Policy Note

REFORMING THE DISCRIMINATORY RATE OF SALES TAX CHARGED TO STEEL UNITS OPERATING ON SELF-GENERATED ELECTRICITY

Background

1. The Competition Commission of Pakistan (hereinafter referred to as the "Commission") took notice of concerns raised in a complaint filed by Madina Enterprises Limited, a steel melting and rerolling unit (hereinafter referred to as the "Madina Enterprises") operating on captive power *i.e.*, a power plant set up by the user to generate electricity primarily for own use. The complaint relates to the current mechanism of determining sales tax being charged to the steel melting and rerolling mills operating on captive energy produced from biomass, *i.e.*, baggasse and rice husk. It has been alleged that the mechanism of sales tax charged by the FEDERAL BOARD OF REVENUE (FBR), discriminates against Madina Enterprises, and results in competitive disadvantage *vis-à-vis* units operating on power supplied by distribution companies (DISCOs).

About the Industry

2. Iron and steel industry provides the basic and critical input for the development of a range of industries including consumer goods, shipping, automotive, construction, energy distribution, infrastructure, etc. This industry is a part of the large scale manufacturing (LSM) sector. In Pakistan, iron and steel carries a weightage of 5.4, which is fourth in rank in the LSM.[1] The Iron and steel industry contributes more than PKR 30 billion to the national exchequer and provides employment to more than 10 million people. It is understandable that the figure will be much greater if indirect employment through linkages with other manufacturing and construction-oriented industries were also be considered. In 2014-15 (July-March), the sector showed a growth rate of 35.63% as compared to 3.38% growth in 2012-13. This rise was due to the growth in the pig iron and billets/ingots at 187.2% and 28.5% respectively. The overall growth in steel production remained strong on account of expanding existing capacities.

3. In Pakistan, the steel producing units are generally divided into three main types, which include steel melting, steel rerolling, and composite units. Amongst these, the steel melting units manufacture intermediary products, such as billets and ingots. Steel rerolling mills manufacture finished steel products such as: deformed bars, girders, angle iron, T-iron, *etc*. The composite units comprise both steel melting and rerolling units. There are more than 550 steel melting and rerolling units in the country.

4. Electricity is used in the melting process to produce intermediary and finished products. The cost of electricity, therefore, is an important portion for determining the feasibility of melting/producing steel products and their final price. Madina Enterprises is the only composite unit in Pakistan that produces

[1] Pakistan Economic Survey, 2014/15. Chapter 3, Table No. 3.1, available at: http://www.finance.gov.pk/survey/chapters_15/03_Manufacturing.pdf

electricity by employing high pressure steam boilers and steam generators through the use of biomass - baggasse[2] and rice husk.

5. Steel melting, re-rolling, and composite units of steel are charged sales tax under the *Sales Tax Special Procedure Rules, 2007* (Sales Tax Rules).[3] Until 2014, the tax liability was determined in a non-discriminatory manner, *i.e.*, *regardless of the source of electricity used in the production process*. However, in the Budget for the fiscal year 2014-15, the Government amended the Sales Tax Rules vide **SRO 421(I)/2014** (4 June 2014). Accordingly, the method of calculating sales tax charged to the plants operating on self-generated electricity, from use of biomass (baggasse and rice husk), was different from the one applied on plants operating on power from DISCOs. The determination of tax liability, thus, became discriminatory as the rate of sales tax implemented on Madina Enterprises is based on quantity produced *ad valorem* basis, whereas the rate charged to other plants is Fixed Sales Tax *i.e.*, based on per unit of electricity consumed. The disadvantage to Madina Enterprises in particular (and others in the steel industry using self-generated electricity) is explained in the following paragraphs.

Relevant Legal Framework

6. The relevant provision of the Sales Tax Rules is reproduced below:

> *"[58H. Payment of tax.--(l) Every steel-melter, steel re-roller [, composite units of melting, re-rolling and MS cold drawing] and composite unit of steel melting, rerolling (having a single electricity meter), [excluding units operated by sugar mills or other persons using self-generated electricity] shall pay sales tax at the rate of [seven] rupees per unit of electricity consumed for the production of steel billets, ingots and mild steel (MS) products excluding stainless steel, which will be considered as their final discharge of sales tax liability[:]"*

7. Under sub-section 1 of Rule 58H of the Sales Tax Rules, the rate of sales tax charged was changed from PKR 7 to PKR 9 in the Budget for FY 2015-16. Presently, this is applicable on each unit of electricity from DISCOs consumed by the steel melters, re-rollers, and composite units of steel melting for the production of ingots and mild steel products excluding stainless steel.

8. Rule 58Hb was inserted in the Sales Tax Rules through SRO 421(I)/2014,[4] which stipulates the following:

> *"[**58Hb. Steel mills operated by sugar mills or other persons using self-generated electricity**.—(1) Sugar mills or any other persons operating steel melting or steel re-rolling mills using self-generated electricity*

[2] Bagasse is the fibrous matter that remains after sugarcane or sorghum stalks are crushed to extract their juice. It is dry pulpy residue left after the extraction of juice from sugar cane. Bagasse is used as a biofuel.

