INVESTMENT IN URBAN INFRASTRUCTURE

LL.M. (BUSINESS LAWS)

DISSERTATION Submitted in partial fulfillment of the requirements of LL.M. (Business Laws) Degree Course.

Under the Guidance of Prof. (Dr.) N.L. MITRA

SUBMITTED BY,

SOMANATH M. TONNE,
LL.M. (BUSINESS LAWS),
ID. 301,
BATCH: 2007-09,
smtonne@gmail.com.

NATIONAL LAW SCHOOL OF INDIA UNIVERSITY
P.O.Box No. 7201, Nagarbhavi, Bangalore -72.

2007-2009

// ACKNOWLEDGEMENT

While writing this acknowledgement, I am at loss of appropriate words to record my sincerity of all who have extended to me the best of the suggestions, help and co-operation in very possible way in completing this work. Still I make this humble attempt to thank all of them.

I would first like to thank Prof (Dr.) N.L.MITRA for guiding me through this research paper, who invested his precious time to guide and supervise this work.

I would like to thank my parents and my brother and sister for their love, blessings and confidence in me who supported me all throughout my life.

I would be failing in my gratitude if I did not thank to the entire staff of the NLSIU library and the administration of national law school for their kind help and co-operation

I wish to offer my sincere thanks to Viny, Don, Muttu, Manu and Gowda for their support throughout my career. I would like to thank all my teachers from K.G to P.G who have enlightened me in more ways than I could ever thank them for.

I wish to offer my sincere gratitude to all my classmates and all my friends in LL.M especially Yogi, Irfan, Hans, Raja and Shradha for their kind support, encouragement and help as and when required.

Somanath M. Tonne

LL.M. ID. No. 301

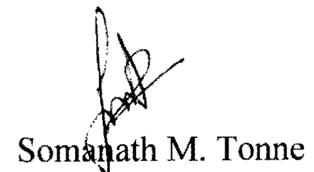
NLSIU, Bangalore

DECLARATION

I, **Somanath M. Tonne,** do hereby declare that this dissertation on the subject **"INVESTMENT IN URBAN INFRASTRUCTURE"** is the product of research undertaken by me in partial fulfilment of the requirements of the Degree of Master of Laws (LL.M) from the National Law School Of India University, Bangalore, under the proficient guidance and erudite supervision of Prof (Dr.) N.L.MITRA.

This research work is original except for such help taken from such authorities as have been referred to at the respective places for which necessary acknowledgements have been made.

I further declare that this research work has not been submitted either in whole or part, for any other degree or diploma from any other university, or any other institution.



Date: 26/03/09

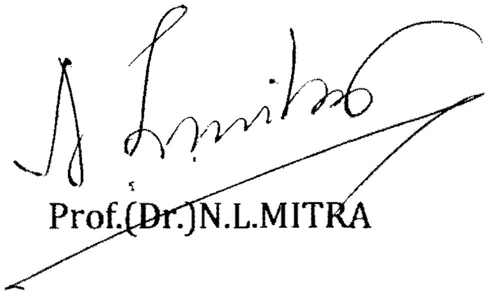
Place: NLSIU, Bangalore

Somanath M. Tonne

ID.301 (Business Law)

CERTIFICATE

This is to certify that this dissertation on the topic of ***"INVESTMENT IN URBAN INFRASTRUCTURE"*** submitted by SOMANATH M.TONNE [ID.301 LL.M (BUSINESS LAWS) 2007-2009], in the partial fulfillment of the requirements of the Degree Of Master Of Law (LL.M) from the National Law School Of India University, Bangalore, is the product of bona fide research carried out under my guidance and supervision.



Date: 26/05/09

NLSIU, Bangalore

Prof.(Dr.)N.L.MITRA

RESEARCH METHODOLOGY

The research methodology scheme is descriptive and analytical. The research exercise is based on the secondary sources such as books, research works, periodicals, articles and other data available on the internet.

Research statement:

With the recent recession and need for safe and sound long term and short-term investments urban Infrastructure sector is a strong tool for safe financial returns, The primary focus of the paper is to critically study the investment environment towards the urban infrastructure sector, the issues involved there in and also the other attributes attached with the topic.

Scope and limitation:

The scope of the paper is limited to the discussion relating to the prospects and issues relating investment in urban infrastructure. The research exercise is circumscribed by the policy and legal regime with respect to investment in urban infrastructure and allied fields. For the said purpose the researcher has concentrated on the relevant notifications, circulars and press notes issued by the concerned authorities as well as the related provisions of the investment laws, RBI, SEBI and ministerial guidelines on the relevant issues.

Chapterization:

The research work has been cauterized into total seven chapters –

Chapter one deals with the general introductory to the research topic 'Investment in Urban Infrastructure' by trying to bring out a case for

investment in urban infrastructure by highlighting the trends in urbanization in India.

Chapter two briefs about the present status of the urban infrastructure in India with respect to housing, water supply , transport , sanitation and solid waste management and the need for investment in urban infrastructure along with existing opportunities.

Chapter three titled as why urban infrastructure is different? Bring out the importance and reasons for considering urban infrastructure unique from that of other sectors.

Chapter four gives the details with regard to the investment outlook, opportunities and further explaining the FDI regime and policy with respect to urban infrastructure. The chapter further enumerates the institutional and sector frame work with regard to urban infrastructure. The chapter also includes the fiscal concession and the environment for NRI investment in urban infrastructure. Chapter four is concluded with the discussion on the implication of the guidelines of the authorities on FDI in respect to urban infrastructure.

Chapter five is dedicated to the important role of the public private partnership (PPP) in urban infrastructure investment. For the said purpose the chapter is segment for highlighting the benefits, risks and regulatory cum strategic issues involved in PPP.

Chapter six tries to bring out reason that the investment in urban infrastructure can't be seen in isolation and it has to be considered along with the real estate

sector, the chapter discusses the other modes of investment in urban infrastructure through REITs, REMFs and municipal bonds. The chapter explains the concept, functioning and regulatory frame work of REITs, REMF. The chapter highlights the advantages and feature of REITs, REMF with a comparative over view.

In the last chapter the researcher concludes with some of the observation and suggestions for investments in urban infrastructure.

Research questions:

The primary concern of the paper is to understand and critically analyse the existing institutional frame work of the FDI regime for investment in urban infrastructure and allied fields. Further the researcher aims to scrutinise in to the existing laws and policy, if any, with respect to FDI that are still providing hindrance towards further raising the scope of the investment in urban infrastructure and allied sector. An objective study over position of law with regard to urban infrastructure, the reforms in existing Indian legislation and innovative approaches viz. REITS as a safe option of investment in both urban infrastructure and real estate.

Mode of citation:

The mode of citation followed by the researcher will be:

Books: Author, "*title of the book*", edition, publication, place, year, page no.

Articles: Author, "*title of the article*", journal name, Volume (issue. no.), year, page no.

TABLE OF CONTENTS

Chapter – 1

INTRODUCTION..1

Chapter – 2

PRESENT STATUS OF 'Urban Infrastructure' IN INDI.........4

2.1 Urban Infrastructure Meaning..4

2.2 Urban Infrastructure Present Scenario...........................5

2.2.1 *Housing*

2.2.2 *Water Supply*

2.2.3 *Transportation*

2.2.4 *Sanitation and Sewerage*

2.2.5 *Solid Waste Management*

2.3 Need for Investment in Urban Infrastructure.................8

2.4 Opportunities...12

Chapter – 3

WHY URBAN INFRASTRUCTURE SECTOR IS DIFFERENT..13

Chapter – 4

OUTLOOK AND INVESTMENT OPPORTUNITY IN 'Urban Infrastructure'...16

4.1 FDI in India/Urban Infrastructure....................................16

4.1.1 *Defining Foreign Direct Investment*....................................16

4.1.2 *FDI Policy for Urban Infrastructure*....................................19

4.2 Institutional and sectoral policy framework.................20

4.2.1 *Water, Housing, and Transport Policies*..............................20

4.3 Entry Strategy for the Investment in 'Urban Infrastructure'..23

4.3.1 *Business Models*..24

- With Equity Investments..25
- Without Equity Investments..27

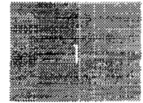
4.4 NRI Investment in Urban Infrastructure........................34
4.5 Implications of the Guidelines on FDI in 'Urban Infrastructure'........................37

Chapter – 5
ROLE OF PPP IN 'Urban Infrastructure' INVESTMENT........42
5.1 *Benefits of Public Private Partnership*........................44
5.2 *Regulation and Strategic Issues*........................45
5.3 *Risks Involved in PPP*........................46
5.4 *Accounting for PPP Arrangements*........................49

Chapter – 6
REITs, REMF AND MUNICIPAL BONDS........................53
6.1 Real Estate Investment Trust [REITs]........................53
6.1.1 Advantages of REITs........................54
6.1.2 Comparative Overview........................55
6.1.3 The Functioning of Real Estate Investment Trust................60
6.2 Real Estate Mutual Funds [REMFs]........................61
6.2.1 advantages of REMFs........................63
6.2.2 Features of REMFs........................64
6.3 Municipal Bonds........................64

Chapter – 7
CONCLUSION AND SUGGESTIONS........................66

BIBLIOGRAPHY



CHAPTER 1

INTRODUCTION

Infrastructure is a prerequisite for the economic growth. It represents, if not the engine, the wheel of economic activity. For a rapidly growing economy, infrastructure availability of the adequate quality and reliability is the key determination. Good infrastructure is the central to all the economic activity. It facilitates efficiency in the economic services, improves the economic competitiveness and increases the productivity. Poor infrastructure, however, can significantly impede economic growth and rapid growth of urban population has obvious implications in terms of infrastructure and services to the cities.

Growing urbanization in India is reflected by the fact that nearly 29 per cent of the total population, resides in urban areas[1] making India the second largest urban system in the world. Trends in urbanisation will continue in future[2]. Structural adjustments, reforms and globalisation of the Indian economy are likely to accelerate the urbanisation. The urban infrastructure bottle necks in the urban areas are likely to pose serious impediments in enhancing productivity. The failure to expand water supply, sanitation system, housing and transportation to match the growth of urban population has emerged as prime cause of urban misery. In Indian context the situation is grim. In nut-shell Indian urbanisation is characterised by rapid increase in urban population and non-availability of physical and social infrastructures.

[1] As *per* 2001 Census

[2] 40% by 2021, Indian infrastructure, August 2008 p.94

What happens to the national economy is now understood as dependent on how well cities provide urban infrastructure as more than 90 per cent of the government revenues come from the cities[3]. With the growing demand for the urban infrastructure a need for increasing investment in urban infrastructure is imminent. Traditionally, urban infrastructure was financed mainly through budgetary allocations of governments and financial institutions like HUDCO. Since the resources from these sources are short of the sector's estimated investment requirements alternative source of financing urban infrastructure is inevitable.

