ISSN-L: 2223-9553, ISSN: 2223-9944
Vol. 3, No. 3, November 2012

MERGER AND ACQUISITIONS POLICY: INDUSTRIAL CONCENTRATION AND DEMAND ELASTICTY APPROACH

Johnny Ibrahim
School of Law, Post Graduate Department
Bhayangkara University Surabaya,
INDONESIA.
john.ibra@yahoo.com

ABSTRACT

Corporations often engage in acquisition of other corporations or businesses. Merger occurs when one corporation is absorbed into another corporation and ceases to exist. In horizontal merger, one firm acquires another firm that produces and sells an identical or similar product in the same geographic area, and thereby eliminates competition between the two firms. In a vertical merger, one firm acquires either a customer or supplier. Conglomerates merger encompass all other acquisitions, including pure conglomerate transactions where the merger party have no evident economic relationship. Each form of merger raises distinctive competitive concerns and need a sound and prudent public policy as a basis for regulation.

Keywords: Merger & Acquisitions, industrial concentration, demand elasticity.

INTRODUCTION

Why Are Mergers And Acquisitions Necessary?

Merger activity is a consequence of attempt to improve the performance of firms and range of the company in order to obtain synergies that cannot be achieved by its existing state. The main key is to merge improve shareholder value beyond what is obtained if the two companies operate separately. In practice, a company acquires other companies in an effort to create efficiency for competitive products and services. Merging both companies will provide a bigger market share with much better efficiency ratios as well.

Basically by doing this, then the company will achieve maximum efficiency in a variety of fields. This can be in the form of downsizing, economies of scale, reduced spending spending, as the consequence of a large volume of purchases. State of the art technology is another equally attractive advantage these mergers offer.

As known, there are currently 80 countries in the world with laws regulating competition among businesses, focusing on mergers and acquisition. Indonesia has Competition Act No. 5 of 1999 concerning the Prohibition of Monopolistic Practices and Unfair Business Competition. Special arrangements regarding merger, acquisition and consolidation are laid out in Article 28 as follows:

1. Companies or firms are prohibited from merging, consolidating or acquiring other businesses which can lead to the obvious chance of monopolistic practices and/or unfair business competition.
2. Companies or firms are prohibited from taking other companies' shares if such action can lead to the obvious chance of monopolistic practices and/or unfair business competition.
3. Next Article 29 set that merging, consolidating or acquiring other companies' shares referred to in Article 28 which resulted in the value of assets or the value of their sales exceed a certain amount, mandatory Supervisory Commission of Business

Competition (KPPU) must be reported within 30 days from the date of the merger, acquisition, and consolidation.

With respect to the existence of a limitation or prohibition to do merger and acquisition, problems that will be discussed are the measurable, applicable, and sustainable merger or acquisition. Limitation of mergers implied in antitrust laws of some countries is based, among others, on an analysis of the concentration of industry and the elasticity of demand for goods and services. This can provide a valuable lesson to other countries currently drafting business competition rules.

Regulation for Mergers and Acquisitions in Indonesia

Merger or acquisition must be arranged for its effects on the intensity of the competition. Along with growingly centralized sales (seller concentration) and or buyers (buyer concentration) in an intensively growing market, competition between many parties can be turned into a competition among the few. The extreme result is the economy form of oligopoly. Mergers give company the latitude to control prices and unilateral terms of sale. This also enables company lead to provide and distribute a large amount of goods or services. In such a dominant position, it has the potential and power to impose terms for the benefit of the company, to the detriment of consumers.

Article 1 subsection (5) of Act No. 5 of 1999 concerning the Prohibition of Monopoly and Unfair Competition, defines a dominant position as a condition where a business do not have competitors in the market, or holds the highest position compared to competitors in both in terms of finance, supply and sales.

Merging two or more corporations are subject to: Article 122 to 137 of Corporation ACT No. 40 of 2007. Article 126 subsection (1) rules that:

Merger, acquisition or consolidation should consider the interests of:

a. The corporation's minority shareholders, employees of the company.
b. Creditors and other business partners of the company.
c. Community and fair competition in performing business.

