

Left Parties Rejoinder To The Finance Ministry's Note On FDI In Telecom

The Finance Ministry, in its reply to the Note submitted by the Left Parties, has addressed some of the issues raised by the Left even if it has disagreed with Left's views on the sector.

The main issues that the Left had raised in its note earlier pertain to a) the strategic nature of the telecom sector, b) the reason for similar caps in other countries c) whether there is a need for FDIs of this magnitude in view of the healthy balance sheets of the telecom companies d) the need for indigenous equipment manufacturing capabilities to bring down equipment costs.

While the Finance Ministry's Note takes up the general case in favour of lifting FDI limits, it does not address the issue of violations of the existing FDI limits by certain Indian and foreign companies. Without this, the lifting of FDI limits would be construed as rewarding those who violate the law and send a wrong message.

We give below our response to the issues in the Finance Ministry's Note.

Telecom: Is It a Strategic Sector?

The key question that we need to address here is whether telecom is to be regarded as a strategic sector. If it is, then we need to put in safeguards regarding foreign control of the sector. India has specific security needs: whether European or American companies should be allowed to own Indian telecom companies is not a decision to be taken without due deliberation.

Historically almost all countries regarded telecom as a strategic sector. The telecom companies were either state owned or under strict regulatory controls regarding foreign ownership. The US and Canada were among the few countries that had private ownership of telecom and both had strict limits on foreign ownership. The Europeans and most other countries had state owned telecom companies. Therefore, they did not need any official caps on foreign ownership.

Subsequent to introduction of mobile telephones and the dominance of neo-liberal economics in the West, there has been a change. Some European countries are now in the process of privatising their public fixed-line telecom networks; mobile companies also are either under public or private ownership, depending on the country. In the US, two changes have taken place. One is the rapid growth of mobile telephony and therefore entry of new players in telecom. The other is the break-up of the Bell system, the only landline telecom company in the US, to a number of smaller "baby" Bells. In spite of these changes, a number of countries still maintain control of foreign ownership of the telecom network

With the technical changes taking place, the question is whether the concept of the telecom sector being a strategic one has become obsolete? If the Finance Ministry is to be believed, there is no strategic significance to the telecom sector anymore and it is a matter of time before all existing controls in advanced countries also disappear. The problem with this view is that it does not match the reality: physical and other non-physical barriers to foreign entry in the telecom sectors still exist in many of the advanced countries. Interestingly, the Indian security agencies have already put forward

their positions that the telecom sector is a strategic one and foreign control of telecom companies need to be carefully circumscribed.

There are a number of ways that foreign ownership can be restricted. One is a simple law limiting foreign equity; others could be security clearances of the concerned companies, mandating local citizens in management positions in these companies, or making the sale of equity and ownership conditional on securing special clearances, etc. While for advanced countries, a more elaborate security procedure may not be difficult to institute, for most developing countries, simple caps on foreign ownership eliminates needless bureaucracy and case-by-case clearances with all its attendant problems.

About a year back, the NDA Government and its Minister Arun Shourie made an attempt to remove FDI restrictions in telecom (February 2003). The security agencies -- the Intelligence Bureau, and Home Ministry -- had suggested that increase of FDI from 49% to 74% should not be considered, as it will mean management control getting into foreign hands; instead, the FII route may be allowed. Even then, they had suggested safeguards including security assessment of the foreign investments and mandatory requirements of majority of the Board being appointed by Indian shareholders.

We have information that the IB and the Ministry of Home Affairs had insisted that *as a security doctrine, communications is a vital national service and is critical to the security of the nation*. If the security agencies consider telecommunications as vital for national security, we see no reason for overruling their concerns. If the reasons for not lifting FDI caps were valid a year back, we would suggest that they still continue to be valid.

The reply of the Finance Ministry on this count to the Left's Note does not address the concerns raised by the security agencies. The arguments advanced are that as electronic surveillance can be conducted without ownership of the telecom network, therefore foreign ownership is not an issue. The key issue here is whether owning physical telecom resources in another country helps in this electronic surveillance. And the answer is an unequivocal yes. In case the Finance Ministry has any doubts on that score, it has only to ask any of the security agencies. And if this is not so, why are the security agencies concerned with foreign ownership of telecom companies at all?

