered. The efficiency of vertical integration is attained through decreased uses of a process/technical tool (technical efficiency), economical transaction cost, and decreased double marginalization or in whole abolish unnecessary costs that are actually avoidable. Technical Excellency may be attained through technological improvement or betterment; thus, the manufacturing processes or operational processes run efficiently (uses of less inputs with the same results) and or more productively (producing more inputs with the same inputs).

As an illustration, a meat-cannery company needs raw meat supplies from an animal-butcher house and an animal husbandry/farm. If the meat-canning company and an animal husbandry/farm are separate and independent companies, in order to assure the raw meat qualities, an air-conditioned warehouse in the animal-butcher house and transportation means with cold-storage are needed; so, there are meat transportation and cold-storage. In case, these two companies decide to undertake a vertical integration, the cost for cold-storage in the animal-butcher house shall not be spent, since the animal-butcher house only supplies meat in line with the needs of the integrated meat-canning company. The one-stop coordination will also increase cost-efficiency.

Another efficiency stemming from the vertical integration is the decreased transactional cost arising out of transactions among production stages and or different distributions. By undertaking vertical integration, such a transactional cost may be internalized so that the company may cut back the cost. The cutting-back of the transactional cost arises from, among others, the cutting-back of economical cost in seeking raw material supplies, undertaking negotiations, contracts and supervision of suppliers and distributors.

Another illustration is that a publishing and media company needs supplies of paper as its main raw material. If the publishing company and a paper producing company are separate and independent companies, in order to obtain the paper needed, the publishing company shall undertake a selection of some paper producing companies. The selection includes such several elements as price, quality, quantity, and additional services that may be provided by the paper producing company. This process takes time and cost. After the selection processes are finished, the next step is the carrying out of negotiations. This phase as well takes time and cost. Upon the completion of negotiations, the next step is the preparation and signing of a contract agreement. Again this phase takes time and cost, inclusive of the cost for monitoring of contract implementation. The costs arising out of the transactions of paper supply purchases by the publishing company could be minimized when the publishing company carries out a vertical integration with the paper producing company. annihilate

Efficiency also may stem from the decreased double marginalization performed by business actors existing in the production stage and or distribution stage that are inter-related. Double marginalization arises when the company in each different stage of production and or distribution applies a margin to maximize profits. With the presence of the vertical integration, the double marginalization can be annihilated in which the margin shall only be applied by one business unit that has performed a vertical integration.

For example, an electronic hand-held device manufacturing company sells its products to a distributor with a 5% margin out of the production cost. The distributor then decides to sell the products to a retailer with a 15% margin.

Meanwhile, the retailer with its own considerations fixes a selling price to end-consumers with a 20% margin. The decision to apply a margin in each stage is based upon their considerations without any influence by the stage right above it. Owing to the applications of a number of margins, the selling prices in end-consumers get very high that are uncontrollable by the manufacturing company. In case, the manufacturing company decides to enter into an agreement of vertical integrations with distributors and retailers, the manufacturing company may control the prices applied to the end-consumers, and the margins imposed need not be successive.

Efficiency arising out of these vertical integration activities impacts on lower production cost and organizational cost; thereby, any business actor is capable of manufacturing goods and services with better qualities and the costs burdened by the community shall turn to be lower. This profit shall make the consumer welfare to be higher, and this is the goal of Law Number 5 Year 1999.

### 2. Fixed raw material supply and increased access to consumers

One of a business actor's goals in carrying out the vertical integration is an effort to decrease the uncertainty of raw material supply that is possible to occur. The business actor decides to carry out upstream vertical integration in the intention of controlling fixed raw material supply. For instance, a cheese producing company needs fresh milk supply as the main material for cheese production. In case the milk supply is blocked due to various factors (such as animal husbandry management in trouble), the cheese production will get blocked. With the vertical integration, uncertainty due to the faults in animal husbandry management might be minimized since the milk supply is under control.