Fair competition is also important. Thus, centralization of economic power by one or more companies resulting in domination in the production or marketing of goods and or services which is the characteristic of unfair competition can be detrimental to the public interest, must be prevented.

As known, before the enactment of Corporation Act No. 40 of 2007, mergers been ruled by Corporation Act No. 1 of 1995. There were also other rules that became the basis for the merger arrangements. For example, Book III of Indonesian Civil Code, article 1233 to 1456, which ruled agreed binding that can be applied in any other agreements like legality of certain agreements, validity of certain agreement, the termination of agreement, and others also apply to the merger agreement. Meanwhile in article 11 of the Finance Minister's decision No. 222/KMK. 017/1993 regarding the requirements and procedures for mergers, consolidation and acquisition of banks, has determined that one of the documents to be attached in applying for mergers are merger agreement and buying and selling stocks certificate. The rules regarding buying and selling contained Article 1457 to 1540 of the Civil Code apply to merger before the enactment of Corporation Act No. 1 of 1995 which has been replaced by Corporation Act No. 40 of 2007.

In addition, there have been rules regarding to merger in banking issued by the Government as follows:

ISSN-L: 2223-9553, ISSN: 2223-9944
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a. Decision of the Minister of Finance No. Kep. 614/KMK/II/8/1971 on Granting Allowances to the Taxation of Merging Private National Banks (the Merger).
b. Decision of the Minister of Finance No. 278/KMK/01/1989, dated 25 March 1989, on Merger and Liquidation in Banking.
c. Circulars of Bank Indonesia No. 3/15/BPPP, dated 25 March 1989 on Merger and Liquidation of National Private Banks, Development Banks and People Credit Bank.
d. Decision of the Minister of Finance No. 222/KMK. 017/1993 of 26 March 1993 concerning the Requirements and Procedures for Mergers, Consolidation and Acquisition of Banks. This provision automatically replaces the Finance Minister's decision No. 278/KMK.01/1989.

It can be seen that before the enactment of the Corporaion Act No. 1 of 1995, the law of merger only focused on banking institutions. The act itself serves as the law for wider practice of merger. The rules of mergers are provided in articles of 76 and 102 to 109 of Corporation Act No. 1 of 1995. It is confirmed by government regulation No. 27 of 1998 dated Feb. 24, 1998.

It is then followed up by some regulations specifically designed for banks. These regulations include;

1. Government Regulation No. 28 in 1999 on 7 May 1999, about Mergers, Consolidation and Acquisition of Banks.
2. Bank Indonesia Directors Decree No. 32/52/KEP/DIR dated 14 May 1999 of the Requirements and Procedures for Mergers, Consolidation and Acquisition of commercial Banks.
3. Bank Indonesia Directors Decree No. 32/52/KEP/DIR, dated 14 May 1999 of the Requirements and Procedures for Mergers, Consolidation and Acquisition of Peoples Credit Bank.

Merger, Acquisition and Consolidation, which has the potential for the occurrence of the centralization of economic power that led to the monopoly practices, have been regulated by Article 28 and article 29 of Corporation Act No. 5 of 1999. In this case all kinds of mergers, be it vertical, horizontal or conglomerate, may be prohibited by this article, but this should be based on the *rule of reason*. So that any businesses (firms or companies) intending to make mergers should obtain clarification letter from KPPU as set by article 29 of subsection 1 of Corporation Act No. 5 of 1999.

Article 3 of Government Regulation No. 57 in 2010 on merger, consolidation and acquisition of other companies' shares that could lead to the occurrence of " Monopolistic Practices And Unfair Competition, provided that mergers and acquisition in article 3 has been set that mergers and acquisitions must obtain an assessment of the Business Competition Supervisory Commission (KPPU), among other, through analysis of market concentration and barriers to entering the market. In replacing PP No. 57 in 2010, the KPPU issued KPPU Regulation No. 13 of 2010 on Guidelines on Merger, Consolidation and Acquisition of other the company's stocks that can lead to the occurrence of Monopolistic Practices and Unfair Competition which was later replaced by KPPU Regulations No. 10 of 2011.

