Enquiry Report

In the matter of Unreasonable Increase in the Price of Urea Fertilizer

This Enquiry Report has been prepared pursuant to an enquiry conducted by the Competition Commission of Pakistan (the "Commission") under Section 37 (1) of the Competition Act 2010 (the "Act") in response to unprecedented hike in the price of Urea Fertilizer starting December 2010 onwards, to enquire while taking into account all relevant factors whether the price hike was unreasonable or a result of anticompetitive practices in terms of Section 3 or Section 4 of the Act.

Factual Background

1. Agriculture is a key sector of Pakistan's economy as it employs a significant percentage of the rural population and contributes significantly to the Gross Domestic Product (GDP), food and nutritional security. Its survival and growth is mainly dependent on the increased and balanced use of fertilizers. The main objective of fertilizer use is to improve the efficiency of the land and to increase crop productivity to ensure growth in the agricultural sector. The role of fertilizers, therefore, has always remained crucial. Considering the importance of agriculture in Pakistan, the GOP has always supported the fertilizer industry to ensure the sustained availability of fertilizers to the farmers at affordable prices. The subsidy by the GOP is in the form of reduced prices on the natural gas provided to the fertilizer producers and used as fuel and feedstock in the production of fertilizers.

2. Keeping in view the importance of fertilizer for the economy of the country, the Commission took notice of various reports published in all the major newspapers

of the country indicating increase in the price of Urea fertilizer. The relevant extracts are provided below.

a. *In the Dawn report of December 29, 2010*[1] *Punjab agriculture Minister demanded a justification from the Federal government for an alarming increase of 22% in the prices of Urea. As per report the price of a Urea bag had gone up from Rs 850 to Rs 1,040 per bag.*
b. *Pakistan Times*[2] *also reported concern expressed by Ministry of Industries and Production in its statement regarding the price hike in urea in the wake of cataclysmic environment brought about by floods at that time.*
c. *As per Business Recorder's report of December 28, 2010*[3] *the 25% price hike in urea was expected to exert an elephantine financial burden of Rs 15 Billion on the farmers. As per Dawn's report of January 10, 2011 a bag of urea was being sold at price as high as PKR 1450 which was approximately PKR 200 more than the manufacturer's price pointing yet to another major problem that of receding Government writ in the sector.*

3. To probe the matter of increase in price of Urea Fertilizer letters were written to all the major Urea Fertilizer producers in the country on December 31, 2010 asking them to provide reasons for escalating Urea prices. In addition, they were asked to report the exact amount of increase and the date from which the new prices were to take effect.

4. In their responses made in January 2011 the Urea manufacturers detailed that natural gas is the primary raw material in the production of Urea. Government of Pakistan imposed gas curtailment on Urea Fertilizer manufacturers starting April

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[1] Retrieved from <http://dawn.com/2010/12/29/urea-sales-rise-76pc-in-nov/>

[2] Retrieved from <http://www.pakistantoday.com.pk/2011/07/28/news/profit/urea-prices-witness-phenomenal-increase/> and <http://www.pakistantoday.com.pk/2011/10/31/news/profit/gas-curtailment-hits-urea-prices/> *et.al*

[3] Retrieved from <http://www.pakissan.com/english/news/newsDetail.php?newsid=23382>

2010 which was to last three months, however the curtailment of gas continued and these conditions persisted at the time Urea manufacturers recorded their reply.

5. In addition the respondents informed that the Government had imposed a 45 day natural gas stoppage to the manufacturing plants starting December 27, 2010. The respondents also argued that the issue of gas supply was creating an environment of uncertainty with the lack of a definite schedule or intimation by the Government regarding gas curtailment.

6. Manufacturers further argued that low gas supply resulted in low production of Urea Fertilizer and poor economies of scale. The producers thus increased the price of Urea Fertilizer to mitigate the losses. It was noteworthy that each manufacturer increased the price by exact similar amount of Rs 190 per bag that took effect around end December 2010. M/s Fauji Fertilizer Limited and M/s Fauji Fertilizer Bin Qasim Limited maintained that apart from other reasons they were also price followers and when the market leader had undergone increase they had no option but to follow suit. M/s Agritech also offered independent reasons such as rise in KIBOR and increase in turnover tax by virtue of the Finance Act 2010.

7. The pattern of price increase continued in the year 2011 as well, as reported by the following news reports:-

   a. *As per Dawn report of July 11, 2011 under the title 'Volatile Urea Prices'*[4] *"Urea prices range between Rs1,450 and Rs1,600 per bag, depending on the location of the sale. Officially the price is still Rs1,215 ex-mill, and Rs1,235 for dealers' sale. But every one is out to make windfall, with governments, both federal and provincial, watching as helpless spectators". Another thing highlighted in this report was that the fertilizer sector was the only sector where the cost of gas crisis was being passed on to the consumers.*

[4] Retrieved from <http://dawn.com/2011/07/11/volatile-urea-prices/print/>

b. *Pakistan Today in its report on July 28, 2011*[5] *quoted the then Chief Executive Officer of Engro Corporation Mr. Usad Umar as admitting that a price increase of PKR 750 -800 in the last 18 months was equivalent to an accumulative increase during the last 32 years. He warned that a continuation of gas curtailment would result in a further increase of PKR 464 per bag of Urea. Umar highlighted urea fertilizer prices in different parts of Pakistan, the prices per bag ranging from PKR 1600 – 1700 in Punjab and PKR 1800 in Khyber Pakhtunkhwa while the same commodity was available at PKR 750 – 800 before the issue of gas curtailment to the sector arose in January 2010.*

8. Such price increases mentioned in the above referred news reports appear to be anti competitive under the Act and the Commission deemed it relevant for the purposes of the Act to conduct an enquiry under section 37 of the Act. Through a Resolution dated 5 September 2011, the Commission appointed Ms. Shaista Bano, Director (C&TA) and Muhammad Qasim Khan, Junior Executive Officer (C&TA) (hereinafter collectively referred to as 'Enquiry Committee') as enquiry officers in the matter. The Enquiry Committee was tasked to investigate while taking into account all the relevant, the reasons for price hike that took place from December 2010 onwards and determine whether the price hike was unreasonable or a result of any anti competitive practices in the relevant market individually or collectively on part of urea fertilizer producers factors in terms of Section 3 or 4 of the Act.

9. To reach any conclusion a thorough cost analysis of Urea Fertilizer production had to be carried out. The Commission, on the request of the Enquiry Committee, appointed a consultant to assist in the cost analysis within the scope of the enquiry.

