2009

STATE OF COMPETITION IN PAKISTAN

Competition Commission of Pakistan

CONTENTS

GLOSSARY OF ACRONYMS

ADB	Asian Development Bank
APCMA	All Pakistan Cement Manufacturers Association
CCP	Competition Commission of Pakistan
CO 07	Competition Ordinance, 2007
CPI	Consumer Price Index
ECC	Economic Coordination Committee
EU	European Union
FDI	Foreign Direct Investment
FWO	Frontier Works Organisation
GDP	Gross Domestic Product
HBFC	House Building Finance Corporation
HHI	Herfindahl-Hirschman Index
MCA	Monopoly Control Authority
MOH	Ministry of Health
MOIP	Ministry of Industries and Production
MRTPO	Monopolies and Restrictive Trade Practices (Control and Prevention) Ordinance, 1970
NIM	Net Interest Margin
NWFP	North West Frontier Province
OECD	Organisation for Economic Co-operation and Development
PAMA	Pakistan Automotive Manufacturers Association
PIA	Pakistan International Airlines
PPMA	Pakistan Pharmaceutical Manufacturer’s Association
PPRA	Pakistan’s Public Procurement Regulatory Authority
PSMA	Pakistan Sugar Mills Association
SME	Small and Medium Enterprises
SMH	Small and Medium Housing
TCP	Trading Corporation of Pakistan
TFP	Total Factor Productivity
UHT	Ultra High Temperature
WHO	World Health Organization

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Foreword

The State of Competition in Pakistan 2009 Report addresses two important themes that are, in essence, a continuation of the core ideas discussed in the first report on the subject, namely the relevance of competition policy to competitiveness and development and ultimately to some broadly defined notion of public welfare. In the minds of many, promoting competition alone has a somewhat esoteric ring about it and its contribution to development is not particularly well understood. In order to enhance understanding, the two themes that this report takes up are the concept of a level playing field – a central theme in competition economics - and the contribution of competition policy within a larger strategy or framework for promoting the competitiveness of the Pakistan economy. It is clear that both subjects are vitally important within a long term development objective for Pakistan and, perhaps, for all developing countries.

It has to be said that although a level playing field in economic terms remains a somewhat abstruse concept to define, it is nonetheless operationally useful for the practitioners of competition policy. It is abstruse in that it applies equally to prior conditions and to outcomes thus seeming to conflate causes and effects; it is operationally useful because it embodies the notion of fairness within it. Fairness is an ethical attribute that we can all identify with and it is an essential component of competition policy; indeed, of all public policy. A level playing field from the perspective of Pakistan's competition regime represents the need to recognize that incumbents in any sector of the economy are not entitled to special privileges, however valuable their contributions to that sector might be in terms of output and employment. Furthermore, based on both theoretical understanding and empirical evidence, it would be a travesty to argue that special privileges in the form, say, of cartelization, freedom to fix prices and erect entry barriers are beneficial in any way either for the sector concerned or for the wider economy.

The second theme that the report discusses is the need for an overall strategy to make Pakistan a more competitive economy and the Competition Commission's role in it. Such a strategy would obviously have several components but, in my view, for any strategy to deliver concrete results it has to be squarely anchored within a competition policy framework. A more competitive Pakistan means a more efficient and more innovative Pakistan, a Pakistan that can capture new and challenging markets at home and abroad and a Pakistan that can harness better the creative energies of its entrepreneurs and managers. It is competition policy which provides the legal framework and incentives for them to pursue the objectives of greater efficiency and innovation and to enjoy the benefits that they will eventually bring.

However, it is well to mention that a more efficient Pakistan could also mean that large and dominant players might emerge in particular sectors of the economy. It will be the responsibility of the Competition Commission of Pakistan (CCP) to ensure that such players are, indeed, allowed to emerge and prosper so long as they do not misuse their market power to harm their competitors or consumers or have entry barriers save those that are technologically necessary, for example in industries with a high minimum scale of production. But a dominant player can only be defined in relation to a particular product or market and I accept that it is the CCP's responsibility to know what that relevant market is and to fill the data gaps wherever they exist and which hamper its investigative and analytical work.

This report provides not only an overview of CCP's own work in the implementation of the Competition Ordinance (now soon to become an Act) but its thinking and approach with regard to some of the central issues of competition economics. I am very pleased to bring the report to the attention of a wider audience inside and outside Pakistan.

Khalid Aziz Mirza
Chairman

Introduction

Besides enforcing the law, the Competition Commission of Pakistan has also been mandated to promote and entrench a more robust culture of competition in Pakistan. To achieve this important objective the preferred means, in addition to enforcement, is advocacy which includes the publication, among others, of an annual report on the *State of Competition in Pakistan.* It has to be remembered, however, that Pakistan's history has been marred by extensive government interventions in economic activity (licensing, public ownership, fixing of prices, subsidies etc.) on the one side and widespread rent-seeking and anti-competition practices and conduct by the private sector on the other. Winning the argument that promoting competition is the best way towards a more efficient and more competitive economy is hence likely to prove a hard battle. It is the responsibility of the Commission as the principal pro-competition protagonist to focus the attention of economic agents in the country as to how a lack of competition has hampered the development of crucial sectors of the country's economy and left the economy vulnerable to the forces of international competition. To achieve this objective, the *State of Competition in Pakistan 2009* evaluates the economy with respect to a broad range of competition-related issues and identifies those factors that are likely to impinge on competition both at the macro and micro levels in the country.

In this context, it is gratifying to note that the *State of Competition in Pakistan 2008*, the first report in the series, was warmly received by all the relevant stakeholders in Pakistan including the Government, regulatory bodies, business organizations and academia. In addition, the Commission's counterpart institutions and multilateral fora including the World Bank, the *International Competition Network*, *OECD* and others were especially generous with their praise. The *State of Competition 2009 once again looks at* the state of Pakistan's economy in 2008/09 and assesses the implications flowing therefrom for competition and competitiveness in the economy. While analyzing the challenges and policy issues confronting Pakistan in 2009/10 and beyond, the report indicates that implementation of competition policy and the role of the Commission will come under ever greater scrutiny. The extra scrutiny implies that efforts at law enforcement and the creation and promotion of a pro-competition culture need to be strengthened so that businesses in Pakistan can both recognize and achieve the benefits of competition, nationally and internationally, and the vital contribution of the Commission of Pakistan in that regard.

At the national level, competition is partly about the creation of a level playing field so that all economic agents are allowed to compete within a non-discriminatory, rule-based economic environment and partly about developing a longer-term strategic framework for enhancing Pakistan's competitive strength. At the international level, competition enables a firm to compete against global competitors and win market share not just at home but on a global basis. With that general background, *the State of Competition 2009* explores the practicalities of the rather complex notion of a *level playing field*. The report explains that the operational usefulness of the concept at the level of the individual firm or even of a sector, is subject to a wide array of technical factors and considerations that are not easy to isolate, define and measure. Notwithstanding these caveats, it nonetheless remains the primary responsibility of a national competition agency to create an environment in which all can participate and compete fairly.

In this regard, it may become necessary at times to go beyond the strict parameters of competition law and point out where the attainment of a level playing field is being hampered by the Government's own policies and actions in other areas. Given this somewhat stark reality, the Competition Commission of Pakistan would need to plead with the Government through its policy notes to iron out the worst anomalies in its taxes, subsidies and in its various interventions in the pricing of different inputs and outputs of the economy so that the benefits of a level playing field and of competition policy, namely fairness, efficiency and greater competitiveness, ultimately accrue to the economy as a whole. It is important also to stress that all stakeholders who want to see a more competitive economy in Pakistan should view this aspect of competition policy not as a short term objective but as part of a long term strategic goal towards which the Competition Commission is making an important contribution. *The State of Competition 2009* addresses both issues at some length.

Chapter 01

The state of the economy: implications for competition and competitiveness

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A. The economy in 2008/09

The Pakistan economy performed poorly in 2008/09. GDP growth slowed from 5.8 per cent achieved in 2007/08 to 2.5 per cent – barely enough to keep pace with population growth. This was in the face of increasingly severe security and public resource problems that undermined investor and consumer confidence in the economy as spending on the Annual Development Programme was sharply curtailed. Chronic difficulties with power generation affected all sectors of the economy to varying degrees but manufacturing as a major user of energy was particularly affected by the disruptions caused by frequent electricity outages. Overall industrial production having declined by 4.2 per cent in 2007/08 displayed only minor growth of 0.6 per cent in 2008/09 with capacity utilization remaining low. As much of the global economy, with the exception of China and India, continued to be mired in recession in 2009, Pakistan was thus confronted by a combination of weak export demand, especially for textiles, and stagnant domestic output. Within this rather bleak picture it is important to stress that agriculture benefited from favourable weather conditions that impacted positively on wheat and rice production although sugarcane production declined. But services, especially banking, saw weak credit demand as interest rates remained firm. Activity in construction also declined significantly. The spectre of rising unemployment in the country thus loomed on the horizon. The main indicators of Pakistan's recent economic performance are given in the attached table.

The slow pace of output growth was reflected in a sharp reduction of both import and export growth and there was downward pressure on Government revenues. On the plus side, however, the lower level of activity tended to ease price pressures in the economy and reduce the external deficit. As a result, the rupee-dollar exchange rate enjoyed a broadly stable run in 2008/09. But, the lower revenue generation meant that Pakistan, unlike many other countries, developed and developing, did not have the fiscal space to make new public sector spending commitments to counter the slowdown in economic activity. Indeed, even the serious problem of circular debt that bedevils power generation in the country could not be decisively addressed by the Government and spending on security made major inroads into development spending. Resort to further large-scale borrowing was ruled out as part of the IMF-supported programme of stabilization within which the Government sought to keep the fiscal deficit at 4.2 per cent of GDP. The general consensus was that it would be unwise to take risks with inflation at a time when the economy was facing challenges on so many other fronts. In the event, consumer price inflation slowed to 10 per cent (on an annualized basis) in September 2009 from nearly 24 per cent in September 2008.

In the 2008 *State of Competition* report it had been noted that, given continuing structural weaknesses in the economy, Pakistan remained dangerously vulnerable to external shocks in its critical macroeconomic variables. Dealing with macroeconomic instability tends to translate itself into a narrower range of public policy options and urgently needed investments in both physical infrastructure and improved governance have perforce to be deferred. The most obvious and visible manifestations of vulnerability are the balance of payments current account deficit, including the servicing of foreign debt and outflows on account of FDI-related profit remittances, and domestic fiscal deficits. It is important to note, however, that vulnerability in these areas has been both cause and effect of low TFP (Total Factor Productivity) in the economy as a whole. Low TFP has, in turn, been reflected in weak internal and external competitiveness. Persistent under-investment in public infrastructure – a result of the country's poor fiscal situation - has failed to bring productivity in the economy to levels prevailing in, say, East and South-East Asia. The low productivity has resulted in a low tax base for the Government *and* persistent trade deficits as Pakistan has found it increasingly difficult to compete in international markets. The slowdown in growth in 2008/09 suggests that short term domestic and international factors have superimposed themselves on difficulties of a more long term, structural nature and Pakistan's already low international competitiveness is likely to erode further.

B. Competitiveness and competition: the Pakistan context

Competitiveness and competition are critically important from the perspective of development policy objectives. They have become doubly important with the advent of globalization. In an open market economy, firms compete *both* in domestic and international markets to win consumers. Such competition provides the spur for firms to strive for the best, to produce quality goods at prices that maximize profits and preserve, or increase, market share. Competition encourages entrepreneurial activity by rewarding the more efficient firms and penalizing the less efficient ones. The entry of new firms provides the necessary stimulus for adjustment, and growth, in particular sectors. At the same time the capacity of firms to adjust to new challenges in the market place is a measure of their efficiency and their competitiveness. Competition is thus a key driver of competitiveness and growth.

What is true at the level of the firm is also true at the national level when the question of a stable balance of payments position is taken into account. With globalization, a distinction can be drawn between static and dynamic competitiveness. In the former, the emphasis was on price competition whereby firms competed on the basis of factor endowments such as low cost labour and natural resources. In these conditions - that apply to Pakistan's current level of development - competitiveness was primarily a function of cutting production costs and competing on prices. Many, if not most, developing countries, including Pakistan, competed on this basis.

Dynamic competitiveness, on the other hand, is a function of the ability of the firm, or a group of firms, to learn, to adjust to new developments in production techniques and consumer preferences and to innovate. In other words, dynamic competitiveness is learning to become more efficient. Here, it is important to stress that globalisation has largely erased traditional distinctions between national and international competitiveness. Firms in Pakistan can no longer rely on protected domestic markets to deliver customers and profits; they have to survive or prosper, as the case may be, by competing against their international peers. In the general and wider case of national economies, the benefits of dynamic competitiveness are not confined to individual sectors but cut across the economy as a whole and have a favourable impact on all sectors through spillovers and positive externalities.

What of Pakistan's current state of competitiveness? Pakistan remains a low wage, labour surplus economy. However, international comparisons suggest that while wages are low in Pakistan they are, on the average, somewhat higher than in India or Bangladesh. However, allowing for differences in TFP suggests that Pakistan is a higher cost location than either India or Bangladesh. As highlighted in the *State of Competition 2008* a high cost and poorly functioning infrastructure has been a major impediment to TFP improvements in the country. Transport bottlenecks, particularly in relation to exports, have also raised costs and there is considerable evidence that port handling costs in both Karachi and Port Qasim are higher than the regional, i.e. South Asian, average. These deficiencies have reduced Pakistan's international competitiveness and have, almost certainly, had a deleterious effect on attitudes to competition at the level of the individual firm in the country.

Looking at the wider picture in the region but more particularly at East and South-East Asia, competitiveness clearly requires a strong base of human and technological resources which can support firms in handling, adapting and improving new technologies and selling the output to sophisticated and demanding global consumers. In this regard, Pakistan performs poorly by regional standards and falls a long way behind East and South-East Asia. More alarmingly, Pakistan's competitive position appears to have remained either static or deteriorated over the last few years.

The State of Pakistan's Competitiveness Report 2009[1] focuses on a number of shortcomings in enterprise competitiveness. These, in turn, create conditions that encourage and facilitate an anti-competitive business culture in the country. For example, the continuing lack of exposure to local competition (and other policy

[1] US AID, 2009, *Creating Sustainable Growth: Competitiveness Support Fund*

constraints) and incidence of market dominance worsened in 2008 compared to 2007. A similar trend was evident in the area of financial market sophistication and ease of access to bank loans over the period 2007-2008. In terms of technological readiness, access to the latest technologies and technology absorption by firms saw a decline in the last two years. Business sophistication in terms of the quality of local suppliers, value chain breadth, production process sophistication and the quality of the marketing effort by firms also showed a loss of momentum in 2008. More fundamentally, the Report underscores the low capacity for innovation over much of the business sector in the country. For instance, not only is company spending on R and D low and declining but the overall national effort in this regard paints a particularly sorry picture. Pakistan registered a paltry 18 patents in the period 1963-1995 with another 23 between 1995 and 2008, numbers that are dwarfed by other developing countries (Malaysia 947, Brazil 2094 and India 4080).

C. Competitiveness and growth: the role of exports

In a largely private sector-driven economy what are the policy incentives that a Government can offer to encourage competitive behaviour? It is the remarkable success of East and South-East Asia in achieving and sustaining a high rate of GDP growth based on export competitiveness where the evidence lies. Following the export success of these two subregions, the importance of trade and, more particularly, the role of exports has become the subject of considerable study. Broadly speaking, there is a consensus of opinion that i) exports enable a country to overcome the constraints of a small domestic market in achieving economies of scale; ii) international competition leads to increased pressure for firms to improve efficiency and to invest in productivity-improving capital equipment and skills; iii) exposure to international markets improves familiarity with new technologies and leads to wider spillover effects in the economy; iv) faster growth of exports allows a faster growth of essential imports such as capital equipment; and v) a dynamic formal sector improves tax buoyancy and enables the Government to invest and upgrade infrastructure thus improving TFP in the economy.

Against this background, Pakistan needs to expand exports because it has a balance of trade deficit in excess of 6-7 per cent of GDP. This puts a limit on the import of capital goods and modern technology needed by both the public and private sectors (not to mention the expensive consumption and demonstration goods demanded by the wealthy elite) and thus acts as a brake on overall growth. While it is true that exogenous capital flows can overcome this constraint, the experience of the last decade has shown that such inflows are highly uncertain and volatile. Indeed, they might even enhance, and not lessen, the risk of a sovereign default and a wide-scale financial crisis even in countries that are managing their affairs prudently, as happened in the Asian crisis of 1997-98.

Furthermore, at the macroeconomic level, most factors of production are endogenous to demand. The supply of capital is as much a consequence of growth as it is a cause. Indeed, even in Pakistan substantial investment is financed out of retained profits and once an industry, or country, begins to grow it can usually generate the necessary resources to sustain its expansion. In this broad schema, labour is a derived demand from output. In Pakistan, with persistent under-employment in agriculture, labour is not considered a constraint on expanding output in the short term, whereas capital equipment is, and the lack of access to capital equipment is largely, if not exclusively, due to a poor export performance by the country over several years.

An external constraint on growth, for instance a low export-GDP ratio, does not mean that once a firm decides to sell in the international markets supply will be automatically forthcoming *and* marketable. On the contrary, the supply characteristics of existing exports are crucial in achieving what is currently called non-price competitiveness which reflects the quality, reliability, speed of delivery, the effectiveness of the marketing effort etc. undertaken by the exporter. Indeed, over the long term these attributes are considered more important than price competitiveness based, say, on an under-valued exchange rate alone. In addition, exports to fast-growing dynamic markets can overcome the limits imposed by the growth rate of domestic demand.

D. A competition strategy for Pakistan

As stated in the *State of Competition in Pakistan 2008* and worth reiterating here is the fundamental need for macroeconomic stability in the economy. This is not a specific part of a competition strategy per se but without it all other policies become much more difficult to implement. There is research that suggests that relatively low inflation and a stable exchange rate, i.e. a rise in the consumer price index of around 5 per cent per annum and a trade weighted exchange rate that fluctuates within a band of plus or minus 5 per cent around an 'optimal' level is positively correlated with growth. For Pakistan, this means keeping the fiscal and current account deficits on a sustainable path where borrowing, whether internal or external, is equal to the total of public and private investment and does not significantly exceed international benchmarks for developing countries.

Another important area is the quality of governance. The shortage of resources is a datum for all countries. But it is in developing countries that Governments have to confront and reconcile the often conflicting demands of efficiency and equity when resources are insufficient to address their myriad problems in a meaningful way. In Pakistan, a long-standing problem is one that emanates from difficulties in the proper implementation of even the best-crafted policies. In this regard, the deteriorating security situation in the country has severely compounded an already existing problem and urgently needed improvements in the delivery of public services, in the upkeep and repair of infrastructure such as utilities and roads and new investment in a range of Government facilities have been effectively deferred indefinitely in many parts of the country. But, accompanying this has been steady erosion in institutional capability so that critical agencies of the state, the police, the judiciary and even the general administration appear to have lost their effectiveness. Recent crises, like the shortages of staples consisting of wheat flour and sugar and the chronic electricity and gas outages, have tested administrative abilities to breaking point. What Pakistan needs is to devise a candidly realistic approach to Government interventions, to eschew interventions where markets generally can do a reasonable job and to develop a system of rolling priorities so that interventions occur where they can be *both cost and effort-effective*.

From the perspective of competitiveness all the above weaknesses in governance take their toll but an area of governance requiring urgent attention is the reform of tariff policy. Indeed, it is the one area where the concept of a level playing field has practical resonance and where the interface between competition policy and competitiveness assumes central importance. Recent research has shown that despite statements and declarations to the contrary there remains an anti-export bias in the economy. The ratio of the effective exchange rate on exports to that on imports suggests that the bias can be quantified at around 20 per cent[2] and perhaps higher still once non- quantifiable barriers are taken into account. The existing tariff structure hence serves to make domestic production more profitable than production for exports.

A World Bank study[3] compared costs and productivity in Pakistan against the costs of comparable exporters in competitor countries. While each export industry had its own particular problems, the general conclusion of the study was that exporters faced a daunting array of barriers in terms of poor logistics and a virtual absence of institutional support in the shape of pre-shipment credit, shipping space and high freight rates, trade intelligence and port clearance procedures. Overall, effective protection rates were skewed in favour of the domestic production of consumer goods. A perverse consequence of this has been that FDI in the automotive industry has come in for low level (but profitable) production with no incentive to help a component industry develop and with significant entry barriers in the form of high capital costs to start operations even at a modest level.

While technical encumbrances clearly play a role, a strategy for competitiveness needs to be informed by a collective vision that involves all participants: Government, business people and consumers. The planning approaches of the 1960s and 1970s variety may have fallen into disrepute but there is a clear need for

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2 ADB, 2009 Working Paper No 160
3 World Bank, 2006, *Pakistan's Growth and Competitiveness,* Report No 35499-PK

articulating broad, but achievable, goals for the economy and to create the capabilities needed for meeting those goals[4] (Industrial Competitiveness: the Challenge for Pakistan, ADBI, 2004). The Government has to identify what the main components of competitiveness are and to decide which sectors, or sub-sectors, of the economy are to be given institutional support as indicated above.

The need for major improvements in physical infrastructure has been mentioned earlier. Another area that needs to be closely examined is the anti-export bias in the tariff structure. A third area is governance. While a reliance on markets to deliver the 'best' outcomes in the form of the ample availability of goods and services at low prices is understandable, real world realities involve having to deal with widespread market failures and distortions. Governments need, therefore, to devise policy regimes that promote the free play of market forces but simultaneously discourage market distortions such as misuse of dominance, the formation of cartels and entry barriers and other anti-competitive practices.

E. Competition in 2009/10 and beyond: policy issues

The overall economic outlook for 2009/10 remains problematic. Given the difficulties in, and rising prices of, power generation and gas, a strong revival of manufacturing growth appears improbable at this stage. The same can be said of exports, textiles and non-textiles, as global recovery has barely begun and consumers in the United States (Pakistan's largest export market) and, indeed, elsewhere are likely to remain hesitant for the time being insofar as discretionary spending is concerned. The threat of further rises in unemployment has not receded and developed country consumers have to rebuild their savings following the massive declines in stock markets and real estate prices in 2007-2009. Agriculture is a bright spot with wheat and rice production likely to remain stable or go up in 2009/10 compared to 2008/09 although the lack of rain during the summer of 2009 and before the sowing of wheat for the 2009/10 crop is a source of growing concern. In addition, inflationary pressures have abated. Services, however, are likely to be adversely affected by the lack of growth in the commodity-producing sectors and the prevailing weak consumer and investor sentiment in the country. On the external front, the current account deficit is likely to narrow substantially but this would be primarily on account of a large compression of imports across a wide range of uses. An overall GDP growth rate of 3.5 per cent is achievable in 2009/10 but this is subject to significant downside risks[5] (IMF Article IV Consultation, April 2009).

Both the Government's own priorities and obligations under the IMF Stand-by Agreement strongly indicate a continuation of fiscal consolidation in 2009/10 and beyond. Indeed, the Government has stated that in the event of any revenue shortfalls public spending would inevitably have to be reduced and borrowing will not be increased. In that event, the axe is likely to fall primarily on development expenditure. The fiscal deficit has been set at 3.4 per cent of GDP for 2009/10 which appears rather ambitious and some slippage is bound to occur. There is expected to be little or no change in the monetary policy stance by the State Bank and the real effective exchange of the rupee should remain broadly stable.

With regard to the exchange rate it is pertinent to note that Pakistan's export performance, while nowhere near the rates of growth achieved in East and South-East Asia, has averaged 12 per cent per annum in the period 2000-2008. Though respectable, it is inadequate, as the absolute magnitude of imports is roughly twice that of exports. Moreover, in addition to machinery, imports include vitally important products such as oil, oil products and fertilizers. As imports cannot be further compressed significantly, it is higher exports that will be needed to narrow the current account deficit in 2009/10 and beyond. Competitiveness and competition issues thus come to the forefront.

