Foreign Direct Investment in the Electricity Sector: The Indian Perspective

So far, India is losing out in the competition against other emerging economies to attract more foreign direct investment to its electricity sector. This is in large part because the Indian approach towards power sector reforms is more haphazard than the more orderly and sensitive growth model of Singapore and Latin American economies.

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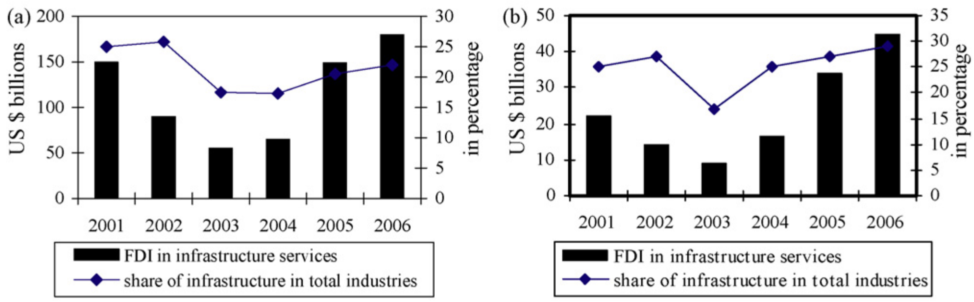
I. Introduction

Infrastructure development is characterized by long sunk cost, long gestation period, and high-risk portfolio. Owing to these drawbacks associated with almost every infrastructure project, it becomes difficult for private investors to raise funds whose maturity matches the project completion time. Foreign direct investment (FDI) is one financing instrument which, besides numerous spillover advantages, is debt free and has no short-term payment obligations. FDI is capable of influencing the development of a country's imports and exports, capital reserves, factor endowments, and terms of trade.[1]

This source has played an important role in rapidly expanding the private sector base in infrastructure development in emerging economies.[2] In the 1990s, many of the world's developing nations opened up their previously state-protected infrastructure utilities to private sector participation. In response



Source: UNCTAD, Cross-Border Merger & Acquisition Database, 2007.

Figure 1: FDI in Infrastructure Services (Cross-Border Merger and Acquisitions): 2001–06. (a) Global (b) Developing and Transitional Economies

to the liberalization policy, these economies witnessed a sudden inflow of FDI into infrastructure development. In recent years FDI in infrastructure services as a group has increased in absolute and relative terms in both greenfield investments and mergers and acquisitions (M&A). In 2006, infrastructure-related industries accounted for 22 percent of worldwide cross-border M&A (**Figure 1**(a)) compared with just 11 percent in 1990 and as little as 3 percent in 1988. In the developing economies,[3] this trend is rising, with almost 30 percent of overall cross-border M&A happening in the infrastructure sector during the year 2006 (**Figure 1**(b)).

Many research studies conducted on India's infrastructure-deficient environment highlighted the paucity of funds as one major cause of underdeveloped infrastructure facilities in the country.[4] Inspired by several of these studies and other empirical findings, the Planning Commission of India emphasized involving the private sector in the development and maintenance of infrastructure facilities in the country. Following this, the government allowed private players, both domestic and foreign, to enter what had been state-owned services. This private sector involvement is mainly occurring in the form of divestitures, greenfield ventures, concessionaire arrangements, and joint ventures. Despite the fact that infrastructure investment in India offers a huge market and returns, the Latin American economies have enjoyed a larger share of FDI in infrastructure.[5] Another major limitation witnessed in the case of India is a heavy imbalance in FDI among various sub-sectors, with most investment coming in the telecommunications sector but very little occurring in an important sector like power. There are number of reasons for this relatively low equity participation of foreign firms. One is the tough competition posed by other developing economies that are also in dire need of adding capacity to their existing facilities. The other is the ease of operations and direct recovery formula in sectors like telecommunications.

II. Rationale of the Study

In recent years the government of India has allowed 100 percent FDI in the power sector under automatic route (with nuclear power being the only exception) and introduced number of incentives and lucrative policy measures to attract major foreign investors into this sector. Also, the recent World Investment Report 2007 ranks India as the second most-preferred destination for FDI by major transnational corporations (TNCs), next only to China. Despite these two favorable developments, India has failed to attract a significant amount of FDI in this important sector.[6] This article examines the reasons behind low FDI into the power sector in India and assesses the policy environment pertaining to private sector participation in this important sector.

 1040-6190/$–see front matter doi:/10.1016/j.tej.2008.08.007