10. The Enquiry Committee wrote letters to the Urea Fertilizer producers on November 15, 2011 in which each was asked to furnish information under Section

[5] Retrieved from <http://www.pakistantoday.com.pk/2011/07/28/news/profit/urea-prices-witness-phenomenal-increase/>

33 of the Act. Manufacturers were asked to provide the following details for the year 2008, 2009 and 2010:

a. Summary of selling price of Urea Fertilizer along with dates they took affect

b. Installed and utilized capacities along with quantity produced and quantity sold

c. Details regarding Sale/Purchase of Imported Urea

d. Cost Components; Major raw material consumption per unit of production and manufacturing cost/bag

e. Reasons for increase in the cost of major cost components

f. Subsidy with respect to Feed Gas

g. Any abnormal non recurring expenses and lastly

h. Gross Profit, Operating Profit and Net Profit before taxation per bag

11. Urea manufacturers provided detailed responses to address the issues pointed in the letters. To better understand the issue and get the perspective of the Urea Fertilizer manufacturers, the Enquiry Committee called the representatives of the latter for a meeting. The consultant engaged by the Commission to assist the Enquiry Committee was also present. The issues brought forward by the manufacturers were those of:

    a. Gas Curtailment; and
    b. Efficiency losses

12. With respect to the above, the manufacturers reiterated and emphasized the same position as projected in their written responses.

Issues

13. Following are the core issues to be addressed in the Enquiry Report.

a. What is the Relevant Market?
b. Whether the Urea Fertilizer manufacturers have a dominant position in the Relevant Market?
c. Subject to fulfillment of condition in paragraph (b), whether the Urea Fertilizer producers unreasonably increased the price of Urea Fertilizer in violation of Section 3 of the Act?
d. Notwithstanding the outcome in paragraph (a), (b) or (c), whether the price rise has been a result of any collusive behavior of the Urea Fertilizer manufacturers in violation of Section 4 of the Act?

Relevant Market

14. Section 2 (1) (k) of the Act defines a "relevant market" as:

> "relevant market" means the market which shall be determined by the Commission with reference to a product market and a geographic market and a product market comprises all those products or services which are regarded as interchangeable or substitutable by the consumers by reason of the products characteristics, prices and intended uses. A geographic market comprises the area in which the undertakings concerned are involved in the supply of products or services and in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighboring geographic areas because, in particular, the condition of competition are appreciably different in those areas;"

15. In light of this definition the relevant market entails a

a. Relevant product market and a
b. Relevant geographic market.

16. The Commission in its earlier order dated July 23, 2010[6] in the matter of show cause notices issued to M/s. Engro Chemicals Pakistan Limited, M/s. Fauji Fertilizer Company Limited and M/s. Dawood Hercules Chemical Limited with reference to the "Tie in of Urea Sales with DAP" held that Urea Fertilizer is a distinct product market with respect to products characteristics, prices and intended uses and is not interchangeable or substitutable with any other nitrogen fertilizer such as Calcium Amonium Nitrate (CAN). Therefore, for the purpose of this enquiry the relevant product market is the market of Urea fertilizer.

17. As maintained by the Commission in the above referred order, the relevant geographic market consists of all the areas where there are homogenous conditions of competition. Two areas are said to have homogenous conditions of competition as long as regulation, availability and pricing of the product in the two areas is such that consumers from region A can buy the product from region B, and vice versa, without incurring significant differences in price. As per the order of the Commission, nothing was brought on record to indicate that the product supplied to all four provinces have any significant price differential, in particular by Engro and FFC who have presence in all four provinces. Also, the factors: that Pakistan's economy is heavily dependent on agriculture, the use of the product remains the same, the price of Urea Fertilizer is less likely to be substantially different from one area to the other and that no barriers exists on the movement or transportation of the product, strengthen and support that the relevant geographic market is the whole of Pakistan and the relevant market as defined under the Act for the purpose of this case is also the Urea fertilizer market in Pakistan.

18. In view of above, the relevant market for the purpose of this enquiry is, therefore, the market of locally manufactured urea fertilizer in Pakistan.

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[6] http://www.cc.gov.pk/images/Downloads/fertilizer_order_final_draft.pdf

Dominant Position

19. Section 2(1)(e) of the Act provides a definition for dominant position as stated below:-

"Dominant position of one undertaking or several undertakings in a relevant market shall be deemed to exist if such undertakings or undertakings have the ability to behave to an appreciable extent independently of competitors, customers, consumers and suppliers and the position of an undertaking shall be presumed to be dominant if its share of the relevant market exceeds forty percent;"

20. Before analyzing whether the undertakings enjoy a dominant position in the relevant market individually or collectively, it is pertinent to mention the historical background and structure of fertilizer sector in Pakistan along with an introduction of the undertakings operating in the sector.

21. At the time of Pakistan's creation, the demand for fertilizers was met through imports. Realizing the importance of fertilizers for agricultural productivity, the Government of Pakistan (GOP) established joint ventures under the regional co-operation arrangement, which include, *inter alia*, Pak Arab Fertilizers Limited[7], Pak Saudi Fertilizers Limited[8], Pak American Fertilizers Limited[9] and Pak China Fertilizers Limited[10] in the public sector. The GOP has also provided incentives to the private sector for setting up of Urea Fertilizer projects. Furthermore, the GOP has also set up the National Fertilizer Corporation, a public sector institution for the purpose of managing the existing fertilizer plants, to establish new plants and to market fertilizers to ensure sustainable supply of fertilizers at affordable prices to agriculturalists and farmers throughout the country. Under its privatization policy,

[7] Established in the year 1962

[8] Established in the year 1980

[9] Established in the year 1958

the GOP has privatized the public sector urea producing companies[11] and hence, the private sector is now running and operating all urea producing plants. Following are the major fertilizer producers in Pakistan.

1. Fauji Fertilizer Company Limited (the "FFC");
2. Fauji Fertilizer Bin Qasim Limited (the "FFBL");
3. Engro Chemicals Pakistan Limited (the "ECPL");
4. Dawood Hercules Chemicals Limited (the "DHCL");
5. Agritech Limited (the "AGL");
6. Pak Arab Fertilizers Limited (the "PAFL"); and
7. Fatima Fertilizers Limited (the "FFL").

All the above fertilizer producers are undertakings in terms of Section 2(1)(k) of the Act.

22. The fertilizer industry in Pakistan has an oligopolistic structure as the two major players FFC and FFBL group[12], and ECPL and DHCL group[13] hold around 84% of the total urea market share. FFC together with its subsidiary, FFBL holds over 41% of the total urea market while DHCL and ECPL (majority owned by DHCL and associates) holds around 43% of the total urea market.

23. There are two crop season in Pakistan i.e., Kharif Season being the first sowing season from April-June and it is harvested during October-December. Rabi season being the second sowing season begins October –December and is harvested in April-May. Urea Fertilizer is needed in the middle of the crops, therefore, urea off-

[10] Established in the year 1982

[11] Pak China Fertilizers Limited was privatized in the year 1992; Pak Saudi Fertilizers Limited in the year 2002; Pak Arab Fertilizers Limited in the year 2005 and Pak American Fertilizers Limited in the year 2006.

[12] FFBL is a subsidiary of FFC which hold its 51% shareholding. Fauji Foundation, the ultimate holding company of FFBL also holds 17.29%.

[13] DHCL and its associates hold majority stake in ECPL.

take between sowing and harvesting period increases. During Rabi season, more urea is consumed as the main crops are grown in this season.