There is no doubt that in enhancing the rate of export growth, the notion of competitiveness and an effective competition regime are closely inter-linked. As matters connected to attaining and preserving macroeconomic stability, changes in the real effective exchange rate and deficiencies in infrastructure and

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[4] ADBI, 2004, *Industrial Competitiveness: the Challenge for Pakistan*
[5] IMF, Article IV Consultations, April 2009

governance are beyond the ability of individual firms to control or influence, the areas in which they can function autonomously and competition policy can assist them are relatively limited. As mentioned elsewhere, the boundaries between national and international markets have become blurred. This development has implications for relatively small-sized enterprises that were previously protected from international competition by high tariff walls. But over-high tariffs can also stifle competition by effectively eliminating the need for improvement and innovation. In many parts of the world, competition is obliging firms to remain competitive by exploiting knowledge spillovers through inter-firm cooperation. Networking, and being an important part of a production chain, are new realities that globalisation has brought in its wake. The importance of innovation and efficiency has to be measured against cooperation and participation in a value chain.

Against this background, it is important to concede that traditional ways of assessing competition and anti-competitive behaviour may not be fully applicable in a globalizing world economy with new pressures emanating from the international capital markets and the information technology required for supporting inter-firm networking. Among the sectors where this is occurring are petroleum refining, airlines, chemicals, automobiles and telecommunications. Most observers agree that the general trend is towards ever larger firms and it is too soon to tell whether the financial market turmoil of 2007/08 will lead to fewer, still larger banks or will the dictum 'too large to fail' be finally laid to rest.

From the Pakistan perspective, once the current phase of slow GDP growth is over, competition policy will need to look again with renewed vigour at market concentrations, specifically abuse of dominance, and what constitutes anti-competition behaviour in the new context. The co-existence of cooperation, whether internationally or nationally, suggests a need for Pakistan's competition policy and law to remain flexible and forward-looking and to remain vigilant to the threat of misuse of market power within the so-called cooperative arrangements. The upshot is that implementation of competition policy will continue to pose new challenges and the role of the Competition Commission will come under ever greater scrutiny. The conclusion is that its hands need to be strengthened so that businesses in Pakistan can both recognize and achieve the benefits of competition, nationally and internationally.

Pakistan: Selected Economic Indicators, 2003/04-2008/09 1/

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Output and prices	(Annual changes in per cent)					
Real GDP at factor cost	7.5	9.0	6.6	7.0	4.1	2.0
Partner country demand (WEO definition)	4.7	4.8	4.8	4.5	4.5	NA
Consumer prices (period average)	4.6	9.3	7.9	7.8	12.0	20.8
Consumer prices (end of period)	8.5	8.7	7.6	7.0	21.5	13.1
Pakistani rupees per U.S. dollar (period average)	-1.5	3.1	0.8	1.3	3.2	25.8
Saving and investment	(in per cent of GDP)					
Gross national saving	18.4	17.7	17.7	18.0	13.5	14.1
Government	1.1	0.5	1.1	1.0	-2.9	-2.0
Non-Government (including public sector enterprises)	17.3	17.2	16.6	17.0	16.4	16.0
Gross capital formation	16.6	19.1	21.7	23.0	22.0	19.7
Government	2.8	3.5	4.8	5.0	4.4	3.0
Non-Government (including public sector enterprises)		15.6	16.9	18.0	17.6	16.7
Public finances						
Revenue and grants	14.6	14.1	14.8	15.2	4.9	14.3
Expenditure (including statistical discrepancy)	16.4	17.2	18.5	19.2	22.2	19.3
Budget balance	-1.8	-3.0	-3.7	-4.0	-7.3	-5.0
Budget balance (excluding grants)	-2.3	-3.3	-4.3	-4.3	-7.6	-5.2
Primary balance (including grants)	1.7	0.2	-0.6	0.2	-2.5	-0.1
Total Government debt	67.8	62.9	57.3	54.6	58.4	55.0
External Government debt	32.1	29.4	26.6	24.6	26.7	25.6
Domestic Government debt	35.7	33.5	30.8	29.9	31.8	29.4
Merchandise exports. U.S. dollars (growth rate, in per cent)	13.5	16.2	14.3	3.2	18.2	-3.2
Merchandise imports. U.S. dollars (growth rate, in per cent)	21.2	38.3	31.7	8.0	31.2	-10.3
Current account including official current transfers (in per cent of GDP)	1.8	-1.4	-3.9	-4.9	-8.4	-5.6
	In per cent of exports of goods and non- factor services; unless otherwise indicated)					
Gross reserves (in millions of U.S. dollars)	10,564	9,805	10,760	14,287	16,158	12,110
In months of next year's imports of goods and services	5.0	3.5	3.7	4.5	4.8	3.0

Sources: Economic Survey, various issues
1/ Fiscal year ends June 30.

Chapter 02

Issues in competition policy: the concept of a level playing field

Issues in competition policy: the concept of a level playing field

A great deal of discussion in applied economics, particularly in the realm of policy-making, revolves round the concept of *the level playing field*[6]. As this concept plays a central role in how competition policy is configured and how its legal and operational sides obtain much of their justification and practical relevance the underlying notion needs to be explained/defined with a degree of precision. At its simplest, a dictionary of economics would define a level playing field as one in which companies (and countries, for example, in the realm of international trade) can compete fairly with each other in a rule-based environment because no one enjoys, or is given, any special advantages. All competition agencies therefore regard the attainment of such a level playing field in individual sectors of the economy and, indeed, in the economy as a whole, as their primary responsibility. But, even a cursory look at the concept suggests that attaining it would be fraught with difficulties.

At a fundamental level there would be situations in which, beyond exhortation, a competition agency might not be able to do much in achieving a level playing field. Such situations lie primarily in the area of macroeconomic policy in general and in exchange rate policy in particular. For example, a government may take a relatively relaxed view of the dangers of fiscal deficits and inflation (and developing country governments, including Pakistan, have traditionally tolerated higher levels of inflation than developed country ones). As is widely recognised now, inflation plays havoc with relative prices and distorts the signaling mechanisms that they provide to both investors and consumers. It also enables anti-competition behaviour to be conveniently camouflaged as it is virtually impossible to distinguish between price increases that are driven by overall inflation and price increases that producers and distributors are able to put into effect on account of their market power. A level playing field would be difficult to achieve in such a situation.

Similarly, with regard to the exchange rate, the relevant authorities in many countries deliberately intervene in its determination on a day-to-day basis without necessarily having a clear rationale for doing so in most cases, other than a perceived need to reduce needless fluctuations in the exchange value of the domestic currency. We know now that a stable exchange rate can play the role of an anchor in monetary policy; equally, it can also be used for promoting exports by keeping it 'under-valued' on a trade-weighted basis. Ideally, the correct level of the exchange rate should be one where it is consistent with maintaining external balance on a sustained basis. In other words, the exchange rate, calculated on PPP (purchasing power parity), should aim to be neutral between exports and imports, although as was observed in the preceding chapter there appears to be something akin to an anti-export bias in most developing countries which makes it more profitable to import than to export, seen from an enterprise perspective. This suggests that if there is such a thing as an exchange rate policy countries probably tend, by and large, to keep their exchange rates moderately over-valued as it apparently encourages investment. But this means that there cannot be a level playing field between exporters and importers.

It is worth noting here that few developing countries have been able to achieve the ideal of exchange rate stability in real life for any length of time. Furthermore, whatever their wider ramifications, such issues are far removed from the operational ambit and legal mandate of a competition agency and fall within the larger corpus of development policy. Nevertheless, they provide the framework within which the objective of a level playing field has to be viewed and fructified.

Another area where significant Government intervention takes place is correcting market failures. As discussed in the *State of Competition 2008* the world of perfect competition is a theoretical construct; the real world, on the other hand, is characterized by widespread instances of imperfect competition (monopolies, quasi-monopolies and oligopolies) and market failure. In a developing country context, the term 'market

[6] Marja Appelman et. al., 2003 *Equal Rules or Equal Opportunities? Demystifying Level Playing Field*, CPB Netherlands Bureau for Economic Policy Analysis, The Hague

failure' conveys a state of affairs in which goods and services are systematically under-provided at prevailing border prices in the country. This can happen deliberately as a result of producers attempting to earn super-normal profits and thus reducing production, or as a natural consequence of inefficiencies or breaks in the production/distribution chain whereby producers are forced to operate at a sub-optimal level of production and economies of scale are thus not available, leading to low production, shortages and high prices. Governments attempt to correct such market failures through price controls or subsidies. However, such interventions can, and do, create widespread distortions in incentives within the sector concerned and between different sectors of the economy[7].

A particularly important facet of market failure is when goods and services are not priced at their full cost to the community. This problem arises in situations where the production of goods and services creates significant negative externalities, e.g. pollutants or waste materials generated by the industry in question that are not properly disposed of or, as a major current concern in the context of global warming, the emission of greenhouse gases whose full import is only now being properly recognised. The costs of these negative externalities vary from industry to industry and within industries (between the more and less efficient) but are borne by society at large. Taxes attempt to but cannot in all instances of market failure rectify the situation. Likewise, some activities create positive externalities, such as building a factory in an area of high unemployment, and the prices charged by the producer would not be able to reflect this aspect adequately.

The purpose of the foregoing discussion is simply to indicate that the real life concept of the level playing field has varying grades of complexity and significance, not all of which might be amenable to corrective measures. What can be said with some degree of confidence is that, broadly speaking, companies should be *enabled* to compete 'fairly' whereby they have the same opportunity and incentives to achieve something by their actions. At another level, the significance could also shift to ensuring particular outcomes and this could be driven by a range of considerations. For the former, the operative conditions are usually embodied in the relevant laws, taxes, subsidies, labour laws and environmental regulations; for the latter, the term 'level' indicates that all participating entities in a particular activity should be able to achieve, other things being approximately the same, largely comparable results, such as return on equity or capital employed (in some countries the tax treatment of debt and equity capital creates a further complication by skewing incentives). In the latter case, the focus shifts towards a notion of socio-economic and geographical fairness within countries, which embodies some version of 'positive discrimination' in which historically disadvantaged groups (or regions) are to be provided with a positive bias by the state; or simply encouraging newcomers, such as SMEs, in certain activities by reducing or delaying the full impact of, say, onerous environmental or labour regulations. The EUs Common Agricultural Policy and Regional Grants are designed to achieve a level playing field in terms of outcomes of the kind referred to here.

By and large, most sectors of an economy tend to have a heterogeneous structure in which large firms co-exist with SMEs and new ones co-exist with old ones, all with very different levels of efficiency and cost structures. In such situations the primary purpose of the competitive process is to sift through the firms in such a way that the most efficient ones gain market share at the expense of the less efficient, with the latter then going out of business at some stage and thereby releasing resources (mainly land and labour but some capital too) that can be utilized by the more efficient entities. By efficiency here is meant not only efficiency in terms of costs and prices but product quality, product differentiation, marketing, branding, after-sales service and the like. In that context therefore efficiency could be affected also by entry barriers, information asymmetry (e.g. lack of access or information regarding public goods like the data on markets held by government departments and agencies), geographical circumstances or restricted access to natural resources and other inputs. Here, it also needs to be remembered that an implicit entry barrier such as switching costs (mainly relevant to mobile telephone operators, banks, pension funds and insurance companies) can negatively influence the ability of newcomers to enter a sector thereby strengthening the position of incumbents.

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[7] Steven Medema, et. al., 2004, *The Evolution of the Theory of Market Failure,* Online Working Paper

All said and done, however, the determinants of efficiency are not immutable, especially over the medium term. If some companies are more efficient than others such a state of affairs cannot be expected to remain unchanged forever. Thus, for instance, economies of scale create heterogeneity in cost efficiency by giving the larger firm an advantage, but over the long term a smaller firm can and will normally strive to increase its scale of production, or develop new technology that gives it a cost (or other) advantage with which it can overcome its initial lack of business standing, overall reputation and customer base. An example here is financial services in which all players can be presumed to have roughly the same cost and revenue structure (e.g. in terms of maxima and minima on deposits and advances which is often a matter of central banking fiat or policy advice), any variations being the result of different attitudes to risk. Existing players will strive to create switching costs to retain their customers, or, the newcomer will invest in information technology and other measures in order to lower its costs over the long term and thus build up market share.

Summarising the above discussion means that the concept of a level playing field is highly complex at the very least. It can mean: i) that the rules for doing business are the same for everybody; and/or ii) that all participants in the sector can expect the same broad outcome. The first definition fits well with normal public perceptions of fairness – e.g. it would not be possible to give state aid to some and not to others in the same sector; the second fits well with the notion of dynamic efficiency (in which socio-economic fairness is also subsumed). The latter notion of an outcome-driven level playing field is needed when a particular sector has become too set in its structure and change is either not taking place at all or taking place slowly. Here, the government may encourage the entry of new firms by providing them with temporary special privileges. But, while an outcome-driven concept of a level playing field is an interesting variant on the theme it is abundantly clear that in both cases the ultimate objective has to be the achievement over time of greater fairness *and* efficiency in the production and/or distribution of goods and services to customers. In this sense the two objectives are complementary, not mutually exclusive.

A particular and rather contentious manifestation of the level playing field that arises on a regular basis is competition between state and private sector firms (airlines and courier services, for instance) and the privileges that state enterprises tend to enjoy implicitly in their operations by the mere fact of being state-owned[8]. All governments have large procurement budgets as well as spending on infrastructure such as roads, airports, ports, municipal services and the like amounting typically to about 15-20 per cent of GDP in developing countries. In the past, such procurement contracts used to go almost automatically to the appropriate state enterprise or agency. Over the last few years most governments have sought to increase the efficiency of their spending and obtain better value for money by making the public sector compete with the private sector, including those from other countries, in bidding for the contracts involved. However, evaluating and comparing the relative costs of public and private sector delivery is not as straightforward as might seem at first sight, as the following brief discussion highlights.

One, in its most familiar form the direct costs of public sector delivery are usually compared to the direct costs of private sector delivery. The experience of countries that have engaged in this form of competitive bidding is that all participants – public and private – would be willing to take part, provided the bidding process is deemed to be transparent and the best way of ensuring transparency is by the creation of a level playing field. In this context, the level playing field is a form of competition that is structured in such a fashion as to be unbiased between the competitors and an assurance that decisions will be made on relatively objective criteria.

Two, while the concept appears to be reasonably clear in the abstract what does it actually mean in practice? How are cost comparisons between the public and private sectors done – are only notional, i.e. direct costs compared or are indirect, long term costs also taken into account? The operational implication of different types of comparisons is that one approach may overstate the cost of public sector delivery while another may understate it. Moreover, is the goal of efficiency to be achieved over the life time of the asset or service and not merely taken as a single cost or price calculation. Achieving neutrality in assessment may thus be easier said

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[6] Marja Appelman et. al., 2003 *Equal Rules or Equal Opportunities? Demystifying Level Playing Field,* CPB Netherlands Bureau for Economic Policy Analysis, The Hague

than done. In other words, any government's efforts at achieving a level playing field in public-private competition are far from being exact. However, as more governments and state agencies adopt competitive bidding for government procurement and contracts additional insights into what constitutes a level playing field are likely to be discovered. For now, it might be sufficient merely to accept that a level playing field ultimately goes beyond simple allusions to fairness between competitors and is related also, from a national economy perspective, to the achievement of more efficient outcomes in the utilization of resources over the long term.

Against this background, the situation in Pakistan is hugely complicated as far as a level playing field is concerned. First, the overall duty structure on imports varies enormously between raw materials, intermediate inputs and finished goods and no clear rationale is discernible in terms of the objectives that are being pursued. For instance, imports of finished goods are normally subject to fairly high levels of customs duties in order to provide protection to local producers. This was presumably initially based on the 'infant industry' argument that was used to justify restrictions on imports by developing countries in the 1960s and 1970s. However, very few of the relevant industries have been set up and the actual result of the high tariffs has been widespread abuse in the form of smuggling or informal imports. The government in the meantime has become dependent on the duties as a vital source of revenue and is reluctant to rationalize them. The notion of a level playing field does not appear to figure in the calculus and domestic producers are confronted with an array of conflicting levies/charges at different stages of the production cycle whose overall logic is not always clear. It is for this reason that Pakistan and most developing countries have found it difficult to introduce a uniform value added tax and have instead continued with several different rates of domestic excise and sales taxes, not to mention several different rates of customs duties, in the economy.

Second, more recently in order to attract FDI, tax holidays and tax free zones have been the modus operandi in Pakistan as elsewhere. But tax concessions for FDI, apart from leading to significant revenue losses, also lead to unevenness in the domestic playing field. Even if the FDI is meant only for exports, the beneficiaries of the concessions are given a cost advantage vis-à-vis domestic exporters who are not entitled to the same privileges/incentives. Moreover, tax holidays create 'free rider' issues and generate disincentives for existing tax payers that cannot be easily redressed. It is true that the economic gains from FDI are not limited only to the investment brought in and extend to important intangibles like transfer of technology, management know-how and international marketing links – factors with significant positive externalities and spillover effects – but on the minus side there is the creation of tax and cost anomalies within sectors and between FDI and domestic producers.

Third, the government is often forced to subsidise the production and sale of staples in household budgets, wheat flour and sugar being particularly apt cases in point in Pakistan today. However, the actual impact of subsidies on production and prices is often unpredictable and the situation is rendered even more complex in an inflationary environment such as the one prevailing in Pakistan over the last two years or more. It has to be remembered, too, that general subsidies generate a massive fiscal burden for the government without, in most cases, being able to produce clear and tangible results in the form of lower prices for the public at large. Moreover, subsidies inevitably generate major leakages creating windfall gains for some but not for others. Targeted subsidies often prove to be beyond the administrative ability of developing country governments – Pakistan is no exception – to be effectively handled. The notion of a level playing field is ultimately all but lost in the process with skewed, i.e. perverse incentives that discourage production, on the one hand, and encourage hoarding and market manipulation, on the other.

Finally, what of public procurement procedures in Pakistan, a contentious area which has a major impact on competition in the country? The prime examples are the Frontier Works Organisation (FWO) and the National Logistics Cell (NLC), two entities dominant in road building and road haulage and indirectly controlled by the state. Over time, their dominance has tended to increase rather than diminish leaving only a small area of activity in their respective sectors where competition exists. Almost across the world the public procurement process is rife with collusion, bid-rigging, predatory pricing, fraud and corruption. While fraud and corruption can be dealt with under the criminal law, phenomena such as collusion, predatory pricing and bid-rigging are less easily dealt with being both difficult to identify and prove. But, in many areas, such as large infrastructure projects, it is the case that governments often lack the technical ability to evaluate bids and massive cost overruns have become the norm rather than the exception. The safer option in the circumstances might be to give preference to the state entities in the award of contracts as some form of redress is at least theoretically possible in the face of egregious conduct. In other instances, the choices are far from straightforward.

From the perspective of a level playing field and public procurement, Pakistan's Public Procurement Regulatory Authority (PPRA) was established in 2002 as part of the government's anti-corruption strategy and provided with the necessary rules, procedures and guidelines for public sector contracting on an arm's length basis[9]. It is noteworthy, however, that while the rules are robust and comprehensive it is in their application that difficulties have arisen. Perversely, it might be in the rules themselves that communication between rival companies is facilitated and collusion and bid-rigging occurs[10]. For instance, full transparency reveals the identities of all bidders making it easier for collusive conduct to take place. And, by and large, public procurement takes place via open tenders – more susceptible to bid-rigging, rather than sealed bid tenders – less susceptible to bid-rigging, and allowing the participation of newcomers. Thus, by taking all these details into account, the creation of a level playing field clearly involves difficult trade-offs in which the needs of fairness between public and private enterprises and of efficiency in the execution of the contract might have to be temporarily suspended or compromised in favour of other considerations.

For a competition agency in a developing country, the objective of a level playing field perforce becomes a more limited and nuanced frame of reference even though it provides the *raison d'etre* for many of its functions and actions. With respect to macroeconomic and exchange rate issues a developing country competition agency can certainly point out the anomalies and distortions that government actions are creating and seek to influence a more conducive climate of opinion towards creating a set of incentives that do not discriminate between importers and exporters. More importantly perhaps, the government needs to carry out a detailed assessment at regular intervals to look at the impact of its myriad duties, taxes, levies and fees – in some cases confusingly offset by subsidies - on different sectors of the economy and recognize that they could be creating an overall structure that *neither* maximises the revenues accruing to it *nor* provides producers with a clear framework within which to take their output and pricing decisions.

What the foregoing underlines is that a level playing field is a vitally important but somewhat abstruse concept. Its practical usefulness, at the level of the individual firm or even of a sector, is subject to a wide array of technical factors and considerations that are not easy to isolate, define and measure. For instance, where having a level playing field involves evaluating the rival claims of the public and private sectors a competition agency does not have clear-cut, objective criteria to assess these claims beyond, say, a possible abuse of dominance or of artificially low bids by the public sector entities. Indeed, the government may adduce any number of reasons based on *its interpretation of the public interest* for not allowing the competition agency to judge such cases purely on the basis of competition law.

This is not to suggest that all efforts at creating a level playing field by a competition agency are likely to be futile. Notwithstanding the difficulties discussed here, it remains the primary responsibility of a competition agency to create a business environment in which all can participate and compete fairly. In this regard, it may become necessary from time to time to go beyond the strict parameters of competition law and point out where the attainment of a level playing field is being hampered by the government's own policies and actions in other areas. Given this, the CCP should continue to plead with the government through its policy notes to iron out the worst anomalies in its taxes and subsidies and in its various interventions in pricing in different sectors of the economy so that the benefits of a level playing field and of competition policy, namely fairness, efficiency and greater competitiveness, ultimately accrue to the economy as a whole. It is important also to stress that all stakeholders who want to see a more competitive economy in Pakistan should view this aspect of competition policy not as a short term tactical objective but as a long term strategic goal towards which the CCP is making an important contribution.

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[9] www.ppra.gov.pk
[10] Section 21 of the Public Procurement Rules, Government of Pakistan, Public Procurement Regulatory Authority

Chapter 03

State of competition: services and utilities*

** Chapters III and IV discuss competition issues on the basis of work already done or underway in the Commission.*

State of competition: services and utilities

The preceding two chapters have sought to shed light on competition issues within a broader macroeconomic context. While this is clearly important, what is of greater interest to the Commission is how various sectors of the economy behave at the more micro level. In this regard, when we talk of competition vulnerabilities we are trying to assess the potential of phenomena such as cartelization or other forms of collusive behaviour by apparent rivals, the evolution of the structure of the sector in terms of concentration ratios, the presence of dominant players in particular sectors, their capacity to misuse their market power and the existence of formal or informal entry barriers in those sectors. Thus, for instance, dominance can obviously exist only in the context of a particular product or market but estimating it for operational purposes is not as straightforward as might appear at first sight. For products with no close substitutes, defining the market is straightforward; for others, definitions have to be empirically based. They need to include measures of the elasticity of substitution of broadly similar products within an overall set of consumer preferences. In this regard, because of data shortcomings the needed information is not easily forthcoming for many, if not most, sectors of the economy in the case of Pakistan.

Chapters III and IV accordingly attempt to provide overviews focusing on the prevailing state of competition in ten sectors covering both services and manufacturing. In services and utilities – aviation, banking, electricity and telecommunications, the analysis presented in the chapter is partly based on work that the Commission has undertaken for these sectors for operational reasons (including a pioneering assessment of competition issues in banking) and partly for research. Services and utilities face competition issues that are qualitatively different from those in manufacturing. In manufacturing, namely automobiles, cement, fertilizers, milk, pharmaceuticals and sugar, there are relatively long value chains often giving space to middlemen (both formal and informal) and distributors to compete. These sectors, however, raise substantial data issues although the Commission has been directly involved in identifying anti-competitive practices in all the sectors mentioned here (cement, fertilizers and sugar have incidentally been the subjects of detailed competition assessments by the Commission).