While the decision to carry out the downstream vertical integration is directed to uplift control over networks of distribution and retailers in order that accesses to consumers increase. For example, a two-wheeled motor vehicle manufacturing company undertakes sales transactions with a motor vehicle dealer. The dealer's capability to carry out marketing strategy to increase the sales of such two-wheeled motor vehicles cannot be influenced by the manufacturing company. Unless a dealer effects aggressive marketing and sales strategies, the sales will be influenced since the end-consumers' accesses to those two-wheeled motor vehicles are limited. Therefore, the manufacturing company may decide to enter into an agreement on vertical integration with the dealer. With the agreement, the manufacturing company may take part in considering business strategies in order to attract such consumers' interests as granting a right for exhibition implementation, giving price discounts and bonuses, or additional after-sales services. Thereby, the marketing and sales certainty may increase.

### 3. Business actor may perform transfer-pricing

Transfer-pricing happens when a business actor gives a lower price to an integrated company under it with an intention of lowering the production cost, thus giving rise to lower selling price than those of its competitors due to its relatively lower production cost. The goal is to press the cost in the lowest level (from a retailer to consumers) that will turn to be relatively lower than product cost that do not stem from the vertical integration process. From the mechanism side, the transfer pricing is the concept of the decreased double marginalization just as previously elaborated on the part of efficiency. The decreased double marginalization is categorized as an efficiency since it benefits the consumers in which the consumers pay the goods and/or services with lower prices. The transfer pricing may benefit the business actor who undertakes it since it could increase sales volume. By way of the vertical integration, the business actor may also provide cross-subsidies among its companies. The benefits of cross-subsidies appears when the integrated business actor charges the transfer pricing on its different subsidiaries (this becomes cheaper) than the cost charged on business actors outside its network. The losses arising out of the charging of subsidy prices or such more inexpensive prices shall be compensated from the profits of raw material sales to the business actor not belonging to its integrated network. Meanwhile, the business actor not integrated with the company will suffer losses (real and potential losses) owing to cross-subsidies made by the integrated competing company.

### 4. Decreasing or getting rid of competitors in the markets

Out of the previous elaborations, it appears that vertical integration is intended to give rise to efficiency for the business actors in terms of cost efficiency and efforts to minimize uncertainty. As such, the vertical integration does not directly impact on the existing competition in the relevant market. Nevertheless, in some conditions, the vertical integration also may cause competitive issues on competition in terms of indirect impacts on a certain relevant market.

In the competition perspective, the company that undertakes the vertical integration will be easier to obtain market power since it is more efficient and capable of making the goods/services more inexpensive and the existence of the distribution assurance. Therefore, a vertically integrated company shall possess more capabilities to create barriers against its competitors in entering the market.

Anti-competitive impact arises out of increasing market power abuse and increased coordinative potentials through prices or outputs. The anti-competitive impact arises out of the vertical integration will be compared to efficiency and other profits made. Regulatory actions shall be taken in case the vertical integration causes greater anti-competitive impacts than the efficiency and other profits, thereby lowering the end-consumer's welfare.

## 4.3 Prohibited Vertical Integration

Pursuant to Article 14 in which it reads that the prohibited vertical integration agreement is the one that aims at monopolizing the production of a number of products. Monopolizing the production of a number of products means the business actor's efforts to monopolize the market. The action to monopolize the market is classified as a prohibited action pursuant to Article 19 regarding Market Monopoly. There are two market monopolistic activities that are most related to the vertical integration agreement, viz: i) rejecting and or hindering certain business actor in carrying out the same business in the relevant market, and ii) effecting discriminative practices against certain business actors.

The vertical integration may influence market performance through influencing competition both with existing companies in the market and potential companies that will enter the market. The vertical integration may cause barriers to enter the market if the vertical integration grade is very high so that the new comers to the downstream markets shall also enter the upstream markets at the same time.

The company that implements the vertical integration may limit the price as much as the production cost of raw material, thereby blocking the entrance of new comers to the market by, for example, increasing market capacity. When the potential company that will enter the market is blocked, the prices may be reset at higher levels. Consequently, the market performance will decrease due to the blocking of the potential competitors that should have entered the market.

The above price fixing set by the business actors in the vertical integration process may be said to be close to price discriminative practice that is categorized as causing the unintegrated business actors to lose.

There are two anti-competition impacts arising out of the vertical integration. They are: i) the impact arising out of the action taken by a vertically integrated company to limit the competitors' capability in competing through the closing of accesses (foreclosure) in upstream market or in downstream market, and ii) the impact arisen because the vertically integrated company facilitates price or output coordination as part of collusive measures both in the relevant upstream market and in the relevant downstream market.