24. Following Tables show the Supply/Demand situation of Urea from Oct 2010 to Sept 2011.

Urea Supply Demand Situation During Rabi 2010-11 ('000 tonnes)							
Description	**Oct**	**Nov**	**Dec**	**Jan**	**Feb**	**Mar**	**Consolidated Position**
Opening Inventory	774	781	350	166	115	53	774
Imported Supplies						148	148
Domestic Production	430	453	433	342	351	379	2389
Total Availability	1205	1234	783	508	466	580	3311
Offtake	427	879	626	394	413	421	3160
Estimated Balance	781	350	166	115	53	157	157

Source: http://www.sindhagri.gov.pk/ferti-rev/nfdc/mfr11/MMR%20apr11.pdf

Urea Supply Demand Situation During Kharif 2011 ('000 tonnes)							
Description	**Apr**	**May**	**Jun**	**July**	**Aug**	**Sept**	**Consolidated Position**
Opening Inventory	157	334	381	303	216	160	157
Imported Supplies	90						90
Domestic Production	487	547	522	513	544	505	3118
Total Availability	734	881	903	816	760	665	3365
Offtake	400	500	600	600	600	400	3100
Estimated Balance	334	381	303	216	160	265	265

Source: http://www.sindhagri.gov.pk/ferti-rev/nfdc/mfr11/MMR%20apr11.pdf

25. The data in the table demonstrates that while the total domestic production during the given period was 5.5 million tones the total off take was 6.3 million tones. This leaves a deficit of 800,000 tones. Of this 238,000 tones was overcome by imported urea while the remaining had to be met through existing inventory of urea. This clearly demonstrates that the demand for Urea in the country surpasses its supply.

26. The following table gives the Supply demand parity for Fertilizers in the years 2006 – 2011

Fertilizer Supply Demand Situation 2006 - 11			
Year	**Domestic Production**	**Off-Take**	**Difference**
2006-07	2747	3672	925
2007-08	2822	3581	759
2008-09	2907	3711	804
2009-10	3082	4360	1278
2009-10*	2255	3445	1190
2010-11*	2315	3054	739
Source; National Fertilizer Development Center; Pakistan Economic Survey, 2010-11 *Provisional Data from July-March			

27. Import of fertilizers from 2006 to 2011was as under:

Year	**Fertilizer Imports ('000' tonnes)**
2006-07	796
2007-08	876
2008-09	568
2009-10	1,444
2010-11	645
2011-12*	1,024
Source: Pakistan Economic Survey 2011-12 *Provisional data from July-March 2012	

28. The data clearly demonstrates that Urea Fertilizer production always lags its demand. This implies that the consumers have no choice but to buy every single ounce of Urea Fertilizer that is available in the market. This then also means that each manufacturer is ensured that their entire production would be sold in the market. This situation leaves no incentive for the urea manufacturers to compete on prices for consumers as their sale is ensured.

29. A comparison of the statistics provided by manufacturers in response to the letters issued by Enquiry Committee revealed that utilized capacity, which is a measure of production efficiency, manufacturing cost per bag and the net profit earning per bag vary from one to the other. Such variation in performance statistics warrants a differentiated pricing strategy by each manufacturer. It is, however, noteworthy that various manufacturers despite having varied level of technical capabilities and varying advantages in economies of scale are charging the same price to consumers. Market forces seem to be absent in this environment where prices by manufacturers are increased simultaneously and by the same margin.

30. The Commission in its earlier referred order states:

"In our considered view, keeping in mind: that there are limited numbers of suppliers in the Urea fertilizer market, there appears to be no price competition amongst the Undertakings concerned, dictating prices is quite possible, there generally exists a commonality in the terms at which Urea is being supplied to the dealers by the Undertakings and most importantly the fact that demand invariably exceeds the supply of the product in question while the imports remain on the increase; all this makes the Urea fertilizer market clearly captive. Notwithstanding 16% or 9% of the respective shares of Engro and DHCL, the undertakings are clearly in a position to behave to an appreciable extent independently of competitors, customers, consumers and suppliers. The fact that even the undertakings having smaller market share like DHCL are able to sustain their business irrespective of increase in costs or other factors - is primarily because of the captive nature of the Urea fertilizer market."

31. The above discussion clearly indicates that the market for urea fertilizer in Pakistan is a captive market and all the undertakings in this relevant market have the ability

<u>to behave to an appreciable extent independent of the customers, competitors and consumers and are therefore, are dominant undertakings irrespective of the individual market share held by each undertaking in the relevant market in terms of Section 2 (1) (e) of the Act.</u>

Abuse of Dominant Position

32. Section 3 of the Act prohibits abuse of dominant position by undertakings by way of unreasonable increases in prices. Relevant extract of Section 3 is reproduced below:

> ***Abuse of dominant position***.- *(1) No person shall abuse dominant position.*
>
> *(2) An abuse of dominant position shall be deemed to have been brought about, maintained or continued if it consists of practices which prevent, restrict, reduce, or distort competition in the relevant market.*
>
> *(3) The expression "practices" referred to in sub section (2) shall include, but are not limited to,-*
>
> *i. limiting production, sales and unreasonable increases in prices or other unfair trading conditions;*

33. To ascertain whether the Urea Fertilizer manufacturers have unreasonably increased the prices of Urea Fertilizer, we have to first look at the amount and frequency of price increases and thereafter we will analyze the reasonability of such price increase.

34. The domestic Urea Fertilizer prices were raised from Rs. 850 per bag in November 2010 to Rs. 1580 per bag in October 2011 i.e. **<u>an increase of over 86%</u>** and a subsequent increase till Rs.1980 in a month's time i.e. **<u>a further increase of 25%</u>**. The increase in price of Rs.400 i.e. from Rs.1580 to Rs.1980 was later reversed by the undertakings concerned on intervention by the GOP in

November 2011. The average retail price which was Rs. 509 per bag[14] during 2005-2006 increased to Rs. 850 in November 2010 which was an average increase of 13% approximately in the last five years.[15] In November 2011 the price was at Rs.1580 per bag. Therefore, between 2006 -2010, the price increased by 13% whereas in a short span of one year the price increased by 86%. The recent price increase is the highest during last twenty years.

35. A summary of price increases during the last three years is placed below:

Summary of Price Increases During 2009-2011						
Date	FFC	FFBL	DHCL	ECPL	FFL	AGL
	Per Bag					
Year 2009						
January	660	673	660	660		690
March	690	713	690	690		
July	700	723	700	700		700
September	730	753	730	730		730
Year 2010						
January	750	773	750	750		750
March	780	803	780	780	780	780
May	855	878	855	855	855	855
August	830	863	830	830	830	830
24-Dec	1020	1043	1020	1020	1020	1020
Year 2011						
March	1155	1158	1155	1155	987	1155
April	1225	1228	1225	1225	1047	1225

[14] Per bag of 50kgs/110 lbs

[15] Source: Pakistan Economic Survey 2011-12

July I	1215	1218	1215	1215	1172	
July II	1360	1363	1360	1360	1188	1360
August	1378	1381	2330	1378	1360	
October	1580	1583	1750	1580	1378	1580
November[16]				1980		
December I	1480	1483				
December II	1580	1583		1580		

Reasons for Price Increase

36. In order to evaluate whether these price increases are reasonable or not we need to delve into various factors such as gas curtailment, input costs, subsidies and Government's role as they are known to have influenced the price directly or indirectly. Further we also need to analyze the profitability of the fertilizer producers and the correlation it has with prices.