A word of warning is in order in this regard. The observations and conclusions made in this chapter and the next might be best described as informed judgments rather than forensic findings based on hard evidence. In Pakistan, the level of detail available at the sectoral level on which competition assessments can be based inevitably tends to vary. Some sectors have been examined largely on the basis of an informed understanding of the competition impediments affecting them; hence the observations are subject to amendment and revision. For others, the conclusions are more definitive as information

* Chapters III and IV discuss competition issues on the basis of work already done or underway in the Commission.

was not a significant constraint. It is important to stress that those sectors for which detailed studies have not been conducted, the information used was gathered from official publications and/or provided by the respective sector industry or trade associations. It goes without saying that the analysis based on these sources cannot match the extensive effort and rigour involved in dedicated sectoral competition studies. However, every effort has been made to provide the most accurate description of such sectors.

In the age of globalization ideas travel freely on the internet and borders are becoming less relevant for consumption and production alike. Advances in competitiveness serve as an engine for economic growth, both for firms as well as countries. Competition in this regard may be conceptualized as a tool through which incentives for firms and countries can be aligned to achieve the objective of greater efficiency which in turn leads to greater competitiveness. Increased competition between firms implies the survival of the fittest, i.e. the most efficient companies that can satisfy the needs of their customers better than their rivals. Such companies do not need cartels or collusive price fixing arrangements to thrive.

Cross-country data prove empirically that only the most efficient, low cost and innovative companies have survived and prospered on a sustainable basis. Pakistan should be no exception to this finding. At the same time, however, in practice such conclusions remain ambiguous in the eyes of many for no other reason than the fact that anti-competitive outcomes, too, are correlated with 'success' in the form of supernormal rents for some firms/individuals. Augmented with the fact that these entities organize quite well and the consumers of their products and services cannot, a move from a non-competitive status quo becomes quite hard to achieve. It is with this hindsight that the sectoral reviews in chapters III and IV need to be considered.

In Pakistan, many important sectors have been in the past under the direct ownership and management of the government. Even after the process of privatization started, numerous formerly Government-held companies still looked towards the state for guidance and short term support, not always in a manner likely to enhance their long term performance. Thus, in Pakistan's experience, it becomes important to study competition concerns through this somewhat distorting lens.

One of the most serious drawbacks of an anti-competitive environment is the perverse incentives it sets for rent-seeking. Rent per se in economic terms is not inefficient as it is merely a transfer of wealth from one entity/individual to another. The problematic facet of such practices is the misallocation of productive resources towards unproductive activity that they give rise to. In an environment of former state control and essential historical links with the bureaucracy, it becomes especially salient in the Pakistani context. Such behaviour also has secondary effects of creating high entry barriers as new entrants lack such political and bureaucratic association as established entities enjoy. On the flipside, the Competition Commission is the first to acknowledge the presence of other impediments to competitiveness in Pakistan such as infrastructural issues, inappropriately targeted tariff and quota policies, exchange rate movements etc. which were addressed in the analyses of the different sectors. The sectoral analyses also refer to the enquiries and any subsequent action taken by the Commission for the sector or for companies within the sector wherever relevant.

A. Aviation

The aviation sector has been directly controlled by the state over the years in Pakistan. This fact alone makes a case for inhibiting competition in the sector. However, as in the case of other sectors and industries, the government has made an effort since the mid- 1990s to liberalize the sector in order to provide greater choice to travelers and reap other welfare enhancing results. The *raison d'être* for the liberalization effort were the subsidies the government was forced to provide in order to keep Pakistan International Airlines (PIA) operational. This became especially crucial at a time of severe fiscal constraints of the government. Despite attempts at deregulation and the subsequent entry by a few firms, the sector has had to confront the looming presence of a loss-making national flag carrier kept alive by cash transfers from the state.

It is also the case that an analysis of the aviation sector needs to be qualified by the observation that airlines have recently been struggling around the globe, primarily due to high and volatile oil prices at a time of declining passenger volumes. Furthermore, the airline business is one with relatively high fixed costs and relatively low variable costs and is thus peculiarly vulnerable to even minor external shocks. Furthermore, an airline with a preponderance of old aircraft will tend to find that its overall revenue stream is significantly affected by the amount of time and expense taken up by maintenance, which is a function of the average age of the fleet. A high cost structure would almost automatically push an airline to indulge in competition-reducing conduct in order to stay alive.

Prior to liberalization, PIA enjoyed monopoly status in the domestic market and had a major share in the international market as it offered direct flights to the most popular international destinations in the UK and the Middle East. Although entry by new airlines did not change the dynamics of the sector drastically, some progress was made from the prevailing status quo, especially in the domestic market. PIAs share of 100 per cent in the domestic market up till the early 1990's came down to about 74 per cent in 2007. Air Blue - a private airline which operates both domestic and international routes has emerged as the second biggest market player. In the international market, PIAs share is currently around 41 per cent. Thus, in both market segments, while reduced, PIA still enjoys a position of dominance.

As stated elsewhere in the report, a modern competition agency's concern with regard to dominance is not with its existence *per se* but more with its potential for abusive and welfare-inhibiting practices that might be packaged with it. Exorbitant price increases, restricted supplies, price discrimination and a lack of innovation are all indicators of how abuse of dominance is extant. PIAs case of a dominant firm combined with its public ownership presents multiple problems of an abuse of dominance as well as misaligned incentive structures.

For the last few years, the airline has been living off direct subsidies from the state; the figure for the fiscal year 2008/09 was around Rs.40 billion. PIA currently supports a fleet of 44 aircraft and about 20,000 employees, thus having an employee-to-aircraft ratio of 450[11]. Most profitable airlines around the world manage with ratios of 120-150 staff per aircraft and, in fact, low cost airlines suffice with as low as 75 staff per aircraft (even Indian Airlines manages with 236). This is not only a reflection of wasteful operating expenditures, but also of the non-competitive business ethos which has led PIA to making staggering losses over the years.

Almost inevitably, PIAs dominance comes with its share of abusive anti-competitive practices. CCP initiated proceedings and took action against two such practices. In both instances, typical price discrimination tactics were being used in order to maximize monopolistic rents. In simple terms, price discrimination refers to different prices being charged for the same product/service based on a consumer's ability to pay. If a consumer has no substitutes to choose from, as in the case of a dominant firm, price discrimination becomes exploitative, and is explicitly termed illegal in the competition law. The first case was an increase in the price of Hajj flights, a market in which PIA enjoys an absolute dominant position. Fares were increased by an exorbitant 80 per cent between 2007 and 2008 without supporting justification for doing so e.g., compulsion from cost pressures. PIA contended that fare increases were made on account of fuel prices hikes, but careful analysis revealed the contrary. Additionally, PIA took the plea that the airline hedged fuel prices in the face of increasing oil prices in 2008 and thus actually faced higher fuel costs than prevalent spot market rates at the time. But, it failed to provide adequate proof of this either. The Commission took action against PIA and instructed it to reimburse the *Hajjis* who had been discriminated against[12].

The second instance of the Commission's intervention was a similar case of discrimination against passengers for re-scheduling and cancellation fees. While it remains a norm locally as well as internationally to charge a fixed fee for re-scheduling/cancellation charges, PIA was charging a percentage fee. This came under the ambit of discrimination as passengers who had paid higher fares were required to pay more than the ones who had got cheaper tickets for the same service. Terming this practice as anti-competitive, the Commission instructed PIA to refrain from such practices in the future[13].

B. Banking

Given the number of banks in the country, banking should be the most competitive sector in the economy. However, the need for financial stability means that the sector has been closely regulated by the State Bank which has laid down a detailed regime of prudential benchmarks and ratios to which each bank in Pakistan has to subscribe. Despite the existence of such strong oversight the fact remains that in the absence of a formal deposit insurance facility there is a tacit working assumption that in the event of a bank failure the State Bank, or the government itself, would step in to compensate the depositors. This may well promote stability but it creates a range of competition and public policy issues in the sector, the principal one being that of moral hazard, i.e. that bank managements, shareholders and depositors all assume – rightly or wrongly – that in the final analysis no bank would be allowed to fail, such would be its negative repercussions for the wider economy. For a central bank the problem of moral hazard cannot easily be wished away. At the same time, it tends to skew the incentive structure towards greater risk-taking within the banks. The upshot is that in most banks risks are neither properly priced nor insured against by adequate capital buffers. Informational asymmetries between the banks and their customers further complicate the situation.

It is noteworthy that promoting competition is not, and has never been, an over-riding consideration in this scheme of things for the State Bank. The State Bank has, formally at any rate, had to balance greater competition in the sector in the form of contestability between the banks for deposits and borrowers, against greater risk-taking by individual banks or by the system as a whole. Competition for deposits, the bread and butter of the banking system, is narrowly circumscribed and any bank offering significantly higher rates than its peers to its customers can expect to arouse suspicions on the part of the State Bank. There is somewhat greater leeway in how banks price their loans and advances but the Pakistan banking system, like its

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[11] 'Air Transport Sector Note', Prepared by Charles E. Schlumberger, Principal Air Transport Specialist, The World Bank, during the appraisal mission for the Civil Aviation component of the Second Trade and Transport Facilitation Project from 26 to 31 January 2009.

[12] Commission's order and inquiry report on PIA Hajj fares can be seen at: http://www.cc.gov.pk/Downloads

[13] Commission's order on PIA Rescheduling and Cancellation charges is available at: http://www.cc.gov.pk/Downloads

counterparts elsewhere, is better at judging the risk profile of existing borrowers than at inducting new borrowers into the system. Thus, even interest rates on loans and advances tend to be set within a relatively narrow range. Against this background, the CCP has conducted a detailed competition impact assessment of the sector. The review in this section presents the major findings of the assessment.

The first competition issue relates to the coverage provided by the banking system. A pronounced bias (risk aversion combined with higher-than-normal profitability elsewhere) prevents banks from catering to the lower-income (especially rural) market. Currently banks serve only 15 per cent of Pakistan's population and only 7 per cent of bank lending is to the rural population, whose share in national deposits is also meagre amounting to 10 per cent of aggregate deposits[14]. The distribution is skewed to the extent that over 48 per cent of the total deposits of the country were mobilized from the two largest cities (Karachi and Lahore), while some 64 per cent of bank advances (lending) went to these two cities. An aversion to risk has meant that the banking system has effectively concentrated its efforts on the 'bankable' areas and segments of the economy leaving the rest to informal, high-cost alternatives. There has been very little competition by the formal banking system in the smaller cities and rural areas[15]. What has made the situation worse, insofar as competition is concerned, is that the five biggest banks have a virtual monopoly in the rural areas owing to their branch network and economies of scale acquired over the years. The situation has shown little improvement for rural areas despite the State Bank's Branch Licensing Policy (2007) that requires banks to have 20 per cent of their branches planned for the future in rural areas. Thus, risk aversion has translated itself into a wider, virtually systemic neglect of the rural economy. This phenomenon almost certainly raises competition issues, possibly some form of a collective 'refusal to deal' bias on the part of the banks.

While denial of access, or insufficient access, to banking services for the less affluent classes of society, is a public policy issue for the State Bank to address, from the perspective of competition there are other facts that also merit attention. Comparing the present situation (2009) with that depicted by the findings of the National Committee on Rural Finance (1999) reveals that the state of rural areas has worsened not only with reference to the number of branches but with respect to bank deposits, loans and advances[16]. During the decade 1999-2009, the virtual monopoly of the top five banks in rural banking remained intact with a minimal decline of share from 90 per to 87 per cent, and this is combined with the fact that agricultural credit has declined in real terms[17].

This neglect of the agricultural sector is partly on account of the absence of any banking competition to secure a rural clientele and meet the huge unfulfilled demand that exists in the rural areas. The causal link between the uncompetitive market structure of rural banking has remained hidden from public view because this market has not been defined, identified and segregated as a separate market – least of all for data-provision purposes. As a result, it has never been realised that commercial banks cannot be compelled to operate in the rural agricultural market that they do not consider lucrative enough, unless there is competitive pressure to do so. The result has been that the then nationalized banks happily paid the penalty imposed by the Government for not meeting the quota of agricultural lending. By the same token, the current mandatory requirement of having 20 per cent of new branches in rural areas, is also unlikely to be effective.

The second competition issue is reflected in the indifference of commercial banks to provide credit to the SMEs who often lack collateral and adequate business records[18]. An SME loan has not been regarded as a product distinctly separate from a larger-sized collateralized corporate loan. In the absence of any competitive compulsion, the incentive structure of the banking system simply does not cater to the needs of the agriculture and SME markets. The problem might be amenable to solution by allowing, and perhaps encouraging, enterprises from outside the banking industry to enter this market. However, this is bound to create major regulatory issues for the State Bank and is unlikely to happen in the near future.

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[14] This highly skewed distribution is reflected in the number of bank branches: 2,580 branches for the 105 million rural population which translates to 42,000 persons served (on average) by a bank branch.

[15] The loans given out by a rural branch were one-tenth the level of an urban branch (in one of the five leading cities), while deposit mobilization was one-fifth.

[16] According to the State Bank In 1999, 78 per cent of bank deposits accrued from urban areas and 22 per cent from rural areas. This ratio worsened in 2009 to 90:10. In 1999, loans and advances in urban areas were 89 per cent of total lending, while rural lending was 11 per cent. In 2009 this ratio had worsened to 93:7. In 1999, 50 per cent of bank branches were located in rural areas (3,529 rural branches, 3,513 urban branches). Ten year later (2009) the share of rural branches was only 31 per cent.

[17] These five banks are Habib Bank, National Bank of Pakistan, United Bank, Muslim Commercial Bank and Allied Bank.

[18] The World Bank study (2009) on 'Bringing Finance to Pakistan's Poor', Finance and Private Sector Development Unit, Washington, DC.

An almost identical case pertains to housing finance, in particular the total denial of funding for low cost housing (construction, purchase or renovation). This is the result of an extraordinary institutional and, indeed, systemic failure in every segment of the country's financial system. Not to speak of the complete absence of competition in this market, there has not even been a mortgage bank or building society that caters exclusively to the small/middle class housing needs (SMH) other than the House Building Finance Corporation[19]. It is remarkable indeed that the banking system has failed to cater to the financing needs of such an important segment of the credit market in the country.

Thus, in each of the three product markets – agricultural credit, SME financing and housing finance - the solution to the chronic problems of policy neglect and bank complacency (in large part a reflection of indifference to competition requirements) must be sought outside of the banking industry. No amount of exhortation or incentives to commercial banks has worked for the past 60 years because, for commercial banks, the opportunity costs of entering these three markets are clearly much too high. This is because the existence of 'monopoly rents' in the shape of high spreads between deposit and lending rates accruing elsewhere in more lucrative markets from which there is no competitive compulsion to diversify out of mean that major chunks of economy have been effectively ignored by the banking system. The obvious solution thus is to open these three product markets to institutions other than commercial banks, such as NBFIs, and *allow them to judge the level of risk* they are prepared to take and at what cost. The State Bank as a regulator should concern itself with the safety of deposits, not how the deposits are converted into assets.

The report on the banking sector that the CCP has produced also deliberates upon a number of indicators and respective values used in the cross-country comparisons to gauge the efficiency of Pakistan's banking system. The H-Statistic at 0.47 illustrates medium competition in the country and in terms of the World Bank's efficiency index Pakistan is ranked fifth; in equity market turnover Pakistan is ranked first in the world. However, the interest rate spread comes out to be the best index of efficiency of financial intermediation by the banking system and is a proxy indicator of competitiveness despite measurement problems. According to the State Bank:

> "The presence of high banking spreads generally give rise to policy issues regarding the competition in, and efficiency of, the banking sector. Lack of competition in the banking sector allows banks to maintain high spreads and extract above normal profits. This does not bode well not only for the overall efficiency of the banking sector, but also for its long-term sustainability."[20]

Although the accuracy or comparability of the exact statistical value of the NIM (net interest margin) or of the

Interest Rate Spread (percent)

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Average yield on earning assets (a)	14.0	12.7	11.3	11.2	8.7	5.7	5.0	7.5	9.1
Average cost of interest liabilities (b)	8.5	7.7	6.6	6.1	4.3	2.0	1.5	2.6	3.9
Spread (a-b)	5.4	5.0	4.7	5.1	4.5	3.8	3.5	5.0	5.2

Source: State Bank website www. sbp.org.pk

[19] Set up in 1952 as a statutory body, HBFC functioned as another Government bureaucratic entity, oblivious of market needs of mortgage finance. Its management was outside the purview of the State Bank of Pakistan. HBFC's share in nation-wide housing advances was only 18 per cent.

[20] "Efficiency of Financial Intermediation: An Analysis of Banking Spreads", *Financial Stability Review 2006*, pp. 29, State Bank of Pakistan.

It is generally accepted that, in addition to macroeconomic factors such as GDP growth, inflation and changes in monetary policy, the most significant determinants of interest rate spreads are the extent of competition in the banking industry and the income and cost structures of the banks. The root causes of the high interest rate spread lie in the opaque nature of banking itself and, in particular, their rather high administrative costs and provisioning for NPLs (non-performing loans), negative real deposit rates, the extent of cross-subsidisation between products and the prevalence of non-competitive regimes in the sector. Full public disclosure and operational transparency are not only essential regulatory requirements, but they are also the *sine qua non* for competition. The most glaring lack of transparency lies in the cartel-like fixing of interest rates on deposits. Insofar as regulatory requirements are concerned, the State Bank concedes that its mandatory reserve and capital requirements are restrictive of competition, but it cannot ease these restrictions in the interest of systemic stability.

The current thinking in the State Bank appears to favour the standardization of several services charges such as issuance of bank drafts, pay orders, etc. However, due to this recommended uniformity, the difference between desirable standardization and undesirable collusion is likely to become blurred. It might therefore be more sensible to let individual banks fix their own charges. The State Bank has also stipulated a minimum floor of 5 per cent profit on savings/PLS accounts. Such policy guidelines and quota allocations are almost certainly going to distort natural forces of competition rather than oblige commercial banks to re-allocate their resources and entice customers with better profit rates. This direct policy intervention militates against the principle of allowing free market competition to determine interest rates. Accordingly, due to lack of competition, Pakistan's November 2005 concept of “basic account” has only achieved limited success.[21]

In tracing the genesis of commercial banking in Pakistan from the vacuum of 1947 to the crafting of financial institutions, beginning 1948 (founding of the State Bank and in 1951 of the National Bank of Pakistan), followed by a decade of rapid financial development (1959 – 1969) that spawned the political turbulence of 1969-1972, which was, in no small measure, the result of a growing concentration of financial and industrial wealth in one segment and in one geographical market the banking system has survived - even though it had to be nationalized. Defenders of the system can legitimately point towards this continuing 'stability' as justification for the tripartite *contract* between the Government, the regulator and commercial banks through which the system has been propped up.

Further evidence of this implicit contract is furnished by the cartelization of banks sponsored by the State Bank itself over the years. This cartelization goes back to the 1950s. Price fixing has not only been the norm, it has been espoused as a desirable practice. Conspicuous instances include the 1959 Inter-Bank Agreement and the micromanagement of deposit rates by the State Bank and more so in the unabashed promotion of banking agreements, including mergers, by the State Bank throughout the 1960s. The implicit collusion and cartelization of the 1950 and 1960s was replaced by complete nationalization and state-control for the next twenty years. During these years of state monopoly, stability was ensured not through the State Bank of Pakistan but by a parallel regulatory body - the Pakistan Banking Council that stifled all possibility of any independent action by any bank and kept competition away from all commercial banks which came under its protective umbrella. This protection continued even in the post-nationalization period. Having allowed private banking entry in 1991, the Government placed a moratorium on further entry in 1995. The incumbents were further protected after 1997 through increased capital adequacy ratios and minimum capital requirements. During the last decade, these entry-deterring requirements have been further fortified in a quest for consolidation. A fresh moratorium has been placed on new entry. The MCR is being raised continuously every year, in accordance with an announced schedule through 2013, to eventually squeeze out the smaller banks in a supposedly risk-reduction exercise based on the comforting premise of exploiting economies of scale but simultaneously fortifying the perception of banks being *too big to fail*.

[21] Such accounts could be opened with a deposit of Rs 1,000 and would have no requirement of a minimum balance or

This leads to the inescapable conclusion that the present banking structure, as mandated by the State Bank, is one that openly requires and promotes the consolidation of banks. Whatever it's other merits, consolidation inhibits competition. Indeed, the current structure of the banking system has not evolved as a result of competition. On the contrary, the failure of competition is itself a result of the promotion and perpetuation of this structure under the quest for stability. For instance, the neglect in providing agricultural credit and lack of transparency in deposit-taking from smaller depositers and from the rural areas is attributable to it. From a public policy perspective, of which competition policy is a component, it is important to recognize that stability has come at a cost, such as limited access to banking services for large segments of the economy and population. Indeed, it may even have had the effect of reducing stability by increasing the likelihood of moral hazard if 'too big to fail' is taken literally by one or more of the biggest banks in the country.

C. Electricity

Electricity is undoubtedly a key element in the growth of any economy. However, the overall energy sector, and particularly electricity, has been dominated traditionally by monopolies or near-monopoly enterprises, typically owned by the Government in most developing countries.[22] This was true till the late 1980s when Governments across the world realized that the ever-increasing need of capital resources for investment in new capacity and for improvements in efficiency necessitated that, wherever possible, utilities be wholly or partially privatized and put under the purview of a dedicated regulator.

Simultaneous developments in IT have allowed the unbundling of public utilities so that the old model of a single monolithic generator and retail distributor of electricity is no longer *de rigueur*. Several key elements within the old monopolistic structure can now be separated and given over to competing interests. There are competitive electricity markets in many countries, both developed and developing, and the power sector in Pakistan is also undergoing a dramatic transformation. Vertically integrated utilities, which had been dominant until recently, are now being unbundled and made to function on the basis of market-clearing mechanisms, although some degree of subsidization of electricity prices continues. The first major step towards the introduction of a more market-oriented structure in the power sector was adopted by the Government through a strategic plan introduced in 1992. The salient features of the strategic plan were:

- Corporatization and privatization of the Water and Power Development Authority (WAPDA) into separate generation (PEPCO, DISCOs and IPPs) and distribution (NTDC) companies
- Developing the outline of a competitive, modern and dynamic power sector, which meets the needs of consumers in the cheapest and most efficient manner
- Creation of an independent regulatory authority to provide a level playing field to potential

In line with the strategic plan, an independent regulatory body in the shape of National Electric Power Regulatory Authority (NEPRA) was created through an Ordinance in 1995 and later promulgated through an Act of Parliament in 1997 (the NEPRA Act XL of 1997).

At present, out of total generating installed capacity of 19,552 megawatts in the country, the available capacity for PEPCO and NTDC is around 13,500 megawatts whereas for KESC, it is around 1300 megawatts. The average maximum demand placed on the system during the summer months of 2009 was 16,500 megawatts and 2,300 megawatts (approx.) for KESC. This resulted in a total demand of 18,800 megawatts. Thus, the shortfall recorded in meeting maximum demand was around 4,000 megawatts in 2009.[23] This is expected to grow in the coming years if substantial new generating capacity is not set up. The available generation mix in Pakistan summarized in the table below:[24]

[22] Direct public management has given way to corporatization in which the enterprises are run as commercial enterprises though still owned by the state

[23] Source: Daily log sheet CPPA

[24] Source: Daily log sheet CPPA plus KESC Presentation

Type	Capacity (megawatts)	Percentage
Hydel	6550	33.5
Oil	6900	35.3
Gas	5600	28.6
Nuclear	452	2.3
Coal	50	0.25
Total	19552	

It should be noted that the available generating capacity does not remain the same throughout the year. In fact, it is principally dependent on the availability of water for hydel generation. Pakistan has peak hydel and peak thermal seasons. During the peak hydel season, maximum hydel energy is available. This season generally lasts from June/July to October/November. Peak thermal season is that time of the year when hydel generation is at its lowest and therefore thermal plants have to be utilized to generate the shortfall in electricity. This season generally lasts from December/January to April/May. During this period, a shortage of capacity amounting to around 4000 megawatts has been observed. In the context of this quite substantial demand/supply gap a debate about the efficacy of the regulatory setup in fulfilling its mandate in light of its statutory responsibilities and powers has acquired an understandable urgency; i.e. the performance of NEPRA. The argument is that NEPRA, unlike the PTA, has failed to create an appropriate mix of incentives through which the country could have benefited from a secure supply of electric power once the monopoly of WAPDA came to an end.