In this context, it may also be noted that the security agencies have restrictions on people using cell phones in border areas. It would be surprising if owning cell phones in border areas by interests inimical to India is considered a security threat but not foreign interests owning telecom networks in India.

The second argument advanced is that countries such as Bangladesh, Pakistan and Sri Lanka do not have FDI restrictions. The security concerns of Pakistan and India's are on a different level. Pakistan has security concerns visa-a-vis India. Irrespective of FDI limits, Indian companies cannot own companies in Pakistan. India's security concerns are much wider. Therefore equating Pakistan and India on this score is an unfortunate comparison. Neither can Bangladesh and Sri Lanka act as a model for India. It is time we look at India's security from a larger strategic perspective.

The Finance Ministry's Note is also misleading with regard to Pakistan and its restrictions on FDI. While Pakistan allows 100% FDI to start with, this proportion has to be reduced to 60% within a stipulated time period.

Apart from security considerations, the telecom sector is a strategic one as it is also of critical importance to other sectors of the economy. Without a large network coverage and telecom access, large parts of the country and large sections of the people will be

denied possibilities of economic growth. The importance of the telecom sector, which we have identified in our Note earlier, means it cannot be left to just the vagaries of the market. The state must play an important role for this sector to develop, which in turn will help other sectors to grow.

If there were reasons why telecom sector's strategic nature needs to be overridden, then we could consider the same. But we see no such overriding concern. As we will show later, India is generating enough surplus to finance the growth of the telecom sector without impacting other sectors. If this is so, is there any reason why we should compromise our security and hand over two-thirds of the existing GSM mobile subscribers to foreign companies?

Restrictions on Foreign Ownership in Other Countries

The second part of the Finance Ministry's arguments is regarding foreign ownership restrictions in many of the advanced and developing countries. The Left had provided a table summarising some of the restrictions on foreign ownership that still exists in many countries. The Finance Ministry's contention is that this table is misleading, as it does not give the full picture. They have in turn produced a table containing countries from Cote D'Ivoire to UK that allow 100% FDI's. The Finance Ministry however, has also given another set of countries that do not allow FDI above 70%, thereby accepting the Left's contention that there are a number of countries that still have restrictions on foreign ownership in telecom services. It might be noted that countries such as China, Mexico, Turkey, Korea, Malaysia, etc., who are all in a similar stage of development, all have restrictions on FDIs similar or more stringent than ours.

The issue here is not that some countries allow unrestricted FDIs. The more important issue is why do countries such as US (and even the Finance Ministry accepts that in mobile telephony, US restricts foreign ownership) restrict foreign ownership at all?

The Finance Ministry's Note argues that even if the US has foreign ownership restrictions in cellular area, it has no such restriction in fixed landlines. Here we need to remember an elementary fact. Telecom fixed-line services in the US were a monopoly, and a regulated monopoly of AT&T (Bell), a US company. The issue of restricting foreign ownership therefore did not arise for the Bell system.

The Finance Ministry's Note states "the restrictions on mobile services are more due to spectrum availability rather than any ideological or security considerations." The facts are otherwise. In the US, the restriction on foreign ownership on radio licenses came in 20's when telegraph and wireless were recognised to be of strategic importance. In the US, Marconi, who was a British citizen owned radio licenses. The US thought that this was not in its strategic interest. It forced Marconi to disinvest its share and this led to the formation of RCA under the US Government's stewardship. RCA was also given Marconi's US patents. The question of similar restrictions on fixed landline telephony did not arise, as this was already a homegrown Bell monopoly. In Canada, where US companies were seen to be foreigners, such restrictions applied to both fixed and radio licenses.

