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OPINION ON COMPETITION CONCERNS IN THE AUTOMOBILE SECTOR

BACKGROUND

1. This opinion is being issued as culmination of the open hearing held on 11 April 2018 to discuss and identify the prevalent competition concerns in the automobile sector of Pakistan.

2. The Competition Commission of Pakistan (the 'Commission') is mandated by the Competition Act, 2010 (the 'Act') to *inter alia* undertake enforcement, advocacy, and research efforts to provide for free competition in all spheres of commercial and economic activity to enhance economic efficiency, and to protect consumers from anti-competitive behavior.

3. Section 29(c) of the Act, as part of the broader **competition advocacy** mandate under the Act, empowers the Commission to hold 'open hearings on any matter affecting the state of competition in Pakistan or affecting the country's commercial activities and expressing publicly an opinion with respect to the issues'.

4. The automobile sector has significant importance in Pakistan's economy. The sector as a whole contributes significantly towards the national exchequer (PKR 147.4 billion in 2017)[1] and provides employment to millions of people directly and indirectly. With the economic growth picking up (average 4.8% in last 5 years)[2] and increase in per capita income (55.8% increase in last ten years)[3], the demand for vehicles, both passenger and commercial, is growing and

[1] https://tribune.com.pk/story/1503749/burden-eight-areas-helped-govt-earn-mammoth-rs1-1-tr/
[2] http://www.finance.gov.pk/survey/chapters_18/Economic_Indicators_2018.pdf
[3] http://www.finance.gov.pk/survey/chapters_18/Economic_Indicators_2018.pdf

consumers are demanding better standards and more choices. **At the same time there are growing concerns over excessively long delivery times, prevalence of unofficial premiums to buy cars immediately, and lack of build quality and safety features in locally manufactured vehicles, and frequent increase in prices**.

5. Through this opinion, the Commission will examine the problems in the sector, particularly related to passenger cars highlighted by the stakeholders, identify the root causes, and give its recommendations to address the same.

BRIEF OVERVIEW OF THE AUTOMOBILE SECTOR

6. Pakistan automobile industry encompasses both passenger and commercial vehicles including tractors. According to industry estimates, the total annual demand for automobiles in the country is currently around 330,000 - 340,000.[4] These figures are in addition to the demand of around 2.4 million motorcycles per year. If the current economic growth rate (>5%) in the country sustains, the demand is likely to double in the next five years in presence of a bourgeoning youth bulge.

7. Figure 1 identifies key economic stakeholders in the industry. On the supply side, approximately 78% (2017) of the demand is fulfilled by four local automobile manufactures (Indus Motors (Toyota), Honda Atlas Motors, Pak Suzuki, and Al Haaj FAW). Approximately 22% (2017) of demand is fulfilled by imported used cars, mostly under 1000cc, under various gift and transfer schemes for overseas Pakistanis. Import of new vehicles, mostly high-end brands such as BMWs, Audi, Mercedes constitute a negligible percentage of total supply. With the implementation of the Federal Government Auto Policy 2016-2021, more car manufacturers including Hyundai, KIA, Renault, Nissan and several Chinese companies are expected to start production from 2019 onwards in partnership with local partners.

[4] https://www.brecorder.com/2018/01/22/394285/pakistan-can-hit-500000-automobiles-by-2022/

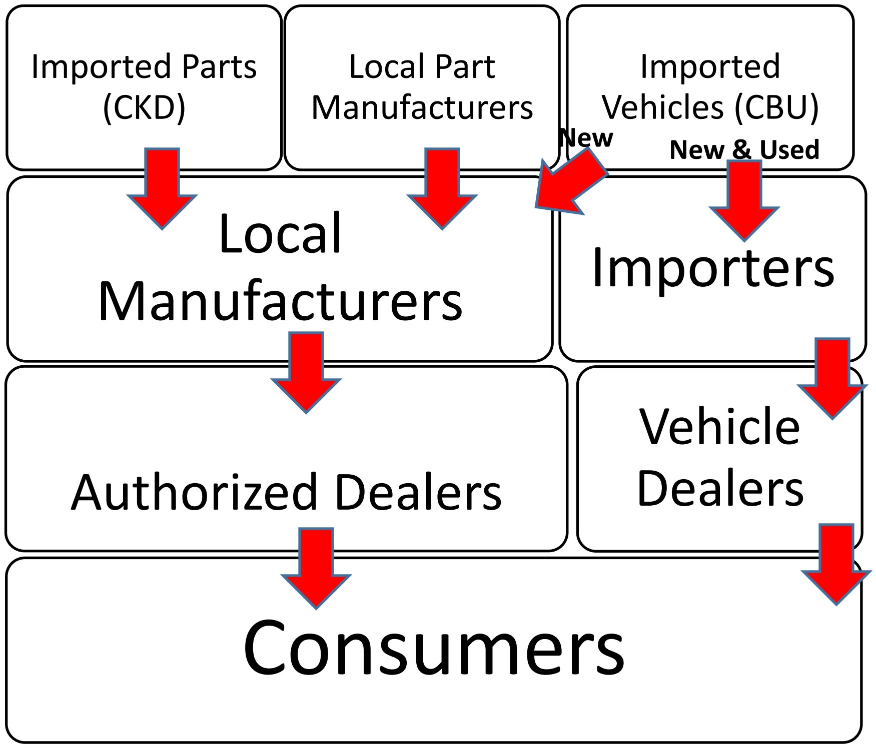

Figure 1 – Major Market Stakeholders in the Auto sector

8. Automobile manufacturers essentially assemble vehicles from parts sourced from within and outside the country. **Manufacturers have achieved high percentage of locally sourced parts for high volume vehicle models, although precision parts and components (CKD) continue to be sourced from abroad**. Indus Motor, Honda Atlas Motors, and Pak Suzuki claim that 60%, 68%, and 75% of parts for their Corolla, City and Mehran brands, respectively, are locally sourced. In the passenger car category sub-compact, compact, jeeps, and SUVs are produced in the country. Light commercial vehicles, buses, trucks and tractors are assembled in Pakistan in the commercial category. At the moment there is complete reliance on internal combustion engine vehicles and no hybrid or electric cars are being manufactured within Pakistan.

9. Taxes are imposed on locally manufactured and imported Completely Built Up (CBU) cars based on engine volume. As a result, automobiles, particularly in the passenger category, are popularly referred to in terms of engine capacity (800cc, 1300cc, 1600cc etc.). There are high import tariffs on new cars especially for 1800cc and above. The government has just recently

announced 50% reduction in duties on electric cars in both CBU and Completely Knocked Down (CKD) form.[5]

10. In 1985, the government introduced a **Deletion Program** for the auto industry in which local automobile manufacturers were to increasingly produce/source parts locally in exchange for protection from imports. To ensure compliance with WTO requirements this program was replaced in 2006 with a **Tariff Based System** which allowed assemblers to import non-localized parts on favorable duties. There is still a consistent expectation from the assemblers to increase localized content.

11. **The automotive industry in Pakistan currently works on the pull model suited for markets with weak demand**. Assemblers plan for and produce vehicles when they receive a confirmed order from customers. For the Japanese manufacturers, parts are ordered in a Just-in-Time model which helps in minimizing inventory pile up. Automobile dealers are essentially authorized agents of their principals and act as conduits between the assemblers and customers. They are compensated by payment of pre-determined commissions. This model is increasingly becoming unsuitable for Pakistan due to higher demand for vehicles.

