POLICY NOTE

EXEMPTIONS TO CERTAIN UNDERTAKINGS IN THE CONSTRUCTION SECTOR

The Competition Commission of Pakistan (the "Commission") took notice of concerns raised in various news items on exemptions granted to the National Logistics Cell ('NLC') by the Planning & Development Division of Pakistan, Ministry of Planning, Development and Reforms.[1] According to these exemptions, NCL is not required to furnish Performance Bond and Bank Guarantee against Earnest Money, and Bank Guarantee for Advance in the case of government works contracts. While the news-items were related to NLC only, the Commission gathered information about similar exemptions extended to other undertakings in the construction sector by any other ministry/division. The Commission also took notice of views expressed by the private sector construction companies/ contractors that they need a level playing field enabling them to bid for civil works' projects.[2]

I. BACKGROUND

In Pakistan, construction is an important sector of the economy: its share in the industrial sector is 11.48%; its contribution to GDP is 2.4%. The sector has shown a high growth rate of 11.31% in 2013-14. This growth is attributable to considerable activity in various development schemes and construction projects of federal and provincial governments.[3] Being labour intensive in nature, it provides employment to 7.44% of the employed labour force.[4] The importance of the construction sector for the economy is evident. It is hence desirable that any anti-competitive constraints to the growth of the construction sector be removed by introducing competition-oriented reforms.

The construction sector consists of two sub-sectors: a) architectural and engineering design; and b) construction and related engineering services, or "physical construction services". According to Pakistan Engineering Council (PEC), construction of any engineering work includes surveys, sub-soil and other investigations, erection, installation, testing and commissioning, and execution of all activities required to achieve the desired final shape of an engineering project, and shall also include extension remodeling, rebuilding and repair works and all other works incidental thereto.[5]

As per prevailing practices in Pakistan, PEC issues licenses permitting a licensee to construct or operate projects, whether in the private or public sector, for the category and period specified in the license. Depending on its strength and capability, a company can be registered for various categories. There are eight categories of constructors (C). Accordingly, constructors in C-6, which is the lowest category, can

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[1] '*NLC coming close to scrutiny under Public Procurement Regulatory Authority (PPRA) rules'*, *The News, 1st April 2012*, "*Transparency International Pakistan (TIP) sees 'corruption' in exemption of PPRA rules in award of contract to NLC*", Pakistan Today, 1st April 2012 and "*Application of PPR 2004, PPRA law 2002: exemption granted to NLC is corruption: TI Pakistan*", Business Recorder, 1st April 2012.

[2] '*The crumbling construction industry*', 'The Express Tribune', October 21, 2012. Available at: http://tribune.com.pk/story/454605/the-crumbling-construction-industry/**.** '*PC-I prepared All eyes turn to 6th Road flyover'*, 'Dawn', 18th March, 2012. Available at: http://dawn.com/2012/03/18/pc-i-prepared-all-eyes-turn-to-6th-road-flyover/

[3] Pakistan Economic Survey, 2013/14. 'Overview of the Economy', available at: http://finance.gov.pk/survey/chapters_14/Overview.pdf

[4] Table No. 16, Labour Force Survey, 2012 – 13. Available at: http://www.pbs.gov.pk/sites/default/files/Labour%20Force/publications/lfs_Annual_2012_13/t16-pak.pdf. This share is larger if indirect employment through linkages with more than forty manufacturing and service-oriented industries is also considered.

[5] Section 2(d) of 'Construction and Operation of Engineering Works Byelaws', 1987 (amended up to 2013). Available at: http://www.pec.org.pk/downloadables/byelaws/engg_works_byelaws.pdf

undertake projects up to Rs. 20 million only. The highest category is C-A, for which there is no maximum limit for the capital cost of the project, i.e. the licensee can undertake the biggest projects.