Regulation by NEPRA

NEPRA has been the exclusive regulator for the provision of electric power services[25] and is the authority that awards licences for the generation of electric power. All decisions vis-à-vis the location of plants, technology, tariffs etc. are decided by NEPRA as well.[26] In addition, PEPCO the sole purchaser and NTDC the sole transporter of electric power within the country (except for the franchised area of KESC) have been mandated to develop a low-cost expansion plan for capacity addition and transmission in the country.

All distribution companies (DISCOs) have been allotted a franchised area within which they may operate. Proposals are under consideration by NEPRA for allowing bulk power purchasers (BPCs) within the franchised territory of a DISCO to undertake power supplies.[27] The break-up of WAPDA was based on the assumption that while competition within a natural monopoly market is costly it is nevertheless possible to set up competition *for* entry into the market.

The basic assumption of electricity networks being assets, which are huge and un-economical to be replicated, has led to the approach where different firms compete to distribute 'goods and services' via the same infrastructure - for instance, different electricity companies competing to provide services to customers over the same electricity network. Government intervention to break up the vertically integrated monopoly of WAPDA and the generation sector has been separated from distribution and transmission. Here, the key element is Open Access, i.e., the ability of any firm to have access to the network to supply its service, with the price the infrastructure owner is permitted to charge being regulated, also commonly known as the use of system charges developed by NEPRA.

Such a system may be considered a form of deregulation but in fact it requires that the regulator set up a new system of oversight rather than simply remove the existing legal restrictions. The system may also require continuous fine tuning, for example, to prevent long-term contracts from reducing the flexibility of the generation market too much, or to ensure that the correct incentives for long-term security of supply are present.

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[25] Taken from Section 7(1) of the REPA.
[26] Rule 3(5) of the NEPRA Licensing (Generation) Rules, 2000.1q
[27] Though it is another debate that REPA recognizes bulk power consumers only, who by definition purchase power for their own consumption and not for further sale.

A competitive electricity market in Pakistan

Generally speaking, the literature on electricity markets suggests that these are characterized either as supply-driven or as demand-driven markets. For supply-driven markets, the available capacity of generation is more than the demand. For demand-driven markets, it is the other way round and the total demand on the system outstrips the available capacity. It is advisable that the entry point to a competitive mode should be at the time when demand at least meets supply. Alternatively, competition should be introduced in such a way that it should be for that period of time when there is some excess capacity in the system for trading and meeting demand through competition.

Over the years, the following types of electricity sector have existed in Pakistan:

- Vertically integrated monopoly of WAPDA to provide retail and wholesale service subject to no competitive pressures
- Vertically disintegrated WAPDA monopoly over retail service, subject to some competitive pressures, with exclusive retail service territories for each of the distribution companies[28]

In order to establish parity with the IPPs all extant thermal power generation has now been restructured and four corporatized companies have been established namely:

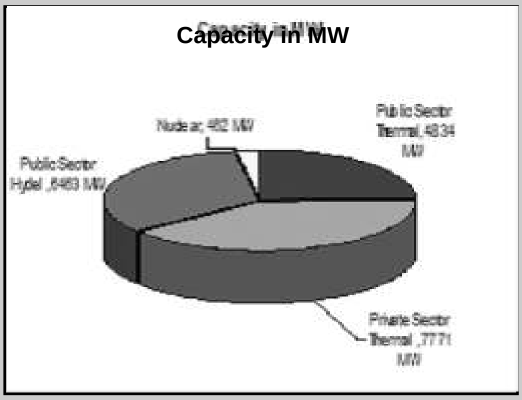
a. Jamshoro Power Generation Company Limited (GENCO-1), with its headquarters at Jamshoro district Dadu near Hyderabad Sindh,

b. Central Power Generation Company Limited (GENCO-2), with its headquarters at Guddu district Jacobabad Sindh,

c. Northern Power Generation Company Limited (GENCO-3), with its headquarters at Muzaffargarh, and

d. Lakhra Power Generation Company Limited (GENCO-IV) with its headquarters at Khanote (Sindh)

Power Sector - Total Installed Capacity



Public Sector	MW	%
WAPDA	11297	58
PAEC	462	2
Sub-Total	11759	60
Private Sector		
IPPs	6045	31
KESC	1156	9
Total	19560	

[28] The Fundamentals of Electricity Law by Scott Hempling Attorney at Law www.hemplinglaw.com

An adequate power supply is necessary to achieve sustainable economic growth. Presently, only 65-70 per cent of Pakistan's population has access to electricity. It is expected that demand will exceed supply by about 5,500 megawatts in 2010. The present electricity demand-supply gap, coupled with steady growth in electricity demand (6-7 per cent per annum), indicates the fundamental and increasingly urgent need for enhancing the country's power generation capacity.

The CCPs broad assessment of the electricity sector is that despite the fact that the sector is highly regulated, the declining performance levels in the sector and of related institutions call for an early introduction of more radical measures to improve the situation. One such measure is a genuinely competitive market in which operators can bid to supply electricity to the national system. In the absence of an environment where neither PEPCO nor the DISCOs are genuinely free to enter into contracts to satisfy the load demand of their consumers, any alternative means would be in the nature of compromises and likely to be 'second best' solutions and less cost-effective, inviting the intrusion of *ad hoc* considerations in decisions that usually have no rational basis. These, in turn, lead not only to long delays in licensing new capacity but mistakes as well.

At present the Power and Infrastructure Board has allowed approximately ten new Independent Power Producers (IPPs) with a capacity of 2,200 megawatts. These have initiated project construction after receiving tariff approval from NEPRA. These Independent Power Producers are sponsored by both local and foreign investors. The Power Policy is projected as an investor-friendly policy that offers an attractive set of fiscal and financial incentives to the private sector, claiming to provide a balanced risk profile for investors, lenders, and Government agencies. The Government of Pakistan guarantees the performance obligations of the power purchaser and the provinces and provides protection to sponsors and lenders should the project be terminated. Typically, a long-term tariff of 25 to 30 years is contracted with the power purchaser, which minimizes the IPPs' market risk in terms of output sales. The tariff is determined on the basis of fixed capacity payments, regardless of the dispatch of power by the purchaser and variable energy payments based on the number of units dispatched and the prevalent fuel price.

The projects are put together in such a manner that they should earn a stable return on investment. All relevant terms and conditions are cast in the form of standardized and tested agreements – namely, the Implementation Agreement (IA), the Power Purchase Agreement (PPA), the Fuel Supply Agreement (FSA) - are known prior to final agreement, which provides for any variation in the price of fuel to be passed on to the power purchaser, any additional taxation over and above the tariff assumptions is likely to be passed on to the power purchaser, indexation for variation in the rupee-dollar exchange rate, protection against any change in duties and taxes and against specified “political risks”. This new generation of IPPs does not appear to have taken into account the fact that a major restructuring of the power sector is likely to take place and another spell of 25 to 30 year long term contracts amounts effectively to an attempt to delay the introduction of genuine competition in the market for another two decades or so. This view is based on the abject failure of the existing system to provide affordable electricity to meet peak demand in the country.

The argument behind the introduction of competition in the power sector rests on the need to undo the monopolistic attitudes and practices of service providers. Generating companies having locked into long-term supply contracts then focus exclusively on their financial performance and, hence, are incentivised indirectly to cutting costs, inevitably relegating into the background the needs of end-consumers. All fixed costs are met through their guaranteed capacity payments and are not affected by rising fuel prices as these are a pass-through in the form of variable energy payments to be made each time an IPP generates and sells electricity. Yet, current mechanisms have made the long term contracts inflexible so that the demand-supply gap has further widened in the wake of the increase in power requirements as neither investment in new capacity has taken place nor has existing capacity been fully utilised.

Ensuring balance between consumers and producers of electric power

The true role of the regulator should be to balance the interests of the producers and consumers of electric power. In Pakistan, over the years, the sole emphasis on power generation under the 1994 and 2002 Power Policy as a means to attract foreign direct investment, did not allow much room to cater for real consumer interests in the overall bargain. Different avenues to ensure that a balanced decision is undertaken by the regulator are embedded in the legislation and other applicable documents developed thereunder.[29] Accordingly, Section 2(iv) provides a specific definition of a consumer as a person who purchases or receives electric power for consumption. Under section 39(1), 'any interested person' may submit a complaint, which may include an ordinary consumer. The same spirit prevails under the Tariff Rules, 1998 whereby consumers have the right to file interventions before the regulator at the time of tariff determinations and participate in public hearings.

These interventions by consumers have been completely ineffective due to a lack of information and the complexities of the electric power business. Hence, while NEPRA took up the decision-making role in terms of tariff fixation and the grant of licences, the powers envisaged in the Act have not proved of much assistance as far as the consumers are concerned.[30] However, since strong and robust consumer interest groups are important forces for a regulator to arrive at balanced decisions, joint efforts need to be launched by consumer bodies and the regulator to act as more alert watchdogs to work for the development of a competitive power sector in the country in which producer and consumer interests are given appropriate weights.

Such balancing on the part of the regulator is of pivotal importance up to the time the competitive forces really establish their role in the market, which then devises its self-regulating mechanism to check any abuses by the suppliers. However, even at that stage, supervision by the regulator would be necessary to check any possible abuse by the service providers.

While drawing up a picture of the future power market, the regulator currently appears to have embarked upon the difficult job of countering the wayward behaviour of its licensees. The restructuring of WAPDA has led to the emergence of state-owned generation (GENCOs) and distribution companies (DISCOs), who are in competition with the IPPs. Thus, once the DISCOs are privatized, they too will notionally have competition among themselves in terms of the contracts they enter into with PEPCO. They will no longer be able to look to the Government for financial help. KESC, though an integrated utility, has already been privatized.

It is important that the regulator operates free from day to day Government influence and direction. Regulation by way of ministerial decisions – often in response to some short term issue - and/or Executive Order has the potential to compromise the regulator's independence and introduce conflicts with the overarching policy approach regarding independent economic utility management and regulation. In particular, there is the issue of regulatory capture, where significant business interests get into the regulatory bodies. Another source of Government intervention is that in Pakistan, the Government retains residual power to issue policy directives to the regulatory bodies, a provision which often distort the effects of their own policies and misaligns incentives between incumbents and newcomers.

Policy recommendations

The economy of Pakistan is capable of sustaining growth at about 7-8 per cent per annum over the medium term. Assuming this can be brought about, it is expected that by the year 2018 the demand on the electricity generating system would be double of what it is today and by year 2030, the expected demand on the system

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[29] It is an extraordinary fact that few law books contain an entry under the category of 'consumer'. As the consumer movement organizes and asserts itself there will then be an increased awareness and an effective incorporation of the consumer point of view. For the moment, however imperfect the present legislation, it is reassuring that a start has been made with consumer legislation and the incorporation of the consumer as an important stakeholder. An example is NEPRA, wherein the consumer is recognized as an affected party and therefore having a legitimate interest in the process of fixing the electricity tariff. *Consumer Laws in Pakistan* by Mohammad Sarwar Khan and Abrar Hafeez, pp. 6

[30] Section 7(6) clearly indentifies a balancing role for NEPRA, as it states,' ……In performing its functions under the Act, NEPRA shall balance the interest of all stake holders including the service providers and the consumers of electric power.' Please check the quote.?

would be around 75,000 megawatts. It is self-evident that a long term integrated energy plan needs to be developed for the next twenty-five years, with an emphasis on developing a mix of primarily indigenous resources to generate electricity so as to ensure the anticipated growth of the country's economy without massively increasing the import bill. The broad framework that should be followed is the telecommunications sector in which the private sector has successfully provided low cost mobile telephone services to the country in abundance. This positive outcome has been partially, if not mainly, predicated upon a conducive overall regulatory regime and the incentives it has provided to the mobile telephone operators *within a competitive framework*.

How might the telecommunication model be replicated in the electricity sector? Within NEPRA, a system of regulatory benchmarks, including checks and balances, needs to be developed in order to ascertain as to why chronic gaps of such a large magnitude in capacity have come about and what role, if any, has been played by its overall policy framework and pricing policies. Here, of course, the situation calls for the true independence of the regulator in decision-making. Arm's length, i.e. unbiased decisions can only be taken by the regulator if it is free from outside interference and is composed of persons who are experts in their field, capable of choosing between different options on a professional basis. Above all, a standardized contract document between the IPPs and PEPCO needs to be developed so that entry, operations and exit from the sector can be properly evaluated by potential investors in the sector on a predictable legal basis and contractual obligations and outcomes fully understood by them.

It is noteworthy that although Pakistan is a major capacity deficit electricity market it is currently only adding small plants as base load plants. This is a development that is almost certainly going to be detrimental to the system in the long run as such investments tend to be high cost and do not generally use the most up to date technology. It has to be stressed that many developing countries, including some with major financial constraints, have achieved far more beneficial outcomes by introducing a competitive framework for the provision of post-privatised utility services by private investors or by public-private joint ventures. One facet of this has been the unbundling of generation from transmission and billing. This has already happened in Pakistan to some extent but effective financial separation is still some way off. A second facet has been encouraging participation by different investors using a diversity of fuel sources for generation and specifying minimum scales of production. In addition, separate entities have been involved in reducing line losses (rather similar to the special arrangements made for banks when bad debts have to be recovered). Combining all three elements in a competitive framework which combines incentives and safeguards would thus involve the following:

Complete legal and functional separation of electricity generation and distribution and a system of 'ring fencing' the cash flows between the electricity providers and the final consumers so that the chronic problem of circular debt can be contained, if not eliminated, over the next two or three years. In this regard, NEPRA might temporarily lower the threshold and make available open access to all new investors, both in distribution and transmission, so that a wider pool of participants can be brought into electricity generation and transmission. Within the available capacity, moves to the market thus far have been cautious, as the current available capacity cannot meet peak demand even on the most optimistic assumptions of improved generation and reduction of line losses. Consequently, for competition during off-peak hours, real time studies and more flexible pricing are required for optimal *demand-load management* which can reduce demand by as much as 15-20 per cent. Merely because there is not enough capacity, progress towards the induction of competition in the sector should not stop, as it provides the ultimate solution, already realized by many other developing countries. Commencement of limited trading of bulk electricity at different times of the day (say, by PEPCO) could be a key in the present crisis which may allow the phased introduction of effective competition in the sector. Such innovations could eventually be extended to all contracts once the electricity market is large enough to operate as a single entity.

In this regard, the determination of tariffs for each consumer category tend to create a number of distortions which discourage the efficient usage of electricity and forces the provision of power at a cost which is below the cost of its generation especially for smaller consumers. The ensuing subsidies are delivered in a manner that carries no analysis over their impact on the overall electricity generation system or on other consumer categories. Here, it is pertinent to emphasize that in creating a subsidy regime the regulator and other stakeholders need to be informed of its overall objectives and priorities. In this way the cross-subsidization involved would help in determining average tariffs that would be more stable *as price signals* and thus more conducive to the long term development of the sector. Further, the subsidy policy should be prepared after consultation with the various stakeholders.

The power sector in Pakistan has taken the path of deregulation through a body outside the Ministry, NEPRA, so that the new regulatory regime can help incentivise investment in the sector, similar to the telecommunications sector. However, progress so far has been very slow to say the least. The response of both the Government and NEPRA appears to be focused exclusively on capacity addition. But, mere capacity addition is unlikely to alter the cost-effectiveness and economics of the power sector in Pakistan over the long term. The Government needs to handle energy policy issues in a dispassionate manner and an independent regulator is clearly a central feature of its approach. The regulator, for its part, needs to articulate a realistic framework of objectives and priorities, an essential first step in making the electricity sector self-sufficient in the short term and, more important, capable of meeting the long term electricity needs of the country.

D. Telecommunications

Efficient and low-cost communication in an economy is a cornerstone for smooth information flows and for keeping the cost of transactions low. Telecommunications in today's age has made a transition from being a luxury good to a basic necessity available to all. It has enabled easy access for individuals and companies and has facilitated the exchange of critical information which has helped markets function more efficiently. Elementary economic thought classifies informational asymmetries and rents as one of the foremost reasons for market failure. Any mechanism that reduces such hindrances is a move towards more efficient markets, lower transaction costs and a more efficient allocation of resources.

Over the last decade, telecommunications in Pakistan have provided such a platform. A recent World Bank research predicts that a 10 per cent increase in teledensity can lead to a 1 percentage point surge in growth rates for the whole economy.[31] In 2004, Pakistan had a 5 million cellular subscriber base. The market leader, Mobilink possessed a 64 per cent share in this market, while the government-owned PTCL subsidiary, Ufone had a 16 per cent market share. In 2004, two additional licenses to set up cellular networks were issued at a price of $ 300 million each. Warid Telecom, an enterprise owned by the Abu Dhabi Group and Telenor, a Norwegian telecommunications service provider purchased these licenses and initiated the setting up of cellular networks across Pakistan. To complement this, Ufone was privatized. Entry by these new firms signaled a major shift for the telecommunications industry and the next few years witnessed phenomenal growth in cellular subscribers across the country as depicted by the figure above. The telecom revolution encompassed both urban and rural areas alike. Indicative of the scale of this exponential growth is the fact that Pakistan has gone from a subscriber base of 5 million in 2004 to 95 million in 2009, an almost 20-fold increase in the relatively short span of five years. This translates into a tele-density of more than 50 per cent. Entry into this market is suggestive of how new dynamic firms can completely change the structure and economics of an industry.[32] As of 2009, Mobilink had a 32 per cent market share while Telenor had managed a 23 per cent share, with both Ufone and Warid possessing almost 19 per cent each of the cellular market.[33] In a nutshell, the accompanying figure suggests the evolution of a bigger, more evenly distributed pie; a win-win scenario for all parties involved and competition has played a major role in this.

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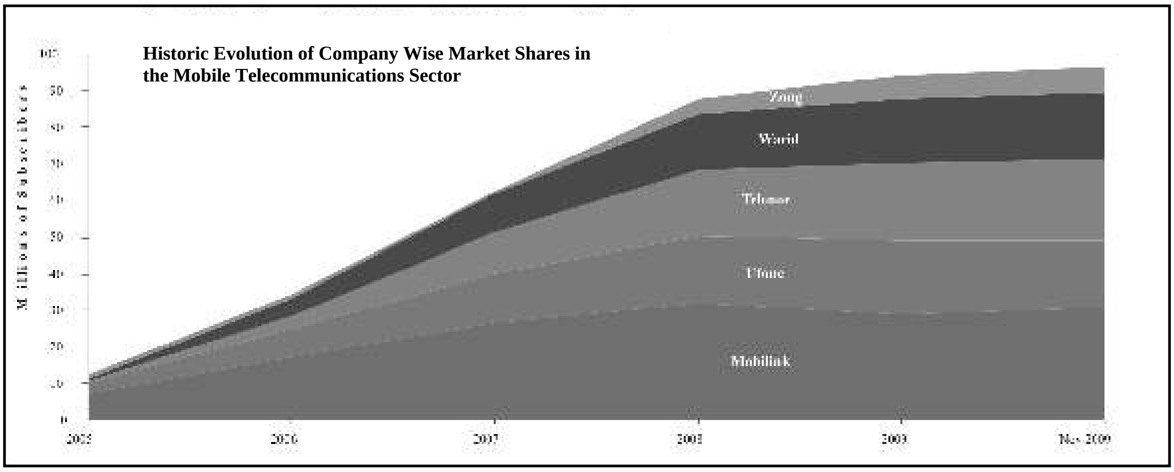
[31] A special report on telecoms in emerging markets, The Economist, Sep 24th 2009, available at: http://www.economist.com/specialreports/displaystory.cfm?story_id=14483896&source=login_payBarrier

[32] FDI in telecom sector was merely 1.26 per cent of the total FDI in the country. This share reached its peak in 2005/06 of 54 per cent and now stands at just under 28 per cent. http://www.pta.gov.pk/index.php?option=com_content&task=view&id=648&Itemid=600

[33] Market shares, number of subscribers and annual growth rates have been taken from the Pakistan Telecom Authority website: http://www.pta.gov.pk



It is understandable that such a major shift in the industry came with a corresponding movement in prices. At the time when Mobilink was a dominant player in the market, prices had reached as much as Rs10,000 per connection and a thriving black market existed as demand routinely exceeded supply. Presently, a new connection costs a meagre sum of Rs 150, which too is waived off indirectly on certain occasions. Rates for airtime were about Rs 5 per minute which have come down to about Rs 0.9 per minute. Factoring inflation, the real price of airtime has thus come down to almost 10 per cent of the 2004 level. An intense price war is a norm in the industry and competitive pressures have significantly reduced margins for the service providers.

It is pertinent to recognise that although Mobilink's share has halved in these five years, it has still managed to register impressive growth in its subscriber base. The subtle point that the CCP as an organization strives to make is that it is enhanced competition in a sector that has improved outcome. It was by virtue of the entry of new competitors that Mobilink took on the expansion of its services. The experience in other sectors of the economy leads us to make the apparently counterfactual claim that had new entrants not entered the market, the sector might still have been marred by exorbitantly high prices and excess demand.

Despite these positive features, the telecom sector still presents issues with regard to anti-competitive practices. In fact, CCP has noted and taken action against such practices. Recently, CCP on the indication of parallel pricing behaviour in the sector conducted an enquiry to investigate the incidence of collusive practices. The investigation indeed revealed price fixing arrangements, especially on balance enquiry charging (Rs.0.10/request) which was simultaneously introduced by four separate service providers.[34] Crucial information on the collusive forum of interaction between CEOs and high level employees was received through an informant under the Reward Payment to Informant Scheme introduced by the CCP. Such incentives become essential in the context of identifying and establishing evidence against cartels which otherwise remain elusive. Based on the enquiry report, legal proceedings against the companies were initiated.

CCP had also investigated earlier a case related to the tying of products and services. The market leader (Mobilink) provided three products and services: a BlackBerry device, internet communication and mobile communication. The company charged for each of these products separately. However if a subscriber gave up one of these three products, he was denied usage of all three. This was implemented through a locking mechanism on the Subscriber Identity Module (SIM). CCP acted against this anti-competitive practice which essentially limited consumer choice. Mobilink made the case that tying was necessary as the company was providing a subsidy on the BlackBerry device. In the CCP's order, Mobilink was instructed to clearly disclose the amount of subsidy to the customer at the time of the contract and include an exit clause for customers.[35] In addition, the order also instructed the Pakistan Telecommunication Authority (PTA), the regulator of the sector, to formulate a policy for the SIM locking of handsets.

[34] Enquiry report is available at: http://www.cc.gov.pk/Downloads/Telecom-latest-04-02_2010.doc
[35] See http://www.cc.gov.pk/Downloads/Mobilink_Order.pdf, for Order of the Commission.

Marketing presents another area of competition-inhibiting concerns. The telecommunication industry makes extensive use of marketing to promote its products as well as for enhancing brand image. In such an environment advertisements are prone to become deceptive marketing practices. One such case deliberated by CCP was an advertisement by Zong for the company's '8 Aanay per Call' promotion.[36] CCP took *suo moto* notice of the advertisement as being misleading regarding the exclusiveness or inclusiveness of Government taxes in the advertised price. CCP in its order also noted that the duration at which call rates were applicable had not been clearly communicated in the advertisement. Zong ceased airing the advertisement after the order and CCP refrained from imposing any penalty.