Mergers and Acquisition have the potential for the occurrence of the centralization of the economy that can lead to the domination of production or marketing which harm the public interest. The problem is that there should be a common framework to evaluate whether a merger has harmful potential or not.

Measurement Technique for Industrial Concentration

Merger is an integration of two or more companies. As described earlier, there are three general categories of company integration. First, horizontal mergers, namely between companies that directly compete in the same market. Second, the vertical merger, that is between companies which have a relationship as a customer and a supplier to each other. Thirdly, conglomerate merger, which is between companies that operate in different markets, and intend to make a diversification of activities.

Determination of concentration of the industry is the first step to assess the size of market share in order to find out how far the industry concentration and centralization of economic power is under the control of one or several companies. By knowing the concentration of industry and size of a market share of the companies, it will be unfolded whether there has been a practice of monopoly, centralization of economic power or misuse of horizontal position that can inhibit the occurrence of healthy competition. Thus there is a correlation between the concentration of the industry and the calculation of the market share, which will determine administrative sanctions and the size of the fines contained by Article 47, criminal sanction represented by article 48, and additional criminal sanctions implied in article 55 of Act No. 5 of 1999 concerning the Prohibition of Monopoly and Unfair Competition.

Unfortunately so far, there has not been a formula or method to be used as parameter to find out the concentration of industry in order to assess the position of the company and its market share. It is extremely important to design the merger, consolidation and acquisition of other companies' stocks and measure the power and dominance of the companies over a certain market. So for this purpose, it is important for a country to learn from other countries that have had similar legislation in the first place.

United States is a country that regulates competition through Antitrust Law by using the approach structure. Thus, to analyze more the background of market share calculation in Act No. 5 of 1999, we need to take a look at US Department of Justice, 1987 Mergers Guideline (Osterle, 1991). In the 1987 Mergers Guidelines, the measurement of the relevant market concentration is no longer using the ratio of four companies (four-firm ratio) as provided in the previous rule (1968 Merger Guidelines) but replaced by what the so-called the Herfindahl-Hirschman Index (HHI). HHI index can be used to measure the effects of horizontal mergers. So it is more comprehensive in assessing industry concentrations, by which to detect whether the increased market share of a company after the merger will inhibit fair competition or not.

The methods used in a ratio of four companies (four-firm ratio) or also known as the CR-4 as set forth in the 1968 Merger Guidelines specify that in a market where there are four companies control 75% or more of market share (the four-firm concentration 75% or more), then the Department of Justice will hold a lawsuit, if there is a merger goes beyond following specification (More et al):

Mergering Company	Mergered Company
4%	4% or more
10%	2% or more
15% or more	1% or more

Whereas in a market that is not very concentrated (the four-firm concentration less than 75%), a lawsuit shall be made if the balancing market share after the merger will go beyond following specification:

ISSN-L: 2223-9553, ISSN: 2223-9944
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Merging Company	Mergered Company
5%	5% or more
10%	4% or more
15%	3% or more
20%	2% or more
25%	1% or more

This became the benchmark for any companies intending to make merger, consolidation or acquisition.

Whereas the Herfindahl-Hirschman Index (HHI) was developed independently by O.C. Herfindahl and A.O. Hirschman two scholars from two different universities (Weston et al., 1990) by way of summing squares of individual market share of all market participants in a given market. Its mathematical notation is designed in a way to add up a variety of the company's market share in a market so as to know the position of the corresponding product industry concentration so that steps will be taken that business competition supervisory authority the Federal Trade Administrations (FTA) with greater precision. Mathematical notation is expressed as follows (Walpole, 1993):

$$HHI = \sum_{i=1}^{n} Si^2$$

Where: n = number of firms in a market

Si = The company market share = I

In calculating the concentration of industry, market is divided into the so- called atomistic market, that is the one with HHI close to zero until 10.000 (monopoly). Market with only one company dominating 100% of the market (pure monopoly) has a HHI as much as 10,000 (100^2). In the meantime the market with 100 firms which each controls 1% (one percent) of the market, HHI is 100 (1^2 x 100). This shows that the industry is not concentrated.