Even today, there is no advanced country, which has effective landline competition. In the US, the baby Bells have metamorphosed into powerful players combining cable, cellular and fixed line services. Local fixed services are still baby Bell monopolies (all are US corporations) and there is hardly any competition in landline services. As long as this scenario continues, there is no need for the US to look at foreign ownership restrictions for landlines. In any case, they have other laws. There are anti-monopoly

provisions; sizeable foreign investments in sensitive sectors need Treasury clearances. In telecom, a Committee on Foreign Investments in the US (CFIUS), an intergovernmental agency consisting of the Federal Communications Commission (FCC), Homeland Security, Central Intelligence Agency (CIA), the Federal Bureau of Investigation (FBI) and the Department of Justice, etc., examines all such investments. Foreign equity caps are only one mechanism for restricting foreign control. Countries with higher FDI limits in telecom companies had put in place security mechanisms long before raising the limits. India has not. The issue for us is that this is the only one we have currently in place and relaxing that as well means no restrictions on foreign control of Indian telecom companies.

The Finance Ministry's Note makes it appear that China has "thrown open the doors to foreign capital." Without going into details of the same, it must be noted that the China has yet to allow FDI limits of 49%, which it would allow only by 2007. It might be noted that in China, Internet services are also covered by the above restrictions unlike India where 100% FDI is allowed in Internet and other data services.

China Unicom and China Mobile – the mobile telephony operators are "State-Owned Enterprises" with more than 70% of their shares owned by unlisted parent companies and ultimately the Ministry of Finance. China Mobile is the country's most valuable enterprise and is ranked in the Fortune 500 list. China has more than 300 million subscribers against approximately 45 million in India at present and accounts for 30 % of the world's net addition in subscribers. And this growth has taken place without any FDI in areas such as mobile, fixed telephony or long distance services.

The foreign owned companies that carry overseas communication, according to the Finance Ministry Note are AT&T and Alcatel Shanghai Bell. A perusal of the website of Alcatel Shanghai Bell will show that it is an equipment manufacturing firm and not a service provider. In India, FDI of 100% is already allowed in telecom equipment manufacturing. With regards to AT&T (China), according to Paranjoy Guha Thakurta (Business Line 25 and 26 October) "Contrary to what the Finance Ministry's note would imply, AT&T (China) is not an investor in telecom services but a representative office that deals with bilateral long-distance phone traffic between China and the United States. A similar representative office is run by AT&T in New Delhi." Therefore, it is inappropriate to use the AT&T China or Alcatel Shanghai Bell examples to argue for lifting of FDI limits in India.

Attracting foreign capital depends on a range of factors including market demand, the regulatory framework, and a stable policy environment. These are the areas that we need to address. We are not aware of any foreign investor in telecom that has said the "low" FDI cap is the reason for not investing (or not choosing to remain) in India. As we have already explained in our earlier note, a number of foreign companies invested in telecom services in a period when these caps existed (32 joint ventures for mobile telephony and 16 joint ventures for fixed telephony when some of the world's largest and best-known telecom companies had bid for mobile and fixed line licenses with a 49% cap in place in 1994 and 1995). Their departure had little to do with FDI caps but the regulatory uncertainty under the previous NDA Government in which the Department of Telecom, Government and private operators, TRAI, were all fighting cases against each other in the courts. As the Table below will show, there is little correlation between FDI limits and actual investments.

License Versus FDI Status

License Type	FDI Limit	Foreign Investors	Availability of License
Fixed Line	49%	Zero	Off-the-shelf
National Long Distance (NLD)	49%	Zero	Off-the-shelf
International Long Distance (ILD)	49%	Zero	Off-the-shelf
Paging	100%	Zero	Off-the-shelf
Internet Service Provider (ISP)	100%	Zero	Off-the-shelf
Mobile Telephony	49%	3 plus	Not available
Equipment Manufacturing	100%	Negligible	Not relevant

The Need for Large Capital Investments in Telecom and FDI's

The Finance Ministry has claimed that unless FDI limits are lifted, huge investments required of the order of \$ 28 billion (Rs.128,000 crore if we use the current exchange rate, though the Finance Ministry also talks elsewhere of investments required to be Rs. 160,000 crore) cannot be made. The Note also talks of estimates of \$2.5 billion per annum of FDI requirements, though no calculations have been given to substantiate this figure.