What the telecommunication explosion has meant for the macro economy is that a cellular phone is a device that almost anyone can own and use in Pakistan. Cellular phone penetration has certainly reached a stage whereby effects on overall economic activity can be felt as posited earlier in the section. Exchange of information is much easier, which has reduced the cost of doing business for entities as well as individuals. A salesman does not need to make unnecessary visits as he/she can screen clients before visiting them, hence reducing fuel expenditure. A farm owner does not need to visit his farm everyday as he can get updates on his crop via the phone. Many others – electricians, plumbers, carpenters - who could not be reached if they were away from their places of work can now be routinely contacted. These are all examples of how trivial everyday activity has been facilitated by ease of communication, which is bound to improve economic performance at the macro level. However, despite these seemingly beneficial results, regulatory bodies and the Government constantly need to be vigilant about competition-related issues in this crucial sector as a move in a non-competitive direction can easily nullify progress previously made.[37]

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[36] Commission's order is available at: http://www.cc.gov.pk/Downloads/ZONG per cent20- per cent20Order per cent20- per cent2029-09-09 per cent20.pdf

[37] A possible grey area in the sector may include the long friction between PTCL and the internet service provides as shown by several items at: http://www.ispak.com.pk/documents_library.php

Chapter 04

State of competition: large-scale manufacturing

State of competition: large-scale manufacturing

In the previous chapter an attempt was made to examine competition issues in services and utilities. In this chapter the examination is extended to large-scale manufacturing. Large-scale manufacturing is a segment of the economy where competition should be the prevailing norm according to text book analysis. This segment of the economy, unlike utilities, is not characterized by one or two relatively big producers, nor is it under the oversight of a regulator having been recently unbundled and privatized. Furthermore, unlike banking services where complex issues of public confidence in the financial system and questions of moral hazard tend to loom large in any discussion of competitive rivalry, large-scale manufacturing should be characterized, in theory at any rate, by the presence of many producers and distributors operating, in principle, on the basis of contestability at different points in the value chain. However, large-scale manufacturing also produces outputs that are highly standardized (cement and sugar) and/or have a very low elasticity of demand (fertilizers) and these traits inevitably provide room for anti-competitive conduct to take place. The CCP has thus been alive to the likelihood of competition vulnerabilities in the form of cartelization, parallel pricing and abuse of dominance occurring in this segment of the economy. The following discussion highlights the main competition issues that CCP has identified.

A. Automobiles

The automobile industry in Pakistan has played a significant role in the country's recent economic growth contributing through upstream and downstream activities to manufacturing, employment, technological capacity and finally in the transport area. In Pakistan, the sector has grown at a rate of 30 per cent per annum, contributing about 4 per cent to manufacturing output.[38] The nine assemblers involved in the assembly/manufacture of cars in the country have a capacity of 275,000 units and with a capital investment of $1.5 billion (both assembly and auto parts), the sector provides direct employment to 5,600 workers. In addition, the auto parts vendor industry has 2000 units and has created more than 140,000 jobs (not including the substantial employment generated in informal roadside repair shops).[39]

In terms of concentration, the sub-sectors - cars, buses, trucks and motorcycles - all are highly concentrated with production dominated by a handful of companies – Pak Suzuki Motor Company Ltd, Indus Motor Company Ltd, Honda Atlas Cars (Pakistan) Ltd. and Dewan Farooque Motors Ltd. This is reflected in the high value of the Herfindahl-Hirschman Index (HHI).[40] The automobile market can indeed be characterized as one of 'non-competing' goods highly segmented in terms of product specifications - each segment catering to the needs of a discrete customer group. Other than Suzuki (which concentrates in the small car segment and accounts for about 47 per cent of the total cars' market), the other assemblers operate at very low levels only relying upon the tax benefits provided by the tariff regime which favour the import of cars in CKD rather than built-up condition.[42] It would appear that global manufacturers like Toyota and Honda, the only domestic assemblers of cars in the 1300-

HHI[41]

Categories	2007-08	2008-09
Cars	4719	3911
Trucks	3358	3713
Buses	6304	6226
Pick-ups/LCV (4x2)	4222	6222
Farm tractors	5004	5000
Motorcycles	5141	5248
Jeeps & LCVs(4x4)	9529	10000

[38] Pakistan has one of the lowest car:person ratios amongst emerging economies – 9 cars per 1000.. In the industrialized countries, for instance, Germany motor vehicles account for about 14 per cent of manufacturing, and in Canada automobiles and auto parts for more than 30 per cent of the total exports.

[39] http://www.autoasia.com.pk/aims_and_objectives.htm

[40] HHI measures the size of individual firms in relation to the industry and indicates the amount of competition among them. HHI greater than 1800 depicts market to be highly concentrated, hence less competitive in nature.

[41] The calculations are based on the data available at: http://www.pama.org.pk/historicaldata.htm

[42] CKD stands for completely knocked down.

1800 cc category, are in Pakistan more to retain their presence here rather than for any substantial commercial reasons. Based on current economic fundamentals, the market – at full potential – is not attractive enough for new entrants in vehicle assembly/manufacture. This may explain, to some extent, the high concentration ratios e.g., jeeps reflect absolute dominance with an HHI of 10,000.

In Pakistan, overall car ownership is still quite low as demand is restricted to the middle and upper income groups even with the more ample availability of car finance and leasing. However, in terms of growth - the sector depicts a steady upward trend in the sale of all automobiles. This increase began around the year 2000 and peaked in 2008, mainly subsequent to economic growth close to 6 per cent per year during this period and the large expansion of car financing through banks.[43] On average, cars, motorcycles and trucks have shown almost a five-fold increase in sales between 2000 and 2008. Thereafter, economic conditions have led to a decline in sales but demand picked up again after April 2009. Sales surged by 34 per cent during July-December 2009 to 48,344 units as compared to 36,079 units in the same period of 2008. Though an increase in the volume of automobiles sold paints an optimistic picture closer analysis of the sector reveals a range of impediments to its long-term growth, the most significant of which is the absence of competition, as described in the paragraphs to follow.

The car market is clearly segmented into three main categories of products: i) 800 cc, ii) 1000 cc, and iii) 1300/1600 cc. Market shares are highly concentrated for cars generally, and more so within these segmented product markets. The 800cc market is dominated by Suzuki (Mehran) and in fact until 2000 was the sole producer. Diahatsu (Cuore) entered the market in 2000, and managed to capture roughly 20 per cent of the market. The 1000 cc market is similarly dominated by Suzuki. Hyundai (Santro) entered this market in 1999 and steadily grew to a 27 per cent market share in 2003/04. Since then Suzuki has regained its lost share and now has about 95 per cent of the market.

As the competition law clearly states, dominance is not an issue *per se*. The most common concerns arising out of a dominant position are the perverse incentives it sets, retarding innovation and enhancing the possibility of the abuse of dominance. These concerns manifest themselves especially in the 800 cc and 1000 cc markets as the dominant player has rarely introduced new models.[44] In the absence of effective competition, consumers are deprived of improved products and a wider range of choices to select from. Similarly, the 1300 – 1600 cc market for cars is dominated by two producers. Until 1998, Toyota (Corolla) was the only producer of automobiles in this category. Since then Honda (Civic and City) have entered this market and managed to acquire a significant market share. It briefly overtook Toyota in annual sales during 2004/05. This is quite a significant development given that Honda achieved this at a time when the market was registering phenomenal growth. Toyota has managed to regain some of its lost share since then. Suzuki (Baleno and Liana) also entered the market and managed a 12 per cent share in the market in 2005/06, which has declined to less than 2 per cent now.

Prices of cars are illustrative of the dynamics of competition and market power. Parallel pricing has generally been the norm in the industry, which *per se* cannot be taken as a proof of collusive practices, though it does hint in that direction. Pak- Suzuki increased prices by Rs10,000-25,000 at the start of 2010 followed by Indus Motor Company which jacked up prices of Daihatsu Cuore and Toyota Hilux by Rs 20,000 and Rs 30,000.[45] Even before this, prices had risen steadily from 2000 to 2007. An increase in prices owing to an increase in demand for cars can be brought about by market forces *over the short term*. However, the trend in car prices since 2008 is what puts the competitive hypothesis into doubt. The fact is that the volume of car sales (in all

[43] In recent years, about 40 per cent of new car purchases were based on financing by leasing companies and banks. After the economic downturn and increase in interest rates, the sale of smaller cars drastically declined as compared to luxury vehicles. Interest rates on car financing range between 17-18 per cent as compared to 20 per cent in 2008/09 while they ranged between 11-12 per cent three years ago.

[44] Mehran is said to be an obsolete model that is no more in production since 1986 in Japan.

[45] http://www.dawn.com/wps/wcm/connect/dawn-content-library/dawn/the-newspaper/business/19-car-dealers-charging-premium-on-spot-buying-920-hh-05

the aforementioned product categories) came down drastically during 2008/09 but skyrocketing prices reflect that the companies are able to maintain a high price level in the face of lower sales, a clear case of market failure with supply not responding to higher demand.

Conventional economic norms depict an inverse relationship between price and demand, i.e. low demand should trigger lower prices. In the case of the car market in Pakistan, the reverse is observed - decreased demand is followed by increased prices. For instance, in the first half of 2008/09, Pak Suzuki increased its prices four times, Toyota three times and Honda twice. The reasons cited included: currency depreciation since mid-2008 increasing the industry's import costs and increased cost of steel, petrochemicals and utility charges. According to experts, the currency weakness was around 20 per cent and the foreign exchange component in car manufacturing is 70 per cent. This implies that the impact on productions should be roughly around 15 per cent but prices actually increased by more than 33 per cent.

Till November 2008, high steel prices in the international market were also responsible for a surge in vehicle prices. According to industry sources, the impact of steel prices on local car prices takes about six months to impact fully. Auto manufacturing profits are highly elastic with reference to the steel price - a 1 per cent decline raises profits by 11 to 13 per cent, other things being equal. Steel prices plunged by 43 per cent in 2008/09 with the general commodity index down by 45 per cent from its 2008 peak.[46] Fuel prices, too, declined from their high of $147 in July 2008 to around $40 in February, 2009. However, the benefits were not passed on to customers and car prices kept on increasing.

The motorcycle product market has also shown tremendous growth since 2000 with sales increasing from 90,000 to 640,000 in 2007/08. The market is dominated by two producers (Yamaha and Honda) with one (Honda) having almost a 70 per cent market share of locally produced motorcycles. Relative to the car industry, prices in the motorcycle industry have followed an entirely different path which suggests much stronger competitive pressures on the producers.[47] The nominal price of a Honda motorcycle has *come down* from Rs.65,751 in 2000 to Rs.48,200 in 2008.[48] These numbers suggest the presence of a strong threat of entry from local as well as international producers, which has been enough to reduce prices. The situation is in total contrast to the car market where local car manufacturers/assemblers effectively have a captive market and can reduce or increase supply at will as imports of built-up cars remain insignificant except for used cars. In being able to restrict supply, assemblers have been aided by the fact that even after a decade or more no significant local component suppliers have emerged on the scene and there is no meaningful deletion process in place to reduce dependence on imported inputs. Assemblers are not constrained by any long term relationships with domestic suppliers of components preferring to import all, or most of them, from their parent companies as needed by their production plans.[49] Indeed, there is some evidence that assemblers may have thus indirectly caused the closure of several local component suppliers that initially appeared on the scene.

It is noteworthy that notwithstanding the frequent slowdowns in the economy which reduce demand for new cars, customers still have to pay a premium for immediate delivery.[50] To counter this practice, allowing the import of used cars should reduce the ability of the assemblers/dealers/agents to charge such premiums but is unlikely to eliminate it entirely. It is important that the Government allow this safety valve to operate on a sustained and predictable basis. The assemblers tend not to increase production to quickly meet demand and this gives an opportunity to charge higher premiums. Thus, somewhat perversely, the availability of excess production capacity does not seem to result in more intense competition and lower prices but the

[46] Pakistan Steel Mills also reduced its various product prices.

[47] All annual automobile (cars and motorcycles) sales have been taken from the PAMA website: http://www.pama.org.pk/productionjuly2004.htm and motorcycle prices for different years have been taken from the Federal Bureau of Statistics Monthly Bulletin of Statistics.

[48] Real prices deflated by the inflation numbers will show an even bigger decrease.

[49] According to an estimate, every job created in the automobile assembly industry, three to four jobs are created in the automotive parts industry. Import of CKDs thus considerably reduce the linkages of the auto industry to the economy and with supporting industries such as iron, steel, aluminium, natural rubber, copper, glass, zinc, leather, plastic, lead, etc.

[50] Depending on the make and model, the customer pays a premium of Rs 40,000 to Rs 150,000.

opposite. Imports may reduce premiums by intensifying competition but the fiscal regime is not supportive of competing imports. There is a 20 per cent customs duty on imported cars and a 50 per cent regulatory duty. With the decrease in the rate of depreciation of used imported cars from 2 to 1 per cent per annum, the total duty comes to more than 250 per cent. As a result, only 5000 cars were imported in 2009.[51]

Under the competition law, car assemblers have to apply to the CCP for exemption for any exclusive franchise, license, service and distribution arrangements. In these circumstances, the CCP weighs the pro-competition effects of such agreements against their anti-competitive effects. While such exclusive agreements might be construed to be competition-reducing they do, on the other hand, provide acceptable levels of service to customers within a particular geographical context. In any case, customers are not prevented from dealing with alternative dealers in other parts of the country.

To conclude, it seems that car assemblers have been able to create an essentially closed, captive market through product market segmentation with the domestic used car market playing a minimal role in facilitating the transition of customers from one segment to the next. In this, the Government may be partially blameworthy as it not been able to establish a testing and certification regime for older cars in the country. Assemblers are aware that consumers have no real choice in the matter. The dependence of consumers on the domestic industry has risen due to the high duties charged on imported cars. The result is that local car assemblers are over-protected and shielded from the competition of imported vehicles. This is why a decline in car sales perversely triggers an increase in prices in Pakistan, though elsewhere it usually leads to a reduction in prices.

Global estimates of demand growth for automobiles for the period up to 2015 suggest that about 80 per cent of the increase in the world's consumption will occur in developing countries.[52] In Pakistan, too, sales are likely to show growth of 20-25 per cent between 2010/11 and 2014/15. It is unlikely, given the small size of the overall market, that a new assembler will appear on the scene. Competition between the existing assemblers is likely to remain muted with the main assemblers using non-price competition to gain an advantage such as improved specifications, enhanced customer service, improved fuel efficiency and quicker delivery. Whether the consumer will also experience greater price competition between the main assemblers remains an open question.

B. Cement

The cement sector, the building block of the construction industry, has a direct linkage with housing/construction activities that are highly labour-intensive and possess immense employment potential.[53] Their economic importance is therefore self-evident. In Pakistan, there are 29 operational units with a production capacity of around 44 million tons against domestic consumption of about 25-28 million tons with around 11 million tons exported in 2008/09. In its entirety, the concentration ratio for the sector is high and as transporting this bulky commodity over long distances is not economical markets are also geographically segmented. Consequently, the sector is divided into two distinct geographical production and marketing regions: North and South.[54] North accounts for the largest share in overall production (80 per cent from 19 units with 35 million tons capacity) due to the ample availability of limestone. This is followed by the South (20 per cent from 10 units with 9 million tons capacity).

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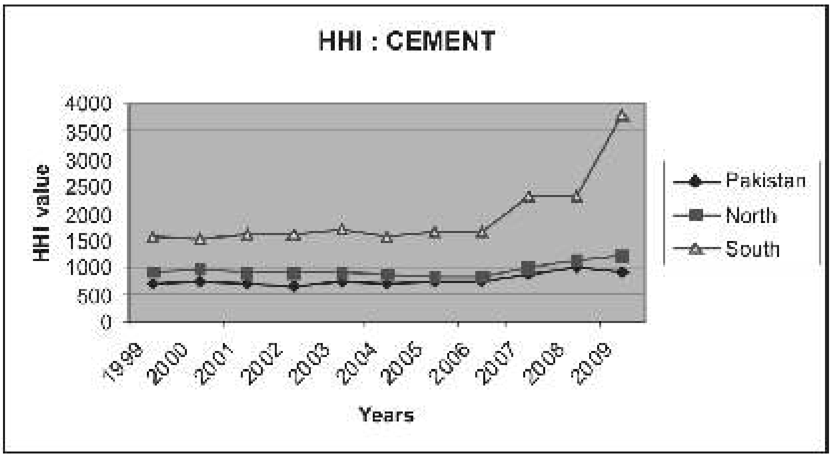
[51] SRO 25 (1) 2009 issued on January 12 and CGO 1/2009 issued on January 13. Source: www.paapam.com/.../Auto per cent20dealers per cent20oppose per cent20curbs per cent20on per cent20import per cent20of per cent20used per cent2

[52] http://www.articlesbase.com/automotive-articles/impact-of-auto-industry-on-the-economy-and-job-market-1208854.html.

[53] More than forty industries directly and indirectly relate to the construction industry - bricks, steel, hollow blocks, marble, ceramic tiles, stone, wood and wood products, hardware, floor chips, iron pipes, plastic ware and pipes, bathroom fittings, electric fittings, telephone wires, paints, kitchen fittings, etc. The cement sector thus contributes to growth through all these industries. However, according to the Pakistan Economic Survey 2008/09, the share of construction in the GDP has fallen from 2.6 per cent in 2006/07 to 2.1 in 2008/09.

[54] North comprising NWFP and Punjab; and South consisting of Sindh and Baluchistan.

The North market is less concentrated as compared to the South. Looking at the decade 1999–2009, concentration is increasing, more rapidly in the South. Increasing concentration depicts several traits - the degree of competition is decreasing; the number of competitors is already limited in the South (two units having a 60 per cent market share), and in the North where four units have a 47 per cent market share, big market players are becoming even bigger (DG Khan, Lucky, Bestway) after significant capacity additions, perhaps to reap the benefits of economies of scale to reduce overall costs, to acquire a larger market share or to utilize the export potential for overseas markets. Whatever the reason, the industry has long been suffering from idle capacity – during 2008/09 the capacity utilization was about 74 per cent - this relatively low percentage coupled with a lower demand resulted in a drop in profitability by 9 per cent for the first quarter of the year 2009/10. After tax aggregate profit of all the units stood at Rs1,030 million for the first quarter 2009/10 as compared to Rs1,131 million in the comparable period of the previous year.[55] Retail national market prices decreased by 1.5 per cent whereas net export prices slumped by 14 to 15 per cent in US dollar terms. In spite of a 56 per cent drop in international coal prices, now the main energy source in the industry, at the beginning of 2009/10 gross margins contracted by 5.2 per cent.



An analysis of the industry reveals the following key aspects relating to the competitiveness of the sector in the country: a) the combination of low per capita consumption and a huge potential for construction, housing and road projects make Pakistani cement an attractive investment destination as there is considerable unrealized scope for scale economies; b) unrealised potential to tap cement markets of the Middle East and possibly South-East Asia due to its locational advantage; c) presence of large-scale limestone and coal deposits in the country; and d) substantial unutilized production capacity. However, due to a lack of competitive impetus over the years in improved capacity utilization, lower costs and aggressive marketing, the industry has failed to make use of these opportunities. On the other hand, the weaknesses of the industry have persisted in the form of cost inefficiencies as, except for a few plants, most have yet to adopt ways to become energy efficient.[56] Starting in early 2000, about 90 percent of the plants in Pakistan had converted to coal firing plants (instead of gas and furnace oil) but the energy component remains high in the overall cost of production, especially in the older less efficient plants. CCPs view is that the root cause of weaknesses of the sector results from an overall lack of competition in the sector. Competition is the end, as well as the means, to attain higher efficiency.

Looking from an international perspective, Pakistan's cement and clinker exports grew at a rate of 47 per cent (from a narrow base) during 2008/09 with total exports of 11 million tones - 35 per cent of the total production .[57] Most of the plants are away from ports; therefore about $15/ton transport cost from plants to port reduce the industry's foreign competitiveness. In any event, Pakistan's cement exporters' competitiveness is

[55] http://dawnnews.tv/wps/wcm/connect/dawn-content-library/dawn/news/business/11-cement-sector-earnings-slip-9pc--il--07 and http://www.iptu.co.uk/content/pakistan_clusters_building.asp#Cement1109
http://www.pta.gov.pk/index.php?option=com_content&task=view&id=648&Itemid=600

[56] For instance, Gujarat Ambuja Cement Ltd, the lowest cost cement producer in India cut energy costs by reducing/replacing coal usage by crushed sugarcane and operated most of its plants at above 100 per cent capacity to reduce overheads. Pakistan's cement plants are looking into the possibility of using synthetic carpet waste, plastic waste, shredded rubber tires and rice husk fodder as fuel.

[57] Pakistan produces less than 1 per cent of the world cement production. Source: http://upload.wikimedia.org/wikipedia/commons/4/41/Cement_Production.JPG

likely to shrink even more rapidly in the future as the FOB price in the international market has effectively collapsed to $52 per ton in recent months from $80 per ton in 2008/09. It is worth mentioning that competitive pressure will be even more severe after the planned increase in output capacity in the Asia-Pacific region becomes operational. Plant expansion in many Middle Eastern countries - GCC U.A.E, Qatar and Saudi Arabia- along with India, China and Iran will make the market even more highly competitive and Pakistan will have missed an opportunity to upgrade its manufacturing when bigger exports would have provided extra cash flow and lowered the cost of production.

As is well known, instead of improving dynamic efficiencies and enhance competitiveness, Pakistan's cement manufacturers have tended to resort to cartelization, as is the case in several other countries. Cement is one of the sectors that are internationally considered to be cartel-prone. Cement cartels have been heavily fined in several countries, for instance, Taiwan (Taiwan Dollars $210 m), Germany (penalty €660m) and Hungry (HUF 120m). Pakistan also joined this list when the Competition Commission of Pakistan established the existence of a cement cartel and imposed penalty of more than Rs 6 billion.

To better understand cartel dynamics, it would seem pertinent to have a look at the overall industry situation. The industry in Pakistan is characterized by cost structures that vary considerably, based on location, access and pricing of inputs (including energy), the production process in use and installed capacity, extent of leverage, and a host of other factors. In ordinary circumstances, the push and pull of market forces should result in productive efficiencies, competitive pricing, and, most important, the exit of inefficient producers, with the beneficiaries of this process being the consumer and the economy as a whole.

However, as has been observed in many countries around the globe, the cement industry in Pakistan has all the basic ingredients that make it a natural cartel namely: a) it is a mature industry; b) it has little prospects for innovation; c) it exhibits excess capacity vis-à-vis demand; and d) the obvious fact that cement is a homogenous product with scant opportunities for pricing power based on branding. On a number of occasions in the past, the erstwhile Monopoly Control Authority (MCA) took steps against cartelization in the cement industry but its efforts were unsuccessful largely due to insufficient investigative authority, e.g., non-availability of legal provisions with respect to leniency and on-site premise inspections - the most effective tools in the fight against cartels.[58] As a result, MCA's Special Enquiry in 2007 could not find conclusive evidence of cartelization. However, it did indicate that cement manufacturers had been involved in cartelization in the past under the auspices of their association, namely the All Pakistan Cement Manufacturers Association (APCMA).[59] The enquiry report concluded:

> "Essentially, it is true to say that the CCP did not find conclusive evidence to indicate that the price hike in February 2007 was the result of cartelization. This conclusion was in line with the Lahore High Court ruling in 2006 that the existence of a cartel needs to be established through much more rather than by merely associating it with the phenomenon of parallel price movements and that the support of corroborating plus factors are necessary to prove collusive price fixing. However, such direct evidence can only be found through the physical search of premises of APCMA, the admission of a member of the alleged cartel, an estranged executive of a member company or of APCMA itself or a so-called 'whistle blower'.
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> Due to the limitations of the 1970 Law, the MCA could not conduct a search of APCMA premises. Under the new Competition Ordinance, the CCP is now empowered to not only conduct searches but also impose punitive fines if evidence of industry collusion is conclusively found. Given these powers, as far as APCMA is concerned and the doubts that

[58] *State of Competition in Pakistan 2008* covers the history of the cement cartel in Pakistan.

[59] Enquiry was conducted subsequent to a cement price increase from Rs 220/230 to Rs 275-300 per bag of 50 kg during the first week of February, 2007.

have been expressed about it in different quarters, its activities clearly need to be thoroughly examined, including through the search of its premises. Is it as benign in its functions as is made out by itself or does its 'monitoring' have another, less savoury purpose?”