12. While the automobile sector in Pakistan is diverse and encompasses several categories of vehicles, the focus of this opinion will be on passenger cars as all of the concerns received from the stakeholders are related to this category.

SUMMARY OF STAKEHOLDER VIEWPOINTS

Submissions from Consumers

13. A comparison with other countries clearly shows that prices of passenger cars in Pakistan are higher than other regional countries despite falling short in the overall features provided.

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[5] https://en.dailypakistan.com.pk/pakistan/budget-2018-19-government-reduces-taxes-on-automobile-home-appliances/

14. Car prices by assemblers should not be increased on random basis, but in a more structured fashion such as in the beginning of a quarter.

15. Across the world taxes are based on considerations such as carbon dioxide emission standards, whereas in Pakistan the same are applied on the cubic capacity of the engine. The tax structure should be modified as per European standards to encourage environment protection and lower fuel footprint/consumption.

16. Each of the automobile assemblers has picked a particular segment of market for sale and continues to dominate it. The 800cc segment is dominated by Suzuki Pakistan, the 1300cc by Toyota Indus Motors and the 1600cc and above segment is split between Honda and Toyota. Owing to this market structure, automobile companies have not laid any emphasis on safety and value added features as are introduced internationally. The continuous production of Suzuki in the same configuration/technology for the last 25 years is a testament to that. Another symptom of this oligopolistic market is frequent increase in prices of cars across all segments of cars.

17. Easing the duty structure on imported vehicles including electric and hybrid vehicles would encourage local assemblers to introduce new technology in their cars thereby improving competition in local automobile market.

18. The automobile assemblers have failed in implementing 'technology transfer' to the extent agreed upon with the Government of Pakistan at the time of launch of their businesses.

19. Despite Pakistan being a signatory of the U.N charter of the car safety standards (UNECEWP 29), the local car assemblers have not introduced the compulsory safety features required by the charter, such as electronic stability control, frontal impact standard, pedestrian protection and airbags.

20. The sudden increase in regulatory duties on cars through Statutory Regulatory Orders (SROs) particularly impacts consumers who have booked cars prior to such directives and on whom such costs are passed on by the automobile assemblers.

21. Most of the models introduced in the local market are obsolete in the international market and lack the quality found in international models. For this reason, the local assemblers tirelessly lobby with the Government to increase taxes and maintain time limitation with respect to import of cars.

22. Delivery of a booked vehicle from a local assembler usually takes up to six months, while cars are being hoarded by investors that charge up to 300,000 extra for on-spot delivery.

23. Exclusive dealers force customers to buy prepaid maintenance, insurance, extended warranty and registration from them which puts unnecessary burden on consumers.

24. The prices of parts available with the authorized dealerships of the local assemblers are 200 to 300 percent higher than those of parts available in open market, but the consumers opting for warranty have no option but to purchase the former at much higher prices or else their warranty is cancelled.

25. Car manufacturers demand advance payments from customers which is a source of earning profits for the manufactures at the cost of customers.

26. Import of used cars has both its pros and cons. On the one hand it can push the local assemblers to compete and allow local parts manufacturers to cater for a bigger market. On the other hand it can create a disincentive for the Original Equipment Manufacturers (OEMs) to make investments.

27. In the last 3 - 4 months the prices of cars have gone up by around 10% due to the appreciation of the dollar rate. Although the provisional booking order allows a maximum of 5% increase in price, it is only applicable in the event of any specification changes carried out in the vehicle

ordered. The price increases carried out lately were imposed on the consumers when no value addition was made to the cars by the assemblers, and when the consumer could not cancel his/her order without significant financial loss.

28. The auto policy in Pakistan needs to be revisited keeping in view technological advancements such as transition to Electric Vehicles (EV) that have already been introduced in other countries such as United States and China with the latter accounting for 50% of the total sales worldwide. The deletion program also needs to be revisited keeping in view the EV requirement and structure besides reduction on import of parts. Transition to EV will ease the burden of fuel price on the common consumers such as the owners of small to middle range cars.

29. There is a problem with implementation of Automobile Development Policy 2016-21. Buyers have been unable to redeem KIBOR plus 2% on late delivery of vehicles and have not found any forum for redressal of this concern, owing to the absence of an overseeing authority in this regard.

30. All over the world 25 years or older vehicles are classified as 'classic' cars. They are subjected to import tax not exceeding 5% of the value declared by renowned vintage car clubs. In Pakistan the import of such cars is banned for no reason. Import of such cars can generate revenue of millions of dollars through employment in refurbishment activity and further export of such cars. Classic cars pose no threat to the local industry as it is a niche market.

Traders of Automotive Parts

31. Pakistan has one of the highest rates of duties on import of auto parts which has an adverse effect on trade and economy of Pakistan. The high rate of duties encourages smuggling of parts. The rate of duty structure on imports of parts should be revised down to a level so that it encourages imports through legal channels thereby increasing government revenues and leading to the end of smuggling.

Automotive Traders Importers

32. To curb the charge of premium on vehicles, a ban should be implemented on the ownership transfer of vehicle for a defined period of time from the date of first purchase.

33. Currently cars in Pakistan are imported through non-commercial schemes that hamper the smooth import of vehicles in Pakistan. To remedy the situation, Government of Pakistan should introduce commercial schemes in this regard.

Importers

34. Government of Pakistan frequently implements taxes through SROs at short notice on the import of vehicles which raises the cost of doing business. Taxes and duties on the import of vehicles should be implemented in a similar manner as is implemented in other industries to encourage import of vehicles.

Parts Manufacturers

35. Any policy in favor of used cars will adversely impact the local industry. Countries like New Zealand and Australia implemented the policy of used car imports that resulted in the closure of their local industry. Local production of parts should be encouraged. Pakistani manufacturers of parts provide employment to thousands locally and contribute significantly to the exchequer.

36. Around 36% of parts used in automobiles in Pakistan are imported. Increase in dollar-rupee parity directly impacts the price of parts and ultimately automobiles assembled in Pakistan.

37. Premium charged by the investors and dealers on the sale of automobiles should be declared as criminal offense.

Pakistan Automobile Manufacturers Association

38. The provision of partial payment facility for booking of vehicles encourages investors to book multiple cars and charge premium on them.

39. Manufacturers are currently operating more than their capacities and are also investing in the capacity enhancement of their plants to meet the demand of automobiles.

40. There should be mandatory policy on booking of cars through pay order from the customer's own account rather than payment through third party to discourage premium money.

41. Penalty should be imposed on the transfer of new cars if sold within 90 days of purchase.

42. Exchange rate of dollar is the cause of rise in the prices of cars. Manufacturers do not hedge against increase in rates due to high costs and risks.

43. The market for used imported cars is bigger than the market for locally manufactured cars when individual segments are compared.