[3] Chapter XI Special Procedure for Payment of Sales Tax by Steel Melters, Re-Rollers and Ship Breakers "[52] [58F. Application.-- The provisions of this Chapter shall apply to— (a) steel melting units, steel re-rolling units, composite units of melting and re-rolling and composite units having complete facility of melting, re-rolling and MS cold drawing, whether operating on electric power, natural gas or any other source of energy and regardless of the type of electricity connection;". See Federal Board of Revenue, page No. 33. Available at: http://download1.fbr.gov.pk/Docs/2015571252715337SalesTaxSpecialProceduresRules2007updated05.03.2015word.pdf

[4] *Ibid*, available at: http://download1.fbr.gov.pk/SROs/20146511632301142014SRO421.PDF

produced from bagasse or other means except those specified in rule 58Ha, shall pay sales tax on the steel products manufactured by them at the rate specified in sub-section (1) of section 3 of the Act, and shall observe all the applicable provisions of the Act."

9. To monitor the electricity usage in the production process, a procedure was laid down in the above mentioned Rules:

> *"(2) Such sugar mills or other persons shall—*
>
> *(a) declare to the Commissioner having jurisdiction their installed transformer capacity for steel melting and re-rolling, which would be subject to verification; and*
>
> *(b) install a tamper proof electricity meter on the transformer used for steel melting or re-rolling, along with a check meter outside the mills premises, on the recommendations and under supervision of one representative each from the RTO or LTU having jurisdiction and the electricity distribution company operating in the area."*

Issue

10. Whether competition is distorted among steel melting and re-rolling units using different sources of electricity through the imposition of Sales Tax based on source of electricity used?

Competition Concerns

11. To summarise, the steel melters and re-rollers who use electricity produced by DISCOs pay a fixed amount of sales tax at the rate of PKR 9 per unit of electricity consumed. On the other hand, a tax rate of 17% is applied on the steel units operating on self-generated electricity as per sub-section (1) of Section 3 of the *Sales Tax Act, 1990*.

12. In the context of foregoing, the Commission considered it appropriate to seek views from the relevant stakeholders – PAKISTAN STEEL MELTERS ASSOCIATION (PSMA), FBR, governmental organisations facilitating the renewable energy projects such as PAKISTAN COUNCIL FOR RENEWABLE ENERGY TECHNOLOGIES (PCRET) and ALTERNATIVE ENERGY DEVELOPMENT BOARD (AEDB)[5] - about the implementation of sales tax rate on the plants operating on biomass (baggasse and rice husk) *vis-à-vis* others. Their arguments are summarised below:

- PAKISTAN STEEL MELTERS ASSOCIATION supported the levy of higher rate of sales tax on Madina Enterprises on the grounds that using in-house self-power generation from bagasse, the unit does not have a reliable power metering. Hence, it could not be subjected to fixed sales tax regime on the basis of power unit like others using DISCO's/ KESC power supply. Also, by using baggasse to generate in-house power, they

[5] Alternative Energy Development Board (AEDB) is the sole representing agency of the Federal Government that was established in May 2003 with the main objective to facilitate, promote and encourage development of Renewable Energy in Pakistan and with a mission to introduce Alternative and Renewable Energies (AREs) at an accelerated rate.

have huge profit margins, therefore, the FBR's decision promotes fair and healthy competition in the market.

- According to the FBR, there is no discrimination in SRO 421(I)/2014 because both categories of manufacturers are getting their electricity from different sources. As Madina Enterprises has no electricity connection from the power distribution companies, it is very difficult to calculate the units and levy sales tax accordingly. Besides, there is no serious competitive disadvantage to Madina Enterprises because other steel melters and re-rollers are opting for electricity from power distribution companies at higher rates. FBR opines that the SRO has created a conducive environment for all the market players of steel sector. If Madina Enterprises is allowed to pay the taxes on self-generated electricity units consumed in the manufacturing of steel products, then it will be disadvantageous to all other steel melters and re-rollers, who are purchasing expensive electricity.
- The PAKISTAN COUNCIL OF RENEWABLE ENERGY TECHNOLOGIES (PCRET) confirmed that production of electricity through rice husk and bagasse lies under the definition of electricity generation from renewable energy sources. So does the AEDB's *Policy for Development of Renewable Energy for Power Generation, 2006*.[6] During the discussion, it was found that the PCRET and AEDB have yet to work on the costing of electricity generation through bagasse and rice husk.