Considering the above facts the researcher would try to bring out as to how over the past 10 years, the urban infrastructure sector has emerged as an area of focus and changes which have been brought about by various reforms and policy initiatives. Since the early 1990s, the government has introduced economic reforms that have direct impact on the urban infrastructure investment. Assessment of the investment has been made by different groups including the working group constituted by the planning commission for infrastructure development accordingly the investment requirement ranges 300-600 billion for 2001-11. Further by the estimates of the India Infrastructure Report 1996, the estimate is more than 2000 crores. In this given context the researcher would be analysing the investment environment in urban infrastructure especially the FDI regime (policy, regulatory and others) in India with respect to urban infrastructure.

[3] World Bank, "India: urban sector strategy", 2002, p.4

In terms of intuitional structure the researcher would be discussing about the institutional, sectoral policies and reforms brought like the 74th Constitutional Amendment giving greater financial autonomy to the urban local bodies for raising investment in urban infrastructure in additions to the major programme JNNURM which provide for investment schemes like in townships etc. Researcher would also discuss the policy wise changes brought to boost and attract the investment in urban infrastructure especially with respect to water supply[4], Housing, Transport[5], Drainage and sanitation, solid waste management. In the later chapters the researcher would try to bring out role of PPP (PUBLIC PRIVATE PARTNERSHIP) in urban infrastructure investment as a viable means for investments in urban infrastructure.

Though the chapter is titles 'Investment In Urban Infrastructure', the researcher would also be focusing on other modes of investment i.e. REITs (REAL ESTATE INVESTMENT TRUST), REMFs (REAL ESTATE MUTUAL FUND) taking in to consideration the important role played real estate in urban infrastructure development and the innovative tools like municipal bonds brought about to attract investments from the financial institutions and private sector to leverage the capital market resources.

---

[4] National Water Policy as amended in 2002
[5] National Transport Policy 2006.

CHAPTER 2

PRESENT STATUS OF URBAN INFRASTRUCTURE IN INDIA

The availability of the urban infrastructure such as drinking water, sewerage disposal solid waste management, housing and transport leaves a lot to be desired and this is highlighted by the present status of the urban infrastructure in India. Before knowing as to the present scenario of the urban infrastructure it is important to know as to what is urban infrastructure.

2.1 Urban Infrastructure: Meaning

To under the as to what constitutes urban infrastructure one has to understand what is infrastructure. The **World Bank Development Report** includes the following in its definition of infrastructure services;

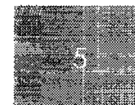
- *Public utilities*

  Water supply, sanitation and sewerage, solid waste management etc

- *Public works* roads etc
- *Other transport services*

  Urban and inter urban railways and urban transport. It also includes social infrastructure, often encompassing education and health care.

According to the **India Infrastructure Report 1996**, infrastructure is defined as '*the physical framework of facilities through which goods and services are provided to the public*'.



Reserve Bank of India (RBI) Circular on Definition of Infrastructure

Vide circular dated 2nd July, 2007[6] The RBI has defined infrastructure to include;

> *".....(vii) urban infrastructure (water supply, sanitation and sewage projects).......".*

Infrastructure include a water supply project, water treatment system sanitation and sewerage system or solid waste management system As per the RBI for treating credit facility as "infrastructure lending" to a borrower company which is engaged in developing, operating and maintaining, or developing, operating and maintaining any infrastructure facility that is a project in any of sectors.

Thus urban infrastructure covers;[7]

(i) Physical infrastructure (water, sanitation, solid and liquid waste management, drainage, sewerage, electricity, roads, bridges and flyovers, transport including Local Rapid Transit System (LRTS) and Mass Rapid Transit System (MRTS), waterways, etc.) and

(**ii**)Social infrastructure (education, health, housing, community centres, recreational centres, sports complexes, etc.)

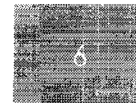
2.2 Urban Infrastructure: Present Scenario

The relentless increase in the urban population has placed great pressure on the urban infrastructure. In 1951, only 10 per cent of the India's population lived in the urban areas. Now almost third of the population lives in urban

---

6 http://infrastructure.gov.in/pdf/doi.pdf visited on 24.03.2009. [For raising external commercial borrowings funds, the RBI has defined infrastructure].

7planningcommission.nic.in/reports/sereport/ser/vision2025/urban.doc. and indiabudget.nic.in/es97-98/chap99.pdf visited on 27.01.1009

areas .according to 2001 census, the urban Indian population stood at about 285 million compared to 217 million in 1991, there by registering an annual rise of 2.73 per cent[8], consequently the urban infrastructure has been deteriorating rapidly.

The present state of urban infrastructure is unsatisfactory with low striated investments and poor governance.

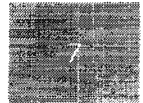
2.2.1 Housing

Though housing sector is in a continuous boom this can be attributed to a combination of low interest rates and easier accessibility to loans. The supply of housing has been increased in urban areas; there has been increase in the facilities such as IT parks as well as in the residential real estate market. But unabated growth of the urban population is aggravating the accumulated of the housing shortages resulting in proliferation of slums and squatter settlements.

2.2.2 Water Supply

The present system of water supply in the country offer in adequate coverage and the demand supply gap is increasing. Water is state subject. The 74th Constitutional Amendment [9]makes ULBs responsible for delivery services like water supply. About 20 per cent of the urban India doesn't have access to safe drinking water[10]. Leakages and unaccounted for water exceeds 50 per cent in many cities. More over the water pricing remain unaddressed.

[8] Indian infrastructure, August, 2005, p 86
[9] 1992 Amendment
[10] India Infrastructure Report 2001



2.2.3 Transportation

Rapid urbanisation has also lead to shortage o adequate transportation facilities in urban India. The provision for the urban rail is limited to only four cities. In absence of efficient and effective public transportation has increased reliance on private modes of transportation. The situation is so grim that the Overall, investment of more than 1000 billion has been projected by the committee for urban transport sector of which 46 per cent of the resources are to be mobilised through the financial institutions and 19 per cent through the private participation.

2.2.4 Sanitation and sewerage

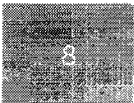
The present system of sanitation is very grim and almost 72 per cent is not covered by any sewerage network[11].The 74th Constitutional Amendment[12] makes ULBs responsible for delivery services like sanitation and sewerage treatment.

2.2.5 Solid waste management

Urban areas in India generate 98,000 tonnes of solid waste per day and only 7 per cent is this waste is treated. The growth in urban solid waste is estimated at 13 per cent per day and there is a huge investment deficit.

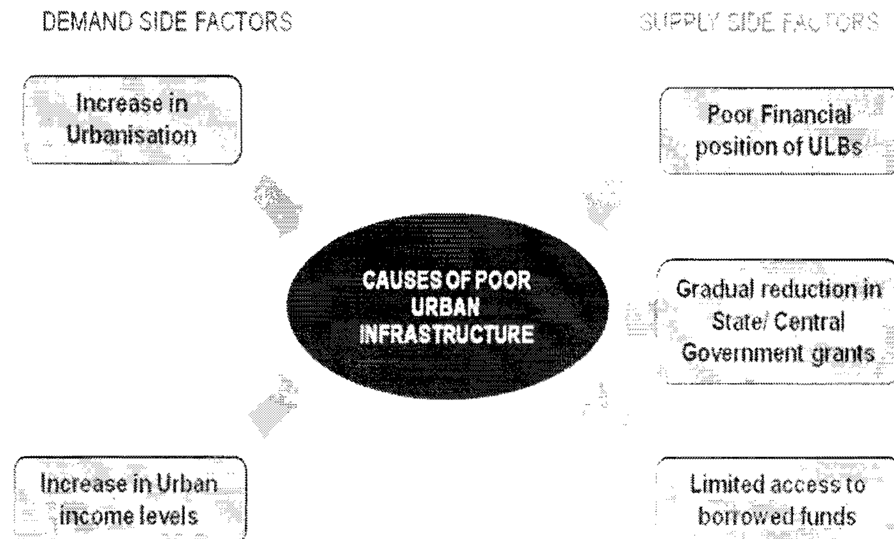
Although several initiatives have been taken, a huge investment gap exists. The Tenth Five Year Plan has assessed a gap of 37 billion. The Steering Committee Report on Urban Development for the Eleventh Plan estimated

[11] Supra 9
[12] 1992 Amendment



investment requirement of 1,270 billion to implement water supply, sewerage and sanitation, and solid waste management projects.

Causes for poor urban infrastructure

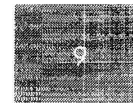


2.3 Need for Investment in Urban Infrastructure

Adequate urban infrastructure has been considered vital not only for rational growth and development centres but also for acceleration of economic development of the country.[13]

The need for the investment in urban infrastructure can be made out buy the inadequacy of urban infrastructure highlighted by the Expert Group on Commercialisation of the Infrastructure Projects Report 1996 (also known as **Rakesh Mohan Committee** Report).

[13] J. k. Gupta, "Urban Infrastructure Development-Need for Innovative Approaches", Nagarlok, Vol. 34(03), 2002, p 41



Highlighting the need for Urban Infrastructure the committee observed,

> *"....the situation is grim, as per the census 20 % urban household do not have accesses to safe drinking water 52 % was left with uncovered sanitation...only 35 % sewerage coverage ...66% drainage coverage... the city roads are inadequate and inefficient for traffic requirements leading to congestion...."*[14]

The study on the urban sector profile by National Institute of Urban Affairs states that the most of the municipalities in the country do not cost the services provided in scientific manner[15].

According to Rakesh Mohan Committee Report,

"The infrastructure bottle necks are likely to pose serious impediments in enhancing productivity".

Commercialisation of the infrastructure is suggested as one of the alternative to overcome the problem.[16]Huge investment requirements have been estimated for urban infrastructure. The customary practice of financing the sector primarily through various plans and budgetary allocations has failed to meet the ever- increasing demand for basic services in cities. In a limited way, the sector has also been funded through public financial institution like the life insurance co-operation, Housing and Urban Development Corporation (HUDCO), banks and domestic financial institutions, and bilateral and multilateral agencies.

---

[14] Expert Group on Commercialisation of the Infrastructure Projects, 1996 The India Infrastructure Report-Policy Imperatives For Growth And Welfare.

[15] Nand Dhameja and Rakesh Gupta, "Urban Infrastructure Financing: Innovative Tools", Nagarlok, Vol-32(03), 2000, p13.

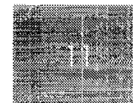
[16] Ibid p 14

Consequently, the focus on introducing new fiscal instruments, credit rating urban local bodies (ULBs), developing commercially viable infrastructure project, and encouraging public-private partnership (PPP) projects has increased. However, issues and concerns regarding the financial health of municipal authorities, lack of a transparent and accountable municipal structure, and credible, good governance persist.

The steering committee report on urban development for the Eleventh Five Year Plan estimates the total investment requirement for the urban sector at Rs. 2,618.27 billion. Put together, the government outlay for augmenting urban infrastructure development stands at Rs. 1,064 billion. That leaves a staggering gap of 1,554.27 billion.