The anti-competition impacts arising out of the vertical integration will be further detailed as follows:

#### 4.3.1. Unilateral Impacts

The foreclosure against competing companies is part of the strategy in raising rivals' costs. With the raised costs that shall be spent by the competing companies, these competing companies shall increase their product prices. This foreclosure may be undertaken through foreclosure strategy against important raw materials, as shown in the following diagram:

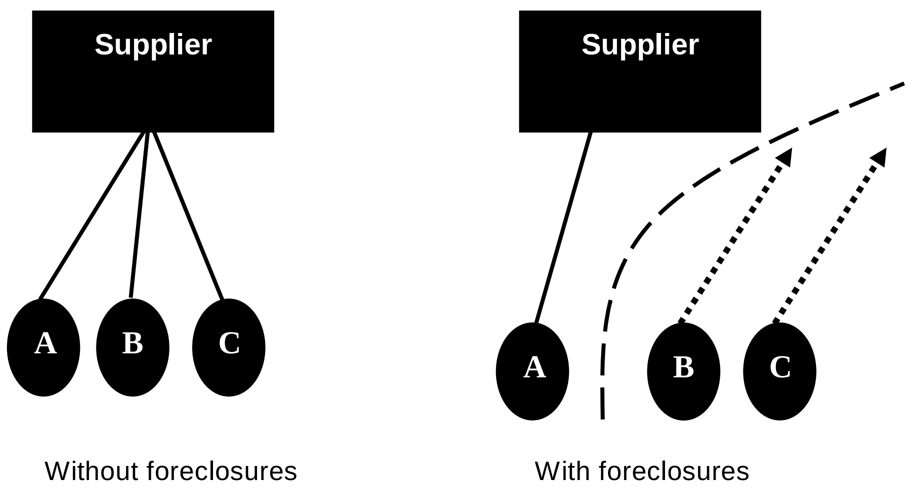


**Figure 2. Relationship between Companies and Suppliers - without foreclosures and with foreclosures**

The Figure 2 shows that companies A, B, and C are in the same relevant market. Thereby they compete with one another. Without foreclosures, these three companies may transact with suppliers (figure on the left). If company A decides to undertake a vertical integration with a supplier, the company A and the supplier are bound to an agreement. Through this vertical integration agreement, company A may decide to issue a policy to close the accesses of companies B and C to suppliers (figure on the right side). If at the upstream market, there are some suppliers, and other suppliers have a capacity that is low and less efficient compared to previous suppliers, companies B and C will spend higher costs, thus positioning company A at a more profitable position. If there are not any other suppliers in the market, companies B and C may directly get out of the market. These two conditions will lessen the competition level in the market (lessening competition).

Foreclosure also may be undertaken against a company that functions as a buyer. This foreclosure in downstream sector is intended to be part of strategy for reducing rivals' revenue, as shown in the following:

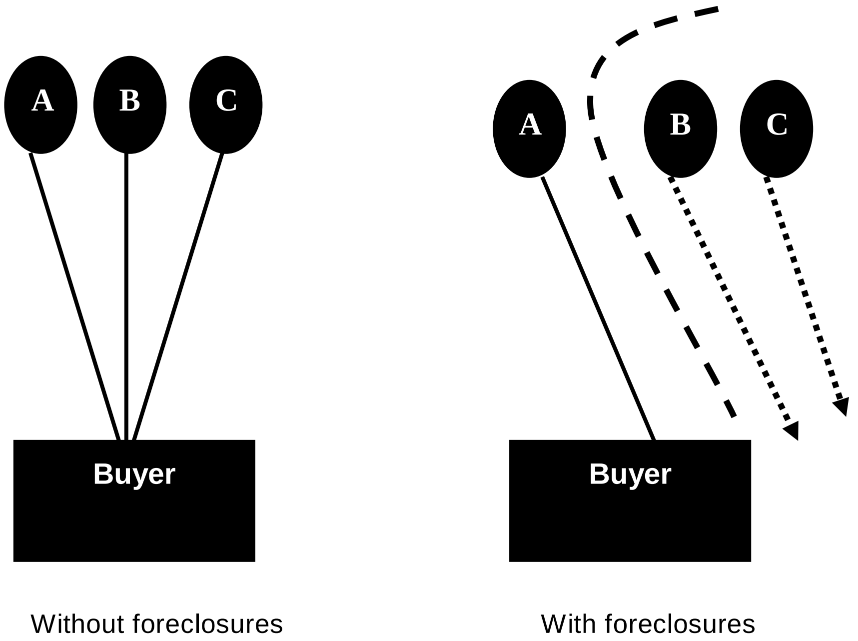


**Figure 3. Relationship between Companies and Buyers – without foreclosure and with foreclosure**

Figure 3 shows that companies A, B and C compete with one another in the same relevant market. These three companies make transactions with buyers (distributors and retailers) as shown in the left figure. If later company A decides to integrate vertically to downstream with distributors, company A and the distributors bind themselves in agreements. Through the vertical integration agreement, company A may issue a policy that closes the accesses of companies B and C to distributors (figure at the right). If the distributor is a dominant one with wide market scope, companies B and C shall turn to other smaller distributors. This downstream foreclosure places company A at a position more profitable than companies B and C.

### 4.3.2 Coordination Impact

Collusion may be retained if a company undertakes coordination. Vertical integration may be used to coordinate through price, output, capacity, and quality. The collusion shall remain if the companies in the market can: (1) produce agreements on such competition aspects as price, output, capacity, and quality; (2) detect deviations against agreements, and (3) punish each business actor that violates. The business actor that performs the vertical integration is not facilitating price or quantity coordination to give way to the continuation of collusion except that one or some conditions is/are met. Even if the conditions are met, it has not yet been enough to keep on investigating except that there is any proof that an anti-competitive action has occurred.

Thereby, the actions of the vertical integration that can be prohibited pursuant to Article 14 of Law No.5 Year 1999 are:

a. Any vertical integration that closes an access to important supply; or
b. Any vertical integration that closes an access to main buyers; or
c. Any vertical integration that is used as facility for coordination of collusion.

## 4.4 Assessment of Impacts of Vertical Integration

As previously stated, the vertical integration may impose a positive impact arising out of efficiency and a negative impact arising out of anti-competitive conduct. Thus, the vertical integration agreement cannot automatically be blamed *except* that it has greater anti-competitive impact than positive impact that it makes.

Analysis on anti-competitive impact arising out of the vertical integration agreement shall be carried out carefully and delicately. In order to prove the alleged violation of Article 14, KPPU shall undertake some examination phases, namely:

1) Ability Analysis;
2) Incentive Analysis; and
3) Consumer Impact Analysis.

<u>The first step</u> is an analysis whether the company that undertakes the vertical integration has an ability to make use of market power at the upstream market or the downstream market, by way of closing access for competitor’s companies in

order that the competitor's costs get higher that in turn impact on the consumer's decreased welfare.

In the first assessment, analysis is directed at the possible method of foreclosure, such as through price rise, supply limitation, or decreased quality of supply provided.

In order to undertake foreclosure, analysis is focused on some of the following elements, but not limited to:

- The market power in the upstream market and/or the downstream market;
- Input interest level at the related end-product or customer's influence on sales network;
- Negative impact on availability of inputs in the market or negative impact on availability of buyers in the market
- Forms of oligopolistic competition and strategies in the market

<u>The second step:</u> even if it is known that a company has an ability to make use of market power, but in the next step, it should be considered whether the company has an incentive to implement any anti-competitive action. If the company considers that the action does not incite increased profit, it will not do the action even if it has the ability to do the action.

Therefore, it is necessary to implement deep analysis on a number of elements as follows, but not limited to:

- Profit level from foreclosure action
- Cost and profit calculation from foreclosure action, for example: for foreclosure on inputs, the cost that arises is the loss of profit from the upstream market due to limited inputs, and profit gained is increased sales in the downstream market due to increased prices.

<u>The third step:</u> is seeing whether the anti-competitive action impacts negatively on consumers. As previously mentioned, the prohibited vertical integration agreement is a vertical integration that aims at dominating production of a number of products that may give rise to cause an unfair business competition and or cause the community to lose. That is why KPPU has to prove negative impacts arising out of the vertical integration agreement. The positive impacts arising out of efficiency also shall be considered in deciding whether the consumers get better or worse. In other words, the decision to declare that a vertical integration causes an anti-competitive

impact is made by comparing between a pro-competitive impact and an anti-competitive impact.