Gas Curtailment

37. The most significant justification provided by the undertakings for the unprecedented hike in the price of urea fertilizer was gas curtailment. The undertakings stated that the low gas supply resulted in low production of urea and subsequently poor economies of scale that led to increased prices. Since the idea of poor economies of scale in this case implies low capacity utilization we also look at those figures.

[16] The price increase of Rs. 400 per bag by ECP was rolled back to the previous level (Daily Dawn 03 November 2011 article by Dilawar Hussain " Engro rolls back urea price increase")

38. As submitted by the undertakings, due to gas curtailment, the fertilizer industry could not fully utilize its available capacity.

Company	**Annual Capacity** *(Metric Tons)*	**Percentage (%)**		
		2011	*2010*	*2009*
FFC	2,048,000	117.0	121.4	120.3
FFBL	551,100	78.6	95.1	113.8
ECPL-old plant	975,000	97.7	99.7	97.6
ECPL-new plant	1,300,000	50.3	0	0
DHCL	445,500	44.9	102.4	115.2
AGL	346,500	62.6	106.8	110.5
PAFL	92,400	30.5	80.0	114.4
FFL	500,000	85.4	64.6	0
Source: Published Financial Reports				

39. The comparison of capacity utilization of urea producers provided in the table above indicates that the hard-hit by gas curtailment were ECPL's new plant, DHCL, AGL and PAFL who could only operate at 30% to 63% of their rated capacity, however the remaining plants are not found to be significantly impacted, in fact one of them namely Fatima Fertilizer operated at 32% over and above its utilized capacity of the previous year. Further it can be noted that capacity utilization of large players like FFC, FFBL and ECPL’s old plant only deviated by 2-15% when

compared with the capacity utilization during previous year and FFL's capacity utilization increased as compared to previous year.

40. The facts available with the Enquiry Committee reveal that the plants connected to SNGPL network i.e., Pakarab Fertilizers, Dawood Hercules, Engro's new plant and Agritec suffered due to the short supply of gas. The aggregate available capacity of these plants during 2011 was around 2.184 million tons as against the total aggregate available capacity of 6.259 million for the fertilizer industry. The total available capacity of the fertilizer units connected to SNGPL network and hit by gas shortage is **only 27%** of the total available capacity of the industry during the year 2011. It is noteworthy that 73% of the Urea Fertilizer producers were unaffected by Natural Gas shortage, however, they increased prices in the same fashion and in the same amount as those 27% who were actually affected. While the circumstances for each undertaking varied significantly, the act of price increment is in complete unison and at such an uncontrolled level that the market appears to suggests complete absence of competition.

41. The representative from the companies connected to SNGPL network argued that they increased the price of urea fertilizer to mitigate the losses caused due to gas shortage while the representative of industry connected to SSGCL network and Mari Gas Company Limited for which there was no gas curtailment or it was within the announced and agreed curtailment were of the view that they increased the prices in line with the market trend. As was the case with **FFC and FFBL** who are not connected to SNGPL network, therefore, there was no justification whatsoever for them to increase the prices of urea fertilizer by a mammoth 86% in just a period of less than one year and securing profits before tax of over **Rs. 49 billion** (Rs. 33 billion for FFC and Rs. 16 billion for FFBL) which *is twice the amount of profitability for the immediate preceding year 2010.*

42. Analysis of financial statement and scrutiny of additional information provided by ECPL to the Enquiry Committee reveals that a ECPL's new plant of 1.3 metric

tons per annum commenced commercial operations on June 24, 2012 and produced 326,994 metric tons of urea which is about 50% of its available capacity.[17] The ECPL's old plant operated at 98% of the capacity during the year 2011 (2010: 99% capacity utilization) as it was not hit by gas curtailment. The old plant of ECPL, however, appears to be the major beneficiary of the price hike. The gross profit before depreciation earned by ECPL (both old and new plants) during the year 2011 was over Rs. 19 billion as against Rs. 9 billion of immediate preceding year of 2010, although the new plant contributed to the sales revenue to the extent of 25% only (as it constitutes 25% of the total production for the year 2011). The profit before tax of ECPL during the year 2011 stood at Rs. 6.9 billion as against 5.2 billion of the year 2010 after charging financial cost and depreciation of over Rs. 10 billion during the year 2011 as against Rs. 2 billion of year 2011. From above analysis it appears that despite the increase in depreciation and finance cost, the profit margin increased as well due to increased prices showing the gas curtailment did not have any material impact and therefore the price hike cannot in any way be justified.

43. While analyzing the issue of gas curtailment, it would be pertinent to discuss **GSA regime** whereby as per GOP policy all fertilizer manufacturing companies have signed Gas Sale Agreement (GSA) with their respective networks for supply of Natural Gas to their plant to be used as feed-stock and fuel. The most recent of such GSA is between ECPL and SNGPL, therefore, the same is also analyzed here for the purpose of this report. This GSA is also relevant to discuss here because it pertains to ECPL’s new plant that according to ECPL was hard hit by the gas curtailment, on the pretext of which ECPL increased price of Urea fertilizer.

[17] ECPL annual report 201 page 155.

44. Unlike other GSAs, the GSA with ECPL signed by SNGPL guaranteed gas supply commitment. ECPL embarked on its urea expansion project[18] in 2006 under 2001 Fertilizer Policy after the GOP allocated 100 MMSCFD gas to ECPL through a competitive bidding process. It has been reported that this project has been established with an investment of US $ 1.1 billion which is one of the largest private sector investment in history of Pakistan. In addition to the equity, an amount of Rs. 70 billion was raised from foreign and local institutions for this project. ECPL complained that that its new plant was subjected to the unprecedented gas curtailment by SNGPL network which has resulted in production losses. The effective gas outage was around 65% during 2011. It is important to note that Article 9 of the Gas and Sale Purchase Agreement dated 11 April 2007 (the "GSA") between SNGPL and Engro Chemicals Pakistan Limited, states:

Failure to Meet Specification or Failure to Supply: (a) In the event Seller's Gas does not meet the Gas Specifications or if the Flow Rate to the Delivery Points is anticipated to be reduced or interrupted, the Seller shall notify the Buyer of such facts as soon as the Seller is aware of the same in order that Buyer may take such steps as Buyer may consider necessary to protects its equipment, machinery and product.

(b) If for any reason other than a Force Majeure Event and subject to Tolerances, the Seller fails to supply or is unable to supply the Guaranteed Delivery of Specification Gas at the Flow Rate, the provisions of Article 9.2 shall apply except during the Supply Shut Down Period. Any period or periods during which the Seller supplies less than 70% of the Guaranteed Delivery to the Buyer shall be considered as a Supply Shut Down Period provided that the Supply Shut Down Period shall not exceed 480 hours in any Contract Year with a maximum of Five (5) shut downs in a Contract year.