The Finance Ministry does not seem to have interacted with the Ministry of Communications or has overlooked the calculations that we had furnished in our earlier note. This would have made clear that the internal resources generated by the telecom companies are quite adequate to meet the needs of the sector. Our earlier note also shows that the *current annual surplus and reserves* of 4 Telecom Companies – BSNL and MTNL, Bharati Televentures, Tata Telecom and VSNL, are in the *excess of Rs.15,000 crore*. If we include Reliance Infocom in this and project the annual surplus for the next 5 years, we are looking at an average annual internal generation of Rs. 20,000 crore, even with the most conservative of estimates. The existing subscribers will pay for almost the entire future expansion of the network!

These figures are not surprising. The Indian telecom sector has been largely self-financing. The entire telecom expansion carried out by the erstwhile Department of Telecom was from its internal accruals. The current surplus of BSNL and MTNL is of the order of Rs.9,500 crore and is ploughed back entirely into further network expansion. Things would have been much better if the previous NDA Government had not sold off VSNL, with an additional annual surplus of Rs.4,000 crore. BSNL has made investments of Rs. 66,372 (\$14.7 billion) crore in the last five years, largely from its internal resources. BSNL has a cumulative outlay in Gross Fixed Assets of Rs.130,000 crore (2004 March), which is

“Annual Investment in the network has increased from Rs. 785 crores (US\$ 17.44 million) in 1986-87 to over Rs. 12,057 crores (\$ 3.20 billion) in 2002-03. This investment has been financed **mainly by the Department's internal accruals.**”

BSNL Website

“The capital expenditure during 2002-03 was Rs 10.33 billion as against Rs.8.22 billion in 2001-02 and the capital expenditure for both the years was **fully met by internal resources.**”

MTNL Website

(Emphasis added)

growing at an annual rate of 15%. If we take this 15% figure and *see BSNL's projected investment for the next five years, it is of the order of Rs. 130,000 crore (\$28 billion)*. And this does not include MTNL's investments, which are of the order of another Rs. 1,000 crore per annum. With the huge cash surplus that MTNL and BSNL today enjoy, they can finance their growth from their internal resources (See Box). Even if they need to tap either the domestic or the international loan market, this is not difficult with this magnitude of surplus.

If we look at the last 5 years of telecom expansion of the country, it has had an investment of about Rs100,000 crore. Apart from the private sector, which had to put in the initial investments and is now generating a surplus, the major part of this investment came from public sector and was through internal generation. Therefore, neither is this sum of \$28 billion as daunting as it reads nor is it likely to impact capital formation in other sectors.

The Finance Ministry has termed the balance sheets of the telecom companies in its Note as "the so-called healthy balance-sheets of Indian companies". Contrary to the misgivings of the Finance Ministry, the balance sheets of the telecom companies are indeed healthy.

The Finance Ministry's Note also talks about the debt equity ratio being of the order of 1.6:1 or at best 2:1, implying that the telecom sector is financially weak and requires more investments before loans can be raised. If the capital investments come largely from internal accruals, the debt: equity ratio is bound to be low; this is not an expression of the weakness of the sector but its strength.

The Finance Ministry's note has shown a requirement of \$17 billion for public sector and \$11 billion for the private sector. The question of FDI in BSNL and MTNL, the two public sector companies, would arise only if the Government is considering disinvesting in these companies. This is quite contrary to what the Ministry of Communications, Dayanidhi Maran has said. According to Maran, there will be no privatisation of the state-owned telecom companies. And as we have shown above, the public sector telecom companies do not need outside financing.

The FDI requirements then are regarding private telecom companies, who according to the Finance Ministry's calculations require roughly 2 billion dollar per year to enhance their telecom infrastructure. By our estimates, the private telecom companies are projected to generate about Rs. 10,000 crore per annum from their internal resources, and therefore do not require such large infusions from outside. The major players here not only are not asking for lifting of FDI limits but also have publicly stated that it is of no concern to them.