Analyses are stressed on some of the following elements, but not limited to:

- Company's roles in the upstream market or in the downstream market;
- Level of entry barrier after vertical integration;
- Number of companies in the upstream market or in the downstream market not influenced by the vertically integrated company's actions.
- Impacts of efficiency on the consumer's decreased welfare.

## 4.5 Things to be considered related to analysis of prohibition of vertical integration

### 4.5.1. Structural Analysis

In the analysis on the prohibition of vertical integration, the understanding on market structure and company's position related to the vertical integration agreement in a market is the first step to be taken by KPPU. As previously stated, the vertical integration agreement may exert an anti-competitive impact if the vertically integrated company commits an act that may cause unfair business competition and/or cause the community to suffer loses.

For example: the act of input foreclosure shall only be undertaken by a company with an ability to carry it out. This ability arises since the company has some market power in the upstream market. The company's market power appears since the company is a dominant one (in this respect, it is a dominant 'buyer') or since the alternatives for inputs available are limited.

Thus, in order to undertake an assessment on the vertical integration impacts, KPPU shall start an analysis by pointing out on the market structure and other market aspects related to the acquisition and management of the market power. The market structures that become subjects of analysis are, but not limited to, the following:

1. Market Share

   The size of market share owned by a company may be recognized from the size of market dominance. The indicator for the market dominance is the size of the company's market share in the relevant market. Therefore, in order to judge the size of dominant level owned by a vertically integrated company, an accurate definition of the relevant market is needed. The scope of the relevant market may be perceived from the product dimension (product market) and the area dimension (geographic market).

2. Level of Entry Barrier

   In addition to the market share that indicates a dominance limit owned by a company against competitors already existing in the market, the company's market power can also be valued from the level of entry barrier. If a potential company is capable of entering the market without significant difficulty, this company can be a potential competitor against dominant companies in the market, in which this means that this will limit the abuse of such a dominant position. The vertical integration agreement will spur unfair business competition if the vertically integrated company commits an act that may hinder potential companies to enter the market.

3. Product Characteristics and Cost

   Analysis on the market structure also includes analysis on product characteristics and cost level included in related products. The elements that become the cores of analysis are, for example, whether the vertically integrated input is very important, whether the cost spent for obtaining such an input dominates sales price fixing, and whether there is another alternative for getting the input.

#### 4.5.2. Cost-Benefit Analysis

There are two Cost-Benefit Analyses used in the assessment on the vertical integration impact. The first is Cost-Benefit Analysis focused on cost and benefit obtained by the company. The second is Cost-Benefit Analysis obtained by the community. The first Cost-Benefit Analysis is required to see whether the strategy performed by the vertically integrated company in order to decrease competition rate in the market is economically rational. Such an act as the foreclosure of access to input may cause the company in the upstream market to spend a cost expected to be covered from the profit gained in the downstream market, even the profit in the downstream market is expected to exceed the cost arising in the upstream market. KPPU shall carry out the Cost-Benefit Analysis in order to evaluate whether the vertically integrated company has incentives to implement foreclosure against inputs.

The second Cost-Benefit Analysis is performed in order to evaluate whether any anti-competitive action undertaken by the vertically integrated company has greater anti-competitive impacts than positive impacts arising out of, for example, efficiency, This analysis is mainly intended to see whether the vertically integrated company has committed an act that may cause unfair business competition and/or cause  the community to suffer loses.

### 4.6. Sample Cases in Practice

4.6.1. Case on Vertical Integration between PT Garuda Indonesia and PT Abacus Indonesia

On 28 August 2000, PT Garuda Indonesia entered into an agreement with PT Abacus Indonesia in which the ticket distribution for the flights of PT Garuda Indonesia within the territory of Indonesia should only be carried out through dual access through Abacus terminal. The reason why PT Garuda Indonesia only gave the dual access to PT Abacus Indonesia as the provider of Abacus system in Indonesia was because the transaction fee for reservation and booking for international flights using the Abacus system was cheaper than using other systems.

The goal of dual access with only the Abacus system was that PT Garuda Indonesia shall control tour and travel agents in Indonesia in undertaking reservation and booking of flight tickets and that more and more tour and travel agents in Indonesia apply the Abacus system in undertaking reservation and booking for flight tickets, and this in turn decreased the transactional costs of PT Garuda Indonesia international flights.