[18] ECPL's new urea plant is the world's largest single train urea plant having capacity of 1.3 million tons per annum. It started commercial operations in June 2011.

The quantity not supplied ("Default Gas") ***shall be liable to be made available to the Buyer in addition to the Guaranteed Delivery within a period of twenty four Contract Months starting from the Contract Month in which the Default Gas has arisen****. The Seller may in any Contract Month with the consent of the Buyer, which consent shall not be unreasonably withheld, increase delivery in any Contract Month following the default until the Default Gas is extinguished. If the amount of Default gas t hat has arisen in an a Contract Month is not taken within the stipulated twenty four (24) Contract Month period from which it has arisen, it will lapse and the Buyer will not be entitled to the same.*

The Default Gas Price shall be the price determined in accordance with Article 4 which is prevailing at the time the Default Gas is taken.

On the expiry of the Term, in the event of any Default Gas volumes remaining, the Term shall be extended up to two years solely to enable the outstanding Default Gas to be supplied to the Buyer on the terms set forth herein.[Emphasis Supplied]

45. The above mentioned provisions which are relevant for the purpose of this study, envisages a situation where the Seller may fail to supply the agreed amount of Gas to the Buyer, i.e. Engro Chemicals. The said provision offers a remedy in such a situation: the amount of default gas will be made available to the buyer within a period of 24 contract months and furthermore the Default gas price shall be determined at the price which is prevailing at the time the Default gas is taken. Further, on the expiry of the term of 24 Contract months, and in the event of any Default Gas volumes remaining, the Term shall be extended by up to two years solely to enable the outstanding Default Gas to be supplied to the Buyer on the terms set forth herein. Therefore, the Buyer has recourse to remedies in a situation where the requisite amount of gas is not available and the Buyer under law is obliged to exhaust the stipulated remedies.

46. A copy of the Gas Sale Agreement between SNGPL and Engro Chemicals dated 11 April 2007 has been annexed hereto as **Annexure-A**

47. ECPL has invoked the writ jurisdiction of the honorable High Court of Sindh at Karachi seeking directions against SNGPL to supply the guaranteed gas to its new fertilizer plant and consequential restraining orders against respondent from suspending, discontinuing or curtailing the supply of gas. The honorable Court has allowed the petition and directed the SNGPL to supply guaranteed gas to the new fertilizer plant of ECPL strictly in accordance with the contract dated April 11, 2007.

48. In view of above, it seems that the remedy in case of failure to supply was already provided in the Agreement between ECPL and SNGPL i.e. to recoup/recover the losses suffered through the abeyance of supply of gas as explained above. However ECPL has also invoked writ jurisdiction at the competent court. In our view the exorbitant price hike on pretext of failure to supply by SNGPL to ECPL's new plant does not seem justified.

Input Costs

49. However, the increase in input cost needs to be examined for any justification of price hike, we therefore, analyze various input cost factors pertaining to urea production to assess whether any of the input costs provoked price hike.

50. The cost of manufacturing of urea fertilizer in Pakistan can be broadly divided into the following categories:

    a. Natural Gas as feed-stock and fuel;
    b. Packing material;
    c. Chemicals;
    d. Other fixed costs;
    e. Admin and distribution expenses; and

f. Financial expenses.

51. The scrutiny of the information available with Enquiry Committee in the form of audited financial statements and additional information provided by fertilizer producers reveal that the main raw material i.e. natural gas used as feed-stock (and subsidized by the GOP) is around 10% of the price at which the finished product i.e., urea fertilizer has been sold by the producers during the year 2011.

52. The following table depicts the cost of subsidized raw material in relation to the sales revenue for the year 2011:

Company	Revenues 2011	Raw Material (Fee-Stock gas) Cost	Raw Material as %age of Revenues
	(Rupees in '000')	*Rupees*	*%age*
FFC[19]	54,552,381	5,552,290	10.18

[19] Data for the financial year ended December 31, 2011

FFBL[20]	11,182,203	1,120,029	10.02
ECPL (Old & new plant)[21]	22,193,158	1,768,000	7.97
DHCL[22]	4,085,282	518,708	12.70
AGL[23]	3,849,186	674,685	17.53
PAFL[24]	2,546,973	149,224	5.86
FFL[25]	2,546,973	149,224	5.86
Source: Published Annual Reports & information provided by companies			

g. **Fuel Gas**: Fuel gas is another major component of cost which varies from one producer to the other. Its price is, however, regulated by OGRA. Like some other consumers, fuel gas is also provided to the fertilizer industry at reduced rates. Fuel cost per ton varies from Rs. 29 per bag to Rs. 176 per bag among the industry players.

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[20] Data for the financial year ended December 31, 2011

[21] Data of nine months ended September 30, 2011

[22] Data of ten months ended October 31, 2011

[23] Data of year ended June 30, 2011

[24] PAFL produced only 28,180 tons of urea as against its capacity of 92,400 metric tonnes.

[25] FFL commenced commercial operations of production facilities from July 01, 2011.

h. **Packing Material**: This is a small component in the cost of production of urea fertilizer and it varies from Rs. 25 per bag to Rs. 29 per bag among the fertilizer producers.

i. **Chemicals and supplies:** This is also a small component in the cost of production of urea fertilizer and varies between Rs. 3 per bag to Rs 25 per bag.

j. **Other fixed costs:** the major part of fixed cost comprises of salaries and wages, depreciation, stores and spares etc., It varies among the producers from Rs. 96 per bag to Rs. 350 per bag depending on the assets capitalized, workforce and consumption of stores depending on the age of the plant.

k. The above comparison of input costs indicate that natural gas which is a major input of Urea Fertilizer production was available to manufacturers at an unchanged price when compared with previous years. The other cost components also remain more or less unchanged in the year 2011. So looking from the aspect of input costs, there were no significant or notable increases to justify unprecedented increase in Urea prices.

Subsidies to Fertilizer Producer

53. While discussing the price hike in Urea Fertilizer, it is relevant to talk about the amount of subsidies given by the Government in this sector. The main objective of providing subsidized natural gas as feed-stock and fuel is to provide sustained supply of urea fertilizers at affordable prices. The farming community has complained that it was getting fertilizer at higher rates and it is not benefiting from the subsidy of billions of rupees provided by GOP to fertilizer industry. It is, therefore, imperative to look at the quantum of subsidies being provided by the GOP to the fertilizer industry.