In an industry that consists of only two firms each controlling 90% and 10% of market, HHI = $90^2 + 10^2$ = 100 = 8100 + 100 = 8200. If two companies controls 50% of market repectively, then HHI = $50^2 + 50^2$ = 2500 + 2500 = 5000. Further, for example in an industry which is made up of four companies controlling 30%, 30%, 20%, and 20% of a market respectively, HHI is much as 2600, i.e. by adding $30^2 + 30^2 + 20^2 + 20^2$ = 900 + 900 + 400 + 400 = 2600.

To understand the workings and the difference between the calculation of The four-firm ratio and HHI simply can be described as follows: in an industry of product A, one company holds 45% of the market, and 11 (eleven) companies hold the remaining 5% respectively. By the four-firm concentration ratio or CR-4 (four market makers who controlled the largest marketshare), the calculation is as follows:

The ratio of four companies 45%+5%+5%+5%=60%

While HHI calculations = $(45)^2 + 11(5)^2 = 2025 + 275 = \underline{2300}$

Compare this to an industry of product B where 4 (four) companies control 15% of the market respectively, and other 8 (eight) companies control 5%, respectively, and then the calculation is as follows:

The ratio of four companies 15% + 15% + 15% + 15% = 60%

While HHI calculations = $4(15)^2 + 8(5)^2 = 900 + 200 = \underline{1100}$

It is quite visible that calculation of industrial concentration of product A and B markets by using ratio of four companies produces the same amount. While calculation by using HHI produces different results, from which it can be inferred that product a market is more concentrated. So under 1968 Merger Guidelines, both types of product will be treated as the same (holding 60% of market), but under 1982 Merger Guidelines, product A has a more concentrated market (2300).

On the basis of this argument, then the Ministry of Justice issued a technical guideline on HHI application that serves a safe-harbour for companies as follows:

1. Merger with HHI under 1000, market is not concentrated (unconcentrated)
2. mergers with HHI between 1000-1800, the market is rather concentrated (moderately concentrated)
3. Merger with HHI over 1800, market is concentrated (highly concentrated)

In connection with these rules, if market concentration after merger according to HHI calculation is under 1000, the Justice Department will not make any reaction. Government is also inactive if market after merger is above 1000 but its HHI rising point is under 100. If the market after merger is rather concentrated (HHI between 1000-1800) with the HHI rising point is100, there is the possibility of an investigation will be conducted to look at the effect of the merger on competition, the openness of the market (ease of entry to the market) and other factors relevant to competition. Whereas in a highly concentrated market (HHI is above 1800), mergers are considered to be harmless if an HHI rising point is under 50. But when HHI rising point is between 50-100, there is the possibility for investigation, while when HHI rising point is above 100, mergers considered harmful and Justice Department will file a lawsuit against the merger.

To find out the increase in the concentration of an industry, measurement is carried out by doubling the market share of the two companies that hold a merger (Roszkovsky, 1989). If before merger, their respective percentage of market is squared ($a^2 + b^2$), but after the merger, the number of the percentage is squared $(a + b)^2$, then the equation become $a^2 + 2ab + b^2$. Here is the increase of HHI is 2ab. For example the merger between the two firms which are holding 5% and 10% of market respectively, then increase of HHI is 2 (5x10) = 100.

The application of HHI by companies in the case of acquisition or other mergers, both vertical and horizontal, the positive impact is reduced litigation or lawsuit filed by the United States Department of Justice attempting to prevent the concentration of the market. This is so because by application of HHI, the companies can obtain a safe harbour for merger, namely the ability to know the first limitations that is safe for the steps he took and exploits it optimally. In the event of a merger between the two giant conglomerates in the United States as the Du Pont - Conoco or by U.S. Steel - Marathon Oil, found not to be sued by the Justice Department, because the merger was well designed with HHI calculations are accurate. Steps like these also reached in orizontal merger between Gulf Oil and Standard Oil of California, Texaco and Getty Oil, Mobil Oil and Superior Oil. Only merger between Jones & Laughlin Steel with Republic Steel who sued because one company has about 1000 and position HHI points added after the merger HHI greater than 100. The Merger is permitted after two of the new steel mill owned by Republic Steel was divested from its business units.

