<u>Policy Note on the Discriminatory Levy of GIDC on Selective Fertilizer Plants</u>

The Competition Commission of Pakistan ("the Commission") took notice of concerns raised by fertilizer companies against the discriminatory levy of the Gas Infrastructure Development Cess (GIDC) that discriminates against the fertilizer plants installed prior to the Fertilizer Policy 2001 vis-à-vis the plants that were commissioned and became operative after the Fertilizer Policy 2001, by placing the pre-2001 plants at a cost disadvantage, thereby distorting the competition in the urea market.

I. <u>Background</u>

The agriculture sector, being the downstream consumer of urea has a strong nexus with the national fertilizer industry. The importance of the agriculture industry of Pakistan cannot be overstated, as it accounts for approximately 21% of Pakistan's GDP, and employs approximately 43.7 % of the country's labour force.[1]

The Government of Pakistan issued the Fertilizer Policy in 2001 ("the Fertilizer Policy 2001") which became effective from 1st July 2001. The objective of Fertilizer Policy 2001 was "*<u>to provide investors in</u>* ***<u>new</u>*** *<u>fertilizer plants in Pakistan</u>* ***<u>a gas price that enables them to compete in the domestic market</u>*** *with fertilizer exporters of the Middle East so that indigenous production is able to support the agricultural sector's requirement by fulfilling fertilizer demand"*[2] The word "new" does not refer to "brand new plants", rather the word new is used in the sense of additional plants, which may be second-hand as well. Thus, the concept of efficient use of scarce resource (gas) was not taken into account by the Fertilizer Policy 2001. In essence, the Fertilizer Policy 2001 was continuation of the Fertilizer Policy of 1989, and was focused on *<u>"bringing in substantive investment to enhance domestic production.</u>*"[3]

The Fertilizer Policy 2001 ensured equal treatment for all market-players by stipulating that *"all the fertilizer producers, domestic and foreign, public and private will be <u>treated equally</u> in commercial, fiscal, corporate and contractual matter."*[4], with the exception that post-2001 plants will be offered "a gas price that enables them to compete in the domestic market." The Fertilizer Policy 2001 granted a certain lower price for gas feed stock to all post-2001 plants. It appears that the rationale behind setting a lower rate of gas price for post-2001 fertilizer plants was to compensate these companies for their project financing, and the ten year period of discount corresponded to the debt repayment period.

With the controlled rate of feed gas, the price differential of feed gas between pre-2001 and post-2001 fertilizer plants rose to approximately Rs. 41/MMBTU[5], with the pre-2001 plants paying the higher rate. Thereafter, GIDC was levied under the Gas Infrastructure Development Cess Act, 2011, to provide imposition and collection of infrastructure development cess on natural gas in respect of Iran Pakistan Pipeline Project, Turkmenistan Afghanistan Pakistan India (TAPI) Pipeline Project, LNG or other

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[1] Page iii, Overview of the Economy, PAKISTAN ECONOMIC SURVEY 2013-2014, Ministry of Finance, Gov't of Pakistan, available at <http://finance.gov.pk/survey/chapters_13/executive%20summary.pdf>
[2] Fertilizer Policy, 2001, Clause 2.1.1
[3] Id., Clause 2.3.1
[4] Id., Clause 2.5
[5] Calculated on the basis of controlled price in 2011 when new plants became operational.

projects or for price equalization of other imported alternative fuels including LPG.[6] With respect to the fertilizer sector, GIDC was applicable selectively on feed gas supplied to pre-2001 fertilizer plants at the rate of Rs. 197/MMBTU with effect from 1st January 2012.[7] The GIDC Act was amended in December 2013, enhancing the GIDC levy to Rs. 300/MMBTU from the previous rate of Rs. 197/MMBTU. However, GIDC was also levied on fertilizer fuel stock on all plants without discrimination of pre or post 2001 plants. Schedule II of the GIDC Act amended in 2013 is reproduced below.

Table I

Schedule II of the GIDC Act

S. No.	Sector	Cess (Rs./ MMBTU)
(1)	(2)	(3)
1.	Fertilizer- Feedstock (except for the fertilizer plants having fixed price contracts)	300.00
2.	Compressed Natural Gas (CNG)	
	(a) Region -I KPK, Balochistan & Potohar Region (Rawalpindi, Islamabad & Gujarat)	263.56
	(b) Region II Sindh & Punjab (Excluding Potohar Region)	200.00
3.	Industrial including Captive Power and Fertilizer Fuel Stock	100.00
4.	WAPDA/KESC/GENCOs	100.00
5.	Independent Power Plants (IPPs)	100.00
6.	Commercial	-
7.	Domestic	-
8.	Cement	-
9.	Liberty Power Plant	-

The Commission held a public hearing on 29 April, 2014 at the Commission's headquarters, to hear the viewpoints of all the stake-holders on the subject-matter, which was attended by the representatives of fertilizer manufacturers and Ministry of Petroleum's officials.

