POLICY NOTE

IMPOSITION OF 15% REGULATORY DUTY ON THE IMPORT OF STEEL BILLETS

1. The Competition Act, 2010 (the 'Act') provides for 'free competition in all spheres of commercial and economic activity to enhance economic efficiency and to protect consumers from anti-competitive behavior. The Competition Commission of Pakistan ('the Commission') is mandated under Section 29(b) of the Competition Act, 2010 (the 'Act') to review policy frameworks for fostering competition and to make recommendations for amendments to laws that affect competition in the country. This policy note recommends amendment to the section of SRO 18(I)/2015 concerning imposition of 15% regulatory duty on imported steel billets in order to create a level playing field in the market for steel end products.

I. Background:

2. The steel industry is comprised of vertically integrated as well as non-integrated units. There are **'steel melters'** that convert imported scrap into billets which are then used to produce deformed steel bars through a process called re-rolling.

3. There are also specialized **'re-rolling mills'** which operate mostly out of the Sindh region that do not have vertically integrated units but convert scrap from the ship-breakers into steel bars. This, however, serves only the low quality end of the market. These same mills can also use high quality local or imported billets to manufacture high quality Grade 60 steel bars.

4. The primary market of concern here is the market for high quality steel bars (the 'relevant market') that are produced from high quality steel billets particularly in the Sindh/Balochistan region. The steel melters (the 'integrated units') produce their own billets whereas the re-rolling mills have the option to either procure them from the integrated units operating in Pakistan or import them from abroad. A flow chart describing the structure of steel industry as discussed above can be viewed in **Appendix A**.

5. Historically the re-rolling mills have been relying on the local supply of steel billets to serve the relevant market up until June, 2014 when the prices of internationally available steel products including high quality steel billets saw a downward trend.

6. The advent of cheap imports had the integrated units pushing the Government for higher regulatory duty on the import of steel billets. In January 2015 a regulatory duty of 15% ('RD') was imposed on the import of steel billets under SRO 18(I)/2015.

II. Issue:

7. The RD imposed under SRO 18(I)/2015 denies a level playing field to the specialized re-rolling mills compared to the integrated units, particularly in the Sindh/Balochistan region, and therefore restricts competition for the following reasons:

III. Competition concerns:

I. Statutory protection

8. Competition is the key to economic growth because it provides greater choice to consumers and provides an impetus to competing undertakings to be their most efficient and cost effective. Where Government generates statutory protection, it reduces competition. There is a broad consensus among economists that the impact of protectionism on economic growth (and on economic welfare in general) is largely negative[1]. This view is reflected in assertions[2] of economists world over.

9. The imposition of RD as it appears has served as a statutory protection for the interest of melting industry, especially the large scale integrated units, at the cost of reduced incentive for entry and expansion at the re-rolling stage of operations. There is no evidence that the melting units have gone out of business as a result of availability of cheap imports. In fact the large scale integrated units, who are the predominant suppliers of steel bars in the Sindh/Balochistan have thrived during this period (from the advent of cheap imports till the imposition of RD). The only effect the statutory protection or any increase in it from here on could be to limit the choice of re-rolling mills for buying billets and force them to buy from their competitors, thereby, denying the latter a level playing field and restricting competition in the relevant market.

[1] See P.Krugman, «The Narrow and Broad Arguments for Free Trade», American Economic Review, Papers and Proceedings, 83(3), 1993 ; and P.Krugman, Peddling Prosperity: Economic Sense and Nonsense in the Age of Diminished Expectations, New York, W.W. Norton & Company, 1994

[2] Protectionism results in deadweight loss; this loss to overall welfare gives no-one any benefit, unlike in a free market, where there is no such total loss. According to economist Stephen P. Magee, the benefits of free trade outweigh the losses by as much as 100 to 1.[2]

10. This scenario is accurately depicted in Alan Greenspan's (former chair of the American Federal Reserve) criticism of protectionist proposals as leading to in his words:

> an atrophy of our competitive ability. ... If the protectionist route is followed, newer, more efficient industries will have less scope to expand, and overall output and economic welfare will suffer[3].

II. Barriers To Entry and Expansion:

11. The impact of an imposition of RD appears to be nothing but to create a barrier to entry in manufacturing steel bars. Also there is no evidence that imports have forced the melting units to close down. These assertions are evident in the light of the following factors:

Conflict of Interest:

12. There is a conflict of interest that is inherent in the market structure with the integrated units being both the potential suppliers and competitors of the re-rolling mills in the downstream market. The availability of cheaply priced imports allowed the re-rolling mills an opportunity to break out of this inherent conflict. It is due to this conflict of interest that the re-rolling mills catering to the Sindh/Balochistan region have been prior to the availability of cheap imports, doing bulk of their purchase from one undertaking, which while supplying them billets did not compete with them in the market of steel bars, and therefore offered them competitive rates.