In fact, the gap in financing urban infrastructure is expected to be wider. Various estimates point at investment requirements of over Rs. 3,350 billion for the 63 mission cities alone by the end of the Eleventh Plan. Clearly, government funding along will not be able to meet the escalating urban infrastructure needs. Funds will have to be pooled from capital markets and private sources.

Currently, the momentum of commercial borrowing by ULBs for projects seems to be influenced by the pace of the JNNURM. Out urban infrastructure development, and facilitate large borrowings from ULBs, disparities in fund allocations between different states and ULBs are evident. As per a study conducted by the Centre for Policy Research, seven of the 55 cities under the JNNURM with high investment grade ratings (AA and A+) account for about 47 per cent of total union government support under the mission. Against this,



15 cities with ratings below investment grade have cornered only about 14 per cent of funds[17]. Likely avenues for private sector participation (PSP) in the sector include water supply and sanitation, solid waste management, urban roads and bridges, urban transport systems, housing, buildings and complexes, public space development.

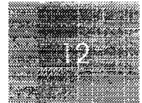
Estimated Investment Requirement for Urban Infrastructure (2007-12)

SECTOR	Investment requirement (Rs billion)
Transport system	1,325.90
Water supply	536.66
Sewerage	531.68
Drainage	201.73
Solid waste management	22.12
Management information system	0.08
R&D, public health education training	0.10
TOTAL	2,618.27

Source: *India infrastructure, February 2009*

More than other infrastructure sectors, each sub-sector in urban infrastructure has its own sets of complexities and each requires different and project-bound approaches. For instance, the urban water supply and sanitation sector, which is considered a volatile segment prone to political interference, has witnessed some encouraging private sector initiatives in the recent past. Other areas like solid waste management and urban transport systems continue to attract PSP

[17] Shailesh Pathak, "Urban financing", Indian infrastructure, February, 2009 p-61



(private sector participation) in varying degrees. Even so, urban infrastructure as a whole is yet to witness large-scale PSP.

2.4 Opportunities

The India Infrastructure Report in 1996 estimated that an annual investment of US$ 5.71 billion is required for providing water supply and sanitation facilities for the urban population. This gives an idea about the quantum of investment requirements and hence the opportunities in this sector alone. The government has planned major schemes like,

- Integrated development of small and medium towns
- Mega city schemes
- Special development plan for the National Capital Region
- Accelerated urban water supply programme
- Low cost sanitation
- Urban transport

Investment opportunities exist in water supply, sewerage and waste management systems in many towns and cities. Construction opportunities exist in roads, bridges, flyovers etc in cities, both in Government sponsored projects as well as Build Own Operate (BOO) and Build Own Operate Transfer (BOOT) basis projects. A number of cities are planning mass rapid transportation systems and light rail systems. These projects are mostly through private participation. Housing is another major investment area with significant potential.

CHAPTER 3

WHY URBAN INFRASTRUCUTRE IS DIFFERENT

To understand why investments in urban infrastructure have not kept pace with overall financial flows in other sectors it is necessary to recognise how urban infrastructure differs from other sectors. There are many reasons for the unique position this sector has the same could be summarized as follows -

Firstly, urban infrastructure is often considered essential by consumers which are frequently provided by monopolists. Together these factors increase political sensitivity to the price charged. Pressure from the consumers to keep prices low makes it politically difficult for the government to maintain prices that cover costs.

Second, urban infrastructure typically requires large sunk investments that may take years to recoup. Over such long periods of time investors are exposed to serious risks, in particular the risk that public authorities will not honour their agreements on tariff policy and payments to the investors[18]. Once the investors are committed to the projects and can pull out only by taking a huge loss. Governments may be tempted to lower the prices or not raise them as agreed. Investors thus risk being the victims of what has been called the "obsolescent bargain".[19]

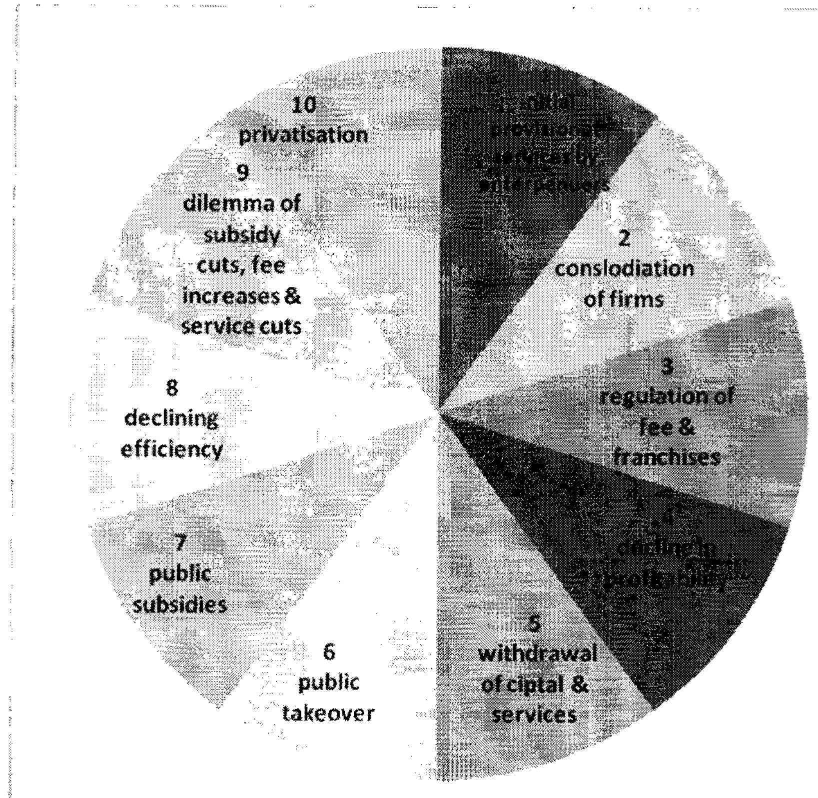
---

[18] Klein and Roger 1994

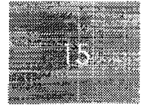
[19] Timothy Irwin , "Dealing With Public Risk In Privates Infrastructure", World bank , Washington D.C ,1998, p.24

These factors help explain the familiar privatization-nationalization cycle that has been observed repeatedly. The figure below gives the diagrammatic representation of the privatization-nationalization cycle.

Privatization-Nationalization cycle



Private entrepreneur may initially develop urban infrastructure-building water supply networks, for example. As these networks expand towards territories operated by another entrepreneurs companies merge with or acquire the neighbours, creating larger, consolidated firms. These new firms are perceived as possessing significant monopoly power, creating pressure for monopoly regulation. Regulation, in turn, reduces price and profitability, which discourages maintenance and new investment.



In the face of the declining quality and the slow down the government nationalises the firm. Low price and the inefficiency sap the finances of the state owned firm, obliging the government to subsidise it. The very availability of subsides encourages more inefficiency. Eventually, concerns about fiscal subsidies and inefficiency create pressure for the price increase and privatization and the cycle begins again.

More over the investors are faced with the possibility of changing contractual agreements or failure by the government to implement the policies. The heavy foreign investment of urban infrastructure creates additional risks. Exposure to the currency risks for the foreign investors. Project revenues are often generated in local currencies, while the servicing the foreign debt and equity involves payment in foreign currency. Fluctuations in the exchange rate of the domestic currency and capital controls limiting currency convertibility and the transferability, creates the risk for the foreign investors[20].

---

[20] Supra 19(Irwin).p25

CHAPTER 4

OUTLOOK AND INVESTMENT OPPORTUNITY IN 'URBAN INFRASTRUCTURE'

The economic model followed by India after independence relied on import substitution and selective foreign capital inflow, both through portfolio investment and foreign direct investment route. This changed radically with the liberalisation measures post 1990. Both portfolio investment and foreign direct investment were not only allowed but also encouraged.[21]

4.1 FDI in India / Urban Infrastructure

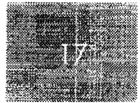
4.1.1 Definition of Foreign Direct Investment[22]

FDI is the process whereby residents of one country (the home country) acquire ownership of assets for the purpose of controlling the production, distribution and other activities of a firm in another country (the host country).

IMF Definition

According to the BPM5, foreign direct investment is the category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise.

[21] Indian infrastructure, November 2005 p 70
[22] Committee on Compilation of Foreign Direct Investment in India, Report 2002, p 3.



UNCTAD Definition

The WIR02 defines FDI as 'an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the FDI enterprise, affiliate enterprise or foreign affiliate.'

FDI implies that the investor exerts a significant degree of influence on the management of the enterprise resident in the other economy. Such investment involves both the initial transaction between the two entities and all subsequent transactions between them and among foreign affiliates, both incorporated and unincorporated. Individuals as well as business entities may undertake FDI.

Flows of the FDI comprise capital provided by the foreign direct investor.[23] FDI has three components: equity capital[24], reinvested earnings[25] and intra-company loans[26]. In the context of the developing countries like India, the role of FDI in easing the financial constraints becomes critical. According to the planning commission, at current levels of efficiency in the economy, the inverse in the investment is needed to achieve a percentage point rise in the overall growth would be 6 percentage points. Since this addition to investment cannot come entirely from the domestic sources, a substantial portion has to be funded by FDI.

---

[23] "Rajiv Jain's Investing in India", India investment publication, 2nd edi, New Delhi, 2004-05, p1.28

[24] It is the foreign direct investor's purchase of shares of an enterprise in a country other than his own.

[25] It is the foreign direct investor's share of earnings not distributed as dividends or earning not remitted to the investor such retained profits are reinvested.

[26] It is a short or long term borrowing and lending of funds between direct investor and the affiliated enterprise.

Foreign Exchange Management Act (FEMA), 1999 is the gateway legislation of India for Inbound investments into India. The new industrial policy of 1991 brought in substantial reforms, which have aimed at encouraging FDI reduced the industrial licensing requirements, particularly in the infrastructure sector.

The policy and procedure of Foreign Direct Investments are governed by the Industrial Policy as well as the Foreign Exchange Management Act, 1999 ["FEMA"]. Section 6(3)(b) of FEMA empowers the Reserve Bank to prohibit, regulate or restrict the transfer or issues any security by person resident outside India. As such, the businesses within India carried out by foreigners are governed by the various regulations prescribed by the Central Government in connection with the Foreign Direct Investment.

The ceilings in the FDI in different sectors were progressively raised. From 2001, 100 per cent FDI were allowed in several industrial sectors. Currently 100 percent FDI is allowed in all the infrastructure sectors[27]. Government has taken series of steps to ensure liberal FDI policy some of the silent features are:

- There are two modalities of FDI approval: automatic route and the foreign investment promotion board/ government approval route;
- All activities, except some, qualify for automatic route where in the companies receiving FDI has to inform RBI within 30 days of the receipts of the funds and issuance of shares to the foreign investors.
- Full repatriation of the original investment and return is generally allowed.
- liberal policy towards ECBs, ADRs, GDRs and FCCBs

[27] Indian Infrastructure, November, 2005, p70.

