POLICY NOTE

SUBJECT: COMPLETE BAN ON ESTABLISHMENT OR ENLARGEMENT OF SUGAR MILLS IN THE PROVINCE OF PUNJAB

Background:

1. The Competition Commission of Pakistan (the 'Commission') received a complaint from Mr. Sheikh Abdul Razzaq (hereinafter referred to as the 'Complainant'). The Complainant intends to establish a sugar mill in the area of district Bhakkar, Punjab, which in terms of his complaint is his fundamental right under the Article 18 of the Constitution of Islamic Republic of Pakistan, 1973 (the 'Constitution').

2. The Complainant has alleged that the Government of Punjab during the years 2002 to 2006 had issued various notifications with regard to the setup and enhancement of sugar mills in the province. From time to time these notifications were amended; some amendments restrict the establishment of new sugar mills in a number of districts of Punjab and others allowing the setup of new sugar mills up to a certain capacity or enhancement or existing sugar mills in specified districts. It was alleged that the final notification issued by the Government of Punjab in this regard is Notification No. AEA-III.3-5/2003(Vol-III) dated 06-12-2006 (hereinafter referred to as the 'Notification'), through which a complete ban was imposed on the establishment and enhancement/expansion of existing sugar mills in the province of Punjab which is also currently in effect.

3. According to the Complainant the aforementioned notifications, in particular, the last Notification, undermines the freedom of trade and creates entry barriers for the new entrants in the sugar industry. It further alleges that by issuance of the Notification the Government of Punjab is encouraging anticompetitive policies. The current state of affairs restricts new entrants in the sugar industry, discourages free competition and encourages monopoly/cartelization of existing sugar mill owners, which needs immediate attention of the Commission and other relevant authorities to rectify the current murky state of affairs.

4. The chronology of the notifications issued by the Government of Punjab is as follows:

   (i). Government of Punjab Notification No. AEA-III.3.9/91 published in the official gazette 30-9-2002: The Punjab Government stipulated that no industrial unit exceeding a total cost of Rs. 100 million shall be set up within 10 miles of the international border. Further, no industrial unit shall be set up in areas affected by flood flowing transversely in the strip of one mile of either side across the Grand Trunk Road from Shahadara Town to Muridke Town without prior permission of the Provincial Government. No new Sugar Mill shall be set up and no existing Sugar Mill can be enlarged in the districts of Multan, Sahiwal, Vehari, Khanewal, Pakpattan, Lodhran, Bhawalpur, Rahimyar Khan, Bhawalnagar, D.G. Khan, Rajanpur, Layyah, Muzafargarh and Okara. Also, each District Government may declare "negative area" for industry, to be determined by a District Committee after consultation with all stakeholders in light of general policy guidelines to be issued by the Industries Department. This conditional prohibition was accompanied by the provision that the Government may relax any of the provisions in case of a particular unit or industry or class of units or industries.

(ii). Government of Punjab Notification No. AEA-III.3.9/91 dated 4-9-2003: Through the said Notification the Government of Punjab amended the previous notification by imposing a complete ban on the establishment of a new Sugar Mill or the enlargement of capacity of an existing Sugar Mill anywhere in the province, as opposed to named cities or towns as was done vide previous notification.

(iii). Government of Punjab Notification No. AEA-III.3.9/91 dated 9-10-2003: The Notification No. AEA-111-3-9/91 dated 4-09-2003 was amended again in October 2003 vide Notification No. of even number dated 9-10-2003. In the revised notification the Government of Punjab lifted the complete ban and prohibited the establishment of sugar mills in the Districts of Multan, Sahiwal, Vehari, Khanewal, Pakpattan, Ladhran, Bhawalpur, Rahimyar Khan, Bhawalnagar, D.G. Khan, Rajanpur, Layyah, Muzafargarh and Oakara. The notification further provided that the capacity of existing mills could be enlarged.

(iv). Government of Punjab Notification No. AEA-III-3-5/2003 dated 1-04-2004: No new sugar mills shall be established in the Districts of Multan, Sahiwal, Vehari, Khanewal, Pakpattan, Lodhran, Bhawalpur, Rahimyar Khan, Bhawalnagar, D.G. Khan, Rajanpur, Layyah, Muzafargarh, Okara and Toba Tek Singh. Existing sugar mills can be enlarged except in the Districts of Sahiwal, Pakpattan and Toba Tek Singh.

(v). Government of Punjab Notification No. AEA-III-3-5/2003 dated 12-10-2004 published in the official gazette dated 20-10-2004: Through this Notification the earlier notification on the subject was revised. The establishment of new sugar mills in the province of Punjab was prohibited and permission was granted to enlarge the sugar mills in the province of Punjab except in the district of Sahiwal, Pakpattan and Toba Tek Singh.