Later in the year, after promulgation of the Competition Ordinance, 2007, the CCP sought to get hold of more conclusive evidence of cartel activity. It is customary in cartel investigations that trade associations are regarded as prime suspects in providing a platform for consensus-building amongst cartel members. Consequently, the Commission's first suspect was, therefore, APCMA. Interestingly, as per its first memorandum of association, one of the aims and objectives of APCMA was “to create an understanding amongst the Private Sector Cement Manufacturers of Pakistan ….to avoid under-cutting the sale price.” It was therefore considered necessary to look into the activities of the APCMA.

In early 2008, the CCP received fairly clear indications of cartel-like activity on the part of APCMA. After considering all aspects, the Commission decided in April, 2008 that the only prudent and effective step in order to get hold of conclusive evidence was to conduct a surprise inspection of APCMA. The Commission's inspectors were able to collect evidence of cartel activity and show cause notices were issued to APCMA and its members for entering into an anti-competitive agreement prohibited in terms of Section 4 of the Ordinance.

Evidence recovered during inspection included a 'marketing arrangement' agreement entered into by the cement manufacturers on 8 May 2003. The Agreement fixed production and supply quotas amongst the APCMA members, in order to maintain the targeted price level. Accordingly, each member's production capacity was capped and this capacity was much less than the actual capacity that the individual member was in fact capable of producing.

On examining the actual dispatches of cement companies in the year 2003, it was observed that these closely matched the allocated quotas. By using the same capacity-based allocation of quotas the year-wise cement dispatches of each member from 2003 to 2008 were analyzed and it was observed that the percentage share of each member in the total cement dispatches very closely matched with its percentage share in the total production capacity of all the members. Thus the Commission was able to determine that the Agreement had been in existence and was being implemented effectively in the years under review by 20 cartel members. For forming a cartel, the CCP imposed half of the maximum penalty i.e., 7.5 per cent of the turnover of each member, which came to Rs. 6.3 billion.[60] The decision is *sub judice.*

To conclude, the cement sector, whether viewed in a broader global perspective or in the context of the national market, has ultimately to become more competitive for its survival. Global linkage of the industry is expected to increase in the years to come. Global demand for hydraulic cement is forecast to rise 4.1 per cent per year to 3.5 billion metric tons in 2013, on account of rising investments in infrastructure in developing countries. Blended cement, is expected to increase its market share over Portland cement. Several countries in the Asia/Pacific region will continue to see strong gains in cement demand. China, which accounts for nearly half the world's cement demand, is likely to see a slowing rate of growth through 2013 as construction spending decelerates, but gains are expected to remain well above the global average. Other fast-growing markets for cement in the region include the Philippines, Thailand and Vietnam, all with growth rates exceeding 6 per cent per year. Therefore, to thrive in such a dynamic global setting the sector must gain international competitiveness and Pakistan's cement manufacturers need to significantly improve national competitiveness first. Increasingly, in the context of the national market, the presence of a strong competition law enforcement agency provides the right milieu in which it should become more difficult and costlier to take refuge in anti-competitive practices.

[60] Order of the Commission is available at: http://www.cc.gov.pk/Downloads/Cement per cent20(final per cent20order) per cent2027-08-2009.pdf. Cement manufacturers filed appeals and presently the matter is sub-judice in the Supreme Court of Pakistan.

C. Fertilisers

Pakistan has traditionally been categorized as an agri-based economy, agriculture making a major contribution of 22 per cent to the country's GDP. In addition to meeting food requirements, the sector has also conventionally provided major industrial crops, mainly cotton and sugarcane. Being a labour-intensive sector, agriculture also provides employment opportunities and as much as 45 per cent of the total labour force of the country is employed in agriculture.[61] Within agriculture, the role of fertilizers has acquired critical importance and Pakistan has taken major strides in attaining self- sufficiency in essential macronutrients. Although capacity increase for urea continues, the hope of more balanced fertilization and, hence, improved yields in the sector are still a far cry.

Appreciating the critical role of fertilizers in yield per acre, successive Governments have formulated policies to encourage private investment in the sector so as to develop indigenous fertiliser manufacturing capabilities. Additionally, subsidies have been provided to keep down domestic prices to enable the farmer to procure these inputs at affordable prices. This has been insured through subsidizing the cost of production by way of subsidy on the gas feedstock. A system of support prices has been introduced to ensure farmer profitability and also maintain incentives for farmers to invest in fertilizers. In the last few years, the oil and commodity price surge has led to a scenario of high subsidies which has put a huge fiscal burden on Pakistan. Although global commodity prices have eased in 2009 and 2010 it is unlikely that the government's responsibilities in ensuring affordable prices for agricultural inputs will decrease by much in the years ahead.

In understanding the role of fertilizers in boosting growth and productivity in agriculture it important to recognize that Pakistan's soil is deficient in nitrogen. Similar levels of deficiency for other nutrients occur in that 80-90 per cent of the soil is deficient in phosphorus and 30 per cent is deficient in potassium.[62] For this reason, the initial focus was towards catering to the nitrogen deficiency. Over the years, the country has shifted to a more desirable NP (nitro-phosphate) ratio. The ratio which stood at an average 5.82:1 during the 1970s has come down to around 3.80:1. However, it is still substantially more than the desirable limit of 2:1.[63] This being the case, and in the backdrop of diminishing soil fertility, the need to promote phosphatic fertilizers such as DAP is high. However, despite the Government's intention to enhance the NP ratio, fiscal constraints on the back of negative external factors have limited its ability to provide such support. In addition, even with massive support to improve NP balance farmers have opted to procure more urea rather than go in for balanced inputs. In other words, there appears to be a tendency to substitute one nutrient over the other in an attempt to improve yields rather than use them as compliments with prescribed NP ratios.

For many years, fertilizer demand was mainly met through imports. However, investment initiatives were taken by the private sector with foreign partnerships in the 1960s and 1970s. The Government followed up by establishing projects through public joint ventures with regional and international players such as Pak Arab and Pak American fertilizers. At about the same time, the Fauji Foundation also entered the industry as a major player. The sector as a whole has thereby evolved through public-private partnerships.

During the 1970s, the process of enhancing capacity started with the formation of the National Fertilizer Corporation (NFC) with the objectives of: i) keeping balance between demand and supply; ii) developing manufacturing capacities of different fertilizers; iii) ensuring the availability of fertilizers through an extensive marketing network; and iv) maintaining prices at a reasonable level throughout the country.

The NFC was the first major public sector initiative formed with an objective to manage supplies to keep prices at reasonable and affordable levels. Later, the government took further initiatives to formulate joint ventures with regional partners. Pak Arab Fertilizers was formed in 1972 with NFC being the major stakeholder. By the

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[61] Source: Federal Board of Statistics
[62] Pakistan Economic Survey 2008-09
[63] Fertilizer Review 2007-08

late 1970s, Fauji Fertilizer Company (FFC) was formed through a joint venture between Fauji Foundation (FF) and Haldor Topsoe A/S of Denmark. The company later evolved into a dominant player in the market. Later on, the group expanded into the DAP business by setting up Pakistan's first and the only DAP producer in the form of FFC-Jordan Fertilizer Company (FJFC) - later renamed as Fauji Fertilizer Bin Qasim (FFBL).

Profile of key players

The sector is mainly dominated by four major firms, namely Fauji Fertilizer Company (FFC), Engro Chemical Pakistan Ltd (ECPL), Fauji Fertilizer Bin Qasim (FFBL) and Dawood Hercules Chemical Ltd. (DHCL). A brief overview and profile of these firms is presented below:

- *Fauji Fertilizer Company (FFC)*
  FFC was incorporated in 1978 as a private limited company. It was a joint venture between Fauji Foundation and Haldor Topsoe A/S of Denmark. The company commenced operations in 1982 with an annual urea capacity of 570,000 tons per year. As a result of de-bottlenecking programme (DBN), plant capacity was increased to 695,000 tonnes per year. Production capacity was further enhanced in 1993 when the company established its second plant with a capacity of 635,000 tonnes per year. In 2002, FFC acquired Pak Saudi Fertilizer Limited (PSFL) urea plant located in District Ghotki from NFC under the Government's privatization initiative. It had a capacity of 574,000 tonnes. This pushed the overall company capacity to 1.9 million tonnes, thus making it the largest urea producer in the country. Further DBN activities have enhanced the company's urea capacity to over 2 million tonnes.[64] Apart from manufacturing, the company has an extensive marketing network comprising 3,258 dealers spread across country.[65] Presently, a 44 per cent stake in the company's total 493.4 million shares is held by Fauji Foundation (FF).

- *Engro Chemical Pakistan Ltd (ECPL)*
  Engro is the second largest player, while also being the first-ever company to establish a urea plant in the country. The company was initially established as Esso Pakistan Fertilizer Company Ltd. in 1965 with 75 per cent shares held by Esso. With an initial investment of $43 million, the plant was established having a capacity of 173,000 tonnes. With Esso becoming Exxon, the company was renamed as Exxon Chemical Pakistan Ltd. In 1991, Exxon decided to divest its fertilizer business on a global basis, which resulted in an employee-led buyout of Exxon's 75 per cent stake in the company. Since then, the company has evolved into a dynamic and well-diversified conglomerate. The holding company ECPL now has a urea capacity of 975,000 tonnes and an NPK capacity of 160,000 tonnes. The company is near to achieving the highest domestic urea capacity by way of its expansion of 1.3 million tonnes, costing over $1 billion, which is expected to start commercial production by mid-2010. The company also has a share of 21 per cent within the marketing segment. Currently, a 41 per cent stake of the company is held by the Dawood group, with DHCL having 81.1mn shares.[66]

- *Fauji Fertilizer Bin Qasim Ltd (FFBL)*
  FFBL is the only DAP producer in the country and also manufactures superior quality granular urea. The manufacturing complex was built at a cost of $468 million. Formulated as a venture between FFC, FF and Jordan Phosphate Mines Co. (JPMC) in 1993, the company experienced a series of crises in its early years due to technical, financial and managerial reasons. As a result, its DAP plant was mothballed in 2001 due to accumulated losses of Rs 6.5 billion. In 2003, JPMC sold its stake and the company was renamed to FFBL, having resumed production after a lapse of two years. The company currently has an annual urea and DAP capacities of 551,000 tonnes and 445,000 tonnes respectively. The company's off-take is handled by FFC and as such, FFC had a 44 per cent share in DAP marketing during 2007/08. Presently, a 51 per cent stake is held by FFC and 17 per cent is held by FF.[67]

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[64] FFC Annual Report 2008
[65] Fertilizer Review 2007-08
[66] ECPL Annual Report 2008
[67] FFBL Annual Report 2008

- *Dawood Hercules Chemical Ltd (DHCL)*
  The company was incorporated in 1968 as a joint venture between the Dawood Group and Hercules Inc. USA. The plant had an initial capacity of 345,000 tonnes which was enhanced to 445,500 tonnes as a result of revamp activities during 1981/1991. DHCL markets its products through Dawood Corporation Ltd (DCL), though its activities are confined to Punjab and NWFP. During 2008, DCL maintained a share of 8.2 per cent in the overall fertilizer marketing activities in the country. The company is primarily held by the Dawood Group while it also holds a 41 per cent stake in ECPL.

The supply-chain can be classified into two distinct areas; manufacturers and marketing companies. However, an assessment of the product-mix is essential so as to fully understand the market power within each area. Two major products, urea and DAP, are predominantly used in Pakistan to cater for nitrogen and phosphorus deficiencies in the soils of the country. While potash is also used, its proportion in the overall mix is fairly low (not more than 1 per cent), considering relatively better potash fertility in the country's soil. Other fertilizers such as CAN, SSP, SOP and MOP are also used concurrently so as to provide certain micronutrients other than the macro NPK. Though some of these fertilizers are also manufactured by local producers, most of the demand is fulfilled through imported supplies. In the context of this brief review of the product mix, urea is the only market dominated by local manufacturers and is therefore subject to domestic pricing arrangements. On the other hand, prices of other fertilizers, including DAP, are primarily based on international dynamics. It is with this premise that we proceed with the analysis of this sector.

With respect to the global scenario, China is the biggest NPK consumer in the world, constituting nearly 30 per cent of overall NPK consumption. Moreover, China is also the largest urea player, consuming 38 per cent of world urea output while having a 30 per cent share in world urea capacity. A similar condition prevails in case of DAP where China consumes nearly 31 per cent of total DAP produced. After China, the second largest driver of world urea and DAP demand is India, which consumes around 22 per cent urea and 20 per cent DAP of the total output. As far as regional capacities are concerned, China holds the largest urea capacity followed by India.[68]

Pakistan expanded urea manufacturing on the back of an indigenous availability of natural gas, which is used as feedstock in the urea manufacturing process. The country's current urea capacity stands at 4.48 million tons. Over the years, Government policies and support of private investment emerged both in fertilizer manufacturing and marketing. While local demand is mostly catered through local urea production, the country still imports additional urea (on average 4 per cent during the last five years) to ensure timely availability and to avoid any temporary shortage. Pakistan still has to import phosphate due to a lack of raw material availability. More recently, the sole DAP producer in the country, Fauji Fertilizer Bin Qasim (FFBL), an associate company of the Fauji Fertilizer Company (FFC), has entered into a joint venture with Morocco to formulate Pak Moroc Phosphate (PMP), which should provide phosphoric acid to FFBL. Though the company entered into this agreement to improve its supply-chain as a result of backward integration, the country as a whole still remains deficient in phosphates and thereby has to import on average 70 per cent of its total DAP needs.

Pricing mechanisms
Since the urea market is highly concentrated and three big players (FFC, FFBL and ENGRO) hold 80 per cent of the total urea capacity, local urea prices are largely determined by the market power of these players. Moreover, urea prices are a function of the subsidy on feed-gas rates, which keeps domestic prices lower than import prices. This has also been the central idea of fertilizer policies and the key reason for providing feed-gas at subsidized rates.

On the other hand, DAP prices remain dependant on international prices, since only 30 per cent of the total demand is met by the sole DAP producer FFBL, while the rest is imported. This exposes domestic DAP

[68] International Fertilizer Industry Association, Food and Agriculture Organization

pricing to both international price volatility and currency risks pushing the Government to provide higher subsidies. In 2008/09 the Government had to provide DAP subsidy to the extent of Rs 21 billion. Nevertheless, demand could not pick up as local DAP prices were 1.5 times higher on a year-on -year basis and farmers opted to procure urea instead. This being the case, it is reasonable to assume that subsidies on DAP will remain integral in raising the NP ratio of the country, given the tendency of volatility in international commodity prices along with the Government's resolve to improve crop productivity in the country.

The case of excess supply

With major urea expansion of 1.3 million tons by Engro Chemical due to come online in 2010, Pakistan will have excess urea capacity. Indeed, there will be a regional supply surplus situation as well since major capacities from China, Iran, Qatar and Saudi Arabia are also expected to become operational by 2011. Markets should therefore remain highly competitive due to excess supply. In the case of Pakistan, the existing subsidy on feed-gas would not apply to such exports and manufacturers will have to market them at competitive rates.

This will remain critical in driving exports as the sector may not achieve superior economies as it has been accustomed to protectionism. Meanwhile, the domestic supply overhang will also put downward pressure on the sector's profit margins. This in turn should result in one of the following tendencies:

- Either excess supply would eliminate super-normal profits leading to price wars and to competitive behaviour where players strive to capture each other's market share; or
- It would result in an arrangement between players where predetermined supply quotas are assigned and prices are settled through mutual consensus (cauterization).

The possibility of the second tendency to prevail is relatively high, as the industry is highly concentrated towards two major players. If this is the case, it would be critical to monitor anti-competitive behaviour in the sector.

Competition analysis

The country currently has a total urea off-take of 4.7 million tons and the four-firm concentration is significantly high as 86 per cent of the total industry off-take is concentrated towards the top four firms. Moreover, the top three firms (FFC, ECPL and FFBL) hold 75 per cent of the urea capacity which further signifies their control over the market dynamics.

The Herfindahl index, which is a more precise measure, also portrays the same picture but with intensified results. The industry has an HHI of 2,660, significantly higher than the benchmark limit of 1,800. With such a high level of concentration, it is quite safe to presume that the level of control these firms can exercise over domestic prices is overwhelming. However, an important externality in the form of Government subsidy on feed-gas may restrict these manufacturers to exercise complete control. Although, HHI of 2,660 is still high enough to raise anti-trust concerns with respect to any industry, the case of the fertilizer industry may be somewhat different due to its strategic nature.

Theoretically, there are both short term and long term effects of deregulation. Short-term effects generally have an adverse impact on the industry's excessive monopoly profits, since the industry has to go through numerous temporary adjustments, specifically in terms of the reduction of costs. However, in case of fertilizer manufacturers, the Government has already provided a cost incentive in the form of lower feed-gas rate.

While policy should ideally focus specifically on how to foster investment in the sector, typically to induce new entrants, it is essential to first understand some of the basic barriers to entry that currently prevail. First and foremost is the capital-intensive nature of the business, followed by diminishing availability of indigenous natural gas. This creates virtually impossible entry barriers for new entrants. The most important barrier however would be the supply overhang position in the urea market post 2009/10. On the back of major upcoming urea expansions (0.45 million tons by Fatima Fertilizer in Nov 2009, followed by 1.3 million tons by

ECPL in Oct 2010), new investment in the urea manufacturing side becomes improbable. Therefore, decentralization in urea manufacturing purely on the basis of market mechanisms appears unlikely and the only reasonable way appears to be constant monitoring by the CCP.

While manufacturers appear to have an influence as far as the urea market is concerned, the dynamics of the fertilizer marketing segment are somewhat different. Under this segment, the urea market is only a component of the fertilizers that are being marketed in the country. The segment is clearly classified as having both public and private domains. The sole public sector marketing company is National Fertilizer Marketing Ltd (NFML), which is a subsidiary of NFC. This company has been handling the entire domestic production of NFC and falls under the jurisdiction of the Federal Government. Since NFC is in the process of being wound up, with its PAFL urea plant and SSP Haripur plant being purchased by Azgard 9 Ltd, NFML's role is now limited to the distribution of urea imported by the Trading Corporation of Pakistan (TCP).[69]

Since the marketing segment was gradually decentralized, in the context of the limited role now being played by the NFC and NFML, its market share in 2007/08 stood at 2.47 per cent. The remaining 97.5 per cent of the supply is now being provided by the private sector. Interestingly, the private sector is again heavily dominated by two major firms, FFC and ECPL, having a 70 per cent share in the marketing of all products, including urea and DAP.

While both these companies still contribute positively towards the sector, not only in terms of catering to overall demand, but also through appropriate research and development measures, it should be noted by the Government and the CCP that they exercise a major influence in the sector. This reality gives rise to the argument related to the extent of Government intervention that is needed for a more balanced approach: i) allowing the forces of the free market to prevail in terms of providing benefit to the end-consumer; or ii) ensuring that oversight and regulation do not hinder fertilizer production and the consumer has access to assured supplies of fertilisers. Thus, focus should specifically be laid on how to moderate the implications of any existing or potential collusion in fixing prices, tying-in of sails and/ or dividing markets.

The case of tying-in of sales

In mid-2009, CCP received a series of complaints via the Government of Sind, stating that fertilizer companies, specifically the bigger players, had been engaged in the practice of tying sales of urea with DAP. It was stated that dealers were obliged to purchase DAP or other expensive fertilizers with the purchase of urea in a prescribed ratio. According to CCPs inquiry, the ratio varied with company to company, ranging in 3:1 to 4:1 urea:DAP.

It was alleged by growers that the practice of tie-in by fertilizer producing companies was being practiced for the last three crop-growing seasons. Although there is no direct evidence of establishing the exact length of the period in which the tying took place, it was presented in a clear manner that urea and DAP were being tied together by fertilizer producer companies. This was supported by the fact that the growers, dealers and even the district and provincial Governments had brought to light the prevalence of this practice.

It was further pointed out in the inquiry conducted by CCP that the fertilizer companies had cancelled the dealership of some of the dealers who refused to buy urea with DAP in the required proportions. Another instance was provided which indicated that the fertilizer companies did not entertain booking orders for urea alone and asked the dealers to book at the same time the proportionate amount of DAP or other fertilizers.

While the link in this chain is associated with dealers, the stringent trade conditions as highlighted by the CCP inquiry, showed that these dealers had little choice in passing on the tied-in proportions to the ultimate consumer – the farmer. With farmers often having low purchasing power and limited liquidity available to them for such procurements, the practice certainly put them in an adverse condition, solely as a result of a restrictive trade practice on the part of the fertilizer manufacturers.

[69] Fertilizer Review 2007-08

The tendency of this practice to prevail clearly rests on the high concentration prevailing in the industry, further accompanied by restricted competition. It should be reiterated that all relevant studies on the subject clearly highlight how important it is for the country to improve its agriculture output, which can be achieved through better fertility owing to limited availability of land under cultivation. Balanced fertilization is definitely a long term solution to address this issue. However, the means through which this can be achieved are also critical and the objective should not be achieved through unfair practices.

It is worth stressing, too, that collusive behaviour usually does not persist for an indefinite period. In fact, it usually prevails in times when conditions are adverse for competition and ceases to exist when the conditions are again favourable. Here, it cannot be inferred that once a cartel has actually broken up it will never reappear and collusion will never happen again. In fact, if the market structure has not altered, a greater possibility remains for such collusive behavior to repeat itself once it becomes rational, i.e. profitable again to practice it. This has been observed and pointed out in the case of domestic cement producers. Instances of a cartel breakup in the cement sector can be clearly observed through media reports and industry sources. The incidence of this behaviour should not be entirely different for other industries, such as fertilizers.

There is therefore a call for long term solutions to alter the prevalence of this behaviour rather than to simply point out that it exists and to act upon it without assessing the underlying cause. The bottom line is that if collusive behaviour has occurred in the past, it could occur again if circumstances call for it. What the CCP should do is to take action that prevents such behaviour from occurring in the first instance. In this regard, the levying of deterrent penalties is appropriate as can be seen in other jurisdictions such as the US and EU. But, penalties on their own, do not alter the structure of any industry, e.g. the presence of excess capacity or of dominance, nor do they address other anti-competitive tendencies over the longer term such as the informal division of markets between incumbents. That is the risk that the CCP will have to confront if competitive forces are to prevail in the fetiliser sector.

D. Milk

The dairy milk sector is an emerging agri-industrial sector in Pakistan. Annual milk production of about 34 billion litres in 2008/09 makes Pakistan the fourth largest milk producer in the world.[70] Dairy products account for 25 percent of total farming output and about 5-9 percent of the GDP. Milk is not only an important part of the diet for all segments of society but is vital for the nutritional needs of infants and children. Demand growth for dairy products is estimated at 5.5 percent per annum.

The raw milk market is based on a vast informal network of intermediaries who collect/distribute milk to an equally informal supply chain network consisting of households, retail shops, sweetmeat makers and other users. This milk has to be used rather quickly as it is not pasteurized. Raw milk passes through a number of middle persons before reaching the urban retailer with price increasing at every stage - from 'dodhees' to farmers and then retailers who supply milk either door to door or sell in a shop.

Milk processing on modern lines dates back to the early 1960s and by the mid-1970's, 23 milk pasteurization/sterilization plants had been established around Karachi, Lahore and Islamabad, mostly by private investors. These plants recombined fresh milk, skimmed milk powder and butter oil (received under the FAO World Food Programme).[71] These dairy plants, generally termed as 'first generation plants' failed on account of not meeting consumer tastes, poor hygiene, operating problems like lack of necessary technical skills and insufficient or uncertain supplies of fresh milk. Production of ultra high temperature (UHT) treated

[70] 21.5 billion litres of this was buffalo milk, while 11.9 billion litres was produced by cattle. Livestock population of the major milk producing breeds stands at 33 million cattle and 29.9 million buffaloes.
[71] The State of Pakistan's Dairy Sector: An Assessment', Abid A. Burki, Mushtaq A. Khan and Faisal Bari, CMER Working Paper

milk was started by 'second generation' dairy plants set up from the late- 1970s onwards.[72] The UHT processing added up to six months to the shelf life of milk, making it a distinct product when compared to raw or loose milk. Thus each market segment developed its own supply, demand and pricing schema.