ISSUES

44. The following concerns can clearly be identified in the passenger car segment from the submissions made before and the concerns received by the Commission.
    a. **Frequent and unjustified price increases by manufacturers**
    b. **Prevalence of premium (on money) for early delivery**
    c. **Excessively long delivery times for domestically assembled cars**
    d. **Low levels of localization of automotive precision parts**
    e. **Absence of consumer protection in the auto industry**
    f. **Substandard production, outdated car models, and lack of safety features**
    g. **Frequent changes in automobile taxation policy by the Federal Government**

h. **Inadequate incentives for fuel efficient hybrid or alternate fuel (electric) cars**

45. These concerns can broadly be categorized into three major issues. The first relates to the **inability of supply to meet existing demand** in a timely manner. The second relates to the **lack of a proper regulatory framework** for safety and production standards, and consumer protection. The third relates to the prevalence of policy measures that do not sufficiently **encourage innovation and growth**. All three issues shall be discussed ahead.

SUPPLY SIDE PROBLEMS

Production Capacity

46. Pakistan first saw a boom in demand of passenger cars in the early 2000s when better availability of consumer auto financing[6] and sound economic growth made it possible for the growing middle class to purchase vehicles. **Between 2002-2003 and 2003-2004 production of passenger vehicles increased from 66,806 to 104,469**. This period of strong demand remained till 2006-2007 with production peaking at 179,314 in the same year.

47. Due to the economic and financial crisis of 2008, production of passenger cars dropped to 85,240 in 2008-09 before recovering back to above 100,000 level. While there was another dip in production between 2012 and 2014, the overall trend remained upward and production topped 200,000 level in 2017-18. **The passenger car production in 2017-18 grew 21% when compared to the previous year.**

48. Table 1 and Figure 2 show domestic production trend of passenger cars (Cars,Jeeps/SUVs) since 2000-2001.

[6] http://www.sbp.org.pk/publications/fsa-2001-2002/Chapter%202.pdf

Year	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Cars	41,556	42,679	66,432	103,662	133,722	170,487	176,016	164,710	84,308
Jeeps	459	564	374	807	1,564	2,472	3,298	1,590	932
Total	42,015	43,243	66,806	104,469	135,286	172,959	179,314	166,300	85,240
Year	**2009-09**	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**
Cars	121,647	133,972	154,255	120,332	116,605	152,524	179,944	186,936	217,774
Jeeps	1,172	883	451	1,475	1,217	1,109	773	3,530	13,364
Total	122,819	134,855	154,706	121,807	117,822	153,633	180,717	190,466	231,138

Table 1 – Passenger Car Production 2008-2017 – Source: PAMA

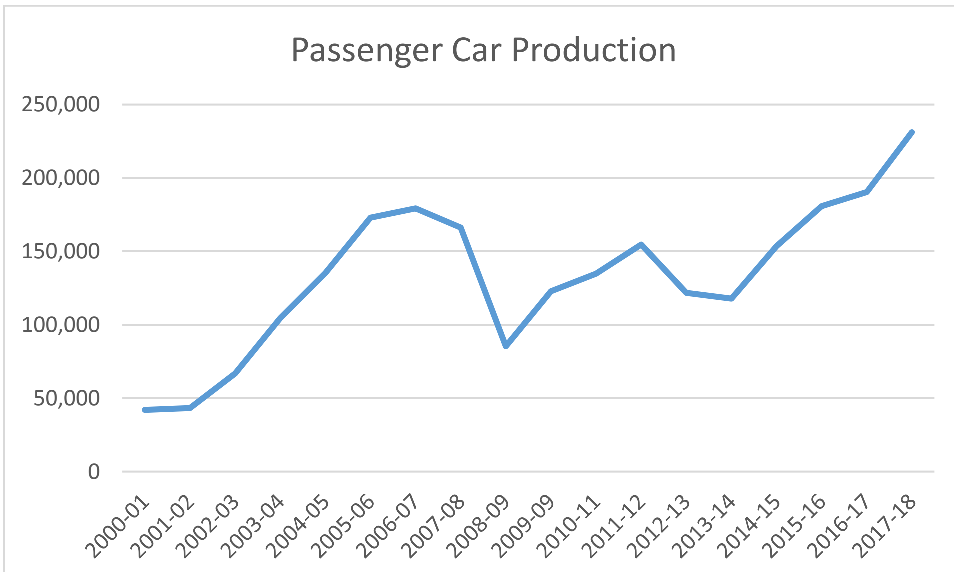


Figure 2 – Passenger Car Production Trend

49. The production breakdown according to automobile manufacturers from 2013-2017 is laid out in Table 2.

Manufacturer Wise Car Production Data						
Vehicle	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Honda (Civic)	9,608	10,020	8,341	*		
Honda (City)	11,638	13,585	15,930			
Honda (Civic & City) Total	21,246	23,605	24,271	25,061	36,531	42710
Suzuki (Liana)	150	144	0	0	0	0
Suzuki (Swift)	5,945	5,047	3,319	4,176	4,376	4920
Suzuki (Khyber/ Cultus)	12,785	14,467	14,142	16,772	17,797	19894
Suzuki (Wagon-R)	0	2,532	5,067	9,504	17,516	29954

Suzuki (Mehran)	34,278	28,485	30,381	36,869	38,311	47199
Suzuki (Bolan)	13,046	13,991	23,952	30,088	19,531	21879
Suzuki (Total)	66204	64666	76861	97409	97531	123846
Toyota (Corolla)	32,882	28,124	51,392	57,474	52,874	51218
Hyundai (Santro Plus)	0	210	0	0	0	0
TOTAL CARS	120,332	116,605	152,524	179,944	186,936	
Toyota Fortuner	847	420	685	582	1,373	4183
Sigma (Defender)	628	797	424	191	0	0
Honda BR-V	0	0	0	0	2,157	9181
TOTAL JEEPS	1,475	1,217	1,109	773	3,530	13364
TOTAL PASSENGER	121,807	117,822	153,633	180717	190466	231138

Table 2 – Manufacturer Wise Car Production Data – Source: PAMA

*Since 2016 Honda only reports consolidated production numbers

50. Table 3 shows the installed annual capacity of existing major car assemblers in Pakistan along with expected increase in capacity by 2019. Pak Suzuki Motor Company is the largest in terms of assembly line capacity with provision for 150,000 cars, Indus Motor Company has an installed capacity of 54,800 cars. Atlas Honda Motors has an installed capacity of 50,000 cars. Al Haj FAW Motors has a capacity of 11,000 motors. It should be noted that **actual production can exceed installed capacity by way of extending shifts or manufacturing during holidays** etc. Indus Motor in particular has been trying to increase production by this method to keep up with strong demand in the previous years. As an example, with this strategy they will be able to produce around 75,000 cars with an installed capacity increase to 65,000 cars.

Manufacturer	**Capacity 2018**	**Capacity 2019**
Pak Suzuki Motors	150,000	150,000
Indus Motor	54,800	65,000
Atlas Honda Motors	50,000	55,000
Al Haj FAW	11,000	11,000
Total	2,65,800	2,81,000

Table 3 – Installed Annual Production Capacity – Submission to CCP

51. According to the government and industry estimates, Pakistan can become a 500,000 vehicle market by 2023-2025 out of which a majority will be passenger cars.[7] To achieve these numbers, auto manufacturers will have to ramp up production quite significantly. Out of the four existing players only Indus Motor and Atlas Honda have shown an indication to moderately (by 10-20%) increase their production capacities in 2018/2019. Indus Motor and Atlas Honda have both submitted that increasing capacity is a time and capital intensive process and investments take over one to two years to mature. While there have been efforts to marginally increase production in the past years, there is **no indication that any of the existing manufacturers is considering a significant increase in production capacity** in the next few years.