Out of 144 registered companies, the majority are in the private sector except a few, including Frontier Works Organization (FWO), National Construction Limited (NCL) and National Logistics Cell.[6] Likewise, the operators (O) have been divided into eight categories, starting from O-6, which is the lowest one. In the highest category O-A, there are eight registered operators which can undertake projects of maximum value. FWO and NLC are also registered in the O-A category.

In the categories of contractors and operators of projects, only public sector companies are availing certain exemptions. Here, we intend to assess as to how the policy of the government of providing exemptions to FWO, NCL and NLC, affects competition.[7]

A. Exemptions to Frontier Works Organization

FWO, established on 31 October 1966, is administratively located under the Ministry of Defence.[8] FWO ranks amongst Pakistan's largest construction organizations. Its areas of operation include the construction of roads, telecom, tunnels, dams, etc. International operations have been extended to Afghanistan, Kuwait and are likely to enter the Middle East. The organization generates revenue primarily from construction activities in the country and abroad.

Since 1985, the Ministry of Defence has exempted FWO from furnishing a Bank Guarantee against Performance Security and Mobilization Advance for services it renders to the federal and provincial governments. Letter No. 607/PQ/East Indus Zone/361/DEC from FWO dated 3 March 2009 addressed to the Port Qasim Authority confirms this.

B. Exemptions to National Construction Limited

NCL is an unlisted public sector-based company incorporated on 16 November 1977 under the repealed Companies Act 1913, now Companies Ordinance 1984. It is an autonomous body functioning under the Ministry of Housing and Works on a self-sustaining basis, i.e. it is a non-budgetary organization that receives no grants from the government. The principal activities of NCL are to carry out the business of construction as consultants, advisors, structural engineers, builders, architects, contractors, job contractors, designers, etc. NCL benefits from exemptions granted by the Ministry of Housing and Works. Accordingly, in the case of government works contracts, NCL is not required to furnish a Performance Bond in relaxation of Rule 276-GFR (Pt-I); and CDR/ Bank Guarantee against Earnest Money and Bank Guarantee for Advance, if any, provided under the contract agreements. These exemptions are applicable in the case of services provided by the NCL to the federal as well as provincial governments.

C. Exemptions to National Logistic Cell

NLC was created in 1978 as a crisis management organization of the federal government.[9] NLC undertakes the construction of highways, runways, bridges and other concrete works, construction of petrol/ oil storage tanks, buildings, border terminals and dry ports. NLC is also engaged outside Pakistan, specifically in Qatar, Saudi Arabia and Afghanistan. In 2000, the Planning and Development Division exempted NLC, in contracts for government works, from providing a Performance Bond, Bank Guarantee

[6] A list is available at: http://www.pec.org.pk/downloads.aspx.
[7] Railway Constructions Pakistan Limited (RAILCOP) is under Ministry of Railways, Government of Pakistan. It works solely on projects for Pakistan Railways; therefore, it will not be considered for looking into competition aspects for commercial projects.
[8] http://www.fwo.com.pk/index.php?option=com_k2&view=item&layout=item&id=6&Itemid=116
[9] Planning Commission, available at: http://www.pc.gov.pk/organization/sections/nlc.pdf

for Advances, if any, provided under the contract agreement, and Release/ Adjustment of Retention Money.

II. Issue

Do the exemptions granted to FWO, NCL and NLC in the construction sector distort market conditions and restrict competition?

III. Competition Concerns

The clients of various construction projects undertaken by the FWO[10], NCL[11] and NLC[12] have remained the federal and the provincial governments. Private sector contractors cannot compete for such projects due to these 'exemptions'. In the long run, this affects their growth and international competitiveness. As they cannot participate in national level construction projects, they cannot develop, strengthen and upgrade the technical expertise that is required to be global players. The undertakings listed above do not face real competition from other construction companies, which they would face in the absence of these exemptions.