The infrastructure focus of India's FDI policy is not attracting the FDI as an end in itself but a means of industrialisation and development though the following:

- PPP
- Concessions agreements
- Leases and other contractual agreements
- New capacity creation through built-operate-transfer(BOT) agreements

4.1.2 FDI policy for urban infrastructure

urban infrastructure have traditionally been provided by the city level agencies, usually financed by the both central and state governments as per the recent amendment to the India constitution , local bodies have been given greater operational autonomy by bringing changes in the FDI policy with respect to urban infrastructure. Under the foreign investment policy, 100 per cent FDI is permitted in urban infrastructure projects thus allowing private entry and also public private partnership in sectors like water supply, sanitation, public transport.[28]

The scheme also encourages NRI investment in the housing and urban development centre to the extent of 100 percent in the equity of the Indian companies. Only Non-Resident Indian citizens (NRIs) and Persons of Indian origin (PIOs) are permitted to invest in the following with 100 per cent:

1) Development of serviced plots and construction of built up residential premises.

[28] Press note 2 of 2005

2) Investment in real estate covering construction of residential and commercial premises including business centers and offices
3) Development of integrated townships.
4) City and regional level urban infrastructure facilities, including both roads and bridges, mass rapid transit systems.
5) Investment in manufacture of building materials, which is also open to FDI
6) Investment in participatory ventures in (1) to (5) above.
7) Investment in housing finance institutions.

Development of land and providing allied infrastructure also form integrated part of township development.

4.2 Institutional and sectoral policy frame work

In terms of the institutional structure the urban infrastructure development responsibilities are fragmented between different governmental bodies at the central level, The Ministry of Urban Development (MOUD) and Ministry of Housing and Urban Poverty Alleviation (MOHUPA) are the nodal agencies for formulating policies and support programmes.

The Constitution of India has assigned the subjects pertaining to the urban infrastructure to the State Legislates. In so far as the urban issues are concerned, the legislative powers of the Union are limited. The Twelfth Schedule of the Constitution lists the functions of the urban local bodies[29] viz, Urban Planning including town planning, regulation of land use, construction of buildings, roads and bridges.

[29] 74th Constitutional Amendment bought by Constitutional Amendment Act, 1992

11th Five Year Plan: The Government of India has recently finalized the 11th Five Year Plan (2007-12). This Plan lays specific emphasis on urban development. The strategy of urban development as outlined in the 11th Five Year Plan includes dismantling public sector monopoly over urban infrastructure and creating conditions for the private sector to invest.[30]

JNNURM: To meet the challenges of growing urbanization and to enable Indian cities to develop to global standards, a comprehensive programme, namely Jawaharlal Nehru National Urban Renewal Mission (JNNURM) was launched in December; 2005.Large projects like Bus Rapid Transit System (BRTS), water supply projects, drainage systems and desalination plants, etc. are being supported under the Mission. States and urban local bodies (ULBs) accessing JNNURM grants .Some of reforms such as streamlining of building plan approval process, simplification of conversion of agriculture land to non-agriculture land, transfer of city planning functions to urban local governments, computerized registration of land and properties, etc. are directly linked to improved city planning and governance[31].

4.2.1 Water, Housing and Transport policies

Policy wise, The National Water Policy has been amended in 2002 to integrate water resource development. Infrastructure status has been granted to water treatment and supply, sanitation and solid waste management. With respect to housing the Housing and Habitat Policy has introduced the part credit and part

[30] http://pib.nic.in/release/release.asp?relid=46453 visited on April 10th 2009
[31] ibid

subsidy based schemes. The housing sector also gets the fiscal incentives under the income tax and wealth tax[32]:

- Introduction of section 80GG in respect of deduction for the rentals paid
- Tax holidays for the approved housing projects
- Infrastructure status to housing industry
- Rental properties have been exempted from the wealth tax on conditions
- Exempted from the wealth tax for the urban vacant land held as stock in trade.

In addition to the above both Ministry of Urban Development and Ministry of Housing And Urban Poverty Alleviation have issued guidelines with respect to development of integrated small and medium townships.[33]

In case of transport, The National Urban Transport Policy introduced in 2006 provides for investment to the tune of 19 per cent from the private sector out of the total estimates. The policy envisages for the investments in mass transit system both bus and rail. The central government and most state governments have begun looking at different models (BOT/ Concessions/Management Contracts) for private participation in developing, operating and maintaining urban infrastructure facilities.

[32] Supra 23 (rajiv. jain)p.1.85
[33] Urban Infrastructure Development Scheme For Small & Medium Towns (UIDSSMT) Guidelines – 2005

Fiscal Concessions

A 10-year tax holiday is available to investors investing in urban infrastructure projects. This is available to developers, and those carrying out operations and maintenance of water supply, sewerage, sanitation, etc. As part of the fiscal concessions, government would exempt from customs as well as central excise duty all machinery and equipment required to establish plants for desalination, demineralisation, and purification of water. On tax concessions, Section 80-IA of the Income Tax Act, 1961, which allows a deduction of 100 per cent of profits of companies engaged in the business of providing any infrastructure facility including a "water supply project" as also a "water treatment system"[34].

Investment in bonds like Municipal Bonds which were introduced for raising resources for urban infrastructure can also be a mode of investment in urban infrastructure. The Central Government had announced tax exemption in case of bonds issued by Municipal / Local Governments. Guidelines were issued by this Ministry for regulating issue of tax free municipal bonds.[35] Under the guidelines, such bonds will be issued for raising resources for capital investment in creation of new infrastructure as well as augmentation of existing systems.

4.3 Entry Strategy for the Investment in Urban Infrastructure Sector

The entry strategies into India in urban infrastructure depend more on investment philosophy of the foreign investor. Foreign investor is permitted to invest in urban infrastructure (housing, transport, water supply, roads and real

[34] http://finance.indiainfo.com/news/2002/08/31/31water.html visited on 18.3.2009
[35] Guidelines issued on 8.2.2001

estate sector, only for development of townships and settlements either through Wholly Owned Subsidiary (WOS) or in a Joint Venture company in India along with local Indian partner subject to complying with all the conditions as envisaged in Press Note No. 4 (2001 series).

Foreign construction and related firms can also do business in urban infrastructure sector without making any equity investments. Such businesses can be done by providing Engineering, Architectural Services, Designing Services, Service and Work Contracts etc. The relevant Provisions of Foreign Investment (i.e., other than NRIs, PIOs, OCBs) into urban infrastructure in India is, dealt with in this.

4.3.1 Business Models

Some business models relating to investment in urban infrastructure are indicated to give a synoptic view of Foreign Exchange Regulations issues related to such models. The models developed are not exhaustive.

With Equity Investments

a. Joint Venture

b. Wholly Owned Subsidiary

Without Equity Investments

a. Engineering and/or Architectural Independent Consultancy (Short term)

b. Engineering and/ or Architectural Independent Consultancy (Long term)

c. Lending without any other relation

d. Works and Service Contract

e. Works and Service Contract with lending.

f. Offshore Supplies Contract;

g. Offshore Services Contract:

h. Onshore Supplies Contract

i. Onshore Services Contract

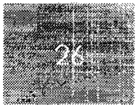
4.3.1.1 Business model with Equity Investments

a. Joint Venture

b. Wholly Owned Subsidiary

Foreign company should register a new company if proposing to invest in a Wholly Owned Subsidiary (100% equity Investment) or can invest in an existing Indian company as a joint venture partner. Following conditions had to be complied with –

- The investing entity shall be registered as an Indian company registered under the Indian companies Act 1956 and hence forth would be allowed to take land assembly and its development as a part of integrated township development.
- All such cases would be processed by FIPB on the recommendations of ministry of urban development.



- The core business of the company seeking investment should be integrated township development with a record of successful execution of such projects.
- Minimum area to be developed should be 25 acres in case where the focal State Government has developed norms and standards for such proposals, if such norms and standards are not developed then a minimum of 2000 dwelling units for about 10,000 population to be developed.

The investing company should achieve the following milestones once it gets approval:

- Foreign company should invest upfront US $ 10 Million for Wholly Owned Subsidiary and US$5 Million for joint venture the funds would have to be brought upfront.
- Lock in period of 3 years applicable for repatriation of original capital investment
- 50% of the integrated project development must be completed within 5 years from the date of possession of first piece of land. If the investor wants to exit earlier due to reasons beyond his control, it shall be decided by the FIPB on case to case basis.

In addition to the above all the building development rules master plans/bye laws and development of other infrastructure as per the standards and norms of State and Central Government should be followed. All community services to be handed over free of cost (police station, milk booths).

The developer has to retain the land for community services such as schools, shopping complex, community centres, ration shops and hospital/dispensary.[36] In case of Indian insurance companies The IRDA vide their notification dated 14th July 2000, regarding Registration of Indian Insurance Companies Regulation, 2000 stipulates that every insurer in the business of life insurance shall invest and at all time keep invested not less than 15% of his controlled funds in Infrastructure and Social sector. Besides, those insurers who are in the business of General Insurance (i.e. non-life insurance) are required to invest and at all time keep invested not less than 10% of their controlled funds in Infrastructure and Social sector. [37]

4.3.1.2 Business Models Without Equity Investments:

Engineering or Architectural Independent Consultancy (Short term)

Indian entities do not require the prior permission of the RBI to engage the services of foreign technicians. However for procuring consultancy services from outside India up to US $ One million per project no prior permission of RBI is required. For more than US $ One Million prior permission of RBI has to be obtained. These payments would fail within the ambit of current account transactions as defined in Section 2(1) of the Foreign Exchange Management Act, 1999.

[36] Infra 45

[37] For this purpose, IRDA defines infrastructure to include road, transport system, water supply project, water treatment system, solid waste management system, industrial parks, and sanitation and sewerage system. http://infrastructure.gov.in/pdf/doi.pdf visited on 24.03.2009.

Engineering and/or Architectural Independent Consultancy (Long term)

Indian entities do not require the prior permission of the RBI to engage the services of foreign technicians. However for procuring consultancy services from outside India upto US $ One Million per project, no prior permission of RBI is required. For more than US $ One Million prior permission of RBI has to be obtained. These payments would fail in the ambit of current account transactions as defined in Section 2(i) of the Foreign Exchange Management Act, 1999.

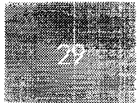
With effect from 15th November 2003, a foreign entity can open a project site office in India without taking prior permission from Reserve Bank of India if such foreign entity has secured a contract from an Indian company to execute a project in India and

a) the project is funded by inward remittances from abroad; or
b) the project is funded by a bilateral or multilateral international finance agency; or
c) the project has been cleared by an appropriate authority in India; or
d) the company or entity in India awarding the contract has been granted term loan by a Public Financial institution or a bank for the project.