52. It appears that the **Auto Policy 2016-21 has been successful in attracting new entrants into the market**. As discussed above, several new manufacturers are expected to enter the market in the next couple of years. To this end, the Federal Government deserves much credit in providing sufficient incentives to attract new entry and attempt to break the existing stalemate. How the new automobile manufacturers affect the production equation, however, is yet to be seen.

53. **The lack of any major expansion plans of existing incumbents is quite worrisome given the growing demand for cars**. There is no doubt that a significant expansion will be costly and time consuming. Nevertheless, in a market that is slated to double in a few years, and in view of strong sales, there is plenty of incentive to make the investments. Currently one passenger car is produced for every 869 persons in the country. This ratio shows that there is great potential for development. The import of 65000 to 70000 used cars annually is further indication that there is adequate room for more local production. It is quite surprising thus that none of the manufacturers want to assemble and offer cars that can directly compete with the used cars being imported.

[7] https://www.brecorder.com/2018/01/22/394285/pakistan-can-hit-500000-automobiles-by-2022/
http://www.engineeringpakistan.com/ADP%202016latest.pdf

54. Part of the reason that none of the manufacturers want to significantly increase production capacity is their complacency with their own market shares. Suzuki Motors, for example, gets a majority of its sales from small cars with engines up to 1000cc. Indus Motor focuses heavily on compact sedans of 1300 and 1600cc while Atlas Honda has an established presence in subcompact sedan of 1300cc and compact sedan 1800cc. Al-Haj FAW is selling subcompact 1300cc hatchbacks. All three companies have their own distinct vehicles in the SUV/Jeep categories with no direct competition. Indus Motor's Fortuner (Local) and Land Cruiser (imported), Pak Suzuki Vitara (imported) and Honda BRV (Local) all cater to different segments of the market. While there are some minor overlaps particularly in the subcompact 1300cc sedan segment, for the most part, **every manufacturer is comfortable in its own category and appears unwilling to compete with the others**.

55. It is very likely that this position was achieved coincidently in the early years with all manufacturers attempting to grab and consolidate a market position. Nevertheless, as the industry is now reasonably mature, there ought to be no excuse for the unwillingness of major players to challenge each other and compete in multiple categories. There is no cogent reason why manufacturers would not want to expand their capacity and introduce passenger car models that challenge each other's market shares in face of growing demand. If Pakistan wants to achieve economies of scale in car manufacturing, automobile assemblers have to engage in more aggressive business strategies.

56. Once again, the strategy of the new entrants will have a great bearing on the overall market. **If one or more of the entrants adopt a competitive approach and introduce quality and competitively priced products that directly challenge existing manufacturers and models, it will serve as an important catalyst for existing players to enhance production, increase quality and decrease prices**. On the other hand, if the new entrants also focus solely on creating niche spaces, there is going to be little impact on the overall level of competition in the market.

57. When talking about production, it is also important to look at the automotive parts industry. The industry representatives explained that different cars have different levels of localization

depending on volumes. For example, 60% of parts used by Indus Motors to produce the corolla are produced locally. For the Honda City, the extent of localization is 68%. Similarly, the localization for Suzuki Mehran stands around 75%. According to the assemblers and automotive part manufacturers, **localization of parts requires economies of scale given heavy investments are required, particularly for making precision parts**. This is particularly due to the fact that high fixed costs have to be spread over high volumes to make economic and financial sense. The industry points to the motorcycle market in Pakistan as an example of where localization is taking place more rapidly given the high volume of production (1.9 million in 2018). According to the auto parts manufacturers, smuggled and counterfeit parts, and high investment costs are a major impediment to realizing the full potential of the industry

58. The contentions of the industry representatives are understandable. There is no denying the fact that the pace of localization of parts will depend on many factors including volumes of production, availability of finance, willingness of global partners to transfer technology, and the curtailment of counterfeit and smuggled goods. We also understand that **some parts may never be produced in Pakistan as it will always be cheaper to import them from abroad**, at least in the foreseeable future. The 'Regional Competitiveness Studies: Research Study on the Auto Sector' is an excellent study on Pakistan's automotive sector in relation to regional markets and talks extensively about issues related to part vendors. [8] At the same time it is important to realize that Pakistani automotive part vendors have a lot of room to improve. Currently there are no tier 1 auto part vendors in the country who supply directly to regional or global OEMS.[9] **In order to develop the auto parts market, it is important that the government facilitate the availability of financing, encourage Research and Development (R&D), and curb sale of smuggled and counterfeit goods through the relevant law enforcement authorities**.

[8] http://ideaspak.org/images/Publications/Fiscal-Federalism/Regional-Competitiveness-Auto-Sector-Report.pdf
[9] http://ideaspak.org/images/Publications/Fiscal-Federalism/Regional-Competitiveness-Auto-Sector-Report.pdf

Delivery Times and Premiums (On Money)

59. When queried about long delivery times, two major players stated that they are currently **experiencing demand that is more than their installed capacity**. Atlas Honda particularly explained that the launch of newer models has contributed towards this rise. Indus Motor while accepting that there is a greater demand specifically blames investors who hoard their vehicles for profiteering. Pak Suzuki rejected the impression of long delivery times and stated that it does not wait for customers to book before producing cars. The industry further blamed the **policy of partial payment at booking for the increase in investor led hoarding**. They claim that where investors were earlier booking one car, they could now book four and create further issues.

60. Under the auto policy a payment of (KIBOR + 2%) is due to customers by manufacturers if delivery is delayed over two months. In their submissions before the Commission, Indus Motor stated that around 40% of car deliveries attract late delivery payments. Atlas Honda and Pak Suzuki have also indicated that heavy amounts have been paid as compensation for late deliveries. It would not be incorrect to say that a **significant portion of deliveries are delayed beyond two months** for the three major manufacturers, which is not a healthy sign for capacity and competitiveness in the industry. The problem is compounded by the fact that there is no regulator or legislation to ensure that customers who face lengthy delivery times are compensated as per the policy.