54. Following is the comparison of sale prices at which Natural Gas was available to various consumers other than fertilizer producers as of 31 December 2011. Such comparison gives a sense about the extent of discount allowed to Urea Fertilizer producers when compared with the other corporate and domestic consumers:

Category	Per MMBTU
Commercial consumers	Rs. 526.59
Industrial consumers	Rs. 434.18
Ice factories	Rs. 526.59
Compressed Natural Gas	Rs. 571.88
Cement plants	Rs. 609.10
Domestic consumers	Rs. 1,142.75
Power stations of WAPDA & KESC	Rs. 447.14
Independent power producers (IPP)	Rs. 377.39
Liberty Power Limited	Rs. 1,260.34
Captive power plants	Rs. 434.18
Foundation Power C. Limited	Rs. 377.39
Fertilizer Old Plant - feed-stock	Rs. 102.01
Fertilizer New Plants – feed-stock	Rs. 59.59
Fertilizer Plants – fuel gas	Rs. 434.18

55. It can be observed from the above comparison that the natural gas supplied to the urea fertilizer producers for use as feed-stock was priced at Rs. 102. 01 per MMBTU till 31 December 2011 which is at a discount of 76.5%, 80.63%, 82.16%, 83.25% and 91.07% compared to the price at which natural gas is being supplied to the urea fertilizer producers as fuel, commercial consumers, compressed natural gas consumers, cement plants and domestic consumers respectively. The main objective of providing subsidized raw material to the fertilizer industry is two-fold; to keep the prices of urea affordable for the farmers and to ensure sustained supply all over the country. In the wake of unprecedented hike in the prices of urea fertilizers during the year 2011, it becomes imperative to assess whether the industry players are passing on the benefits they have been receiving from the GOP in the form of subsidy to the end-users i.e., farmers.

56. The subsidy provided by the Government[26] to the fertilizer industry during last three years was as under:

Subsidies provided by the GOP to Fertilizer Industry			
	2009	**2010**	**2011**
	Rs in Mln	*Rs in Mln*	*Rs in Mln*
FFC	9,640	10,551	11,008
FFBL	4,092	3,729	3,500
ECPL	5,788	6,949	4,495
DHCL	3,412	3,580	1,494
AGL	2,847	2,669	1,568
PAFL			
FFL			1,681

l. The quantum of subsidy provided by the GOP to the fertilizer industry during last three years as reduced price of feed-stock gas compared to fuel gas price amounted to approximately 77 billion. As gas is the preferred fuel for several industrial process, therefore, we have also calculated the subsidy on the basis of difference in price charged to other consumers and the fertilizer industry. In case price being charged to other consumers are compared, the subsidy amounts to much higher.

m. The industry has reported that the amount of subsidy per bag of 50 kg is Rs. 325. The production of one tone of urea fertilizer requires approximately 0.58 tonnes of Ammonia. For producing one ton of Ammonia, approximately 44 MMBTU of feed-stock gas is required. In

[26] Source: Individual company responses

this way, the cost of one tone of fertilizer at Rs. 102.01 per MMBTU works out to be Rs. 2,603 as against Rs. 11,080 per ton if feed gas is considered at the rate at which fuel gas is provided to the fertilizer industry. The subsidiary, therefore, works out to be Rs. 424 per bag of 50 kgs (Rs. 11,080-Rs.2,603/20 = Rs. 424). If subsidy is calculated considering the rate at which gas is supplied to other customers, the subsidy per bag would be over Rs. 500 per bag of 50 kgs.

n. The price of natural gas provided by the twine transmission and distribution companies is fixed by OGRA through a transparent process under Section 8 of the Oil and Gas Regulatory Authority Ordinance, 2002. Whenever, there is a shortfall in revenue of gas distribution companies, a petition is filed to OGRA for determination which is decided after due process including open public hearing. It is worth mentioning that the gas distribution companies are obliged to provide gas to the fertilizer industry at the price fixed as per fertilizer policy. The shortfall of revenue from the fertilizer industry is made up by other consumers which eventually are passed on to the common man.

Profitability Analysis

57. An important indicator used by economists worldwide to assess the reasonableness of prices is the profitability of the undertakings concerned and it’s a generally agreed principle that unreasonably high prices always lead to abnormal profits.

58. **Gross margins:** On the basis of audited financial statements of the urea producers following table has been compiled, providing a comparison of the gross profits earned by the undertakings during last three years.

Gross margins of Fertilizer Industry			
	2009	**2010**	**2011**
	Gross profits as % of sales		
FFC	43.3	43.6	62.2
FFBL	26.3	31.1	36.0
ECPL		46.9	53.37
DHCL	36.0	40.0	35.9
AGL		26.5	32.6
PAFL		50.4	57.0
FFL			67.8

59. The above table indicates that the urea producers are enjoying massive gross margins which no other industry enjoys in this or any other country and there has been a significant increase in the gross margins of all the undertakings concerned during the period of price hike.

60. **Profit before tax:** The table below provides a comparison of the profit before tax earned by Urea Fertilizer producers during past three years

Profit before tax of fertilizer industry			
	2009	**2010**	**2011**
	Profits before tax as % of sales		
FFC	36.1	36.4	60.1
FFBL	15.8	22.4	28.9
ECPL		27.37	21.9
DHCL	26.0	25.0	13.7
AGL	28.2	2.2	Loss
PAFL		25.0	37.1
FFL			41.o

61. While the fertilizer plants connected to SNGPL network have suffered grossly on production as is evident from underutilization of their available capacity due to gas curtailment but still they were able to make increase their profits manifold. The industry has a right to make legitimate profits but no one can justify exorbitant profits particularly when the main raw material is heavily subsidized as has been examined in the previous chapters. Perhaps no industry in the world makes such massive gross margins as are available to urea producers in Pakistan who enjoy as high as 62% gross margins on their sales.

62. The above analysis clearly indicates that the price hike was unjustified as it only led to excessive profiteering for the urea producers as evidenced by increase in the gross margins and profit before tax. FFC and FFBL attained up to 100% increase in their profits while ECPL recorded substantial growth in its profits despite significant increase in depreciation and financial charges. There appears to be no justification for such huge gross margins (enjoyed by the fertilizer industry for quite a long period of time). Such huge margins appear to defeat the objective of the

fertilizer policy as it is benefiting fertilizer producers more compared to farmers. Apparently, the profitability analysis indicates that the price increases during the year were quite unreasonable.

Government's Role

63. As pointed out earlier, fertilizer production is a heavily subsidized sector, therefore, it is imperative to discuss the role of Government in detail and to assess the government policies in this regard.

64. **Government of Pakistan Fertilizer policy and its objectives:** As compared to other countries, Pakistan's yield per hectare is significantly lower. As the industrial output is also dependent on agriculture like textile, sugar etc., therefore, successive Governments have taken several policy measures for increasing the agricultural productivity, including the fertilizer policies announced from time to time.

65. The objective of fertilizer policies is to encourage private sector investment so that the country achieves both self-sufficiency in production of fertilizer and the provision of urea fertilizer to the farmers at low cost.

66. The latest fertilizer policy was announced by the GOP in the year 2001. The object of this policy like previous fertilizer policies is to assure reasonable prices of fertilizers to farmers below the import price and to bring in substantive investment to enhance the domestic production. The fertilizer policy 2001 was applicable till June 30, 2010; however, it has been extended till June 30, 2012 for the purpose of signing of Gas Sale Agreement[27].

[27] Notification No. 11(15)/2005-P&P-I dated April 05, 2010.