Over the last two decades or more, the industry has made limited progress. The lack of progress is evident in that the dairy industry today consisting of 17 units is able to processes only about 2-4 per cent of the raw milk compared with India processing about 50 per cent of their milk produce. As a result, Pakistan falls short by 10-15 per cent in meet local demand and Pakistan's annual imports of powdered milk are in the range of 25,000 tonnes, costing a huge sum of $ 380 million in 2008/09. To cite one instance, the country spent $ 40 million on import of formula milk alone, the highest amount spent by any country in the world on this particular commodity.[73] To make out as to why the industry has made little progress either in innovation or efficiency requires the close examination of the specifics of the market.

About 80 per cent of the milk is produced in Punjab. This phenomenon makes the industry highly concentrated around Lahore and limits market size drastically. Dairy units consequently seem to be engaged in aggressive marketing to create a sizeable niche for themselves in the immediate environs of Lahore in order to avoid transport costs.[74] None of their products (milk, cream, butter, butter oil, yoghurt, cheese, ice cream and now '*lassi*') is being exported or even widely distributed in other parts of the country. However, dry milk powder is imported in substantial quantities for further processing, being often used as an additive in local processed milk production; this is because the supply chain of raw milk for processing is not efficient. Generally, large dairy companies make supply contracts with *'dodhees'*.[75] Farmers sell milk for cash which provides an opportunity to bulk buyers operating in a totally unregulated environment to raise their margins by exploiting farmers by offering low prices for their produce.[76]

Turning to the structure of the sector, an HHI of 3046 makes it a highly concentrated industry. Milk Pak and Haleeb Foods had the largest market shares of 46 and 30 -35 per cent respectively for several years till the entry of Olpers changed the scene in 2006. Olpers was able to acquire a market share of about 15 per cent while the market shares of Milk Pak and Haleeb declined to 40 per cent and 15 per cent respectively. The remaining market is targeted by small package milk suppliers such as Nurpur (2 per cent), Nirala (2 per cent) and Good Milk of Shakarganj (3 per cent). These market players have diversified their products and introduced ice cream, flavored yoghurt, low fat milk, etc. In the packed yoghurt market, Nestle has the largest share. Introducing greater variety in the sector Engro entered the ice cream market and is competing with established market players such as Walls, Hico and Igloo. This development, should it last, is an indication of competition in the sector that is bringing more choice to the consumer.

In the economics of the sector the price of loose and packaged milk is a central consideration. Food items have a major weight in the Consumer Price Index and thus rising milk prices have a potent impact on general increases in this index. In line with prices of other food items, milk prices, particularly of packaged milk, have also risen steadily, as well as in occasional spurts, in the recent past. In an overall inflationary environment, there is the further issue of an increase in costs specific to milk production, e.g. increase in raw milk price (which comprises about 55-60 per cent of the total cost of milk), milk collection expenses (comprising about 6-7 per cent of total cost) and cost of packing materials (about 13-19 per cent).[77]

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72 In the UHT manufacturing process the raw milk is first diluted with water and then heated to 130-150 degrees centigrade. Processed milk by regulation is standardized at 3.5 percent butterfat and 8.9 percent solids-not-fat (SNF) compared to fresh milk containing more than 5 percent butterfat and less then 8.9 SNF. This treatment is also known as “flash pasteurization” giving high bactericidal effect to the milk.

73 'Dairy industry in Pakistan', The Dawn, February 1, 2010.

74 As per industry sources, on average, milk companies are spending Rs200 million per annum on advertising.

75 Nestle for instance, has set up 'Village Milk Centres' (VCMs) to collect milk directly from farmers or 'dodhees'.

76 Report of the 'Food Price Structure Study – Pakistan', Consumers International Asia Pacific Office, available at: http://www.consumersinternational.org/Templates/Internal. asp?NodeID=93303

77 Companies feel constrained due to non-availability of alternatives to Tetra packaging which being expensive constitutes a major cost item.

Direct intervention in rising prices is, of course, not within the jurisdiction of the CCP. However, the Commission is mandated to explore the prevalence of anti-competitive conduct and practices, such as cartels or collusion, abuse of dominance and entry barriers. In the past, the former Monopoly Control Authority (MCA) took cognizance of substantial public concern with the phenomenon of rapidly rising prices of milk and milk products. MCA made an attempt to gauge the existence of any anti-competitive practices, as to whether or not a cartel-like situation involving price manipulation or quasi-monopolization by producers in the processed liquid milk market existed in the country. It appeared as if the steady upward movement in the prices of milk and milk products was primarily a cost-driven phenomenon. Undoubtedly, the overall inflationary pressures in the economy can prompt and facilitate anti-competitive conduct on the part of milk producers but rising and parallel pricing alone do not constitute evidence that the sector is cartelized. Neither the MCA nor the CCP, have been able to discover any clear-cut, i.e. actionable, evidence that the market is being manipulated or competition distorted by major players in this sector.

Nevertheless, a number of factors have been identified that appear to obstruct the efficiency and growth of the sector and will continue to do so unless removed in a pro-competitive manner. These include mutually reinforcing reasons, primarily the inefficiency in the supply chain that results in a lack of milk supply in the market. These inefficiencies are an inadequate market infrastructure like hygienic milk containers, chilling centres and refrigerated transportation system facilities. As reported in our review of competition in the banking sector, banks have not established a presence in the rural market due to a lack of competitive pressure. A similar phenomenon has disadvantaged the position of the dairy sector, in which a majority of cattle-owners being small farmers have been unable to benefit from competitive price incentives and remain at the mercy of bulk purchasers. Nor do they have any access to credit facilities. This has created breaks in the value chain - few cattle per farm, scanty purchasing power for good feed, low yield per cattle and lack of assistance from research institutes. In fact, it is difficult to provide veterinary/extension services to unorganized dairy herds/farmers to educate them about improving milk quality/output through good animal husbandry practices and in the use of feed supplements and diagnosis/treatment of livestock.[78]

These issues can be addressed by streamlining the value chain as have been done in several countries. A step in this direction seems to be the establishment of Pakistan Dairy Development Company (in 2005), a public-private sector joint initiative to bring about long term structural change to develop the dairy industry.[79] The company is embarking on a phased plan targeting all the key players in the dairy sector. Its work is at the preliminary stage, so it is too early to evaluate its effects on the overall industry.

However, to become competitive at the international level as the Pakistan Dairy Development Company envisages, the industry will have to address the crucial issues relating to product standards and quality. Adulteration in loose milk is a well-known fact, whereas the mixing of melamine and detergents in packaged milk has recently been confirmed by the Pakistan Standards and Quality Control Authority.[80] This raises serious concerns and leaves consumers with the choice of either buying low quality but cheaper raw milk or purchasing higher -priced packaged milk that might pose serious health risks.[81] The dairy sector in Pakistan is said to be a perfect example of a market where paranoia prevails. Classical economics stipulates this as a case of *adverse selection*, whereby one party *has preferential access to un-verifiable information* **-** buyers can hardly determine milk adulteration which creates information asymmetries. Market mechanisms under such circumstances lead to inefficient outcomes both for consumers and producers. The obvious solution is to have proper checks and balances and conscious efforts to better inform consumers – something that still has to happen in the case of Pakistan's dairy industry.

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78 Arshad H. Hashmi, 'The Asian experience (Pakistan): Approach to ensuring safety and hygiene in the dairy production chain in emerging dairy nations', March 05, 2004. available at: http://www.milkproduction.com/Library/Authors/ Arshad_H_Hashmi.htm

79 Dairy Pakistan is a company established under Section 42 of the Companies Ordinance, 1984 and was incorporated as Pakistan Dairy Development Company on the 9th September 2005.

80 The matter is sub-judice in the Lahore High Court.

81 Melamine though causes kidney and renal failure, has high nitrogen content, it makes products to have higher protein content in some tests.

To conclude, the dairy sector in Pakistan clearly has considerable potential that remains more or less untapped.[82] If looked at in its chronological setting, the dairy sector did not get an appropriate place in public policy aiming at the agriculture sector as a whole and has therefore grown in a haphazard fashion. For that reason, the milk product market, as a sub-sector of agriculture has remained hidden from both public view and Government attention. The green revolution of the 1960s which improved crop yields did not have much of an impact on animal husbandry and thus did not significantly raise milk production. Pakistan currently lags many countries in per animal yield of milk as well as in the processing of the milk.[83] Public policy did not recognize that by increasing the competitiveness of the dairy sector through provision of credit, improved infrastructure/techniques could enhance incomes of a large number of rural households. A 2005 paper on the dairy sector estimated that only by improving the feeding habits of animals a 30 per cent increase in per animal yield was feasible. According to a US AID study, a 3 percent growth in dairy output could create about 0.9 million new jobs. There is a need therefore to reduce both the cost of production and distribution of the milk in order to make the dairy industry competitive and to improve the efficacy of competitive forces in the industry.

E. Pharmaceuticals

The pharmaceutical industry has made considerable progress over the years. At the time of independence, there was no pharmaceutical manufacturing unit in the country and imports were the only supply source. The industry developed over time responding to growing indigenous demand for modern medicines. Now only 20 per cent of pharmaceutical requirements are met through imports. With a size of about $1.5 billion in 2008/09, the sector contributes about 5 per cent to total manufacturing output - greater than automobile or fertilizers. Against this, however, Pakistan is still amongst the lowest per capita medicine-users - reflecting the sector's growth potential, on the one hand, and its inability to widen the usage of modern medicines at affordable prices in the population, on the other.

The industry consists of as many as 455 licensed pharmaceutical manufacturing units producing about 47,000 products.[84] Some 24 multinational companies comprise over 53 per cent of the market and the remainder is shared by more than 400 national companies. This phenomenon is indicative of the openness of the sector for FDI; it also throws light on the low level of national capacity development.[85] Size matters a lot in the pharmaceutical sector as bigger units are better able to face cyclical risks, afford expensive/sophisticated machinery, conduct R&D, clinical trials and undertake product liability.[86] Over the last few years the share of national companies has been catching up with that of foreign firms at roughly 5 per cent a year, from a 30-70 split in production between domestic and foreign firms in 1998 to about 50-50 in 2009 (this was only possible, however, when a few big MNCs wrapped up their businesses in Pakistan).[87]

The presence and prominence of national companies in their home markets varies considerably across countries. For instance, eight of the top 10 companies in India are national, in Korea seven, four each in Indonesia and Thailand, two in Taiwan, and one in the Philippines while Pakistan has none. In India, national companies hold 75 per cent of the home market. National companies' performance seems to be correlated with openness to competition and exports and vice versa. The situation is somewhat different in Pakistan where competition has never been allowed to thrive. The Government has been regulating the sector since

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[82] The dairy sector thrives on huge investment base of around one trillion Pak rupees with major share coming from the poor and landless farmers maintaining small dairy herds of two to three animals.

[83] One New Zealand dairy animal produces as much milk as three dairy animals in Pakistan, while one American cow produces as much milk as seven cows in Pakistan, though it compares appreciably well to other South Asian countries.

[84] Around 1500 molecules are registered with Ministry of Health.

[85] Local manufacturers, about 170 of them, are represented by Pakistan Pharmaceutical Manufacturers Association (PPMA), whereas MNCs, are represented by Pharma Bureau Pakistan (PBP). In addition to this, there are 212 drug importers.

[86] R&D alliances could partially offset such limitation.

[87] Competition law does not discriminate on the basis of origin, the narration here is merely for the sake of describing market players.

long, ostensibly to keep prices in check on the grounds of public interest/social welfare.[88] Whether social welfare has been enhanced or not (with per capita per annum allocation of Rs.451, less than US$5!) is a separate issue but direct Government interventions in the production/pricing decisions have created substantial market distortions. This facet of the pharmaceutical market is further explored below.

The Federal Ministry of Health regulates the manufacturing, registration, pricing, import and export of drugs.[89] For the last several years, there has remained a formula to increase prices annually based on inflation and currency devaluation. Price increases were allowed under a process called 'hardship' cases, otherwise there was a price freeze.[90] All the same, to address the concerns of stakeholders, especially pricing, the Federal Government constituted a Board for Formulating Drugs Pricing Policy in 2008.[91] The recently formulated (draft) policy proposes putting under price control some critical medicines (such as cancer, hepatitis) but allows a ten per cent yearly increase in prices of others. The policy envisions that prices in Pakistan will not be "over and above" comparable prices in the SAARC countries (this ignores a host of factors that affect pricing, say, cost of doing business). It suggests that drugs whose maximum retail prices are below threshold prices will be exempt from price control and allowed a 10 per cent increase every year. Threshold limits will be re-examined as and when the Federal Government enhances the salaries of its employees.[92]

The new suggested mechanism, as in the past, gives regulatory leverage to the Ministry of Health and the latter can add or remove drugs from the controlled category. Prices of the new chemical entities will be controlled for four years after their introduction, provided four generic competitors are available in the market. The maximum retail prices of medicines in the controlled category are proposed to be fixed either on cost-plus pricing or reference pricing (derived from regional markets like India and Bangladesh). The Pakistan Pharmaceutical Manufacturer's Association (PPMA) believes that the pricing policy of leader prices, adopted during 1992, should be reinstated and the price of drugs be linked to the annual Consumer Price Index (CPI) to take into account inflation and the high cost of production. This is a situation where none of the stakeholders seem to appreciate the role of the competitive process as an alternative to stringent regulation. The pharmaceutical sector nevertheless makes a case for deregulation and an overhaul of the price setting mechanism.[93]

The deregulation of any sector, although it should align the incentive structure for each producer, is still prone to anti-competitive practices such as abuse of monopoly power or cartelization. Moreover, the prevalent market structures can give an indication of how a certain market will evolve in the face of possible deregulation. Abuse of monopoly power is a potential threat in a market dominated by one firm. On the face of it, this does not seem to be a threat owing to the concentrated nature of the pharmaceutical sector. Since the market is not defined by one single product, the potential for possible abuse is minimal. However, it needs to be monitored by the CCP as cases of dominance or cartelization may arise within specific drugs[94]

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[88] According to the World Development Indicator, 2009, Pakistan has the highest infant mortality rate in the region - 73 per 1000 child births (ranks 36th out of 195 countries) – this rate is often used as an indicator of the level of health in a country. Government's fiscal allocation for health system was Rs.74 billion (both development and non-development) in 2008-09. With this spending, Government was able to provide one hospital bed for about 1575 persons and one doctor for 1212 persons (Pakistan Economic Survey 2008-09).

[89] Under the Drugs Act 1976.

[90] Companies showing their 'hardship' to supply a product for the already determined price and requesting MOH for a revision.

[91] The Board comprise of officials from ministries of Health, Commerce, Finance, Industries and Production. Expert from World Health Organisation, civil society consumer group, representatives of national and multinational pharmaceutical companies are other members of the Board.

[92] This is perhaps application of 'ability to pay' doctrine!

[93] Competition Commission needs to focus its advocacy efforts on pharmaceutical sector for awareness creation.

[94] A few cases involving mergers and acquisitions were cleared by the Competition Commission under its merger regulation regime; none of the transaction was reducing competition. These include global acquisition of Wyeth by Pfizer, merger of Schering Plough Corporation, USA with Merck & Company, USA, which resulted take over of Schering Plough Corporation in Pakistan by Merck, Acquisition of rights of two specialist medicines of Glaxo Group Limited namely Septrin Kemadrin by Aspen Global Incorporated, Mauritius, acquisition of UCB S.A's business in Pakistan carried out through distributors and agents by M/s. GlaxoSmithKline Trading Services Limited. Merger of M/s. Merck Sharpe and Dohme of Pakistan Limited (MSD) with and into OBS Pakistan (Pvt) Limited. Merger of M/s. Pfizer Laboratories Limited (PLL) with and into Parke, Davis & Company Limited. Acquisition of total paid up shares and associated assets of Bristol-Myers Pakistan (Pvt) Limited by S.R One International B.V Netherlands.

The Commission is entrusted with the mandate to provide for free competition in all spheres of commercial and economic activity to enhance economic efficiency and to protect consumers from anti-competitive behaviour. Therefore, on various occasions the Commission has raised its concern to the Government in relation to policies that impinge upon free competition and economic efficiency in any sector.[95] In respect of the pharmaceutical sector as well, the CCP is of the view that the Government needs to avoid any steps that have the effect of promoting, directly or indirectly, anti-competitive or collusive behaviour on the part of economic agents in this sector. The overall purpose of competition policy is very clear - market forces should be allowed to operate freely. It needs to be appreciated that fixing prices is a regulatory instrument that is likely, over the long run, to have detrimental effects on competition, eradicating or seriously reducing the benefits that competitive markets deliver for consumers. While fixing prices, be it minima or maxima, both have their anti-competitive effects. Price fixing inhibits R&D -based competition, encourages inefficiency and stifles innovation in widening demand and markets. Therefore, while regulatory checks are required say, primarily for standards, they are needed more to deal with issues of quasi-criminal behaviour. The World Health Organization (WHO) fears 40 to 50 percent of drugs in Pakistan are spurious.

Pakistan's medicine exports have, incidentally, touched $125 million, growing at a rate of 23 percent per annum for a number of years - implying that the pharmaceutical industry has potential both for exports and to fill the demand-supply gap prevailing in the national market. The only long term means to enhance the contribution of the sector thus is to improve its competitiveness by means of greater efficiency, higher productivity and meeting the stringent international drug formulation standards. According to PPMA, hardly any Pakistani pharmaceutical manufacturing plant has a license/approval from renowned international regulatory authorities (India has 74 US FDA- approved plants). Despite a fairly colossal regulatory infrastructure in the shape of Government Health Ministries at the Federal and Provincial levels, there does not appear to be an integrated pharmaceutical-specific overall policy. The Government has covered the sector in its various action plans, showing little or no impact so far. To cite a few instances, the Rapid Export Growth Strategy (adopted in 2005) focused on raising exports of pharmaceuticals to $1 billion but even after five years the achievement is far below the set target. The Vision 2030 (again adopted in 2005) also aimed to raise productivity and the international competitiveness of the pharmaceutical sector and to substantially increase its share in GDP.[96]

The current Development Plan for 2006-13 concentrates on manufacturing and additional investment in pharmaceuticals (US$5-8 billion). The strategic thrust of the Plan is on creating an enabling policy environment based on consistency and providing tax/investment incentives while revamping the physical, scientific/technological infrastructure. Among other things, the target is to be achieved by reducing the cost of doing business, improvement of infrastructure, skills and technology, export-oriented foreign investment, trade promotion and the diversification of products. Judging by the performance in other countries, market players in the sector could have achieved these goals as their own strategic targets, without Government intervention, had there been an effective competition regime in place.

F. Sugar

Sugar is another relatively homogeneous product with few close substitutes. Like cement it is open to anti-competitive practices on the part of producers. In this, sugar producers have been aided by the fact that the product has a low elasticity of demand having acquired the status virtually of a staple in the consumption patterns of nearly all segments of the population.

Within agriculture, sugarcane is an important cash crop of Pakistan. It is mainly grown for sugar and sugar-related production. It is an important source of income and employment for the farming community of the country. It also forms an essential item for industries like sugar, chipboard and paper. Its shares in value

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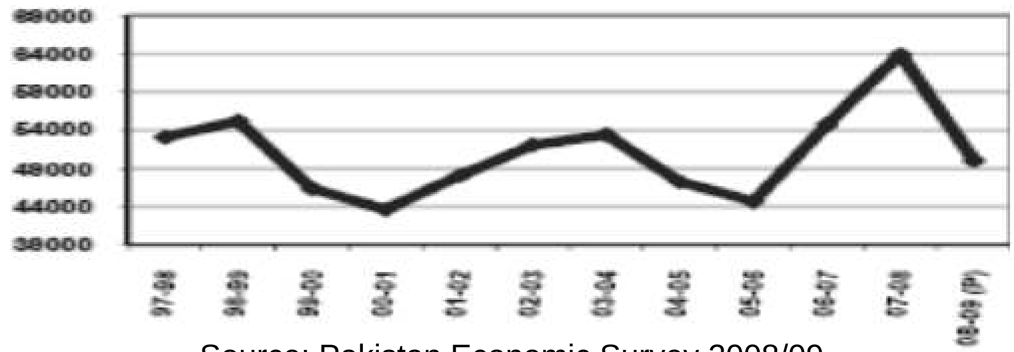
[95] For instance, in case of cement and sugar.

[96] Medium Term Development Framework (2005-2010) was prepared to assist in implementation.

added in agriculture and GDP are 3.4 per cent and 0.7 per cent respectively. In 2008/09, sugarcane has been sown in the area of 1,029,000 hectares, 17.1 per cent lower than the previous year, largely owing to lower rainfall and a mismatch between domestic and international prices of sugar. Sugarcane production for the year 2008/09 was estimated at 50.0 million tons, against 63.9 million tons in the previous year. This indicates a significant decline of 21.7 per cent over the production of last year. A table showing sugarcane production (and its decline) in recent times appears below:

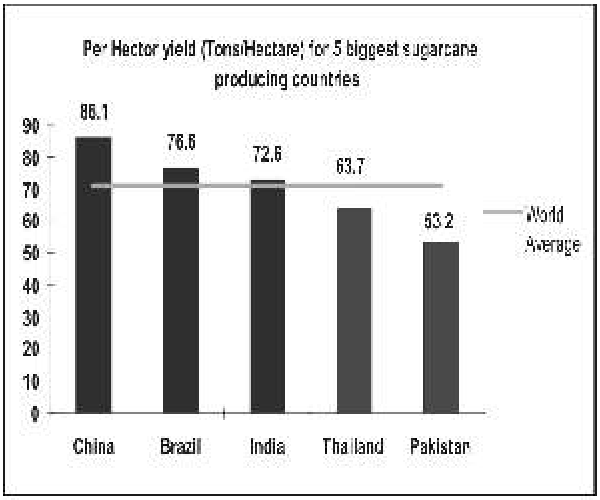
Year	Area		Production		Yield	
	(000 Hectare)	per cent Change	(000 Tons)	per cent Change	(Kgs/ Hec)	per cent Change
2004-05	966	-11.8	47244	-11.6	48906	-3.8
2005-06	907	-6.1	44666	-5.5	49246	0.7
2006-07	1029	13.5	54742	22.6	53199	8.0
2007-08	1241	20.6	63920	16.8	51507	-3.2
2008-09	1029	-17.1	50045	-21.7	48634	-5.6



Source: Pakistan Economic Survey 2008/09

The Pakistan sugar industry consists of 82 mills, 44 in Punjab, 32 in Sind and 6 in the NWFP. The total amount of sugar produced was 4,740,913 tons in 2007-08 and 3,205,993 in 2008-09 as per the records of the PSMA. The domestic consumption requirement of sugar in Pakistan is estimated to be around 300,000 tons per month. This demand rises periodically, especially during the month of Ramadan. Almost the entire sugar output is used domestically while molasses, a by-product of sugar production, is mostly exported. A few sugar mills also use part of the molasses to produce industrial alcohol (ethyl alcohol) a significant quantity of which is also exported. Another by-product of sugar production is baggasse which some mills use as boiler fuel.

The competition impact assessment of the sugar sector brings out the disorderliness in the organization of production in the sector with significant competition implications. This is the outcome of a combination of political, economic and technical factors. These factors have reinforced each other in the entire history of the sector and caused major levels of inefficiency in both production and trade. As a cumulative effect, the industry has not established an environment conducive to greater production and a comparative advantage in the international market. Despite being one of the five largest countries in the world in terms of the area devoted to sugarcane cultivation, relatively favourable agro-climatic conditions and controlled irrigation supplies, Pakistan has not emerged as a significant player in the global sugar market. In the process, visible harm has been inflicted on both farmers and consumers in the country.