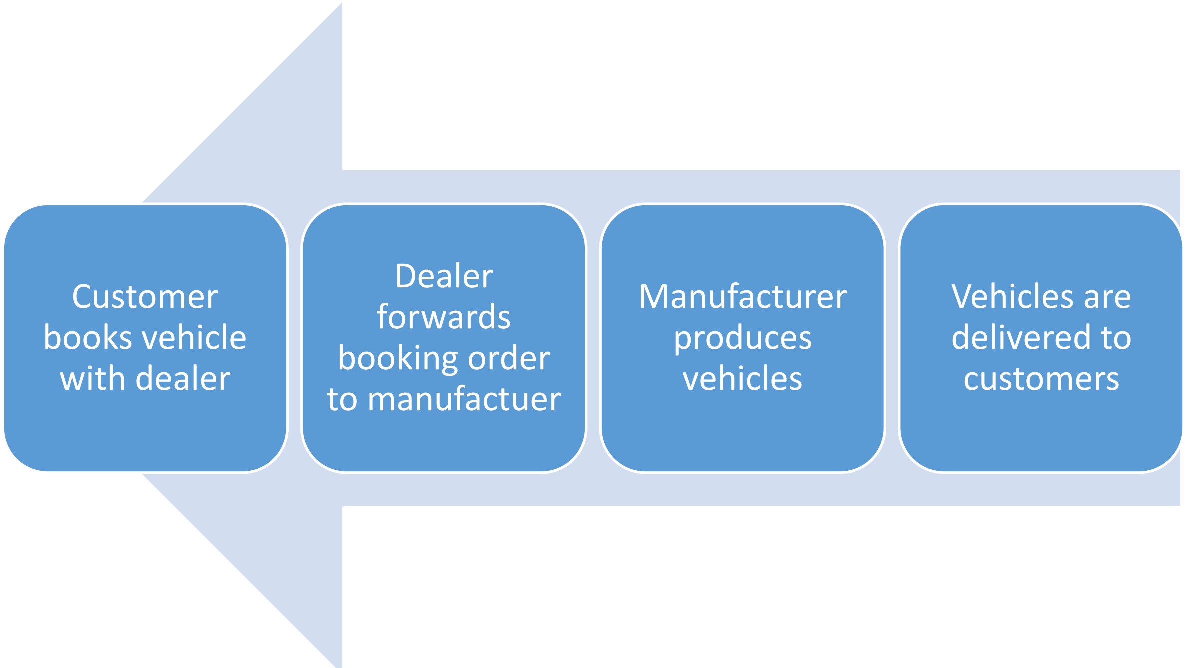
61. Indus Motor has asserted that it actively scrutinizes booking orders to identify **investors** from among the **end-user customers**. It further stated that whenever these investors are identified, the bookings are cancelled. It contended that due to the policy of accepting partial payments, investors have been emboldened and are now booking more cars than before.

62. It is important at this point to understand the direct retail model on which the automobile industry generally operates. All manufacturers have agents (showrooms\dealers) who book and deliver cars to customers on behalf of the former. The industry operates on a demand pull factor. A car is only produced once there is a confirmed order from an end user along with at

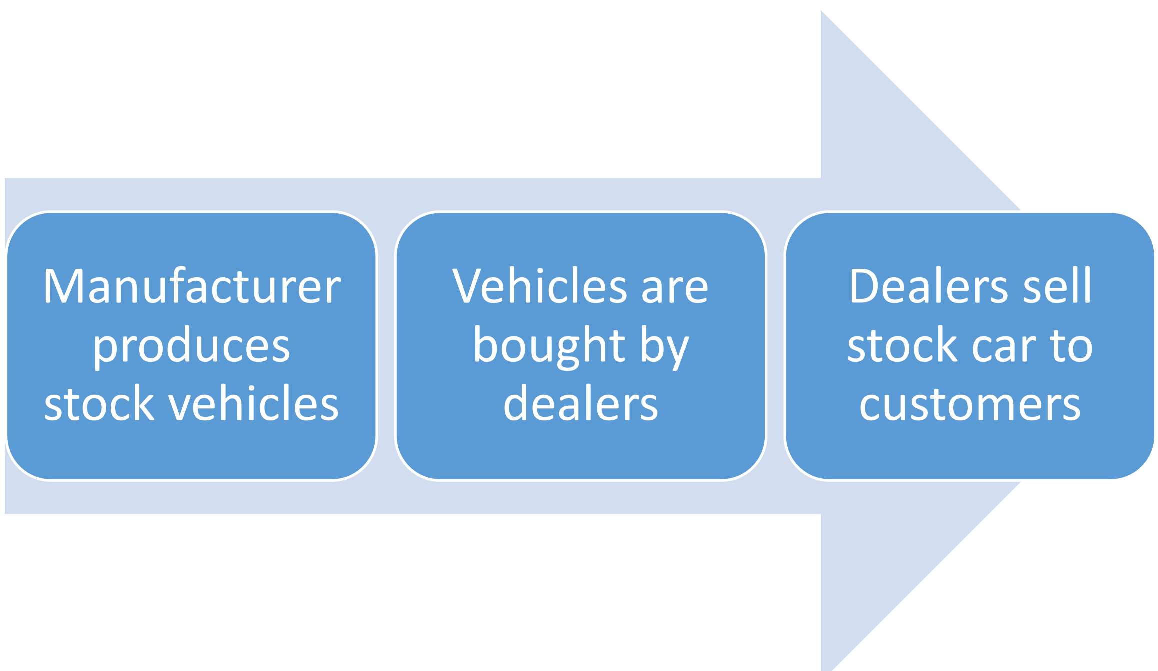
least a partial payment. The showroom/dealers have no official inventory of their own (apart from limited numbers for showcasing and test driving) and act as agents of the manufacturers, taking payments from the customers and handing over their cars for a commission from the manufacturers. **This is invariably a demand-pull model of operation, where cars are only produced when an order is placed**.

63. This model ties itself back to the low risk policies of the existing automobile manufacturers. None of the automobile manufacturers feel the need to push vehicles outwards by offering better quality, options or prices. **At the same time, this model opens up opportunity for investors seeking to make quick money by booking several vehicles and then selling them to customers for a premium by offering an immediate sale**. Those with personal bookings are effectively pushed ahead in the timeline further exacerbating the situation. This model was adopted for low demand markets but is unsuitable for the high demand market Pakistan is becoming.

64. **Many countries carry an alternative push, or wholesale, model instead, in which manufacturers sell stock cars (variants with most commonly demanded specifications) to dealers who resell these new vehicles to consumers**. These dealers can be exclusive to one manufacturers or can carry multiple brands depending on acceptability and business requirements. This model creates competition inter se the dealers and allows customers to get better deals on the spot, particularly when there are multi-brand dealerships. When dealers will own the cars themselves, they will be less inclined to hold stocks as that will tie up working capital and lose clients as well. Those customers who wish to have **custom cars** (variants with less commonly demanded specification) instead of stock cars will have to wait a little longer for their car to be produced.



Direct retail market model based on the ‘pull’ model



Wholesale market model based on the ‘push’ model

65. The manufacturers have submitted that they have proposed this alternate wholesale model which would require **changes in the taxation regime**. In the existing model, if manufacturers

sell vehicles to the dealers who sell it onward to customers, withholding tax under Section 231B of the Income Tax, Ordinance will be applied twice (once when manufacturers sell cars to dealers and once when dealers sell cars to customers) leading to double taxation and an unwarranted increase in vehicle price. Furthermore in the current scenario, if dealers sell vehicles to corporate entities, a withholding tax of 4% under Section 153 of the Income Tax Ordinance, 2001 has to be paid, a tax from which manufacturers are exempt, which again causes anomalies. Furthermore, they submit, if dealers currently buy wholesale and then retail to consumers, a minimum 1% turnover tax is applicable under Section 133 of the Income Tax Ordinance, 2001.

66. According to the industry, this taxation framework makes the wholesale model unfeasible. To make it viable, the industry submits that the government should reduce minimum turnover tax for car dealers from 1% to 0.25%, exempt dealers from withholding tax at time of wholesale purchase from manufacturers under Section 231B of the Income Tax Ordinance, 2001, and also exempt dealers from withholding tax under Section 153 of the Income Tax Ordinance, 2001 when selling cars to corporations.