67. A copy of the fertilizer policy 2001 is attached hereto as **Annexure –B.** In addition to other concessions allowed under the fertilizer policy 2001 for the expansion and new investments in fertilizer plants, the provision of subsidized feed stock gas has also been allowed. As per terms of the policy, the new investors have been assured that on signing of GSA, the feed stock gas price will be US$ 0.77 per MMBTU or the Middle Eastern Price prevailing at that time less 10% discount, whichever is higher. This rate will remain fixed for ten (10) years and thereafter will increase gradually.

68. While the objective of the policy is to enhance domestic urea production, the main spirit behind providing huge subsidy in the form of cheap feed stock gas is the provision of reasonable prices of fertilizer to farmers. Therefore, the objective is served only when the farmer get benefits of huge subsidies provided to the fertilizer industry.

69. Selling price of fertilizer was deregulated by the Government on the understanding that the manufacturers will allow free market forces to prevail and they will pass the benefits in the form of lower price of fertilizer to the farmers to achieve the objective of the fertilizer policies of the Government.

70. The fertilizer policy 2011 stipulates that in order to ensure that this objective is achieved, a committee will be set up and shall meet as and when required, but at least on a regular quarterly basis and take appropriate steps as necessary. The committee will be headed by the Minister for Industries and Production and will include Minister Food, Agriculture, Livestock as well as a senior representative from the Ministry of Finance.

71. Chemical fertilizers of all sorts have been declared as an essential commodity under the Price Control and Prevention of Profiteering and Hoarding Act, 1997**.** The GOP has been empowered to regulate the prices, production, movement, transport, supply, distribution, disposal and sale of any essential commodity. It is noteworthy that while there was a hue and cry for the unprecedented price hike in

urea fertilizer prices during the year 2011, the Ministry of Industries, has issued a Notification dated 25 November 2011 whereby the price of urea fertilizer was fixed at Rs. 1,480 per 50 bags to be printed on the bag of urea effective from the date of the aforesaid notification. It is pertinent that this price was also agreed by the fertilizer industry as has been noted in the notification.

72. While the main purpose of the Government policy was to protect the farmer's welfare it has more of been a silent observer while these dramatic price hikes were taking place. Lack any active and meaningful government intervention and the independent and collective abuse of dominant position on part of urea manufacturers have failed in serving the purpose of government policy i.e. farmers welfare.

73. It is also pertinent to note that this notification was issued under Section 3 of Price Control and Prevention of Profiteering and Hoarding Act, 1977. The National Price Monitoring Committee taking notice of high prices of fertilizers in Pakistan, has also asked the Ministry of Industries to investigate and take steps to lower its price. *The Committee observed that the prices of urea are higher in Pakistan as compared to India, Bangladesh, Sri Lanka and Afghanistan*[28]. Prime Minister has also set up a committee comprising of Federal Ministers for Finance and Industries to ensure elimination of black marketing, profiteering and hoarding of fertilizers by middlemen and to remove the disparity of prices of imported and local urea[29].. The Ministry of Industries Notification dated 25 November 2011 is attached herewith as **Annexure-C**.

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[28] Daily Dawn report by Mr. Amin Ahmed dated 26 January 2012 titled 'Monitoring body takes notice of urea price hike.

[29] Daily Dawn article dated November 24, 2011"Urea bags to carry price tag"

74. In a later development, the economic Coordination Committee (ECC) cabinet increased the price of imported urea from Rs. 1,300 per bag to Rs. 1,600 per bag and the price differential of Rs. 300 per bad was collected from the dealers / individuals who has already booked urea and paid Rs. 1,300 per bag. The Ministry of Industries Notification dated 16 March 2012 is attached herewith as **Annexure-D.**

75. While the Government has increased the price of imported urea by Rs. 300 per bag, there were news reports about a massive urea scam and it was alleged that the relevant ministry /concerned department are putting additional burden of Rs. 150 billion on the farmers. It was also alleged that the powerful fertilizer industry is resisting printing of price on urea bags. It was also alleged that gas loan management plan approved by the ECC for the fertilizer sector was also reversed. *Business Recorder news report dated [•] is attached here* as ***Annexure –E.***

76. The recent price hike of 86% in the price of urea fertilizer during a short span of one year and the financial results of public listed fertilizer companies are eye opener for everyone. The exceptional increase in profitability of the fertilizer industry players during the year 2011 make it obvious that the industry is making profits which cannot be termed as reasonable. Perhaps no other industry make such a massive gross profit as has been made by the fertilizer industry – FFC over 62%, FFBL over 49% and Engro over 53%. It is, therefore, imperative that a long term fertilizer policy is formulated by the GOP which ensures the benefits of huge subsidies to the farmers.

Summary of Findings

77. **Gas Curtailment has impacted only 27% of the total Urea Fertilizer manufacturing capacity**. While Gas curtailment was given as a major reason by the manufacturers for lost efficiency and price hike, it is to be noted that the fertilizer manufacturing plants representing only 27% of the total urea

manufacturing capacity i.e. Pakarab Fertilizers, Dawood Hercules, Engro's new plant and Agritec were impacted by it. The remaining 73% i.e. Fauji Fertilizer Limited (FFC), Fauji Fertilizer Bin Qasim Limited (FFBL), Engro ECPL old plant and Fatima Fertilizer (FFL) have no apparent justification for such an unreasonable increase in Price.

78. **No significant increase in input costs for price hike.** The analysis of input costs indicate that natural gas which is a major input of Urea production was available to Urea manufacturers at an unchanged price when compared with previous years. The other cost components also remained more or less unchanged in the year 2011. So looking from the aspect of input costs, there were as such no significant or notable increases to justify rising of Urea prices.

79. **Profit margins significantly higher**. The profitability analysis reveals that not only are profits of manufacturers significantly higher as compared to previous years but also compared with profit average in other industries operating in the country. This is a serious cause of concern in an industry that directly has an impact on the agriculture markets and that feeds people. In particular FFC and FFBL, whose plants are not significantly impacted by gas curtailment, registered profits before tax of over **Rs. 49 billion** in 2011 (Rs. 33 billion for FFC and Rs. 16 billion for FFBL). This amounts to *twice the amount of profitability for these undertaking in the immediate preceding year ie.*2010. While ECPL's old plant was a beneficiary of price hike due to insignificant impact of gas curtailment its new plant was impacted. Despite that the profit before tax of ECPL during the year 2011 was PKR 6.9 billion as against PKR5.2 billion of the year 2010 in spite of the fact that financial costs and depreciation charges for the new plant amounted to over Rs. 10 billion in 2011 as against Rs. 2 billion in 2010. ECPL might have ended into losses due to heavy depreciation and Financial cost even if the gas supply was not curtailed in the absence of price hikes.

80. **Benefits of subsidies availed not passed on to the consumers**. Government of Pakistan has given subsidies of more than PKR 77 Billion to Urea Manufacturers in the last 3 years in the form of reduced price of feed stock gas as against the price of fuel gas. Despite the fact that this concession is granted specifically so that Urea is made available to growers at cheaper rates there are no sign of growers benefiting from this amidst regular and very high price hikes.

