Liberalisation of the Telecom Sector

The big news in telecom circles in India this month is the recently announced liberalization of investment regulations that finally allows non-resident entities to own Indian telecom companies without having to identify an Indian partner. This has, at long last, completely opened up the troubled sector to foreign investment, allowing Indian telecom companies to be entirely owned and funded from outside the country. Given the troubles and travails that has beset telecoms over the past year and a half, it is hoped that this measure will be the tonic that is needed to re-invigorate the industry.

Foreign investment in Indian telecom companies has always been restricted. In the early days of liberalization this was limited to 49% foreign shareholding with government approval. This limit was steadily liberalized over the years and immediately before the new liberalization was announced, non-resident entities could own upto 49% of an Indian telecom company without prior permission of the Government of India and upto 74% with government approval. This still meant that at least 26% of the shareholding of Indian telecom companies had to be held by Indian promoters.

The Government has always maintained that this is a restriction is necessary to ensure that the ownership and control over a sensitive industry like telecoms does not vest entirely in foreign hands. Be that might be as it may, most Indian telecom companies have offered as much of their shareholding to foreign companies as is legally possible under the existing regulations in order to maximize their access to foreign capital. In fact, most companies that are largely owned by global telecom majors have Indian shareholders for the sole purpose of fulfilling the 26% domestic shareholding requirement and, in order to remunerate them for holding the statutorily required percentage, guarantee them returns through complex and sometimes dubious structures. In the light of this, the decision to liberalise investment restrictions in the sector seems almost inevitable.

However, the fear that "unfriendly" nations will gain control of our telecom networks has not entirely gone away and the decision to liberalise the investment restrictions on the sector has not been without opposition. In a bid to address these concerns the government has pointed to a host of other security measures that have been adopted over the years that should adequately address this issue.

The government was referring to a host of measures targeted at vendors of telecom equipment that were designed to ensure that they do not install backdoors or other vulnerabilities into the telecom equipment sold to Indian telecom companies. While these regulations initially caused considerable consternation among the telecom operators, over the years a new balance has been struck with telecom operators and vendors both coming to terms with the new challenges of working in India. In the past few months the government has augmented these measures by implementing preferential market access regulations that require telecom vendors to adopt local manufacturing in order to continue to supply to the Indian telecom industry. The Indian government is convinced that these measures will do more to address the security requirements than any restrictions on ownership.

The liberalization of the investment restrictions will have a significant impact on how the sector is structured. The immediate consequence of this decision will be felt by the large international telecom companies that are operating in India – such as Vodafone, MTS and Telenor. Each of these players operate in a joint venture model with an Indian partner in order to comply with the investment restrictions. They will all now have the opportunity to offer their Indian partners an exit and will have greater flexibility in the manner in which they can fund their operations. This will doubtless spur greater investments in the Indian telecom space.

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However there is one regulatory change that the industry is still waiting for. Earlier this year, when the government announced the new telecom policy, prominent among the list of reforms was the proposed amendment to the regulations around mergers and acquisitions. Today, close to 6 months after the initial announcement, there is no further clarity as to how companies can acquire other businesses. While the liberalization of the foreign investment limits will go a long way in allowing Indian companies freely structure their shareholding, this measure will still not address the concern that there are too many operators in the market.

What is needed is regulatory reform that will allow consolidation in a market that is struggling to deal with competition and price pressures. One can only hope that now that the government has taken the difficult first step of freeing up the sector from investment limits that allowing greater flexibility in mergers and acquisitions will be easier to implement.