If the above conditions are not compliable, a prior permission from Reserve Bank of India has to be obtained.

Works & Service Contract

Indian entities can give works and service contracts to persons resident outside India. All such transactions are of current account transactions and are



permitted without any limit. However, if the nature of contract is a consultancy contract, then for value of more than US $ One Million prior permission from RBI has to be obtained.

Offshore Supplies Contract

Indian entities can procure equipment and other, goods as per the existing FDI policy, of India. All payments with respect to imports are permitted without any limit.

Offshore equipment supplies would be taxable in India where profits of such supplies would-be deemed to accrue or arise in India. The profits on the sale of goods by a non-resident to an Indian importer will not be liable to income tax in India if the sale is made outside India and consideration is received outside India and the transaction is done at arm's length and at prices which would be normally charged to other customers.

Offshore Service Contract

Indian entities can procure offshore services without any prior permission from Reserve Bank of India. However, in case of consultancy projects of value more than US $ One Million prior permission from RBI has to be obtained. Technical services include any consideration (including any lump sum consideration) for rendering of any managerial, technical or consultancy & services (including the provisions of such service through technical or other personnel) and such services consist of also development and transfer of a technical plan or technical design. If a permanent establishment is constituted,

tax rate will be on profits attributable to permanent establishment including, fees for technical services.

Onshore Supplies Contract

To make onshore supplies to a project in India, the foreign investor normally, will open a liaison office or a branch office. Opening of such offices require prior permission from RBI. The activities that can be undertaken by such offices are given clearly by RBI in permission letter. Where the supplies are made by foreign contractor to the project in India the income accrued thereon would be liable to tax in India. If a permanent establishment is constituted in India the profits attributable to such supplier are taxable. If a permanent establishment is not constituted then there will not be any tax liability in India.

For example: liaison office is not permitted to earn any income in India. Whereas a branch office is permitted to import and export and can earn income in India.

Onshore Services Contract

To provide onshore services to a project in India, it is normal to open an office. To set up an office in India, prior permission of RBI is required.

Lending and Borrowing

External Commercial Borrowings (ECB)

ECB refer to commercial loans, External Commercial Borrowings (ECB) can be in the form of bank loans, buyers' credit, suppliers' credit, securitised instruments (e.g. floating rate notes and fixed rate bonds). ECB can be

accessed under two routes, viz., (i) Automatic Route and (ii) Approval Route. ECB for investment especially in infrastructure sector which include urban infrastructure (water supply, sanitation and sewage projects) in India, are under Automatic Route, i.e. do not require Reserve Bank of India (RBI) / Government approval.

Automatic Route

Borrowers can raise ECB from internationally recognised sources such as (i) international banks, (ii) international capital markets, (iii) multilateral financial institutions (such as IFC, ADB, CDC, etc.,), (iv) export credit agencies, (v) suppliers of equipment, (vi) foreign collaborators and (vii) foreign equity holders (other than erstwhile OCBs).

A "foreign equity holder" to be eligible as “recognized lender” under the automatic route would require minimum holding of equity in the borrower company as set out below:

- For ECB up to USD 5 million - minimum equity of 25 per cent held directly by the lender,
- For ECB more than USD 5 million - minimum equity of 25 per cent held directly by the lender and debt-equity ratio not exceeding 4:1 (i.e. the proposed ECB not exceeding four times the direct foreign equity holding).
- The maximum amount of ECB which can be raised by a corporate is USD 500 million or equivalent during a financial year.

- ECB up to USD 20 million or equivalent in a financial year with minimum average maturity of three years.
- ECB above USD 20 million and up to USD 500 million or equivalent with a minimum average maturity of five years.
- ECB up to USD 20 million can have call/put option provided the minimum average maturity of three years is complied with before exercising call/put option.

As per AP (Dir series) circular No. 46 dated January 2, 2009 issued by the reserve Bank of India (RBI) the requirement of the all-in-cost[38] ceilings on ECB has been dispensed with until June 30, 2009. Accordingly, eligible borrowers, proposing to avail of ECB beyond the permissible all-in-cost ceilings specified above may approach the Reserve Bank under the Approval Route. This relaxation in all-in-cost ceiling will be reviewed in June 2009.

End Uses/Sectors Allowed

There is end use restriction. ECB can be raised only for investment in:

- The Infrastructure sector and infrastructure is defined to include urban infrastructure (water supply, sanitation and sewage projects)
- the existing limit of USD 100 million has been raised to USD 500 million per financial year for the borrowers in the infrastructure sector [includes urban infrastructure (water supply, sanitation and sewage projects)]for Rupee expenditure under the Approval Route. The

[38] All-in-cost includes rate of interest, other fees and expenses in foreign currency except commitment fee, pre-payment fee, and fees payable in Indian Rupees. Moreover, the payment of withholding tax in Indian Rupees is excluded for calculating the all-in-cost.

provision for ECBs in excess of USD 100 million for Rupee expenditure should have a minimum average maturity period of 7 years has been dispensed with for the infrastructure sector.

- Non Banking Financial Corporations (NBFCs), which are exclusively involved in financing of the infrastructure sector, can avail of ECBs from multilateral / regional financial institutions and Government owned development financial institutions for on-lending to the borrowers in the infrastructure sector[includes urban infrastructure (water supply, sanitation and sewage projects)] under the Approval route. The direct lending portfolio of the above lenders vis-à-vis their total ECB lending to NBFCs, at any point of time should not be less than 3:1[39].
- Corporates, engaged in the development of integrated township[40], are permit to avail of ECB under the Approval Route. Integrated township includes housing, city and regional level urban infrastructure facilities such as roads and bridges, mass rapid transit systems and manufacture of building materials[41].
- Utilisation of ECB proceeds is not permitted in real estate. The term 'real estate' excludes development of integrated township[42].

The eligible lenders as per the extant regulations are –

- Any internationally Recognised Source

[39] AP (Dir circular) No. 46 issued by the RBI dated January 2, 2009)
[40] as defined in Press Note 3 (2002 Series) dated January 04, 2002, issued by DIPP, Ministry of Commerce & Industry.
[41] AP (Dir circular) No. 46 issued by the RBI dated January 2, 2009
[42] as defined by Ministry of Commerce and Industry, Department of Industrial Policy and Promotion, SIA (FC Division), Press Note 3 (2002 Series, dated 04.01.2002).

- Banks
- Export Credit Agencies
- Suppliers of Equipment
- Foreign Collaborators
- Foreign Equity holders
- International Capital Markets etc.

If the lender is categorized as non recognized lender then such lending is prima facie not permitted. Prior permission of Reserve Bank of India or Government of India required if the Automatic Route conditions are not complied with.

4.4 NRI investment in urban infrastructure:

FDI policy allows NRI investment in urban infrastructure especially in the housing and urban development centre to the extent of 100 percent in the equity of the Indian companies. Only Non-Resident Indian citizens (NRIs) and Persons of Indian origin (PIOs) are permitted to invest in any existing or new company , both private and public limited, engaged or proposing to engage in;

1) Development of serviced plots and construction of built up residential premises.

2) Investment in real estate covering construction of residential and commercial premises including business centers and offices

3) Development of integrated townships. Development of land and providing allied infrastructure also form integrated part of township development.
4) City and regional level urban infrastructure facilities, including both roads and bridges, mass rapid transit systems.
5) Investment in manufacture of building materials, which is also open to FDI
6) Investment in participatory ventures in above.
7) Investment in housing finance institutions.

The entity shall be authorised to issue equity share/ convertible debenture to NRI Indians up to 100 per cent of the new issue with repatriation benefits. The repatriation of the original investment will be allowed after a lock in period of three years from the date of issue of equity share/ convertible debenture with the prior permission of the reserve bank[43]. According to FEMA, NRI are allowed to acquire immovable property also[44]. FDI up 100 per cent which is permitted in development of integrated township[45] includes city and regional level of urban infrastructure (roads, bridges and mass transport systems) are subjected to conditions[46].

Provisions regarding automatic entry route, and 100 per cent FDI cap/equity in construction-development projects including housing, city and regional level

[43] Supra 23. P.1.83
[44] As per Foreign Exchange Management (Acquisition and transfer of immovable property in India) Regulations, 2000
[45] Press note 2 of 2005
[46] Supra, 37

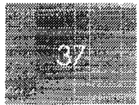
infrastructure, townships, as also other guidelines given in Press Note 2 dated March 3, 2005 were reiterated.

The said Press Note dated 10.2.2006 also stated that for investment by NRIs, conditions mentioned in Press Note 2 dated March 3, 2005 were not applicable. Thus, NRIs have been given a special and preferential treatment in this regard. (All these stipulations have been re-affirmed vide items number 23 and 6 of Annexure 2 of Master Circular Number 2/2006-2007 dated July 1, 2006).

Permissible FDI private / joint / state investment in construction in the export processing zones (EPZS) / special economic zones (SEZS) is as follows:

- 100% FDI real estate investment within Special Economic Zone (SEZ). 100% FDI for developing a township within the SEZ i.e. residential areas, markets, playgrounds, clubs, recreation centres etc.
- Standard Design Factory (SDF) building development in existing Special Economic Zones. SEZ land may be leased or sub-leased to developers as per relevant guidelines for this purpose.
- 25% of the SEZ has to be for the commercial and other recreational purposes.

Full freedom to allocate developed plots to approved SEZ units on commercial basis including competent authorities for provision of water, electricity, security, restaurants, recreation centres etc.



4.5 Implications of the guidelines on FDI in urban infrastructure

The detailed implications of the above guidelines have been discussed as under

1. *Investment by a 'Company' vs. 'Public' Investments*

   The debate has for long been on the necessity of bringing foreign capital. The basic issue being shortage of funds, money can be mobilized in either of the two ways; from the 'public' or from 'foreign' investors. In various sectors of the economy, the former was rejected on the pretext that the 'public' investor sentiment is not good while on the other hand, not only foreign capital but foreign know-how is also needed. Therefore, where high technology and big fiancé are jointly involved, FDI has been found to be the appropriate choice.

   In the particular case of the real estate sector in India, whilst technology at home is almost on par with global standards, public fiancés can be easily raised through real estate mutual funds (REMF) on the lines of REITS for which the path is more or less cleared. That being the case, the very fundamental assumption as to whether FDI by a foreign company in needed or not comes under scrutiny, more so when foreign money involves a certain level of cost of capital.[47]

2. *Minimum Area of 25 Acres Care*

   In most cities in the country, prime land parcels on the fringes have been taken by local developers. Even otherwise, it would be difficult

[47] P.S.N.Rao, "FDI For Real Estate Development In India", Nagarlok, Vol -25, 2003 p 23

for the foreign consortium to assemble several land parcels in order to make up. Ultimately, this would lead to haphazard spatial spread, infrastructure development problems. Integrating such developments at a later date would be extremely difficult. Further, in many states, the Urban Land Ceiling Act has yet to be repealed and therefore, it would not be possible for the mobilization of such huge chunks of land.[48]

3. *Integrated Township*

The guidelines stipulate the development of an integrated township. However, in practice, the demand for foreign investment in a particular city may not be for an integrated township but for a specific development, say for commercial mall complexes, entertainment complexes and so on. The guidelines do not seem to accommodate this reality of the property sector. This would therefore limit the entry of FDI.