67. The industry's proposals with respect to the wholesale model are reasonable and require a patient and thorough consideration from the government. The model, by spreading financial risk on assemblers and dealers, would **incentivize quicker ramping up of production capacity**. Furthermore, it would **allow investors/dealers to conduct over-the-table legal dealings while becoming part of the tax net**. The system would allow for multi-brand dealerships which will improve competition considerably and allow consumers to make choices on the spot. This would also greatly assist the tax authorities in **documenting the economy and expanding the tax base**.

68. One potential objection that can be contemplated is that the proposal will require more effort from the revenue department as tax which was earlier deducted from a handful of manufacturers would have to be collected from potentially hundreds of dealers. The government should not, however, reject this proposal solely on account of convenience of tax collection. The wholesale or push model of sales will be extremely important for the growth

in the automobile industry and for checking the problem of ghost investments that result in returns through under-the-table premiums/on-money.

69. The automobile industry has given other recommendations as well to check the issue of premiums. During the hearing it recommended that an additional advance tax of PKR 100,000, over existing taxes, should be collected in case a vehicle is sold prior to registration. It further recommended that transfer fee and taxation for vehicles whose registration is changed during six months of initial registrations should be the same as that applied to a new registration.

70. While these measures are not unreasonable in theory, they may be practically impossible to implement as people will carry on buying and selling cars on contract and transfer for a few months to avoid these new costs. The transfer of car before registration is currently not possible in any case. On the other end, applying these stringent conditions beyond a few months will hurt people who have to sell their vehicles due to a host of genuine reasons. It can also have a negative effect on the resale market as an unintended consequence.

71. The recommendation by the automobile manufacturers to **require payment from the customer's own account in form of a pay order for car purchases** is quite sensible and should be adopted. The policy will lessen the opportunity for invisible investors making bogus multiple bookings and help in documenting the economy further.

72. At the end of the day though, **delivery times will significantly improve when manufacturers increase their production capacities to keep up, or ahead of, demand**. Cancelling investor bookings frees up a very small portion of production for end-users and does nothing to significantly reduce delivery times.

Pricing

73. All major car assemblers have increased prices of their passenger car models several times in the last six months. The following table shows the price increase for some of the passenger car models.

	January February	March-April	June-July	Total Increase	Total % Increase
Suzuki Mehran VXR	742000	762000	795000	53000	7.14
Honda City 1.3 MT	1599000	1699000	1729000	130000	8.13
Corolla GLI MT	1949000	2049000	2149000	200000	10.26

Table 4 – Increase in Retail Prices of Select Passenger Cars – 2018

74. The price increases shown are in most commonly sold models. The increase in other models maybe more or less than that captured in the table above. The assemblers have increased these prices primarily citing depreciation in the value of the PKR vis-à-vis the US dollar as various parts are imported from abroad as CKD.

75. The **USD-PKR depreciation** is recorded in the figure below which shows that between January and July 2018, the conversion ratio of USD to PKR changed from 1:105 to around 1:125. **This is a percentage increase of around 19%**.

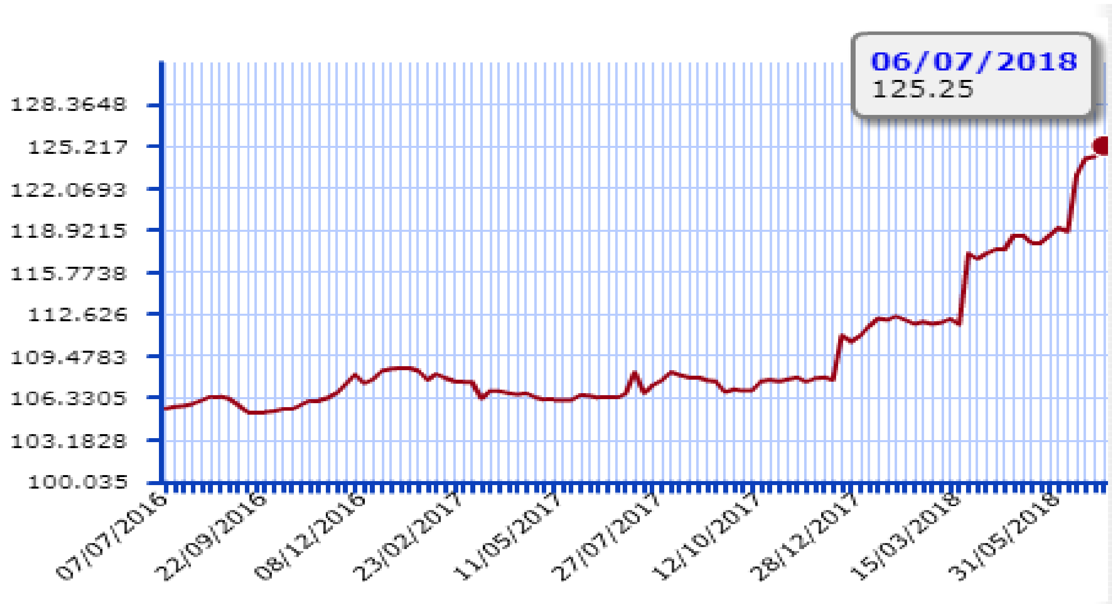


Figure 3 – US Dollar – PKR Valuation Trend

76. On the face of it, the **price increases appear to be within or less than the degree expected due to the depreciation**. However, as price is never only a function of cost, the actual **ability of these manufacturers to raise prices essentially lies with their existing market power**. In other words, these **companies are able to raise prices comfortably without fear of losing market share as there is no sufficient competition in the market**. As discussed earlier, this is likely to change if new players enter the market with vigorous business plans.

77. Apart from the issue of raising prices, another complaint routinely received from consumers is that these **manufacturers apply these price changes even on those customers who have partially or fully paid in advance** for their vehicles. Such consumers feel that they should be insulated from the increase.

78. The assemblers have submitted that as per policy they do not maintain any long term stocks of parts particularly in line with the Just-in-Time model. Therefore, even if people have paid in advance, it is not possible to shelter them from an increase beyond a certain time period. Indus Motor particularly added that it does not apply the increase on fully paid bookings that are to be delivered within a month but that it is not possible to apply this policy beyond that. On being

asked, Indus Motor replied that it does not enter into forward contracts to cushion itself from PKR devaluation. It explained that hedging against dollar-rupee parity entails financial cost and that there was little reason to expect a sudden devaluation of the Pakistani rupee given the stability in the past few years.

79. The position of the manufacturers in this regard is quite untenable. **Where manufacturers have taken partial or full payment several months in advance, it is only fair that they do not pass on subsequent price increase, even if due to depreciation of Pakistani rupee, to the customers**. It is the right of every business to decide for themselves the model they want to operate on. For example, a manufacturer has every right to implement a Just-in-Time model so that it does not pile up inventory. Similarly, not entering into forward contracts is a decision that the manufacturers can rightfully take depending on market conditions. Once they take these decisions, however, they are also subject to their consequences and must accept the subsequent business risk. Therefore, if assemblers face cost fluctuations due to their own business decisions, they should not pass these on to consumers, particularly when they take extremely long to deliver the vehicles. Once a booking has been made, whether by partial or full payment, the customers need to be shielded from any subsequent price increases. By keeping the price susceptible to change till the actual date of delivery, customers are made hostage to arbitrary decisions of the assemblers. Price increases announced by manufacturers should be prospective and only applicable on bookings made after the price announcements are made.