While we support the increase of Teledensity, we must also point out the skewed nature of the current expansion. With the private sector concentrating on the well-off consumers and the high revenue urban areas, the rural-urban divide is getting even sharper: at present it stands at 1:11. TRAI, in its Press Release, October 27, 2004 has stated, "despite several attempts over the last more than ten years, the gap between penetration of telephony in rural (1.7%) and urban (19.7%) areas is widening." Even today, 70,000 villages are not connected to the network. Even the Finance Ministry's note accepts that the network coverage in the country is only 20%. While improving Teledensity is important, it is now becoming clear that unless immediate measures are taken, the urban-rural divide would continue to grow.

Increase of competition and new private players has not helped in increasing network coverage or rural telephony. While well-off urban consumers have benefited from the increase in Teledensity, the growth of the network coverage has not kept pace; it is largely concentrated in areas that were already connected.

The issue of FDI limits must be seen in the context of priorities in the telecom sector. The urgent need is to expand the network coverage and extend rural telephony. In both these, private players have very little contribution. The private telecom companies have fulfilled only 10% of their rural telephony commitments. Therefore the issue of raising FDI limits has little relevance to the key issues of improving coverage and rural telephony. Regarding resource constraint, the key constraint is capital for the expansion of the rural network. Raising FDI limits or FDIIs are not going to address this.

The only company that has pursued rural telephony is state-owned BSNL. The Finance Ministry, instead of encouraging BSNL, is hampering its ability to provide rural telephony by not releasing the Universal Service Obligation (USO) Levy, which has an unspent current cumulative balance of Rs. 5,500 crore.

Some private operators are not paying BSNL the TRAI mandated Access Deficit Charges, thus hampering BSNL's ability to provide rural telephony. They are routing long distance calls through their network and hiding the origin, treating it as a local call, which has a lower access charge than long distance calls. Both BSNL and MTNL have filed cases against Reliance. The Government needs to expedite the release of USO levy and come down heavily on such attempts to fraudulently bypass legitimate access deficit charges. The Government also needs to strengthen BSNL and MTNL's competitive capabilities by a merger of the two, after proper valuation of BSNL.

The Finance Ministry also argues that if we do not expand the market for buyers we may be limiting competition and may end up with only one or two large players. This is a very surprising statement as India has already four major players, MTNL-BSNL, Tatas, Reliance and Bharatis, operating with unified licenses across various circles. If we include both GSM and CDMA, there are seven operators in mobile telephony. In most circles, there are three land line operators, four in ILD services, three in NLD services and hundreds in ISP. Apart from mobile telephony, where new license are restricted by lack of spectrum availability, in all other areas, licenses are freely available (see Table License Versus FDI Status). It is one of the most competitive markets for telecom in the world, allowing competition in the local loop as well. Something, which is yet to take off in the west.

The Finance Ministry has suggested that the advantages of competition outweigh the cost of duplication of resources. Whether competition will bring down rates or it will lead to needless duplication of infrastructure depends on the degree of competition already existing in that market. Currently, Indian telecom sector is already highly competitive. So much so that TRAI regards tariffs need no longer be regulated. Given the highly competitive environment of the telecom scenario in the country, TRAI, in its consultative papers, has also talked of needless duplication of infrastructure. There is little that competition can do at this stage to bring down telecom rates. It may be seen that the introduction of the 4th cellular licensee did not bring down rates further.

We have argued in our earlier note as well as here that FDI limits have no relevance in either attracting foreign capital or in expansion of the telecom network. The biggest proof of this can be found if we contrast the mobile and Internet services in the country. In Internet services, 100% FDI is permitted. We not only have yet to attract foreign

capital, our broadband services are 60 times more costly than Korea's. Our Internet growth rates are stagnant, with VSNL concentrating after privatisation in the more lucrative international long distance telephony. In the same period, with a 49% cap in FDI, we have grown at a phenomenal pace in mobile services. China, with an even more stringent FDI policy also has grown at a staggering pace.

Experience shows that a blind faith in the market coupled with relaxing FDI limits will not lead to increased telecom penetration or expand telecom manufacturing base. The key here is not FDI limits but the cost of services and the thrust that the Government is willing to put into these sectors.