4. *Local Development Laws*

There are a host of local government laws which impact the real estate development in India cities. Whilst the guidelines state that local laws need to be followed, in almost all cities in India, the local laws may not be appropriate at all for developments involving FDI. The high cost of capital would automatically put a pressure on space utilization. The density prescriptions, social facility area norms, etc. are very luxurious and not conducive to intense utilization of the land available. FDI

[48] Ibid .p. 24

developments demand high densities, so that the project becomes economically feasible. Where high densities are not feasible, the project would become extremely costly. In such cases, cross subsidization needs to be done from other uses, such as commercial and so on.

5. *Physical Infrastructure*

A development involving urban infrastructure would obviously involve a huge investment. Not only internal infrastructure needs to be provided but also external infrastructure (II) may not pose any problem since the same is under the full control of the promoters, the external infrastructure (EI) would pose several problems. Ultimately, the development needs to be linked up to the city system; it may not be possible to make the project entirely stand alone.

Therefore, investments here would boost the product pricing heavily. Secondly, invariably the government agencies viz. water boards etc. would have to be involved. Delays here would be obvious.

6. *Free Social Amenity*

The provision of social amenities is very much transferring necessary and although the industry has been opposing the same, this provision should remain and free social amenity transfer needs to be insisted upon. Whilst the government has permitted FDI, free social amenities are a small and legitimate return to expect from the foreign

investors/private sector. In fact, quite a few social amenities can be retained by the developer as per the stipulations.

7. *Open Spaces Transfer*

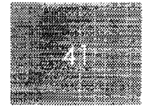
The guidelines stipulate transfer of opens paces such as parks, playgrounds, etc. to the local bodies. It is presumed that the 'transfer' means transfer of ownership. However, the question of maintenance of open spaces and their protection from encroachments needs to be viewed in the current context of asset management practices.[49]

8. *Maintenance*

One of the key issues that have not at all been addressed in the guidelines has been the issue of asset maintenance. Assets worth crores of rupees are to be developed through FDI. While private properties would be sold and their maintenance would vest with private owners, the 'public' properties' which need to be maintained would become the responsibility of the local bodies.

In such circumstances, one need to see the question of the state of fiancés of local bodies, their executive expertise and capacity to undertake asset management, etc. without the creation of appropriate systems in this context, the assets created would become very expensive in the long run to maintain.

[49] Supra 47 (P.S.N)



9. Local Regulator

There is a need for a local regulator to monitor the progress of the FDI project and ensure compliance of the guidelines. The real estate industry in India has been notorious for non-compliance of various laws. In the cities of India, there are a host of organizations which would come into play. It may not be possible for foreign investor companies to liaison with all these.

There is thus an urgent need for apex Local Regulators to be designated, so that they can act as a single window' for clearances, monitoring, clarifications on rules and procedures, etc.

10. Detailed Guidelines

In the ultimate analysis, it can be seen that the guidelines prescribed by the government are too preliminary and general. A detailed set of guidelines need to be evolved.

CHAPTER 5

ROLE OF PPP IN URBAN INFRASTRUCTURE INVESTMENT

No discussion of urban infrastructure investment could be complete without discussing private participation in urban infrastructure (PPP). This development represented a significant shift in attitude. For most of the period following World War II, much of network infrastructure was operated and financed by the state, both in developed and developing countries[50]

Of late it is felt that publicly provided infrastructure services viz. Water, sewage disposal/treatment, garbage disposal etc. have often delivered poor quality and inadequate coverage[51]. Therefore the governments in many developed and developing countries have begun to allow private provision of infrastructure services so as to enhance efficiency and to ease strain on public finances through ideal joint-venture in the form of public-private partnership. PPP as a mode of investment works best when it is seen as a positive and progressive process[52]with initiatives for Privatization Process[53] providing for special contracts viz. service, operation and maintenance, concession agreements. The term "public-private partnership" (PPP) describes a spectrum of possible relationships between public and private actors for the cooperative provision of infrastructure services. The only essential ingredient is some

[50] Patricia Clarke Annez, "Urban infrastructure finance from private Operators: what have we learned from recent Experience?", World Bank Policy Research Working Paper 4045, November, 2006.p 1
[51] World development report, 2002
[52] Peter Young, "Privatization around the World" in Steve Hanke's prospects for privatization. p .204.
[53] John .D. Hanrahan, "Government for Sale, Contracting out the New Patronage", American Federation of State, Country and municipal Employee, 1983.

degree of private participation in the delivery of traditionally public-domain services. Private actors may include private businesses.[54]

Many reasons have been identified for commercialization of infrastructure services.[55] Therefore the issue of prudent Public-Private Partnership (PPP) for infrastructure development is a matter of immense significance for over all development of the country. Hence keeping in view socio-economic, political, legal and institutional framework, the government of India has come up with PPP guidelines so that meaningful strategies could be developed for harmonizing investment and private capital as an additional financial source for accelerated economic growth can be attracted only if conducive environment for effective PPP is established/ created.

The new with PPP guidelines has advocated the changed approach for comprehensive investment reform in water supply, sanitation, sewerage, transport etc and these include:[56]

- Service contracts for the PPP in the operation and maintenance of water supply and sanitation.
- Performance based service contracts- where the municipal services are managed by the private sector on labour contract basis which include not only advice but also transmission and distribution system.

---

[54] Dr. Sasi Kumar, "Public - private partnerships in urban infrastructure", Kerala Calling, February, 2004. p.36

[55] The India infrastructure report volume-II

- Huge investments, resource crunch and delayed payback period of investment is forcing government to rethink and operate infrastructure sector like a business concern;
- Changes in technology has introduced competition in otherwise a "Natural Monopoly;
- To compete globally and internationally, the countries are required to provide adequate infrastructure services to their business in a cost-effective and competitive manner.
- Higher cost/price of the services delivered to citizens coupled with overall time delay in completion of project are likely to be the deciding factors between firms being globally competitive and successful.

[56] Indian infrastructure, February, 2006, p.29-30.

- Operator consultant – includes the Performance based service contracts to a private consultant for carrying out the improvements by collecting the technical investigation in the water supply etc.
- Management contract- for O&M of water supply and sewerage services.[57]
- Joint sector company- special purpose company with a concession agreement for the various projects.[58]
- Construction-cum-BOT contract for the areas like sewerage treatment plant construction, pumping station etc.

5.1.1 Benefits of Public-Private Partnership (PPP)[59]

When properly designed and matched investment in urban infrastructure is made through PPP, PPP usually benefits all of their participants. Ideally, they provide competitive economic returns to the private partners while delivering high-quality services at a reasonable cost to users.

Partnership arrangements can be made for the following reasons,

(i) *Cost effective* : Reduced costs result from competitive bidding and paperwork associated with intergovernmental grants, as well as design/construct/operate and access to low-cost/or cost effective technologies.

(ii) *Project Completion:* It is observed that project completion and operation is monitored in a more effective manner avoiding contracting constraints

[57] Eg- JUSCO (the Jamshedpur utilities and services company-WOS of Tata steel)and VELLA French company.
[58] New Tiruppur Area Development Corporation and Visakhapatnam Industrial Water Supply Company Limited (VIWSCo)
[59] A. Sarada and Lla Singh, "Public-Private Partnerships For Infrastructure Development", Nagalok.vol-36, 2004.p.38-39

associated with intergovernmental grants, process and procedure. A faster start up and project monitoring is the essence of project completion.

(iii) *Guaranteed Performance* : Any PPP that involve private operation generally shift from public to private sector the responsibilities for project permitting, proper operation and maintenance, compliance with all applicable project regulations and efficient and effective monitoring, generally shift from public to private sector.

(iv) *Reasonable Private Returns*: The private sector will be able to secure reasonable returns in order to ensure the success of partnership arrangements. The advantage of public financing is that it allows access to tax-exempt debt.

5.1.2 Regulation and Strategic Issues

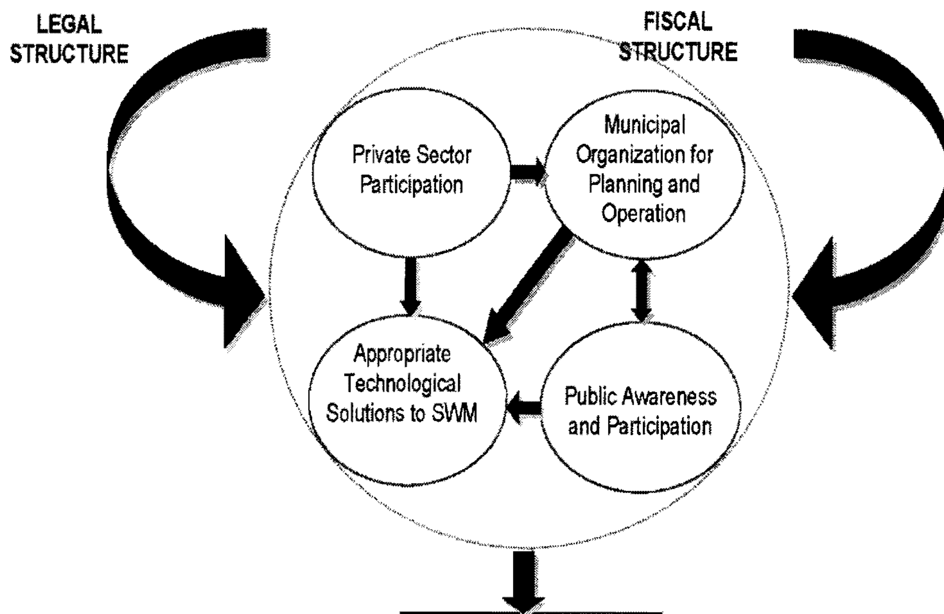
Investment in urban infrastructure with PPP as a mode requires effective government regulation which is based on enforceable laws concerning property rights, contracts, disputes and liabilities. Regulation is administered to protect both the public users of the service i.e. consumers and private partner i. e. industry.

Key elements of regulatory framework include rates, performance, reliability, degree of competition, and access to interconnection with other systems/services as water supply and airline operation. Utilizing PPPs requires dealing with several strategic issues viz.: roles of different parties, competition, regulation, procurement and financing.[60] The regulatory regime

[60] E.S. Savas, Privatization and Public Partnerships

has to be transparent, limited, fair and consistent. The government has issued guidelines with respect to PPP[61].