(vi). Government of Punjab Notification No. AEA-III.3-5/2003 dated 15-7-2005: Through this Notification, the establishment of new sugar mills up to the capacity of 16,000 TCD is allowed in the province. However, the sugar mills were restricted not to enlarge existing capacity over 16,000 TCD.

(vii). Government of Punjab Notification No. AEA-III.3-5/2003(Vol-III) dated 6-12-2006: Finally, through this Notification a complete ban was imposed on the establishment of new sugar mills or enlargement of any existing sugar mill.

Commission's concern and recommendations:

5. In order to verify the contents of the complaint, the Government of Punjab vide letter dated 02-03-2011, was requested to apprise the Commission as to whether the Notification is still in effect and whether any other notification regarding the ban on establishment or enlargement of sugar mills has been issued or not. The said letter was responded by the Assistant Economic Advisor-III of the Industries, Commerce and Investment Department of the Government of Punjab.

6. In the said letter it was stated that the Government of Punjab in the large national interest imposed a complete ban on the establishment or enlargement in the existing capacity of existing sugar mills or any category throughout the province of Punjab vide the Notification. It was further stated that the aim of this ban was to protect cotton growing areas from the encroachment of sugarcane crop; which due to its strong substitution effect would adversely affect cotton crop-the backbone of our economy. Cotton ensures economic security as its value added products contribute 60% to foreign exchange earnings. The country requires 18 million bales of cotton by the year 2015 and 80% of it is to be produced in Punjab. It was further stated that Prime Minister Secretariat (Public) Islamabad vide their U.O. No. 3(20)/E-I-II/08 dated 09-02-2008, also advised the provincial governments to consider imposing complete ban on new installation and expansion of sugar mills for atleast five (5) years for the following reasons:

(i). The sugarcane is highly water intensive crop and needs 18-20 irrigations for proper growth as compared to cotton crop which needs only 5-6 irrigations. Our ground water sources are already depleting, increase in sugarcane area will only worsen the situation;

(ii). Sugarcane is already substituting cotton and wheat in many areas;

(iii). Sugarcane crop nourishes pests and bacteria, detrimental to cotton crop.

It was further added in the reply that final product of sugarcane i.e. sugar has no export value. Presently, there is 36% shortage of sugarcane crop production as compared to installed crushing capacity of existing sugar mills.

7. In the present complaint the main issue is that the Government of Punjab by virtue of the Notification (also supported by the U.O dated 9-02-2008 issued by the Prime Minister's secretariat) has created a legal barrier to entry by imposing a complete ban on the establishment of a sugar mill. However, we note that the Notification also creates a barrier to expansion by restraining the existing sugar mill not to enlarge their capacity.

8. The Commission has been established *inter alia* 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. According to Section 29 of the Competition Act, 2010 (the 'Act'), its duties include but are not limited to:

(a). reviewing policy frameworks for fostering competition;

(b). engaging in competition advocacy, and taking all other actions as may be necessary for carrying out the purposes of this Act.

9. It is Commission's mandate to promote competition norms through advocacy and persuading economic agents including government agencies/ regulators to act in accordance with the Act. While there is still no consensus on the exact definition of "Barrier to Entry", broadly speaking barriers to entry are impediments an undertaking may face when entering a market. Such obstacles may be of three types; firstly, they may be *structural*, i.e. due to cost and demand and economies of scale enjoyed by existing players in a market. Secondly, barriers to entry may be *strategic*, i.e. intentionally created or enhanced by incumbent firms in the market, such as exclusive dealing arrangements[1]. Lastly, barriers to entry may be *legal or statutory/regulatory*, for example, by way of government regulations/notifications which restrict entry into certain markets due to policy considerations, or licensing procedures which impose onerous conditions which must be satisfied before a new player may successfully enter a market and begin operations.

10. Legal/Statutory/Regulatory barriers to entry are usually the result of lobbying by existing players. We note that in economics and especially in the theory of competition, barriers to entry are obstacles in the path of an undertaking which wants to enter a given market. It is any factor that makes it difficult for a new undertaking to enter a market.[2] The term refers

[1] OECD Policy Brief: http://www.oecd.org/dataoecd/9/59/37921908.pdf
[2] Sullivan, Arthur; Steven M. Sheffrin (2003). Economics: Principles in Action. Upper Saddle River, New Jersy 07458: Pearson Prentic Hall. pp. 153. ISBN 0-13-063085.

to hindrances that an undertaking may face while trying to gain entrance into a profession or trade.