REGULATORY FRAMEWORK & CONSUMER PROTECTION

80. The Commission has been inundated with **consumer complaints related to poor quality of vehicle production, high fuel consumption, lack of customer support in fixing new vehicle issues, delays in delivery, lack of safety features**. Very often the problems encountered by consumers who have bought new cars encompass badly fitted or damaged car parts and the long process through which these problems are fixed. During the open hearing, participants frequently highlighted that they were unaware of the authority or organization mandated to

resolve these issues. Given the nature of the complaints a look into the regulatory framework for this sector is important.

81. **The regulatory framework for the automobile sector in Pakistan is extremely fragmented**. At the top, the Federal Government approves policies developed by the Engineering Development Board (currently defunct), a body under the Ministry of Industries and Production. Some aspects of vehicle standards are set by Pakistan Standards and Quality Control Authority, a body under the Ministry of Science and Technology. Standards of emissions from vehicles at one point were set by the Environmental Protection Agency, Ministry of Climate Change, though never implemented, and now all provinces have their own environmental laws and agencies. Standards of fuel are set by Oil and Gas Regulatory Authority in coordination with Ministry of Energy. Vehicle registration and safety is also a provincial subject and is implemented by the motor registration authorities and traffic police respectively. Consumer courts, as established by provinces, can deal with individual complaints from consumers.

82. **While government policies outline various actions, there is no legal or regulatory framework which allows any of the mentioned agencies from implementing them**. As an example, under the Auto Policy 2016-21, the government imposed a penalty on manufacturers for late deliveries. Although EDB claims to have oversight, in reality there is no legal basis or mechanism to impose and recover the same.

83. Moreover, the fragmentation has led to no standards being implemented. When EPA set emission standards in early 2000s the industry went to court and obtained a stay order on the premise that emission standards could not be met without corresponding standards of fuel. The situation has now further been complicated with all provinces having separate environmental protection regimes. Unless all provinces implemented the same emission standards, it would be impossible to implement all of them. A similar issue exists for safety standards which are completely non-existent in the first place and if they were to be implemented, all the provinces would have to agree on one set of standards.

84. At this point, therefore, there is no viable and cogent sector regulatory framework in place for protecting the customers and enforcing standards. This is the complete opposite to best practices where vehicles have to prescribe to basic standards and face testing prior to their sale. **The lack of this framework is one of the major reasons the automobile manufacturers feel no pressure in improving standards. Realistically they have no standards to meet or tests to pass**. As a result, for example, Suzuki Motors is still selling a passenger vehicle that the rest of the world stopped producing 30 years ago. Similarly, car recalls for technical issues are purely at the discretion of the companies and there is no authority for consumers to go to if they are sold sub-standard products.

85. Given the nature of the industry and its problems, there is a dire need to bring about legal and regulatory changes to establish a separate, **independent and empowered vehicle standards and safety authority at the national level** to deal with technical and consumer aspects in the automobile sector. We are aware that some powers currently reside with the provinces. As a result, the Federal Government will have to work with the provincial governments to seek their agreement and requisite legal approvals to create such an agency. This national agency should have adequate powers to introduce standards for quality, safety and emissions, conduct inspections and tests at various stages of production and sale, and remedy harm to individual consumers. Furthermore, this regulator should have the power to impose similar standards on imported used cars.

86. It is important that provincial governments realize that this problem cannot be solved without their active interest and support. Having four to five different standards of safety and emissions will not help the automobile industry at all. Similarly, having disjoint consumer protection for automobile consumers is impractical and serves no ones' benefit. On the other hand, if all provinces agree to common standards and consumer protection, it will greatly assist in the development of the automobile industry and in delivering value to the consumers in general.

87. At the same time, the Federal Government must bring harmony within its own policies. For example, if Pakistan wants introduction of cleaner more efficient engines, it must also ensure

that the fuel being supplied is up to the standard and that the taxation regime supports the initiative. Otherwise, achieving these aims will not be possible.

POLICY CONSISTENCY AND INNOVATION

88. As mentioned earlier, the Auto Policy 2016-21 has been successful in attracting several new entrants into the automobile sector in general and passenger cars in particular. The policy shows that the right incentives lower barriers to entry. **With new players coming in, one can imagine more competition in the market which will be beneficial to all stakeholders in the market.**

89. **Incentives that are offered in the policy to new entrants must be preserved**. This means that the deliberate better terms offered to those starting green field or brown field assembly projects as compared to existing players and imports must be maintained for the duration that is agreed to with the new entrants. Without these incentives, new entry is going to be unlikely.

90. There are growing demands by the existing players to grant them similar incentives to increase their production beyond current levels. If this demand is acceded to, there may be no incentive for new assemblers to enter or continue their operations. **It must be kept in mind that the existing players have had ample time to recoup investments they have made in near monopoly conditions due to protections afforded to them**.

91. If the new entrants play their part right, the existing players will have all the incentive they need to expand on their own unless they want to lose market share. **The entrance of new players offering good quality products at competitive prices will push the existing players to adopt a more robust production and sale strategy**. Therefore, the Federal Government needs to ensure that this policy is not changed.

92. Arbitrarily changing policy mid cycle will be extremely detrimental to the overall level of automotive sector's development. During the hearing some participants pointed out the tendency of the Federal Government to change tariffs and accompanying conditions through

Statutory Regulatory Orders. As mentioned above, it is important that the policy be kept consistent so that it's reliable and dependable for new entrants. The Commission has no doubt that the Federal Government is well cognizant of this.

93. Innovation is the key to constant technological advancement in any industry. While Pakistan's automobile industry has come a long way compared to a couple of decades ago, there is still a significant difference when compared to the global automotive industry. Most of the engines used in Pakistani passenger cars, for example, are outdated and inefficient having **high fuel consumption** which also has an impact on the environment as well as operating costs for consumers.

94. **The way taxation is generally applied on vehicles i.e based on engine volume, takes away the incentive for adopting more efficient technology**. The greater the engine by volume, the higher the applicable taxes on the car. A general impression is that bigger engines use more fuel as compared to smaller ones. While this may have been true several decades ago, it is no longer the case. Increasingly, better technology has enabled very efficient internal combustion engines which means that cars carrying newer engines of bigger volume may actually be more fuel efficient than older engines with lower volume.

95. The taxation regime in Pakistan does not allow any incentive for bringing in better and newer engines and other hybrid/electric technology. Instead of promoting efficiency which would also have an impact on the fuel import bill, it rewards status quo. **A much better way which would incentivize innovation would be to tax vehicles based on verified fuel efficiency of engines and emissions.** This would mean incentivizing customers in demanding and manufacturers in selling vehicles that are fuel efficient in modern terms. Similar tax relief could be extended to vehicles which carry contemporary safety measures.

96. We understand, that the recent budget just passed by the Federal Government, has further slashed import tariffs on electric vehicles. This effort is laudable and will encourage the introduction of latest technology in the country.