Section 29 of the Competition Act, 2010 empowers the Commission to promote competition, *inter alia*, by reviewing policy frameworks for fostering competition and making suitable recommendations, to the Federal or Provincial Government, to amend any law that affects competition within Pakistan. Ensuring competitive markets is the basic public good, which the Competition Commission ensures. Competitive markets lead to competitive prices, better quality goods, more choices and innovation, thereby enhancing consumer welfare. If market conditions are distorted, through regulatory measures or otherwise, the competitive process is tilted and consequently consumer welfare is harmed.

II. Issue

Whether the selective levy of GIDC on pre-2001 fertilizer plants distorts market conditions and has restricted competition in the market of urea and thereby harmed consumers. We reply in affirmative for the reasons recorded below.

[6] Gas Infrastructure Development Cess Act 2011 Act, 2011, Section 4.

[7] Id., Schedule II.

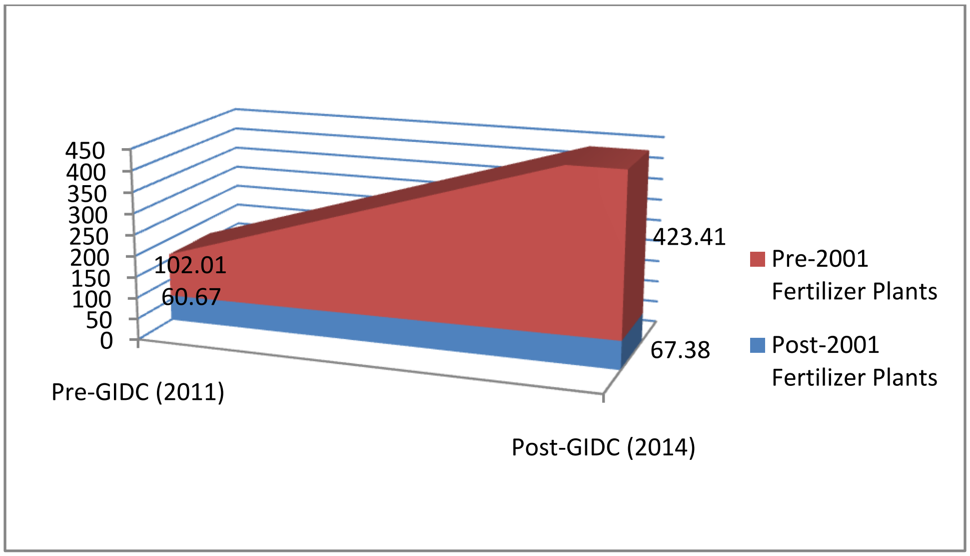
III. Competition Concerns/Discussion

A. Discrimination resulting in consumer loss

Feed gas is a major (80%) raw material used in the production of urea fertilizer. Lower rate of feed gas coupled with exemption of GIDC for post-2001 fertilizer plants results in a price difference of RKR 355/MMBTU for feed gas between the pre-2001 and post-2001 plants. This cost disadvantage makes it difficult for pre-2001 plants to compete with the post-2001 plants. Following graph shows difference in cost of feed gas per MMBTU incurred by the fertilizers plants before and after the introduction of GIDC:

Graph 1

Increase in Cost of Feed gas/MMBTU



The red portion above includes the selective levy of GIDC on pre-2001 plants for feed gas, which increased the cost of feed gas from PKR 102 in 2011, PRK 320 in 2013, to PKR 423 in 2014. Below is industry-wide production data:

Table II

Production Data for 2013*

Company	Feed Gas/Ton (MMBTU)	Price of Feed Gas/MMBTU (PKR)	Cost of Feed Gas/Ton (PKR)	GIDC per Ton	Total Production (tons)	Urea Market Price/Ton (PKR)	Total GIDC (PKR in Billions)	Production cost Feed Gas (PKR in Billion)
Post-2001 Fertilizer Plant	23	67.38	1550	4513	2,912,000	34,440	13.1	21.5
Pre-2001 Fertilizer Plant	23	320.41	7369	-	1,917,000	34,440		3
Post-2001 Plant (Windfall)			5819	-	1,917,000			11.2