In order to find that the dual access run effectively, PT Garuda Indonesia required that each tour and travel agent that would be appointed as its domestic passage agent should prepare its Abacus system first prior to obtaining ARGA system. The ARGA system was a system used for making reservation and booking for domestic flight tickets, while the Abacus system was used for making reservation and booking for international flight tickets.

PT Garuda Indonesia had 95% shares of PT Abacus Indonesia. PT Garuda Indonesia placed 2 Directors as the Commissioners of PT Abacus Indonesia. This caused a conflict of interest since the business activities of PT Garuda Indonesia and PT Abacus Indonesia were interrelated. This appeared in each synergy meeting between PT Garuda Indonesia and PT Abacus Indonesia, at least they knew and agreed on any agreement in each meeting, including dual access policy.

This policy caused barriers against other CRS providers in marketing their systems to tour and travel agents. Most of the tour and travel agents chose CRS Abacus provided by PT Abacus Indonesia. This was due to the fact that the Abacus system provided easy accesses to getting PT Garuda Indonesia reservation access and domestic ticket booking. Meanwhile, any CRS other than Abacus was less preferred by the tour and travel agents since they were not integrated into the ARGA system. The absence of the ARGA system caused the tour and travel agents to be unable to issue/book flight tickets with better prices than the ticket prices offered by the Abacus system providers in which the tour and travel agents were not interested in other systems. The requirements of Abacus connection caused each tour and travel agent that only acted as a domestic passage agent of PT Garuda Indonesia to spend additional costs in terms of Abacus system installation cost and Abacus equipment rental cost. In fact, the Abacus system was not used for reservation and booking of PT Garuda Indonesia domestic tickets. PT Garuda Indonesia used the ARGA system.

### 4.6.2. Case on Acquisition of the Ingram Book Group by Barners & Noble, Inc.

The roles of retailers and wholesalers are very important in the distribution of products to end-consumers. The example of the vertical integration case in the United States of America was the acquisition of the Ingram Book Group by Barners & Noble, Inc (the biggest book retail company in the United States of America). As a matter of fact, Barners & Noble, Inc had its own distribution network to run its particular function as a big seller. The backgrounds for the decision of Barners & Noble, Inc to acquire the Ingram Book Group were the Ingram Book Group’s very good performance and its provision of better facilities than other companies’. With this vertical integration, the anti-competitive effect was raising rival’s cost. This occurred since the Ingram Book Group could not sell its products to other retailers other than Barners & Noble, Inc. In addition, the integration may cause product delivery to another retailer to get halted, limit other retailers’ accesses to newest products, limit other retailers' accesses to the Ingram Book Group's collection and other retailers' higher prices.

However, a regulating body was required to consider positive effects from this acquisition, such as company's increased efficiency, availability of goods with better service quality and cheaper prices in order to decide whether this integration gave an overall impact which was beneficial or not beneficial for competition and public interest.

## CHAPTER V

## RULES OF SANCTIONS PURSUANT TO LAW NUMBER 5 YEAR 1999

Law Number 5 Year 1999 regulates the sanctions on violators against its regulations in terms of administrative punishment, primary criminal punishment and additional criminal punishment. The following are regulatory sanctions against violations of vertical integrations.

Any violation against the vertical integration (Article 14) is threatened with a sanction as follows:

**(1) Administrative Punishment**

1. Order to the business actor to stop the activity that has been proved to have caused a monopolistic practice and or have caused an unfair business competition and or have caused the community to lose
2. Fixing of Compensation Payment
3. Imposing of a fine with a minimum amount of Rp.1,000,000,000 (one billion rupiah) and a maximum amount of Rp.25,000,000,000 (twenty-five billion rupiah)

**(2) Primary Criminal Punishment**

This punishment shall be imposed a minimum amount of Rp.25,000,000,000 (twenty-five billion rupiah) and a maximum amount of Rp.100,000,000,000 (one-hundred billion rupiah) or prison punishment, as substitution of a fine, at a maximum of 6 (six) months.

**(3) Additional Criminal Punishment**

a) Revocation of business license; or
b) Prohibition for the business actor who has been lawfully proved to have violated this Law in order to get a position as a director or a commissioner for a minimum of 2 (two) years and a maximum of 5 (five) years.
c) Stopping of business activity or certain action that causes another party to suffer a loss.