13. If we only look at the record of purchase of billets by the re-rolling mills in the Balochistan/Sindh region from the local manufacturers over the last 3 years, it is apparent that supply from the largest integrated units who have the lion's share in the market of steel bars was very limited. In comparison to that the subject re-rolling mills have done more of their purchase from mills located as far as Lahore and Islamabad, an activity that entails high transportation cost.

14. The only plausible explanation for this is that the large integrated units had been unable to offer competitive rates. This is not surprising considering that the primary interest of these units has been to produce billets to cater to their downstream market. Furthermore it would not be of interest to the large integrated units to supply billets at competitive rates to the re-rolling mills as it would inevitably raise competition for them in the relevant market. This above assertion is also evident from the fact, that large scale units in Sindh

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[3] Sicilia, David B. & Cruikshank, Jeffrey L. (2000). *The Greenspan Effect*, p. 131. New York: McGraw-Hill. ISBN 0-07-134919-7.

have large excess capacity for producing billets. They utilize roughly 50% of their capacities for production of billets. If they utilize their capacities to the maximum, not only will it reduce the cost of production substantially, but also enable them to cater to the entire demand of re- rolling mills.

Decreasing trend of prices on scrap import surpasses that of prices of imported billets:

15. This conflict of interest is also apparent in the fact that it is not just the price of billets that has gone down in the international market. The prices of scrap that serve as raw material for the integrated units has also undergone a similar decreasing trend. In fact while the prices of imported billets have gone down by 25.9%, those of scrap have gone down by 30.9%. Despite that, the largest integrated units in Sindh/Balochistan felt no incentive to supply billets at competitive rates to the re-rolling mills.

Impact of imports on the incumbents:

16. The figure for overall billet availability in the year 2014-15 is between **3.5-4 million tonnes**. Of this, the imports constituted between **200,000 to 227,000 tonnes**. If we take the lower of the figures for billet availability and higher of the figures for imported billets, the imports constitute a mere **6.5 %** of the market. Just the mere quantum of these imports is enough to show that they are unlikely to hurt the local melting industry that produces the remaining 93.5% of the billets albeit primarily for their own requirements.

17. Furthermore the figures also reveal that the re-rolling mills in Sindh/Balochistan catering to the market of steel bars are responsible for roughly 35,000 metric tonnes of imported billets for the period June 2014 to April 2015 of the total imports of 227,000 metric tonnes.

18. The remaining imports, as per our information, can be attributed to melting and re-rolling units operating in other regions primarily Punjab and capital territory, who do not produce sufficient billets to fulfill their re-rolling requirements or in some mills' case when their billet production operations break down. The imposition of RD thus has the effect of closing other options, forcing these melters to fulfil their requirement of billets from fellow melters (integrated units) even though the likelihood of getting competitive rates is slim to none. Therefore even outside of Sindh/Balochistan, the imposition of RD is not protecting the melters' primary business (steel end products) but only limiting options for procurement of an intermediate product (billets) that the integrated units primarily use as a raw material for the production of finished steel products.

Financial Situation of the LSUs:

19. The large scale integrated units in Balochistan/Sindh market were among the foremost proponents of imposition of RD on steel billets claiming that their own businesses and that of their fellow melters have been negatively affected due to availability of cheaply imported billets. If we look at the period from June 2014 to June 2015, however, not only has the growth of the largest integrated units in Sindh/Balochistan remained unhindered, but resumed the same rate as in the immediately preceding year (when cheap imports were unavailable) with their profits more than doubling in this period.

20. Even prior to the imposition of RD on cheap imports in the mentioned period, the electricity consumption pattern of the large scale integrated units showed a growth trend.

RD imposed across the board even though concessions are exclusive to China:

21. While all the parties, those advocating the present RD and its further increase and those opposing it - the former blaming it on dumping by China and the latter attributing it to concessions by the Chinese government - agree that chinese billets have a price advantage over others, the same is not true for other countries that export steel billets.

22. A prohibitive RD across the board, including other countries, would remove any competitive pressure for the local manufacturers of billets to sell the billets at competitive rates to the local re-rolling mills.

23. This would in turn also serve as a barrier to entry for fresh entrants, allowing only the local integrated units to predominantly supply high quality finished bars, at the cost of efficiency, consumer welfare and economic advancement.

III. Denial of a level playing field:

24. FBR in its letter informed the Commission, that as a result of the imposition of RD, imports of steel have drastically come down (imports worth Rs. 793 Million as against Rs. 4,217 Million before the RD imposition).

25. This can mean one of two things, either the mills who were previously importing are now forced to buy billets from their competitors or they have curtailed operations involving high quality steel billets. Each of these scenarios implies lessening of

competition in the market for high quality steel bars. This is especially worrisome given that the market for high quality steel bars is growing as more and more infrastructure projects are being unraveled.

26. If such protection is maintained or in the worst scenario strengthened, it can eliminate competition all together in the long run, leaving the ground open for the large scale integrated units to carry out business on their own terms. This would especially serve as detrimental to the interest of end consumers.