Structure

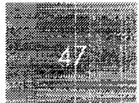


5.1.3 Risks Involved in PPP

Urban infrastructure investment by way of PPP presents significant risks that are shared between public and private partners. Many risks can be allocated in the basic contract document that establishes the PPP. Usually such risks are categorized in three main groups: business, financial and political.[62]

Business risk: Cost-overrun risk is due to construction delay, design changes, late discovery of site problems, failure to obtain permit and so on, this will

[61] http://www.pppinindia.com/guidelines-forms.asp visited on 24.02.2009
[62] A. Sarada and Lla Singh, "Public-Private Partnerships For Infrastructure Development", Nagalok.vol-36, 2004.p.40-41.



result in costs greater than expected, Government to bear the risk of delays due to site problems, government design changes etc.

Operating risk : is the risk when the operating cost of enterprise is greater expected or quality or capacity fall short of desired levels. This risk has to be borne by private investor.

Revenue risk : is the risk where demand is insufficient or the rates are too low to generate expected revenue. The government can reduce this risk by guaranteeing a minimum level of demand at agreed upon rates. At times private operators are unable to enforce payment of bills by consumers who are public agencies or voters.

Financial risk

(i) Debt-service coverage risk : Where the operating cash flow is not enough to cover principal and the interest payment for debt and is used to finance the project. The private investor has to bear this risk alone.

(ii) Exchange rate risk: is when local currency earnings are not convertible to foreign currency at expected exchange rate, this reduces value of earnings. This risk is to be borne by private partner. Public provision of infrastructure lowers the financial risk as compared to private provision because of government's lower cost of capital. But usually this risk is shifted to third party namely taxpayers.

Political risk : Where the government regulator will not allow increase in rate or will even mandate reduction in rates due to political reasons. This risk can

be mitigated by establishing a specific regulatory mechanism to allow increase in accordance with agreed formula without government approval.

Dispute resolution risk is the risk that contract dispute between the private developer (investor) and sponsoring government will be settled in neutral jurisdiction. Private partner may require contracts be enforceable in their country and can insure themselves against breach of contract through International Investment Insurers such as Overseas Private Investment Corporation (OPIC) or Multilateral Investment Guarantee Agency (MIGA).

Other risks:[63]

(i) **Technology risk**: that new technology being utilized will encounter unexpected problems that will slow or even halt a project.

(ii) **Environmental risk**: that the enterprise still in government hands may cause environmental damage and the new private operators will be required to correct it. The government usually agrees to justify such damages.

Inadequacies in the Operating Legal System

Often prevents effective implementation of its policies, laws and regulations. Any loop hole/gap in basic legal framework necessary for PPPs including property rights (ownership, transfer and bankruptcy), contractual rights, law of association, criminal law, labour law, problem of dispute settlement and enforcement etc. can have adverse motivational effects on entrepreneurs and impinge upon the efficient operation of market. Thus public task can be

[63] Ashwani Luthra, "Public Private Partnership: A Tool For Integrated Urban Development", Vol-38, Nagarlok, 2006, p.28

transferred to private PPP in a reasonable manner and in conducive conditions there by increasing the investment in urban infrastructure.

5.1.4 Accounting for PPP Arrangements[64]

In recent years, public-private participation has gained momentum, whereby the public sector (or Government) is able to attract private sector (or operator) participation in order to provide infrastructure facilities for common public use, such as roads, bridges and airports. Globally, it is even common to construct and operate water distribution facilities, energy supply, etc, under public-private participation. In accounting parlance, such arrangements are referred to as service concession arrangements.

In India, we have recently seen service concession agreements entered into for toll roads and airports. Under these arrangements, the private operator constructs the infrastructural asset/facility and maintains and operates the same for a specified term. At the end of the specified term, the constructed asset/facility is transferred to the public sector. The common characteristic of all service concession arrangements is that the operator receives a right and incurs an obligation to provide services.

Currently, there is no specific accounting guidance under Indian accounting standards for the service concession arrangements. Generally, infrastructure companies account for the infrastructure as part of their fixed assets at the construction cost and do not recognise any revenue during construction period.

[64] http://www.thehindubusinessline.com/mentor/2009/04/27/stories/2009042750731100.htm , visited on 27th April 2009.

Revenue is normally recognised for amount recoverable from public sector and/or amount recovered from the customers for use of the infrastructure only after the construction is complete. Further, there is no clarity or consistency regarding accounting for replacement and maintenance expenditure.

Towards standardisation

India's proposed move towards convergence to International Financial Reporting Standards (IFRS) from 2011 will certainly bring about standardisation in the manner in which service concession agreements are accounted for as it offers detailed guidance in this regard, which has been set out hereunder. Recently, an Exposure Draft was laid down on the subject by the Institute of Chartered Accountants of India and is generally consistent with the IFRS. Infrastructure companies need to be aware of the changes that IFRS will bring in 2011 and gear up for effective implementation.

The operator cannot recognise infrastructure as its own asset as the operator does not control the public service infrastructure but is merely a service provider. The operator recognises the revenue and costs relating to construction activity in accordance with guidance applicable to construction contracts. The consideration receivable for construction services is recognised at its fair value.

Two Types of Arrangements

There exist two types of service concession arrangements. In one, the operator receives a financial asset, i.e. an unconditional contractual right to receive cash

or another financial asset from the government in return for constructing the public sector asset. In the other, the operator receives an intangible asset, i.e. no more than a right to charge for use of the public sector asset that it constructs. A right to charge users is not an unconditional right to receive cash because the amounts are contingent on the extent to which the public uses the service. The consideration received or receivable by the operator is recognised at its fair value.

Further, there could be arrangements wherein both the elements, i.e. financial asset and intangible asset, exist within a single contract. To the extent that the government has given an unconditional guarantee of payment for the construction of the public sector asset, the operator has a financial asset and to the extent that the operator has to rely on the public using the service in order to obtain payment, the operator has an intangible asset.

Level of serviceability

Most service concession agreements contain contractual obligations to maintain the infrastructure to a specified level of serviceability or to restore the infrastructure to a specified condition before it is handed back to the grantor at the end of the service arrangement. To the extent that the government specifically pays or guarantees payments for these services, they are considered a revenue generating activity and accounted for when the service is rendered. Otherwise, it will be a cost for the operator and provision will have to be accrued for such obligation at its present monetary value.

In case it is the policy of the operator to capitalise borrowing costs attributable to the construction of the assets, he will capitalise those costs during the construction phase of the arrangement only if the consideration received or receivable is an intangible asset.

In all other cases, borrowing costs are expensed as incurred; however, if a financial asset is recognised in respect of the construction services, that receivable will accrue interest during its life.

The above principles can be quite complex and would require professional judgment during practical application, and will involve use of valuation experts to arrive at fair values of various services rendered by the operator. It will significantly impact the manner in which the operators present their financial position and performance and also result in tax and regulatory issues. Therefore infrastructure companies need to be aware of these changes that IFRS will bring in 2011 and gear up for effective implementation.

CHAPTER 6

INVESTMENT THROUGH REITS, REMF AND MUNICIPAL BONDS

With the recent recession along with declining interest rates, new and different sources of capital are continually required for long term and short-term investments. As compared to volatile returns, from the stock market, and limited returns from bank deposits, the infrastructure is a safe and high yield investment. The backlog of housing, water supply and other services shortage is increasing every year this demands huge financing thus the capital market and the debt market are new platform of investment in urban infrastructure through REMF, REITS and investments in the municipal bonds

It is no that the REITs and REMFs would be investing only in the housing sector or real estate but, like any other mutual fund scheme, a lot of diversification can take place. On horizontal front, invest could be diversified across cities and products. Similarly on the vertical front diversification could be in housing, urban infrastructure projects and infrastructure companies.

6.1 Real Estate Investment Trusts [REITs]

Real Estate Investment Trusts (REITs) were originally conceived in the United States to open up the capital-starved property markets to smaller investors. The US experiment has been wildly successful.[65]

[65] Booth Rachel, "Real Estate Investment Trust- A Global Analysis", Globe Law & Business Publication, 2006

Real Estate Investment Trust (REIT) is defined as a corporation or trust that uses the pooled capital of many investors to purchase and manage income property and/or mortgage loans.[66]

A REIT fund is focused on owning publicly traded REIT that are purchased and sold on the major stock exchanges. There are three kinds of REITS namely equity REITs, Mortgage REITs and Hybrid REITs .Individuals can invest in REITs either by purchasing their shares directly on an exchange or by investing in a mutual fund that specializes in public real estate. Among other things, REITs invest in shopping malls, apartments, warehouses and hotels, and is a liquid, dividend-paying means of participating in the market.

6.1.1 Advantages of the REITs

These are as under:

- Dividends - REITs are exempt from corporate income taxes, as long as they distribute at least 90 per cent of their net taxable income as dividends to shareholders.
- Deferral of income taxes - No tax is payable on REITs until they are sold. At that point, profits are taxed as capital gains, not as ordinary income. Some REITs frequently distribute more than 100 per cent of their net income. The amount over 100 per cent is reported as a return of capital, which is not taxable for the investor.
- *Inflation hedge* - As an investment in tangible hard assets, REITs can provide an inflation hedge.

[66] Maqnish raj, "The Future of Real Estate Investment Trust in India", SEBI & Corporate Laws, vol-84, 2008.p 7

- *Liquidity* - REITs offer the most liquid way to invest in real estate. REIT shares are traded daily on a national exchange, so, unlike actual real estate, they can be bought and sold at any time.
- *Portfolio Diversification* - As per international practice REITs have been shown to add diversification benefits to portfolios with stock and bond exposure. REIT returns historically have a low correlation to the returns of large stocks, small stocks and bonds. Adding REITs to a portfolio with exposure to stocks and bonds has improved returns and decreased risk. Diversification to manage risk is achieved by investing in different types of REITs, as well as selecting REITs that invest in different geographical areas.[67]

6.1.2 COMPARATIVE OVERVIEW

➢ Position in U.S.A

In the U.S., REITs generally pay little or no federal income tax, but are subject to certain special requirements set forth in the internal Revenue Code, one of which is the requirement to annually distribute at least 90% of its taxable income in the form of dividends to its shareholders. This distribution requirement may hamper a REIT's ability to retain earnings and generate growth from internal resources. This restriction imposed by the internal Revenue Code generally limits a REIT's suitability for growth-oriented investors. However, other considerations may result in potential for stock price appreciation, such as improvements in the REITs

[67] See, http://www.cutlercapital.com/REIT_adventages.asp, visited on January 16th 2008

underlying leasing markets, changes in interest rates or increasing demand for REIT stocks.

As of early 2005, there were nearly 200 publicly traded REITs operating in the US. Their assets included a combined $500 billion, and approximately two-thirds of them were trading on national stock exchanges. The number of REITs not registered with the Securities Exchange Commission and not publicly traded is about 800.[68]

➢ **Position in UK**

For many years the introduction of REITs was resisted in UK, However, due to limited secondary trading, liquidity in the property sector, limited access to commercial property investment for small scale investors; and limited institutional investor participation in the residential property market, the introduction of REITs became inevitable, and following 20 years of lobbying by the real estate industry, the UK Government introduced legislation in the Finance Act 2006 to enable the creation of REITs in the UK. It is expected that the REITs will deliver greater flexibility and liquidity in the property investment market.