Demand Elasticity

Although the HHI index provides legal certainty, it however still contain some shortcoming, i.e. exclude imported and exported products, characteristic of demand elasticity, and the use of latest technology in the production process. Therefore the economic analysis provides

ISSN-L: 2223-9553, ISSN: 2223-9944
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solution, through the calculation of demand elasticity coefficients. The coefficient is a comparison value between changes of demanded amount to price changes. Thus the coefficient is indicator describing how much change of amount of demanded goods there is compared to price changes.

$$E_d = \frac{\text{The change of amount of demanded goods}}{\text{Prices change}}$$

Suppose there is price changes of P becoming P1, then the formula above can be described as follows:

$$E_d = \frac{\dfrac{Q_1 - Q}{Q}}{\dfrac{P_1 - P}{P}}$$

By using the above formula, then the demand elasticity coefficient can be calculated. For example if the sugar price is 7000,-/kg, whereas the amount of the sugar bought is 60,000,-kg. When the price of sugar falls to Rp. 6000,-/kg, the amount of sugar bought is 75,000 –kg, then the demand elasticity of sugar is:

$$E_d = \frac{\dfrac{Q_1 - Q}{Q}}{\dfrac{P_1 - P}{P}} = \frac{\dfrac{75.000 - 60.000}{60.000}}{\dfrac{6.000 - 7000}{7000}} = \frac{\dfrac{15.000}{60.000}}{\dfrac{-1.000}{7.000}} = \frac{1/4}{-1/7} = -1.75$$

The final value is negative, due to the changes of price and of demanded good towards the reverse direction, but in the economic analysis, the value of the negative sign is always ignored. Conversely if prices fall, then the demand amount will increase. Elasticity coefficient values range between zero and infinity. Elasticity is zero if the price change is not going to change the demanded amount.

Economic analysis categorizes different types of demand elasticity. One is imperfect elasticity if the value of the coefficient of demand elasticity is zero. Another is perfect elasticity when the value of coefficient of elasticity is unlimited. This is the condition when market affords to absorb all available goods. Another type is unitary elasticity, when the value of coefficient of demand is 1. If the coefficient is between zero and 1, the character of demand is not elastic. If it is more than 1, it is called elastic, that is when the change of demand exceeds the price change. According to the nature, there are two types of elasticity, those are arch elasticity and cross elasticity. Factors affecting demand elasticity include substitutability of goods, income to buy the goods, and duration of analysis of demand (Sukirno, 1998)

Finally what Rosenfield said that *"economic analysis plays a major role in every area of antitrust law"* find its ground. Economic analysis plays a major role in solving the problems in nearly all cases in the business competition. Formulation and modelling in the economic analysis of the law has been so sophisticated, as illustrated by recent legal scientists (Georgakopoulos, 2005).

CONCLUSION

There are some valuable lessons can be taken from analysis of merger and acquisition in law by means of economic tools. Those are:

1. In order to create certainty in the business world, especially fair competition, companies need to have guidelines for right and safe mergers and acquisitions. With the help of economic analysis, it turned out that only mergers and acquisitions that has potential of monopoly and unhealthy competition that should be prohibited.
2. The guidelines (merger guideline) should be sustainable, applicable and reasonable in terms of the characteristic of certain country or market.

Hopefully, the results of this research can provide valuable contribution to those country which are currently formulating anti trust law or competition law, by which sound policy and its good implementation become possible.

ACKNOWLEDGEMENTS

This research is dedicated to civitas academica of Bhayangkara University, Surabaya - Indonesia, particularly for the Post Graduate of School of Law. They contributions and support is significantly meaningfull to the completions of this article.

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