11. The object of erecting barriers to entry is to exclude new entrants to a market or sector of industry. These prospective entrants may bring with them efficiencies that could reduce costs related to production (e.g. by introducing novel technology) or through better research and development, which in turn would enhance competition by forcing existing players to stay competitive. This threat can be neutralized by erecting barriers to entry for new players. Further, if existing players have managed to exploit some of the economies of scale that are available to undertakings in a particular industry, they will have developed a cost advantage over potential entrants. They may use this advantage to cut prices if and when new players enter the market. Although they will be moving away from short run profit maximization objectives, they will however inflict losses on new undertakings and thus protect their own market position in the long run. Once a potential entrant is successfully barred from a market, existing players are free to revert to their prior anticompetitive conduct. This will eventually have a negative impact on the end consumer, who must now face higher prices (due to monopolistic or oligopolistic pricing structures and inefficient and obsolete technology), lower quality products (the effect of less research and development) and ultimately fewer alternatives.

12. Further, capacity expansion restraint in the industrial sector may indirectly support the anti-competitive practices such as production curtailment and quota allocation and eventually manipulating the prices by the incumbent undertakings. However, on the other hand incentive of capacity expansion would facilitate in achieving economies of scales and scope which can result in better prices and quality for consumers. It is worth mentioning that in the province of Punjab, despite the fact that there are maximum number of sugar mills i.e. 44 out of 82, the sugarcane crop utilization percentage[3] by these sugar mills has been 64.02% for the year 2008-09, 66.95% for the year 2009-10 and 74.37% for the year 2010-11. Hence, it can be inferred that the total sugarcane crop produced was not utilized fully.

13. Moreover, the imposition of ban on the establishment of a sugar mill or restricting the enlargement of existing sugar mills may not strictly speaking result in deterring the farmers from substituting the sugarcane crop for cotton crop; however, a more open to competition approach as of policy needs to be adopted which is beneficial to the economy, such as (i) setting parameters to determine the efficiency of existing sugar mills, and (ii) educating the farmers about cultivation of the most suited crops in their respective areas in order to make the best use of the climatic

[3] As per the information available on the website of the Pakistan Sugar Mills Association (Source: Federal Bureau of Statistics)

conditions, soil and available resources. This would not only give the economic freedom to the farmers but will also create a level playing field. In the event the undertakings are allowed to expand their capacity, the competition would weed out the failures, the incompetents, the inefficient and those slow to respond. Competition benefits the economy, as a whole, the consumers and other producers by a process of natural economic selection where only the fittest survive.

14. The importance of the agriculture sector in Pakistan can be judged from the fact that as per the '*Economic Survey of Pakistan 2011-2012*' the agriculture sector contributes 21% to GDP. The agriculture sector in Pakistan generates productive employment opportunities for 45% of the country's labour force and 60% of the rural population depends upon this sector for its livelihood. Major crops, such as wheat, rice, cotton and sugarcane account for 91% of the value added in the major crops. The value added in major crops accounts for 32% of the value added in the agriculture. Thus, four major crops (wheat, rice, cotton, and sugarcane) on average, contribute 29% to the value added in overall agriculture and 6.0% to GDP. The minor crops account for 10.1% of the value added in overall agriculture combined.

15. It has been expressly mentioned in the letter dated 16-03-2011 of the Government of Punjab that '*the aim of the ban was to protect cotton growing areas from encroachment of sugarcane crop, which due to its strong substitution effect would adversely affect cotton crop."* As per the Economic Survey of Pakistan 2011-12, the cotton crop account for 7.8% of value added in agriculture and 1.6% of GDP. It has also been mentioned that the production of cotton for the period (July-March) 2011-12 was 13.6 million bales as compared to last years production of 11.5 million bales. It is worth mentioning that in the Economic Survey of Pakistan the increase in the cultivated area and the production of cotton is attributed to *"the use of BT cotton, control over wide spread attack of cotton leaf curl virus and sucking pests"*. We also note that in another report titled '*Economic Analysis of Competing Crops with Special Reference to Cotton Production: The case of Multan and Bahawalpur Regions*[4]*'* the factors which are held to be responsible for lower production of cotton are (i). shifting of cultivation from cotton to sugarcane and rice, (ii). heavy rainfall, (iii). poor germination and cotton leaf curl virus infection. Hence, the substitution effect of sugarcane is not perhaps the only reason. It is pertinent to highlight that the total area for cultivation has increased from 988 thousand hectares of last year to 1046 thousand hectares of 2011-12. It is also worth mentioning that despite the increase in area of cultivation of sugarcane crop, the area of cultivation of cotton crop has also increased from 2689 thousand hectares (2010-11) to 2835 thousand hectares in 2011-2012.[5] Furthermore, based on climatic

[4] Published in the Pakistan Journal of Social Sciences (PJSS) Vol. 29, No. 1 (June 2009), pp. 51-63
[5] Economic Survey of Pakistan 2011-12

and other factors, cotton cultivation is not substitutable with sugarcane cultivation. Therefore, the substitution ground does not seem to explain or justify the ban on the establishment and/or enlargement/expansion of sugar mills. Also, in order to have efficient use of the land and other resources, Government needs to explore how to further enhance the yield of the cotton and sugarcane crop which is much below the global standard.