Indigenous Manufacture

The Left had also raised concerns that unless equipment manufacturing is indigenised, the cost of equipment will not come down, impinging ultimately on the cost of telecom services. The Left had pointed out that at present we offer reverse protection in the Indian market; we have higher duties for raw materials than for finished goods, leading to the destruction of the indigenous telecom industry. The Chinese example is just the opposite. They have used their very large internal market to develop a manufacturing base, which is now one of the largest in the world. The Finance Ministry calls it the "infant industry" model, but the fact is that this Chinese "infant" is currently the biggest player in the global cellular market. It manufactures the largest number of handsets in the world, and is giving global MNCs a run for their money in the more sophisticated equipment such as switches and routers, etc. Having 100% FDI has not attracted significant capital into Indian telecom equipment manufacturing sector. In contrast, China, has secured very substantial FDIs in manufacturing, with the presence in China of almost all the major telecom equipment manufacturing companies such as Nokia, Ericsson, Alcatel, etc.

The manufacturing sector in China is growing enormously and it is likely to be major supplier of telecom equipment internationally – from mobile handsets to more sophisticated network equipment. This has been possible due to a holistic view of the telecom sector it took: from manufacturing to services. This has not only helped China in building manufacturing capabilities, but also resulted in cheaper telecom equipment and thus cheaper expansion of the telecom network.

In India, in contrast, we are providing negative protection to indigenous industry: we have higher duties on raw materials and intermediate goods than on the finished products. No wonder Indian industry is in the doldrums while huge amounts flow out of the country for import of almost every thing in the telecom sector, from mobile switches to handsets. The premier switch manufacturing company, ITI is now sick. There is no manufacture of mobile handsets taking place, in spite of the huge cellular market. One can understand this being the policy of the NDA Government, where the trading interests had a strong lobby, but not for a Government that has promised employment and support to indigenous industry. These policies of continuing discrimination against Indian industry must be rectified if Indian industry has to grow and prices of telecom services brought down.

Apart from the issue of manufacturing protection or the infant industry argument, we need to be clear about certain fundamentals. We believe that unless telecom equipment costs are brought down, the telecom services costs will remain high. We look upon domestic manufacture as a means of lowering costs. This is the Chinese model. If India has a market for 150 million new subscribers, then this means a larger market for new

subscribers than that of the US and the EU put together, less only to the Chinese market in size. If we do not use this market to build our manufacturing strength, not only will the cost of telecom services not come down, but it will also lead to huge outflows of foreign exchange.

Let us take a quick look at the foreign exchange outflows that would take place if we do not build up telecom equipment manufacture. Out of the 150 million additional lines, about 120 million is expected to be cellular. For handsets alone, this means an outflow of \$24 billion! If we add to this the 50% of the \$28 billion as cost of equipment, we are talking of another \$14 billion. In other words, we are talking about an outflow of the order of \$38 billion for not having telecom equipment manufacturing sector of the type that China has built. While the Finance Ministry is concerned about how to secure foreign capital of the order of \$11 billion, it does not seem to be worried about this much larger outflow that is projected to take place.

The telecom equipment manufacturing, telecom services and their cost must be seen in a holistic way. This is what the NTP 94 and 99 had promised. This is what the Left is arguing the Government must do.

Legalising Violations of the 49% FDI Cap

The key question here is whether the breaching of FDI limits by Bharati and Hutch illegal or not? If it is legal, then there does not seem to be any argument for lifting of the caps. If it is not, should violators be rewarded by legalising their illegal acts? Unfortunately, the Finance Ministry's Note adds little light on this question.

The issue of lifting FDI limits in telecom services needs to be de-linked from that of violations of the existing cap of 49% on FDIs. The violations are a matter of law and the Government needs to take appropriate steps of either penalising these companies or plugging the existing loopholes. After plugging the loopholes, the concerned companies should be asked to dilute their foreign holdings and bring it in line with the 49% FDI cap. Policy should not be changed because there have been violations.

We must also emphasise that if foreign capital comes in to buy existing shareholder holdings, this does not go towards new telecom investments of the type that the Finance Ministry has stated the country requires. Instead, it is a kind of portfolio investments that go to the pockets of the existing shareholders and generate windfall profits for them. Good policy should encourage productive investments. Instead, the current proposal of lifting FDI will encourage speculative profits and reward those who have violated the existing FDI caps.

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