97. Generally speaking, most passenger car models (generations) are introduced in Pakistan much later than their global launch. The public usually has to wait several years before a new generation is made available. The assemblers submitted during the open hearing that introducing a vehicle generation requires substantial investment of capital and time by their parts vendors and suppliers. They further submitted that whenever a new generation of a vehicle is launched, preparation in the supply chain starts almost a year or two ago. Assemblers further cited that it does not make economic sense to immediately launch new generations.

98. We are unconvinced by these arguments. If the launch of new car models can take place elsewhere in the world, it is entirely possible that the industry in Pakistan can do the same. This does not mean that a reasonable delay in line with business strategy cannot take place. However, delaying entry of newer generations for several years beyond the global practice is unacceptable. **A serious question is raised as to why Pakistani assemblers keep buying CKD parts of older generations from abroad when their principles have moved on**.

99. While in a free market, business decisions of private entities cannot be controlled by the government, the latter also cannot allow the sale of outdated vehicles that pose a significant safety and environmental threat. In this regard, it would be useful to consider **legislation or policies that penalize import of CKD kits of outdated vehicle models/generations** beyond a certain point by charging higher tariffs. This would incentivize assemblers to introduce newer models more in sync with the rest of the world.

CONCLUSIONS AND RECOMMENDATIONS

100. **Pakistan automobile industry is essentially marred by a lack of competition**. Complaints of quality, availability and pricing of passenger cars particularly is characteristic of an uncompetitive market where existing players are not facing any meaningful competitive pressure. As a result, consumers have to face the consequences. Nevertheless, the following recommendations, if implemented, would improve the situation in the sector and provide some relief to the consumers.

a. **No price change after booking:** We have received numerous complaints that manufacturers announce arbitrary price increases retrospectively even after a booking has been made usually on account of rupee depreciation. As explained in paragraphs 77-79, automobile manufacturers take a calculated business risk when they apply the Just-in-Time inventory model and do not hedge against currency value fluctuations. These are valid business and commercial decisions that automobile manufactures take. Nevertheless, once customers book a vehicle, whether through partial or full payment, they have a reasonable expectation that any future price increase would not be applied on them particularly when they have to wait several months to get delivery of their vehicles for no fault of their own. **It is strongly recommended that automobile manufacturers not apply price increases on customers retrospectively after booking has been made**. **Price increases announced by manufacturers should be prospective and only applicable on bookings made after the price announcements are made.**

b. **Removal of double taxation to allow for supply-push based wholesale automotive market:** As discussed in paragraphs 62 to 68, the current direct retail model selling vehicles based on demand pull is increasingly becoming unsuitable for Pakistan's market. This model concentrates business risk on manufacturers, making expansion and production decisions harder. This system also allows undocumented investors to make multiple bookings and then later sell cars on under-the-table premiums (on-money) to actual customers. As a long term measure to discourage blockages created by undocumented investors looking to make quick money from premiums, and to allow for a more suitable supply push based wholesale model which cater to the growing demand, **we recommend that the government should consider appropriate changes in the advance/withholding income tax regime, particularly Section 153 and 231B of the Income Tax Ordinance, 2001, to remove double taxation in order to encourage a documented wholesale car market**.

c. **Measures for reducing premium/on-money**: As discussed in detail from paragraphs 59 to 72, **the issue of long delays in car deliveries from assemblers is essentially due to supply of cars being unable to keep up with growing demand**. The problem is unlikely to be resolved completely unless there is significant expansion by existing players. **The entry of new assemblers and availability of new vehicles by next year may improve the situation provided the new entrants bring significant production capacity and an attractive vehicle range across all passenger car segments (sedans, hatchback, jeeps etc) and various engine sizes**.

d. Short term measures such as **banning or taxing transfer of new vehicles within three to six months of initial purchase,** proposed by some stakeholders including the assemblers, **are likely to have no or little effect and should be avoided**. However, there should be a **mandatory requirement to pay for new car purchases through pay orders made on the customer's own account**. This will help in reducing the incidence of multiple booking by investors on names of unrelated people and will assist in documentation of the economy.

e. During the open hearing, consumers pointed out the fact that there is no authority to implement the penalty (KIBOR +2%) introduced in the Auto Policy 2016-2021 on assemblers that deliver vehicles later than 2 months. **As an immediate measure to overcome this lacuna, appropriate legislation should be undertaken to implement the penalty and an appropriate government body should be made responsible for its implementation.**

f. **Creation of a national automotive sector standards and safety authority:** As discussed in paragraphs 80-87, the current regulatory framework regarding the auto industry is fragmented and distributed across several departments of the Federal and provincial governments. This makes regulation and consumer protection ineffective. To ensure introduction of quality, safety and environmental standards, and to take care of consumer issues in the automobile sector, the **Federal and provincial governments should work together to create an independent and empowered national vehicle standards and safety authority**. The authority should have ample powers to:

i. Introduce and enforce various standards relating to production, quality, safety, fuel efficiency, and emissions of both locally produced and imported cars.
ii. Deal with all consumer issues and complaints related to vehicle quality, manufacturer warranties, and after-sale services.

g. In this regard, a task force comprising representatives of all the relevant stakeholders including Federal and provincial governments should be formed to finalize proposals for creating the new organization.

h. **Taxation based on innovation and efficiency:** In paragraphs 93-99 we have discussed in detail how government policies can encourage the automotive industry to innovate and bring in newer technologies. The Federal and provincial governments should consider incentivizing efficient and modern technology by replacing the **existing taxation regime based on engine volume**, to one that rewards **fuel efficiency, lower emissions, and newer technologies**. Furthermore, assemblers who import **CKD parts of outdated vehicle** models/generations beyond 2 years from the global average should be discouraged by charging them **higher import tariffs**.

i. **Measures to support automotive part venders:** The lack of localization of automotive parts is essentially a question of economies of scale and transfer of technology as discussed in paragraphs 57 and 58. As precision and sophisticated parts require substantial investment, it only makes commercial sense to produce them when there is demand for sufficient volumes. Currently there are no tier 1 auto part vendors in the country who supply directly to regional or global OEMs. The government can support part manufacturers by offering them concessional financing rates and other incentives aimed at starting R&D efforts, with the eventual goal of enabling local part vendors to gain regional and global Tier 1 status. Similarly, the use of smuggled and counterfeit parts must be discouraged through strong enforcement of intellectual property and custom laws.

j. **Enhancing competition and supply through new entry:** To address the lack of competition in the market in general, **Federal and provincial governments should continue to support the timely entry of new assemblers in the market** which will have a positive effect on the market in general. In our opinion, the incentives provided to the new entrants vis-à-vis the existing players should be maintained during the periods agreed with the new entrants as per the Auto Policy 2016-21 which is a major step in catalyzing competition in the market.

k. **Consistency in automotive policy:** In paragraphs 88-92, we have discussed in detail the importance of continuing existing automobile policies, particularly around taxation. The Federal Government should ensure a continuity in policies that have attracted new entrants in the automotive manufacturing market. A vibrant and competitive automobile sector will only be built and sustained if players are able to enter and challenge the hegemony of existing players and put competitive pressure on them.

Islamabad, September 14, 2018