16. With reference to the shortage of water, we note that as per the report published by Directorate of Land Reclamation Punjab Irrigation and Power Department, June 2009 titled 'Groundwater Monitoring in Punjab', generally in the northern part of the Punjab province and upper part of the irrigation system - such as Sialkot, Gujranwala, Gujrat, Mandi Bahauddin have shown rising trends in water levels. Almost all the districts in Bahawalpur Zone – lying in the southern part of the Province have shown a rising trend in groundwater levels – particularly the areas near Abbasia Canal. On the other hand, in the Districts of Lahore, Okara, Lodhran, Multan and Jhang– areas lying in tail reaches – have shown somewhat declining trends in the groundwater levels.

17. In this regard, a news report was also published in the daily dawn dated 21-05-2012 under the caption *"Ban on New Sugar Mills helps Sugar Barons'*. It was reported that in Dec 2006, a complete ban was placed on setting up new sugar mills and enlargement in the existing mills under a notification superseding the previous one. The Notification has not been touched by any government over the past six years, with no imminent chance of the ban being lifted to allow fresh investment and promote competition in the sugar industry.

18. It is also worth mentioning that the Commission had already concluded an enquiry in the sugar sector vide enquiry report dated 21-10-2009. It would be relevant to highlight the fact that through the said report *prima facie* evidence of institutionalized collusive behaviour in the refined sugar industry was uncovered. It was stated that the collusion has been so extensive that the forum for collusion, the Pakistan Sugar Mills Association (the 'PSMA'), could not be called a mere representative of sugar mills but that it seemed to be functioning as a "business decision making body for the latter". The Enquiry Report contains *prima facie* evidence of strategic lobbying on behalf of the refined sugar industry to advocate the imposition of a ban on the establishment of new sugar mills in Punjab. The Enquiry Report concluded that the dichotomy of views and stances of PSMA may be attributed to the fact that "PSMA decides and attempts to control who enters the market and the above correspondences are manifestations of such decisions" and that "this enables PSMA to manage the business interests of its members in a secure manner. It also highlights the fact that PSMA has effective regulatory capture mechanism in place whereby it tries to influence government policies in its own

interest."[6] Pursuant to the enquiry report a show cause notice and a provisional Order was passed against PSMA; wherein it was observed that contraventions of Section 4 of the Act i.e. cartelization are clearly made out on part of PSMA and the ratio of the findings called for the imposition of the maximum penalty. However, no order in respect of penalty was passed in view of the restraint placed by the Court. The Commission therefore, held that penalty shall be decided by the Commission upon disposal of C.P.D-No. 149/2010 or if earlier permitted and directed by the Court. These proceedings of the Commission are *sub judice* and pending adjudication before the Honourable Sindh High Court at Karachi.

Conclusion:

19. It needs to be appreciated that competition law is only a sub-set of competition policies, which simply put are a set of pro-competitive economic measures taken by the Government (be it relating to trade, labour or investment). The more robust these policies are; the better, the enforcement of law and higher the chances of enhancing economic efficiency. The consumers stand to gain the most from greater competition. Competitive markets encourage more trade, lower prices; provide greater choice and more employment.

20. In the given circumstances as detailed above, rather than creating legal barriers to entry for establishment or capacity expansion restraints in the sugar sector either through bureaucratic or governmental interventions, it is recommended that the Notification No. AEA-III.3-5/2003(Vol-III) dated 06-12-2006 may be withdrawn and the Ban so imposed, be lifted. Let the market forces of demand and supply prevail, which will ensure competition. Free market envisages that an entrepreneur be allowed to decide whether the opportunity to setup any business enterprise, including a sugar mill is worth availing. This will encourage manufacturers and service providers to be more efficient, to better respond to the needs of the consumers, to innovate, to initiate, to venture and the consumers would benefit from better prices, quality goods and more choices.

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Islamabad, the 8th of June, 2012

[6] Enquiry Report in the matter of Collusive Practices in Sugar Sector dated 21-09-2009 available on www.cc.gov.pk