13. The issue raised by the association about the non-existence of a reliable metering mechanism for captive power plants does not justify implementation of a different method of calculating sales tax. We did not find substance in the claim of PSMA that there is no mechanism to determine the electricity units consumed by Madina Steel. We have confirmed that an adequate metering mechanism is in place, whereby a representative of the REGIONAL TAX OFFICE, Faisalabad, verifies on monthly basis, by conducting on-site visit, the units of electricity consumed from the sealed meter installed at Madina Enterprises.

14. This Commission is of the view that the levy of dissimilar rate of sales tax on a production unit for being operationally efficient is against the spirit of the principles of competition. In fact, it is restrictive of a basic right of any undertaking to maximise profit by adopting methods to reduce its production cost. The current case of having two different methods of calculating sales tax on the steel plants operating on biomass (baggasse and rice husk) depicts a scenario whereby the industry players are dis-incentivised to enhance efficiency through measures that reduce cost, ensure reliability, and reduce the burden on DISCOs coping with electricity demand-supply issues.

15. The practice of implementing different rate of sales tax on the players of the same industry discourages new firms to enter into the market and prevents those who intend to innovate and invest in the alternative ways of production, thereby keeping the market conditions stagnant. It is absolutely illogical to argue that charging a different rate of sales tax from Madina Enterprises for being operationally efficient just to bring it at the level of high cost producers creates healthy competition. Businesses and firms around the world engage in the processes to enhance their efficiency by investing in new technology. The very

[6] http://www.aedb.org/Documents/Policy/REpolicy.pdf. The policy classifies bagasse and rice husk as sources of renewable energy (pg 5)

concept of 'competition' entails upon firms to be operationally efficient. This struggle for efficiency initiates and accelerates competition among the market players, which ultimately results in the growth of the industry. Not only this, consumers also benefit by getting high quality products at competitive rates.

16. It is pertinent to mention here that Pakistan has been facing a persistent gap of about 6,500 MW in the supply and demand of electricity over the past several years.[7] The energy crisis is adversely affecting Pakistan's industry and the economy. According to some estimates, the loss to the industry is about 13 percent of total manufacturing sales or nearly PKR 130 billion annually. According to the energy policy, the Government encourages the production of electricity through alternative resources and offers incentives to all producers of electricity, even at small scale.[8]

17. Under the AEDB's *Policy for Development of Renewable Energy for Power Generation, 2006*, the government encourages the generation of power through the use of renewable energy sources to bring-in energy security and improve the energy mix of the country. The policy offers investment-friendly incentives, and facilitates renewable energy producers and envisages increasing per capita consumption of energy and reducing the cost of production. However, the current mechanism of implementing a different rate of tax on those who have taken steps to produce their power independently (such as Madina Enterprises) reflects the antithesis of this policy to encourage the generation of power through renewable energy sources. The implementation of a higher sales tax discourages the firms to endeavour for energy self-sufficiency and help reduce the oil import bill.

18. The importance of LSM for the economy, and that of the iron and steel industry within the LSM sector is clear. It is necessary that any anti-competitive constraints in the growth of the industry be removed by introducing competition-oriented reforms.

19. This Commission has come to the conclusion that charging a different rate of sales tax from Madina Enterprises – and any other units using captive power – is a discriminatory practice that penalises efficiency, unnecessarily increases their cost of products rather than allowing them to pass on any savings to consumers, and puts them at a competitive disadvantage compared to those plants that are operating on electricity provided by DISCOs.

20. In the larger scheme of things, the Commission is of the view that the present methods of determining sales tax liability based on the source of electricity consumed is discriminatory in nature, creates barriers to improve and innovate, sets perverse incentives, and is anti-competitive.

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[7] According to the Pakistan Economic Survey, 2015, the installed capacity of PEPCO system was 20,850 MW at the end of June 2013 which has gone up to 22,104 MW by the end of June 2014 with hydro and thermal capacities occupying 7,097 MW and 15,007 MW, respectively.

[8] For the last several years, through the power/ energy policies, the Government has been encouraging electricity generation by the private sector. In this context, National Electric Power Regulatory Authority, has introduced a method of net metering mechanism under which spare electricity produced through solar panels will be added back to the lines through the same meter that is passing electricity to the consumer. See: http://www.pakistantoday.com.pk/2015/09/09/business/nepra-gives-nod-to-net-metering-regulations/

RECOMMENDATION

21. Ideally, any sales tax must be fair, difficult to avoid, simple to calculate, and simple to collect. To eliminate discrimination meted out to the market players of the steel industry, this Commission, through the mandate provided under Section 29(b) of the *Competition Act, 2010*, recommends that the *Special Procedure Rules, 2007*, be amended to make the sales tax charged to the steel units operating on self-generated electricity from baggasse and rice husk the same as for plants operating on electricity from DISCOs.

22. In principle, all players should be charged at the same rate and no one should be penalised for attaining or trying to attain operational efficiency. To create a level-playing in the steel industry, any difference created in the tax rate through any other special/general orders or otherwise may be rationalised.

Islamabad, 17 June 2016