81. The urea producers reported that the amount of subsidy on feed stock gas per bag of 50 kg is Rs. 325. However, as per the finding of the enquiry committee if feed gas is considered at the rate at which fuel gas is provided to the fertilizer industry the subsidy works out to be Rs. 424 per bag of 50 kgs. If subsidy is calculated considering the rate at which gas is supplied to other customers, the subsidy per bag would be over Rs. 500 per bag of 50 kgs. With the amount of profits being made by the fertilizer manufacturers, the subsidy if at all has to be offered it should rather be offered directly and in targeted manner.

82. The price of natural gas provided by the transmission and distribution companies is fixed by OGRA through a transparent process under Section 8 of the Oil and Gas Regulatory Authority Ordinance, 2002. Whenever, there is a shortfall in revenue of gas distribution companies, a petition is filed to OGRA for determination which is decided after due process including open public hearing. It is worth mentioning that the gas distribution companies are obliged to provide gas to the fertilizer industry at the price fixed as per fertilizer policy. The shortfall of revenue from the fertilizer industry is made up by other consumers which eventually is passed on to the common man.

83. In case of ECPL's new plant it seems that remedy in case of failure to supply was already provided in the Agreement between ECPL and SNGPL i.e to recoup/recover the losses suffered through the abeyance of supply of gas as explained earlier. In our view the exorbitant price hike on pretext of failure to supply by SNGPL to ECPL's new plant does not seem justifiable.

84. **Call meaningful government intervention in order to serve purpose of the policy**. While the main purpose of the Government policy was to protect the farmer's welfare it has more of been a silent observer while these dramatic price hikes were taking place. Lack any active and meaningful government intervention and the independent and collective abuse of dominant position on part of urea manufacturers have failed in serving the purpose of government policy i.e. farmers welfare.

85. **Independent and collective abuse of dominance by urea manufacturers**. Taking all the above factors into account, it appears that the price increase of this magnitude representing 86% increase from Rs.850 per bag to Rs.1580 per bag by all the manufacturers at the same time was unjustified and unreasonable and prima facie makes out a case of individual and collective abuse of dominance on part of each of urea manufactures i.e. FFC, FFBL, ECPL, DHCL, AGL[PAFL, FFL????]. Where factors such as Economies of scale, operation efficiency, innovation and impact of gas curtailment varied from one urea producers to the other, they increased prices at the same rate and at same time. This increase is unmatched in any other period of Pakistan's history. The manufacturers have not been able to provide any convincing reasons or justifications for simultaneous increase in prices of urea fertilizers without any significant increase in their cost of production. The simultaneous and coherent increases in prices of urea in the absence of an objective justification by the industry players indicate some formal or informal understanding between urea producers. Even if one is to assume that such an understanding is non-existent it is worth noting that FFC and FFBL[30] group and DHCL[31] and Engro group collectively hold 84% (including its new

[30] FFBL is a subsidiary of FFC which hold its 51% shareholding. Fauji Foundation, the ultimate holding company of FFBL also holds 17.29%.

[31] DHCL and its associates hold majority stake in ECPL.

plant) of the total urea market. Analysis of the price increase patterns indicate that ECPL is always the price leader despite having lesser market share when compared with FFC & FFBL. Generally these two players appear to dictate the urea price in the country and both have benefited tremendously by the recent price hike as detailed in the profitability analysis. Such situation further supports and strengthens the aspects of abuse of 'collective dominance' in the urea market in Pakistan .

86. Individual undertakings can be collectively dominant if they are participants in a tight oligopoly and act in unison. To be more precise, a dominant position is held collectively when legally independent undertakings are linked in such a way that they adopt a common policy on the market. The links may be structural or economic but they make the undertakings to adopt the same policy on the market without ever explicitly agreeing on a particular practice/conduct.

87. Following characteristics are considered as essentials for existence of collective dominance:

   a. A few large producers occupy the market, as is the case in urea fertilizer market where there are a total of 7 producers and if we consider the producers of the same group as one, there are only 3 producers in the relevant market.

   b. Either these few companies offer homogenous, or standardized, products OR offer different products and place an emphasis on non-price competition, such as advertising. – this condition also appears to be met by urea producers as Urea fertilizer is a homogeneous product.

   c. Mutually interdependent and react to each other's change in price, output, product or advertising- as stated in earlier part of the report, urea producers have always increased prices in parallel manner and irrespective of their individual market shares, production capacity, input costs, economies of scales etc they have increased prices in a coherent fashion, so the urea market appears to satisfy this condition as well.

d. Relatively high entry barriers – huge initial investment and scare resource of natural gas as a key input appear to make entry barriers relatively high in urea market.

88. Section 2 (1) (e) of Act provides a deeming provision for collective dominance of several undertakings. Dominant position of several undertakings in a relevant market shall be deemed to exist if such undertakings have ability to behave to an appreciable extent independently of competitors, customers and suppliers and the position of an undertaking shall be presumed to be dominant if its share of the relevant market exceeds forty percent.

89. In view of above discussion, urea fertilizer market appears to satisfy all the four conditions for existence of ‘collective dominance’. In terms of earlier paras of the report, urea market in Pakistan is a captive market where undertakings have no incentive for price competition as sale of every ounce of their production is ensured irrespective of the price, so every undertaking in this market is individually dominant irrespective of their market shares. This dominance can be ascertained from the observation that ECPL always leads price change despite having lesser market share when compared with FFC and all remaining companies appear to follow the suit of price hike.

90. As stated above, it is reiterated that taking into account all the factors, such as gas curtailment, input costs, subsidies, profitability analysis and government policies, it appears that the mammoth price hike of 86% in the price of urea was unjustified and unreasonable. Such act of unreasonable and unjustified price hike appears to be exploitative and abusive independently as well as collectively.

91. Urea fertilizer producers being individually and collectively dominant in the relevant market appear to have indulged in the practice of unreasonable price increase and have appear to have abused their dominant position, therefore, a prima facie violation of Section 3(3)(a) of the Act is made out.

92. The high concentration with two major players of the industry for a long period of time requires stricter vigilance to ensure that there is no excessive profiteering. While the availability of Urea Fertilizer to the farmers at affordable prices is the responsibility of the Government, needs to take initiative both at the Federal and Provincial Governments to bring in a corrective behavior for fertilizer manufacturers for the benefit of the consumers.

93. As Urea Fertilizer is a key input in agriculture and is also an essential commodity it therefore impacts all the markets and all stages of supply chain in each of these markets in the agriculture sector. The costs of doing business, entry and growth in all these markets have been severely affected by anticompetitive practices in the fertilizer industry. In the interest of the farmers, the citizens of Pakistan and innumerable stake holders in this sector, it is paramount that immediate action be taken to check, halt and remedy this situation.

Recommendation

94. In this regard it is proposed that the Commission may initiate proceedings under Section 30 of the Act against the Urea Fertilizer producers for *prima facie* abusing their dominant position independently as well as collectively violating provisions of Section 3(3)(a) of the Act by way of unreasonable and unjustified increases in the price of urea fertilizer in Pakistan.

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