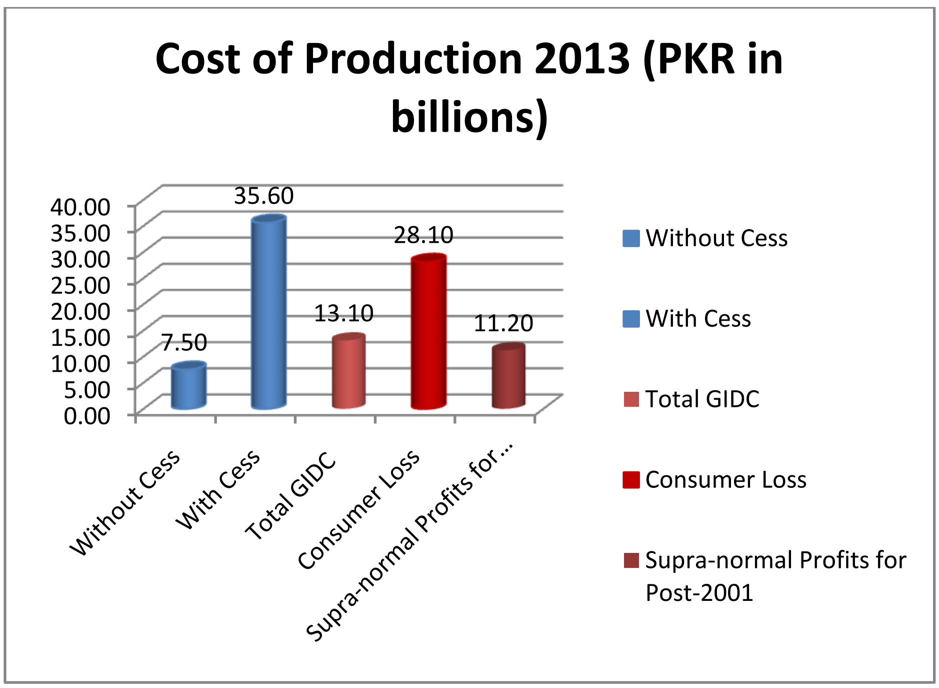
*Source: Data gathered by the Commission from fertilizer plants. Possibility of +/- 5 % error.

Despite the cost-savings for the post-2001 fertilizer plants, they sold urea in 2013 at the same rate as those sold by pre-2001 plants, resulting in supra-normal profits for the post-2001 plants and supra-competitive price to the consumers (farmers).

Given all other factors of production are constant and equal for the post and pre 2001 plants, in a competitive market, the price of urea based on the cost of feed gas alone, should have tilted towards the price of post-2001 plants, i.e., feed gas without GIDC. Revenues would have been somewhere close to PKR 7.5 billion for the year 2013. However, the fact is that post-2001 plants sold the urea at the same price as that sold by pre-2001 plants; the price of urea based on the cost of feed gas alone, tilted towards the price of pre-2001 plants, i.e., feed gas with GIDC. Thus, the total urea produced was sold as if all plants paid GIDC. This resulted in Consumer Loss of PKR 28.1 billion and supra-natural profits for the post-2001 plants to the tune of PKR 11.2 billion, equal to 31% of the production cost based on feed gas. Whereas the GIDC accrued for the national exchequer was 13.1 billion.

Graph 2

Production Cost Feed Gas, 2013



Similarly, the data for the first quarter of 2014 reflects the same scenario as was in 2013.

Table III

Production Data for 1st Quarter, 2014*

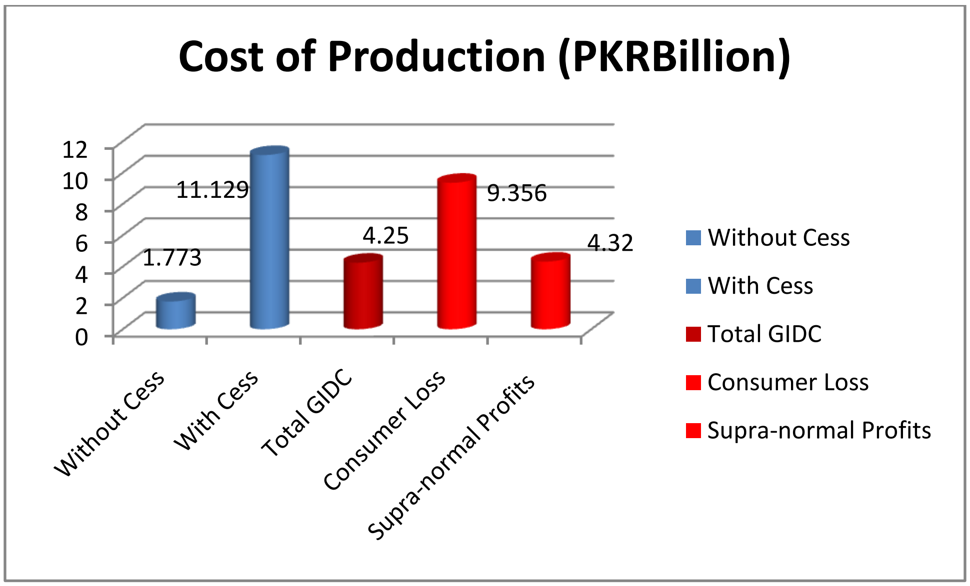
Fertilizer Plants	Feed Gas/Ton (MMBTU)	Price of Feed Gas/MMBTU (PKR)	Cost of Feed Gas (PKR/Ton)	GIDC per Ton	Production (Tons)	Urea Market Rate (Ton /(PKR)	Total GIDC Accrued (PKR in Billions)	Production Cost Feed Gas (PKR in Billions)
Pre-2001**	23	423	9,729	6,900	616,000	35,680	4.25	5.99
Post-2001	23	67.38	1,550	-	528,000	35,760		0.818
Post-2001 (Windfall)			8,179	-	528,000			4.32