IV. Conclusion:

27. Summarizing the above , the RD on steel billets discourage their imports, limiting the options of re- rolling mills to rely on their competitors for the supply of billets as raw material. This is of particular concern in the Sindh/Balochistan region, where the existing suppliers of steel bars or any potential entrants may find no incentive to enter the market despite an ever growing demand as mentioned above.

28. Furthermore the tiny quantum of imports, the impressive financial health of the large integrated units catering to the Sindh/Balochistan market and a decreasing trend in the prices of international scrap defy any reasoning of existential threat to the steel melters operating in the country.

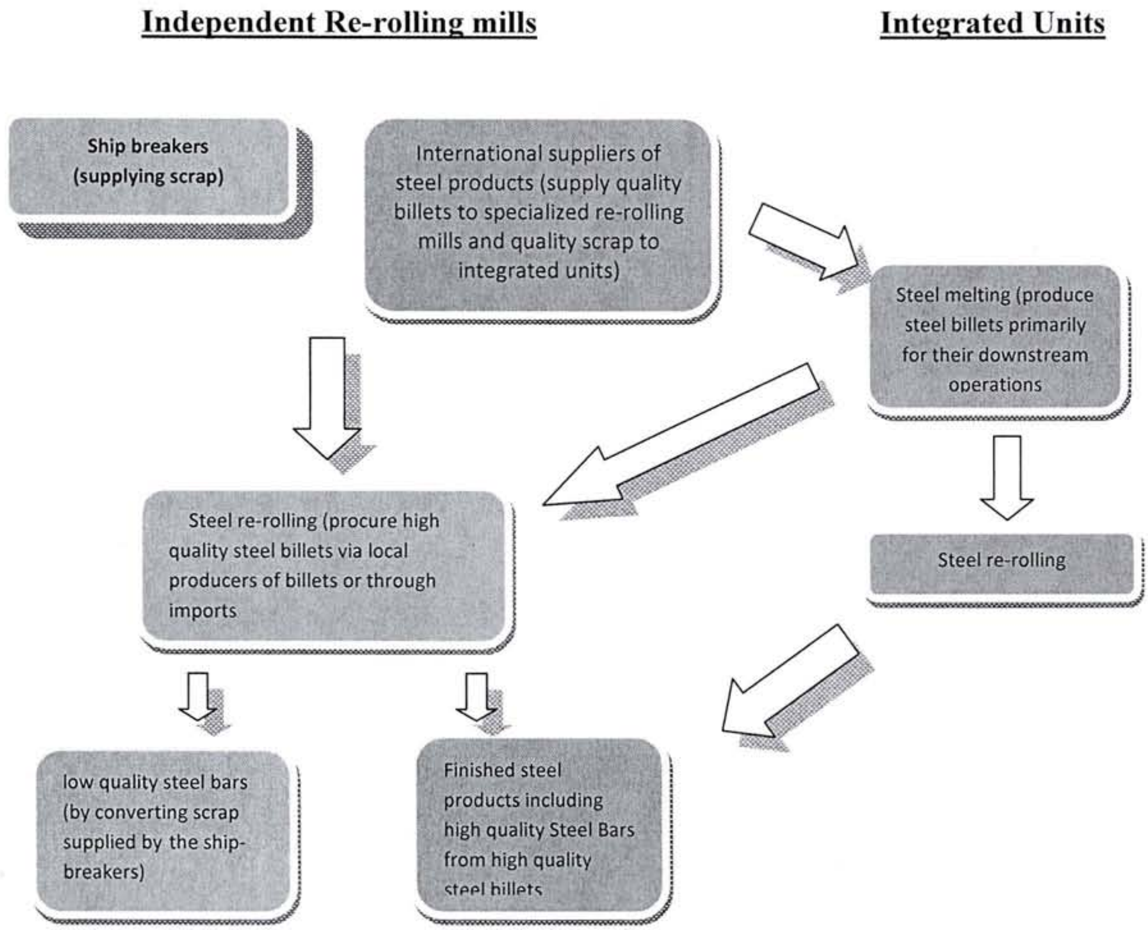
29. Given the above, the current RD structure or any measure to increase it would serve no other outcome, but to restrict competition, inevitably hurting the interest of consumers and economy at large.

V. Recommendation

30. Based on the foregoing, it is recommended that the Federal Government may amend SRO 18(I)/2015 so that it maintains its previous cascading tariff structure, and accordingly reduce the RD on steel billets to a suitable level.

31. Based on the ramifications on competition detailed above, it is further recommended that the Government may refrain from increasing the regulatory duty on steel billets any further.

Appendix A:


Independent Re-rolling mills
Integrated Units
Ship breakers (supplying scrap)
International suppliers of steel products (supply quality billets to specialized re-rolling mills and quality scrap to integrated units)
Steel melting (produce steel billets primarily for their downstream operations
Steel re-rolling (procure high quality steel billets via local producers of billets or through imports
Steel re-rolling
low quality steel bars (by converting scrap supplied by the ship-breakers)
Finished steel products including high quality Steel Bars from high quality steel billets