FWO, NCL and NLC have remained strategically important organizations for Pakistan. Initially, these exemptions may have been necessary to allow growth under protection to achieve economies of scale, and to swiftly go through a managerial and technical learning process. Over the years, the three undertakings have grown stronger. They no longer need protection in the form of 'exemptions'. The strong financials of NCL and FWO, and their ability to compete abroad illustrate this point.[13] Hence, the infant industry argument is no longer valid; therefore, continuation of exemptions is not justified. Besides, other companies in the construction industry with heavy investments in machinery and equipment should also get a fair chance to compete.

This Commission is of the view that the exemptions, being discriminatory in nature, create a barrier to entry. The exemption of the requirement to submit a Bank Guarantee to serve as a Performance Bond, and Bank Guarantees to secure Advances provides an advantage to the undertakings at the beginning of the project, as these guarantees are needed at the bid stage. The exemption from furnishing Bank Guarantees that are contingent liabilities impact the financial commitments of the undertaking. The exemption from the requirement of Retention Money Adjustment provides a clear cash flow advantage during the course of the project at any point when money is not retained from payments made to the undertaking, and is retained from its competitors. Also, on account of being exempt from the Retention Money requirement, the undertaking availing this exemption can earn bank profits on funds; its non-exempt competitors do not have these funds available to earn profits on. The approximate competitive advantage because of these exemptions is worked out in Table 1:

[10] Various categories of projects, undertaken by FWO, are available at: http://www.fwo.com.pk/
[11] A list of projects by the NCL is available at: http://nclgov.org/projects/completed/
[12] http://www.nlc.com.pk/websitef.nsf/galleryfinal.html, http://www.nlc.com.pk/websitef.nsf/ProjGallerySouth.html, http://www.nlc.com.pk/websitef.nsf/ProjGalleryNorth.html, http://www.nlc.com.pk/websitef.nsf/ProjGalleryCentre.html
[13] For details see: http://www.nlc.com.pk/websitef.nsf/nlcprofile.pdf and http://www.fwo.com.pk/jdownloads/Brochures/Profile.pdf

Table 1

Competitive advantage arising out of exemptions

(Percentage of contract value)

Type of exemption	FWO	NCL	NLC
1. Not furnishing a Performance Bond (Bank Guarantee)	10%	10%	10%
2. Not furnishing a CDR/ Bank Guarantee against earnest money	--	2 - 5%	--
3. No requirement for a Bank Guarantee to secure advance payment	10%	10%	10%
4. Material advance	10-30%	--	10-30%
5. No requirement for release/adjustment of retention money	--	--	10% of interim payment, but subject to a limit of 5%
Total advantage	30%	22-25%	30-35%
Approx. **Competitive advantage** for a project of Rs. 1 billion	Rs. 300 million	Rs. 220 -250 million	Rs. 300 to 350 million

Since public resources are scarce, the efficiency of the procurement process is a prime consideration for the government. Open, transparent and non-discriminatory procurement is the best tool to achieve 'value for money' through competition among suppliers. Competition principles envisage a level-playing field between all undertakings acting in a competitive market, regardless of whether they are government entities or privately owned. The Act has specifically taken away the exemption given to government entities through the application of Section 25 of the Monopolies & Restrictive Trade Practices (Control and Prevention) Ordinance (MRTPO), which the Competition Act, 2010, repealed and replaced.

Instructions issued by the P&D Division, Ministry of Defence and Ministry of Housing and Works are applicable to all federal ministries/ divisions and departments, autonomous/ semi autonomous bodies under their administrative control as well as to all provincial governments and departments, autonomous/semi autonomous bodies under their administrative control requiring services of FWO, NCL and NLC. Therefore, the exemptions granted to the undertakings distort competition in the public sector construction work and result in undue advantage to them, while their competitors are subject to more burdensome terms. The magnitude of the financial advantage estimated above is significant. The exemptions are hence not in line with the letter and spirit of the Competition Act, 2010.

IV. Recommendation

This Commission recommends that the Planning and Development Division, the Ministry of Housing and Works, and the Ministry of Defence immediately withdraw the exemptions granted in order to ensure a level playing field for all market players.

Islamabad, 1st October, 2014.