*Source: Data gathered by the Commission from fertilizer plants. Possibility of +/- 5 % error.

** Data for Pre-2001 is based on the figures supplied by one plant only.

Graph 3

Production Cost Feed Gas, 1st Quarter 2014



After the amendments in GIDC Act in December 2013, cost differential of feed gas has magnified and currently stands at Rs.355 per MMBTU, resulting in supra-normal profits of PKR 4 billion only in the first quarter of 2014 in respect of feed gas cost saving for post-2001 fertilizer plants. The supra-normal profit for post-2001 plants rose from 31% of the production cost based on feed gas in 2013 to 39% in the first quarter of 2014. Whereas the total GIDC accrued to the national exchequer was 4.25 billion, less than the supra-normal profits.

B. Catch-22 Situation

The selective imposition has placed the fertilizer sector in a catch-22 situation. If the post-2001plants sell urea at a price based on their own cost of feed gas, they will certainly sell at a much lower price than that of pre-2001 plants, and therefore will drive the pre-2001 plants out of the market. This will completely be the antithesis of the Fertilizer Policy 2001: the investment will be driven out of the market, and domestic production will be reduced.[8] On the other hand, if the post-2001 plants will sell urea at a price based on the cost of the feed gas to pre-2001 plants, the price will certainly not be the competitive price, and the farmer will end up pay much higher prices. This will again be the antithesis of the Fertilizer Policy 2001: assuring reasonable prices of fertilizers to farmers below the import-price.[9]

It is certain that the framers of the GIDC have not perceived the negative impact of cost increase for selective plants on farmers and end consumers. Agriculture also provides for the generation of economic growth through provision of raw materials for other industries. Therefore, the cost differential among fertilizer producers not only has a direct impact on agriculture, it also has a cascading effect on every connected industry.

Apart from the violation of competition principles, the discrimination goes against the very spirit of the Fertilizer Policy 2001 *i.e*., to *"enhance domestic production"* and *"equal treatment"* for all fertilizer producers. It cannot be presumed that the Fertilizer Policy 2001 intended to encourage new investment at the cost of pre-2001 fertilizer plants.

C. <u>Summary of Impact of Selective Imposition of GIDC</u>

i. Distorting market conditions resulting in exorbitant huge prices for farmers.
ii. Windfall for selective players (of more than PKR 4 billion in just one quarter of 2014).
iii. Multiplier effect – high prices of urea result in high prices for crops (staple food).
    a. High cost impact on population living on poverty line.
    b. Cascading effect on every industry connected with agricultural produce.
iv. Catch 22 situation for the fertilizer sector.

IV. Recommendation

In view of the above, it is recommended that GIDC is charged equally to all fertilizer plants to create a level -playing field in the urea market. Therefore, it is proposed that the levy of GIDC on feed stock for pre-2001 fertilizer plants be withdrawn and that the Second Schedule of the GIDC Act may be amended to rationalize the GIDC on fuel gas used by fertilizer plants, thereby eliminating the cost disadvantage to pre-2001 fertilizer plants. It is pertinent to mention here paragraph 2.1.5 of the Fertilizer Policy 2001 that states that the "fuel gas prices shall continue to be treated as at par with other industrial consumers." Currently, the price of the fuel gas supplied to fertilizer plants is not treated as at par with other industrial consumers because of the discriminatory cess on fertilizer plants vis-à-vis other industrial consumers.[10] This discrimination may also be rectified.

<u>ISLAMABAD, THE 19TH OF JUNE, 2014.</u>

[8] See preamble of Fertilizer Policy 2001.
[9] Id.,
[10] See Schedule II at Table I above, at page 2.