Pakistan's sugar sector works with relatively old technologies. This, combined with the continuation of political leveraging that has restricted the emergence of promising entrepreneurial capacity in the sector has lead to the adoption of extremely low levels of value addition. By and large, it appears to be a natural quasi-rent seeking industry. It primarily works on the basis of recurrent costs and earnings which exclusively focus on producing refined sugar by crushing local cane production and processing imported raw sugar. Low sugarcane prices are the key in the economics of the industry. During the past 60 years or so, the sector has persistently followed a path that has avoided investment in technological development and value addition through an improved product-mix. As a consequence, any capital investments made have tended to turn into irretrievable sunk costs.

In Pakistan, sugarcane accounts for as much as 80 per cent of the total cost of sugar. It is obvious therefore that the setting of the sugarcane support price by the Government has always been the central component of Pakistan's national sugar policy. The support price notionally aims at ensuring a regular supply of raw material for the mills to process. However, support prices have been mechanically fixed by the provincial Governments and in doing so there has been no concerted effort to introduce high yielding varieties of cane. No professional exercise appears to have been done to arrive at the cost of production-related data while fixing the support price. Furthermore, in the absence of a mechanism ensuring timely payments to growers, the aims underlying a support price have been rendered largely ineffective.

Indeed, the outmoded practice of cane payment by weight is clearly out of line with best practice in comparator countries in South-East Asia. Determining the price according to weight of sugarcane treats crops of varying quality in the same manner as long as the weight is the same. This is also clearly contrary to the principles of a market economy that are supposed to reward efficiency. A crop with higher sucrose content directly contributes to efficiency as it reduces the cost borne by sugar mills whilst recovering sugar and this reduction in cost can be passed along the supply chain to the consumer in the form of lower prices as well. Not taking the sucrose content into account also fails to encourage growers to produce sugarcane of better quality using improved production methods. Hence, the determination of the sugarcane price according to weight is an anomaly that hampers efficiency and contributes to needless distortion along the supply chain.

The main competition concern for the sugar industry emerges from the fact that the sugarcane yield is substantially below international benchmarks (refer to the graph above) virtually across the entire country. The pricing mechanism for sugarcane makes the sector inefficient right from the start of value chain. In addition, the average capacity utilization of the sugar mills is 60-70 per cent which translates into higher per unit costs for mills that are inevitably passed on to the consumer. By-products of the sugar industry such as molasses can be used for ethanol production, but only 5-10 per cent of the molasses produced is used by local distilleries and the rest is exported. Thus, the industry has failed to realize significant potential value addition, improved cash flow and earnings and diversification of the product mix.

Two characteristics of the sugar market in Pakistan are particularly disturbing from a competition perspective: a) the role of politics remains central as politicians from both sides of the political divide own more than half of the 80 sugar mills. The policy-making process is hence prone to fundamental conflicts of interest. b) Sugar is a homogenous product. There is consequently an inherent temptation for the industry to be involved in collusive practices. In October, 2009, the Supreme Court of Pakistan appointed a one-man 'commission' comprising of Mr Khalid Aziz Mirza, Chairman, CCP to determine the cost of production of sugar and profit margins in the sugar sector and to submit a report after hearing from the different stakeholders in the industry. The Commission was appointed during proceedings in appeals filed by different parties against the Order of the Lahore High Court, Lahore which fixed the retail price of sugar at Rs. 40 in the Punjab. Later, the CCP itself investigated the sugar industry from a competition standpoint and discovered a number of major competition-related issues that appeared to be working against the public interest. The most prominent issues are briefly discussed below.

Rapidly rising sugar prices in the international market in 2009/10 almost certainly created incentives for sugar millers to act in unison and make windfall profits. The All Pakistan Sugar Mills Association (APSMA), a representative body of the sugar producers, primarily concerned with representing the industry in Government dealings and to facilitate coordination amongst producers, appeared to be operating collectively, effectively as a cartel. Analysis of APSMA documents suggests that the industry uses it as a forum to control the purchase of sugarcane as well as the production, sale and trade of refined sugar. The buyers market was also controlled by collective price fixing of sugarcane through the provincial arms of the Association. Geographic boundaries are also clearly defined, often leaving cane producers stuck with limited and, on certain occasions, no alternatives. Violations of defined boundaries by rival sugar mills for sugarcane procurement are promptly reported to APSMA.[97]

The Association also appeared to be engaged in a number of collective practices in the production, sale and trade processes. In order to control supply, decisions on the timing of the start of the crushing season were usually made together. Similarly, for end-product prices of refined sugar rates tended to be fixed for all the mills. The Association engaged with the Government by making collective bids to the Trading Corporation of Pakistan (TCP). Moreover, high informal entry barriers appear to have been erected. On certain occasions, APSMA supported the view of not allowing any new mills to be set up as existing mills were operating at full capacity; on other occasions it has campaigned for allowing for more sugar mills on the argument that many sugar-growing regions do not have mills in reasonable proximity to the growers. This clearly hints at a culture of hand-picked selection into the industry. Based on this, and other evidence, the Commission initiated legal proceedings against APSMA and individual sugar mills for engaging in several anti-competitive practices that affected the general public.[98] The matter is *sub judice.*

[97] Enquiry report is available at: http://www.cc.gov.pk/Downloads/Enquiry per cent20Report per cent20- per cent2021 per cent20October per cent202009 per cent20(Final).doc

[98] Show cause notices were issued to 66 companies in October, 2009 and stay has been granted to various sugar mills and their Association by the Lahore and Sindh High Courts.

Chapter 05

CCP's contribution to a more competitive Pakistan

CCP's contribution to a more competitive Pakistan

The primary purpose of this report has been to provide a context in which Pakistan's competition regime has perforce to operate. It has to be remembered that the state of competition is a multi-dimensional concept in its more practical connotations. It emanates from, and is the resultant of, the myriad actions of individual economic agents in the economy. These actions are, in turn, responses to opportunities and challenges that the wider economy presents at any given time, with the policies and actions of the Government often having the greatest impact on how economic agents are incentivised to conduct their affairs.

In Chapter 1 we looked at the current difficult state of the economy in Pakistan and outlined the impact that it might have on its state of competitiveness and on the effectiveness of the competition regime. In Chapter 2 we discussed the term 'level playing field', an essential element in any competition agency's toolkit, and concluded that while it could not be defined with mathematical rigour it was nevertheless a useful concept within the corpus of competition policy. In particular, the chapter highlighted the widespread lack of coherence and consistency in the country's fiscal regime and the biases and distortions that it created in different sectors of the economy thus making a level playing field difficult to achieve in practice. In Chapters 3 & 4 we considered the state of competition in a number of sectors of the economy in which the CCP had carried out investigations and had developed its own 'view' of what the competition vulnerabilities might be in those sectors. This Chapter is both a summing up of what has been discussed before and an agenda for the future in terms of outlining a broad-based strategic framework for a more competitive Pakistan and CCP's role in it.

From a short term perspective it is of course the state of the real economy that has the greatest influence on how economic agents – companies, consumers and regulatory and oversight bodies – look at themselves and the world with which they have to interact on a day-to-day basis. A strongly growing economy generates confidence in the future, expands the range of options available to individuals and corporate bodies and lessens the need for defending the status quo through egregious conduct whether by individuals or by companies. In other words, economic dynamism not only brings benefits like increased employment opportunities in the economy and buoyant revenues for the Government that enable it to increase the supply of public goods, but also, as a bonus, delivers positive externalities in terms of making the task of regulatory and oversight bodies easier. A poorly performing economy, on the other hand, is likely, other things being equal, to have the opposite effects.

It has to be remembered, too, that barring the impact of strong exogenous shocks, the state of the real economy at any given time is an agglomeration of decisions and actions either taken or, indeed, not taken in the past. Given this reality, we need therefore to understand the reasons for Pakistan's poor current state of competitiveness,[99] outline a broad framework for improving Pakistan's international competitiveness in the years ahead and indicate the role of competition policy in that regard.

In the *State of Competition in Pakistan 2008* it was stressed that an essential pre-requisite for promoting the aims of competition policy was sustained macroeconomic stability. In the past few years high fiscal deficits have fed chronic inflation in the Pakistan economy and undermined the stability of the exchange rate. Underlying high inflationary pressures and exchange rate weakness have thus not only shortened the time horizon of decisions by investors but, more damagingly perhaps, put a premium on investment in inflation hedging outlets and instruments such as real estate. High Government spending, which the fiscal deficits have facilitated, has thus come at a considerable cost in terms of lower levels of investment in the economy as well as a lower level of competitiveness. These factors and a lack of security have contributed to a marked deterioration in economic performance in the country both in comparison to Pakistan's own recent history and in relation to competitor countries in South-East and South Asia.

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[99] US AID, 2009, ibid.

For the CCP, chronic inflation is a datum and, insofar as it has its origins in fiscal laxity, it recognizes the Government's compulsions in this regard, especially in the current phase of slow growth of the global economy. Nevertheless, from a longer term perspective it must continue to exhort the Government to commit itself to a robust and credible programme of fiscal consolidation. Such a commitment would not only lower inflationary expectations but should encourage investors to eschew a preference for short term gains. It would also allow the forces of competition – inter-firm contestability through innovation, quality and prices - to operate better.

A second observation was to do with reducing transaction costs and entry barriers in major sectors of the economy and to improve overall business profitability for marginal incumbents and newcomers. It has to be stressed here that the profitability of individual businesses is primarily the result of how competent the promoters/owners and managers of the business are and how good are their business plans. However, their profitability is also affected by external factors like power outages, transport and distribution inefficiencies, access to working capital and the costs of compliance with the requirements of regulatory agencies. These factors are primarily the responsibility of the Government of Pakistan.

While achieving macroeconomic stability and lowering the costs of doing business are unlikely to be attainable over the short term, the CCP is of the view that significant improvements in many other relevant areas could be made at relatively low cost that should have a major impact on the ability of enterprises to be able to thrive. Here, the CCP can only reiterate the need to re-focus public investment expenditures where they are most needed and to suggest that devolved local initiatives, say, from district authorities (including inputs from Chambers of Commerce and Industry and trade associations) influence how public expenditure decisions are made and implemented. Given the rapid pace of urbanization in the country, there is evidence that future growth in the economy might need to be redirected away from the largest urban conglomerations, where transport bottlenecks are the most severe, to smaller towns and cities. Such a shift might not only reduce distributional inefficiencies but could simultaneously open up new markets for both goods and services. Taking the cue from South-East Asia, grass-root localism (through, say, the local Chambers of Commerce and Industry) has a clear role to play in facilitating this shift by advocating to the government the benefits of a wider dispersal of economic activity in the country and for investments in support of that dispersal.

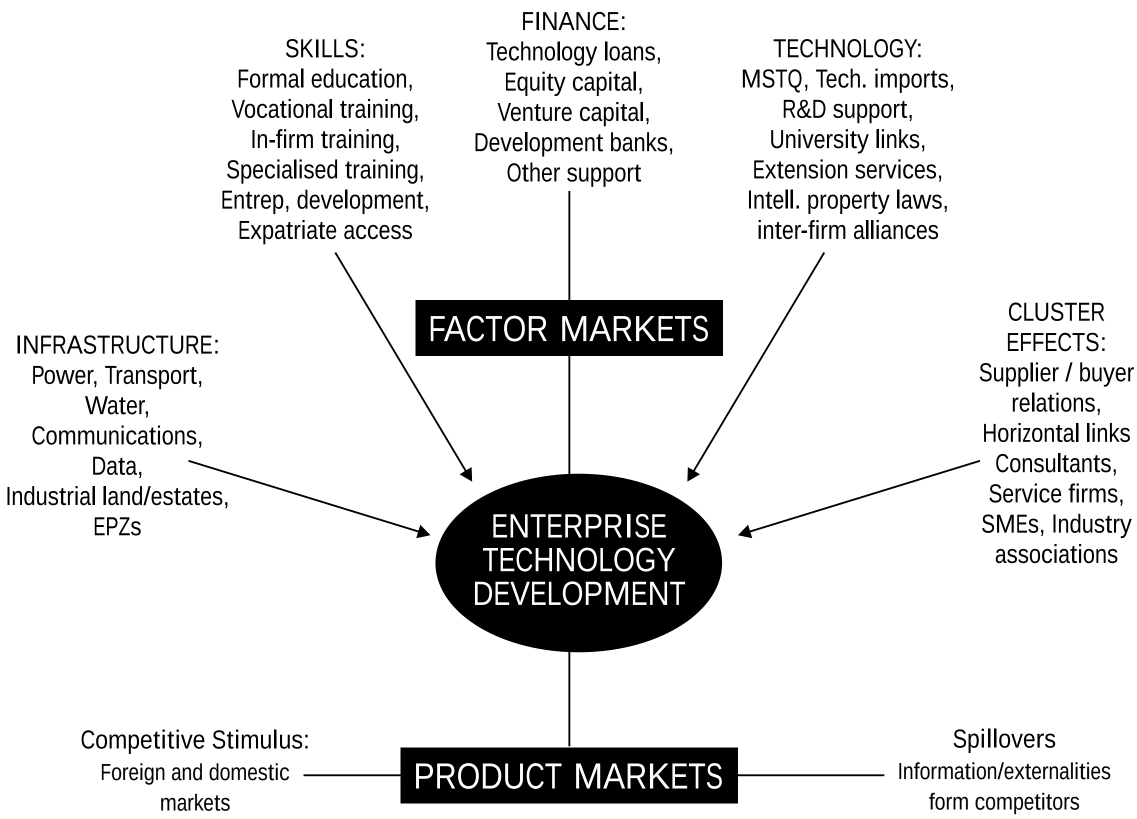
Given this overall background, where does competition policy fit into the objective of making Pakistan a more competitive economy? It is undeniable that conditions currently prevailing in the economy are not conducive to encouraging businesses to use the forces of competition to thrive. As stated elsewhere, macroeconomic fragility and uncertainty is one impediment; informal entry barriers and breaks in the value chain are another. Their long history has almost certainly incentivised existing players to take refuge in cartels and anti-competitive practices; it is such practices that make it necessary for the CCP to intervene.

Across the world incumbents have a natural tendency to defend the status quo and do not take kindly to actions that might weaken or alter it. This makes the task of an agency like the CCP more difficult as it has to argue the case *both* for its own legitimacy *and* for the need to intervene in particular instances. From the CCPs perspective there would be little harm if anti-competitive actions could be assumed, or shown, to be relatively benign in their impact. The real truth is that the price of anti-competitive conduct is substantial and is paid, in the first instance, by the consumer (final or intermediate) and, in the second instance, by the wider economy itself. The consumer is the one who has to pay higher prices, often for poorer quality goods and services, and it is the wider economy that becomes the victim of cartel-induced stasis. It is the economy that has to bear the cost of deadweight losses that manifest themselves in a low capital-output ratio as inefficient incumbents continue to survive and prevent land, labour, management and capital from shifting to more productive uses and render the economy less competitive. Thus, if there is a trade-off between allowing the status quo to exist and taking action against anti-competitive behaviour there is little doubt that the latter needs to be given priority. On both theoretical and empirical grounds, it is a travesty to argue that anti-competitive conduct can be beneficial in any way.

In order that the competition regime becomes more acceptable in the country and to its various stakeholders and more effective in its economic impact, it needs to become part and parcel of a wider strategy to enhance competitiveness in the Pakistan economy. As Paul Krugman has noted[100] that it is firms or companies that compete, not countries. However, at the level of international trade national rivalries are a central element in the way that individual countries see themselves. International trade theory is based upon the concept of comparative advantage, a concept that assumes national authorities to be the relevant decision-making units in that regard. Bilateral or multilateral trade agreements are attempts to make comparative advantage work better at the level of the individual country by removing the distorting effects of custom duties; they do not negate its underlying rationale.

A national strategy to promote competitiveness is thus valid both conceptually and as a practical technique to increase consumer welfare and strengthen the development process. In the following paragraphs an attempt is made to outline what such a strategy might consist of and what role competition policy could play in achieving its objectives.

Factors affecting competitiveness



Source: ADB Institute, 2004, *Industrial Competitiveness: The Challenge for Pakistan*

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[100] Paul Krugman, September 1996, “Making sense of the competitiveness debate”, *Oxford Review of Economic Policy*

In the figure above an attempt has been made to present the different factors that affect competitiveness at the level of the individual firm. No attempt has been made to assign them individual weights as the figure is for an illustrative purpose and not for any operational use. Skills, finance and technology are essentially inputs that the firm itself has to create or obtain. Here, it should be stressed that finance is in most developing countries a problematic area. Such countries lack both financial width and depth and new investors, by and large, have to rely on their own resources, initially at any rate. A particular lack in developing countries is start-up or venture capital finance and the capital markets, too, are not in a position to help (most companies cannot fulfil the listing requirements of stock markets). The state of infrastructure and the availability of clustering, or its lack, are factors largely beyond the control of individual enterprises. If the infrastructure is poor there is very little that a single investor can do about it (although a group of investors could have an impact up to a point).

Finally, there is the impact of competition from foreign and domestic markets and this, in turn, is facilitated by how effective a competition agency is in carrying out a policing role in checking anti-competitive conduct and promoting competition in the economy. Cross-country experience provides ample evidence which suggests that another important area where the forces of competition can play a beneficial role is in driving innovation. The successful exploitation of innovation requires: a) an effective intellectual property regime and b) an economic environment that does not put mechanical limits on a company's size. Protection of intellectual property is not a competition issue in itself. However, creating conditions in which an enterprise could successfully exploit a competitive advantage that it has acquired through innovation suggests awareness on the part of the competition agency of the need to allow enterprises to grow without running foul of abuse of dominance provisions.

The conclusions that can be gleaned from the above are that there are many factors that affect competitiveness. But for those factors to produce their full impact a properly empowered competition authority is an essential prerequisite. The role of a competition agency falls in the category of 'governance' broadly defined to indicate that oversight and regulatory bodies are a) public goods and b) they need to be suitably empowered and enabled to produce a rules-based economic environment in which incumbents and newcomers play on a level playing field. A level playing field here is defined as one which has no barriers to entry except those that are technologically necessary, as in, say, oil refining, or are of an ethical nature, as in banking and finance where 'fit and proper' individuals are needed to look after the public's savings and assets.

What conclusions can be drawn from the foregoing? There appears to be a strong case that in order to make the work of a competition agency more effective it should form part of an overall competitiveness strategy. The strategy should be articulated by a strategic vision that realistically reflects the ambitions and interests of all stakeholders, including the government, private sector bodies and public agencies. An essential pre-requisite of such a strategy is measuring and evaluating the country's competitive strengths, the main drivers of performance, the main impediments to improvement and the role of public agencies in this regard. Many, if not most, indicators in such evaluations tend to be of a qualitative, rather than quantitative, nature and involve in-depth knowledge of the policy apparatus that governs economic activities in comparator economies. Implementation of a strategic framework in Pakistan will involve not the 'picking of winners' as in an industrial policy but allowing and encouraging winners to *emerge*. It is in this context that the role of a modern competition agency like the CCP becomes relevant. The best way to proceed would be by careful analysis of cross-country experience in which such analysis is based upon countries that have broadly the same factor endowments, the same institutional set-up and with a comparable set of laws. Such analysis, as would be self-evident, is likely to be more an art than a science as it will involve judgments of the varying impacts of economic, political and cultural factors in Pakistan.

One of the consequences of globalization has been that, despite a long history of central planning most Governments today, including that of Pakistan, are no longer structured a) to take a long term view of the economy and b) to critically evaluate and judge the contribution made by different physical and institutional factors to the implementation of a long term development strategy. The required responsibilities and functions appear to be scattered now over an array of ministries and agencies. More seriously perhaps, the ministries and agencies appear not to consult on a regular basis and may even be operating at cross-purposes – the inconsistencies in the fiscal regime mentioned in Chapter II being a prime case in point.

Given such shortcomings in the structure of governance, it is obvious that developing a strategy for enhanced competitiveness in a fast-changing global economic environment is not likely to prove an easy task. Indeed, in view of the critical role of cultural factors, taken in their widest sense (whereby they influence and impact upon the effectiveness of oversight bodies), some countries will simply respond better to the same set of incentives than others. Hence, merely establishing an identical 'package deal' of incentives will never be enough whether in Pakistan or elsewhere. What is needed is flexibility on the part of the government in drawing up a long term vision for the future, one with which all the main players can identify and accept and a strong, frequently reiterated, commitment to eschew the temptation to have 'favourites' (say, the textile industry) whose excessive influence will almost certainly tend to distort economic decisions *ab initio.* The effectiveness of a strategic framework will be enhanced if the Government plays the role of a neutral arbiter as best as it can in guiding the development of the economy over the long term. The long term strategy to boost competitiveness should embody a multi-pronged agenda in which achieving a higher rate of GDP growth is given the same emphasis as improving the implicit contract between the Government and the citizens of Pakistan which manifests itself through enhancing the effectiveness of all public agencies, including the CCP.

What of the CCP itself? Now in its third year of existence the Commission has clearly marked out a role for itself in bringing competition issues to the forefront of public awareness and recognition. But, the CCP is not truly regarded as being a significant contributor to enhancing the competitive strength of the economy. Indeed, on the contrary, its role is misconstrued to be one that is damaging to business. In view of this, much remains to be done to enable the Commission to play a more directly meaningful role in making Pakistan an internationally competitive economy. Already the Commission is confronted with increasingly difficult choices in its work. We have noted earlier that one of the objectives of development policy is to allow the emergence of winners in the economy. Thus, for instance, given the small size of the market and relatively high minimum scale of production in many sectors of the economy, in a developing country setting it may become necessary for a competition agency to look at market dominance in a much more nuanced way than, say, the standard tests of market dominance might suggest.

There are essentially two sets of issues facing the CCP within the articulation and implementation of a long term strategy for competitiveness in Pakistan. First, many companies in Pakistan are on average much smaller than their counterparts in the developed countries and are therefore unable to enjoy economies of scale in the context of globalization. They are consequently losing market share domestically to imports and, by the same token, are unable to compete externally. In determining what constitutes dominance the CCP would need to weigh the respective merits of promoting competition in the relevant sector against the emergence of an internationally competitive company that appears then to have more than a dominant share of the relevant market.

Second, how does CCP deal with the huge competition posed by imported goods? Pakistan is flooded with imported goods that are sourced through both formal and informal channels. With the growth of satellite television imported goods no longer need a large infrastructure of promotional support to enter the Pakistan market. In this context, it has also to be remembered that the Pakistan market is not large enough to allow, say, a competitive, household goods industry to exist profitably and the dominance of one or two domestic players is virtually inevitable. Yet, neither one of them, or even the two together, are in a position to really exploit the consumer in a harmful way. Viewed in this manner, import competition could be construed to be an opportunity to promote the virtues of competition while simultaneously allowing the incumbent companies to obtain the benefits of scale without indulging in abuse of dominance.

What all this boils down to is that the CCP has to develop robust in-house tests and benchmarks to establish market size. These inevitably will tend to vary from sector to sector. It is self-evident that employing mechanical, rule-of-thumb, benchmarks to determine the number of relevant players in a particular sector ultimately depends upon how substitutable their products are. A large volume car maker (say, Suzuki), makers of a relatively small number of up-market cars (say, Honda and Toyota) and makers of small trucks (say, Suzuki and Hyundai) exert little competitive pressure on each other. Yet, they belong to and supply the overall market for transport in the country. The question that CCP has to answer is not whether they are, or are not, deemed to be in the same relevant market but rather that given their low substitutability whether the different segments of Pakistan's car market do, or do not, constitute a competitive structure in the car industry.

Defining the relevant market is usually a straightforward matter in developed countries (where rates of substitutability between segments of the same broad product group are known); in developing countries and in Pakistan in particular, with its size and quality of infrastructure and data shortcomings, such an exercise will require far more nuanced judgments by the CCP. It is only *after* the CCP has developed sufficient expertise to define and measure markets in this more subtle way will it be in a position to assess whether i) dominance is an important characteristic of that market or sector and ii) if any abuse of dominance is taking place. Dominance may, or may not, ultimately equate with winners but the CCP's role in a long term strategy for competitiveness is likely to rest on its ability not only to identify dominance in particular sectors of the economy but to facilitate the process of competition on a level playing field that leads to the emergence of winners in those sectors and in the wider economy of the country.

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