STRUCTURE OF UK REIT [69]

Not every company can become a REIT. Section 106 of the Finance Act lays down the criterion which has to be met if a company desires to convert to a REIT.

[68] Pragya Awasthi , "Real Estate Investment Trusts", Lawz , October 2008, p.10
[69] Ibid,p.11

A company must:

- Be a UK tax resident (and not a dual resident).
- Be listed on a recognized stock exchange (i.e. not the Alternative Investment Market).
- The only classes of shares allowed are ordinary shares (one class only) and non participating preference shares.
- Distribute 90 percent of its net taxable rental profits (not capital gains) during the relevant accounting period or within twelve months of its end.
- Derive at least 75 percent of its total tax exempt property letting business.

A company must not:

- Be an open ended investment company or must be close-ended investment trust.
- Make any individual or corporate body own more than 10% of the shares in the company.
- Have properties within its exempt business which are owner occupied. This would include occupation by the REIT, occupation by any other group REIT Company, or occupation by any company whose shares are stapled to those of the RIET. This could potentially impact hotel groups and owner occupiers wishing to enter the regime and oblige them to hold property in a separately traded group from their associated operating business.

- The value of a single property must not exceed 40% of the combined value of the property business.

REIT in India

India is currently in the process of formulating definitive legislation for the introduction and smooth functioning of REITs in the Indian[70] Once introduced these Indian REITs [and also - Real Estate Mutual Funds (REMF)] will help individual investors enjoy the benefits of owning an interest in the securitized real estate market. The best benefit being that, of fast and easy liquidation of investments in the real estate market unlike the traditional way of disposing real estate. Under the draft guidelines[71] issued by the SEBI, the scheduled banks, public financial institutions, and insurance companies and corporate will be eligible to set up a REIT, with initial net worth of Rs. 50 crore. REITs are listed entities, similar to mutual funds that use collective funds for owning and managing investments in real estate projects.

The REITs will be managed by a separate real estate investment management company. These trusts (REIT) will be allowed to float schemes for a maximum 90 days and also have to specify the amount to be raised but cannot offer guaranteed returns. They will also be required to distribute at least 90 per cent of their annual income as dividends. REITs will be allowed to invest only

[70] Draft REITS REGULATION 2008

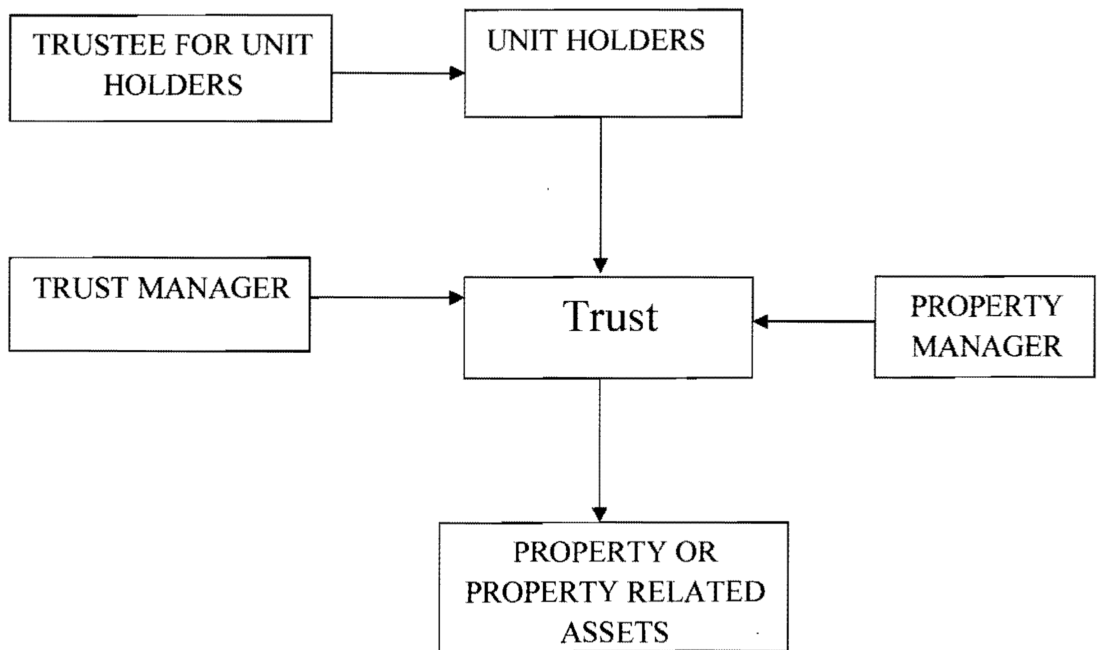
[71] *See,* http://web.sebi.gov.in/comrnreport/amfirep.html, "Report of the sub-committee Formulate A Working Plan For Launching Of Real Estate Investment Schemes", (last visited January 10, 2008).

However, the following points need to be considered: The CIS Regulations appear to be made keeping a specific project in mind. Therefore, these regulations prescribe a maximum subscription level and recommend proportionate allotment of units while, Real Estate Funds are not project specific and therefore do not have predetermined size of subscription. The Sub-committee was of the opinion that keeping a maximum limit on subscription would disadvantage small investors desirous of taking exposure to the real estate sector.

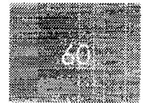
up to 20 per cent of total asset value in incomplete and non-income generating assets, and can borrow only up to 20 per cent of the gross assets of the scheme.[72]The safeguards are also proposed by putting a limit of 15 per cent for investment in a single real estate project, and 25 percent in real estate projects by a single group.

Generally speaking there would be many laws which may be applicable to REIT, more importantly the SEBI (Collective Investment Schemes) Regulations, 1999[73] and SEBI (Mutual Funds) Regulations, 1996 would be applicable to REIT after some significant changes.

STRUCTURE OF THE TYPICAL REITS



[72] Supra 65(scl),P11.
[73] Supra 68(lawz),p11



6.1.3 The Functioning of Real Estate Investment Trust[74]

REITs have a board of directors elected by its shareholders. Typically, these directors are real estate professionals who are highly respected in the field. They are responsible for selecting the REITs investments and hiring the management team, which then handles day-to-day operations, The REITs are required to distribute 90 per cent (as the case may be) of their taxable income to investors; they must rely upon external funding as their key source of capital. Just like other stock offerings, publicly traded REITs collect funds *via* an Initial Public Offering (IPO). Those funds are used to buy, develop and manage real estate assets.

The IPO works just like other security offerings except that instead of purchasing stock in a single company, the buyer will own a portion of a managed pool of real estate. Income is generated through renting, leasing, or selling the properties and is distributed directly to the REIT holder on a regular basis. When a REIT pays out its dividends, they're equally distributed among shareholders as a percentage of paid-out taxable income. The Trust structure is the most appropriate for such investments.

[74] Supra 66(scl),p 7

6.2 REAL ESTATE MUTUAL FUNDS [REMFs]

Real estate mutual fund scheme has been defined by the SEBI vide notification dated April 16,2008 where in it has amended SEBI (Mutual Funds) Regulations, 1996 to permit mutual funds to launch REMFs accordingly it has defined REMF as following:

"real estate mutual fund scheme" means a mutual fund scheme that invests directly or indirectly in real estate assets or other permissible assets in accordance with these regulations"[75]

An REMF is a scheme much like any other closed-end Mutual Fund (MF) scheme (that invests in shares and bonds) except for the fact that the new entity will invest in real estate.[76] The regulations define a REMF as a scheme of a mutual fund established in the form of a trust, which invests directly or indirectly in real estate assets or other permissible assets. There are two conditions of investment set by SEBI. First, it is mandatory for an REMF to invest at least 35 per cent of its corpus in completed real estate assets (read flats, row houses, bungalows, shops). These may be either residential or commercial properties, but must be finished and ready-to-use and not under construction. The second investment condition of SEBI mandates that at least 75 per cent of the corpus must be invested in real estate or related securities. These may be debentures of real estate companies and mortgage-backed securities and equity shares of real estate companies listed on the stock exchange.

Under this, REMF may also invest in 'under-development' properties. But it may neither buy barren land, nor may it undertake construction activities. It

[75] Regulation 2 (sa), SEBI (Mutual Funds) Regulations, 1996

[76] Dr.Sanjiv. Agarwal, "Investment Opportunity In Real Estate Mutual Funds", Tax And Corporate Reference, Vol-38(06), 2006, p.266

will partner with a real estate developer and then take a stake in a special purpose vehicle that the developer will have set up for constructing a particular project.

An REMF is like a mutual fund for real estate assets. In other words the asset management company (AMC) invests in a range of real estate assets around the country and creates a fund based on those assets. Investors may buy shares in those funds which are traded on a daily basis on stock exchanges. The value of the shares depends on the value of the underlying real estate assets.

6.2.1 REMFs have many advantages over direct investment.

- it allows investors to invest according to their income and financial circumstances;
- the portfolio of real estate assets will be a lot more diversified than a single home with assets ranging from office space to residential properties all around the country as well as securities based on the real estate sector; and
- Investors don't have to deal with the legal and maintenance hassles of owning property and may instead rely on the professional expertise of the AMCs. Finally if they need quick money, these funds are liquid assets, which may be sold conveniently and rapidly.

6.2.2 Features of REMFs as allowed by SEBI

For years, there were no concrete steps taken to promulgate regulations for the establishment of REMFs. However, on 25 April 2008, SEBI announced

amendments to the SEBI (Mutual Funds) Regulations, 1996 that permit the launch of REMFs:

1. Existing Mutual Funds are eligible to launch real estate mutual funds if they have adequate number of experienced key personnel /directors;
2. Sponsors seeking to set up new Mutual Funds, for launching only real estate mutual fund schemes, will be carrying on business in real estate for a period not less than five years. They will also full fill all other eligibility criteria applicable for sponsoring a MF;
3. every real estate mutual fund scheme will be close-ended and its units will be listed on a recognized stock exchange;
4. net asset value (NAV) of the scheme will be declared daily;
5. At least 35 Per cent of the net assets of the scheme will be invested directly in real estate assets. Balance may be invested in mortgage backed securities, securities of companies engaged in dealing in real estate assets or in undertaking real estate development projects and other securities. Taken together, investments in real estate assets, real estate related securities (including mortgage backed securities) will not be less than 75 Per cent of the net assets of the scheme;
6. Each asset will be valued by two valuers, who are accredited by a credit rating agency, every 90 days from date of purchase. Lower of the two values will be taken for the computation of NAV;
7. caps will be imposed on investments in a single city, single project, securities issued by sponsor/associate companies etc.;
8. unless otherwise stated, the investment restrictions specified in the seventh schedule will apply;

9. no mutual fund will transfer real estate assets amongst its schemes;
10. no mutual fund will invest in any real estate asset which was owned by the sponsor or the asset management company or any of its associates during the period of last five years or in which the sponsor or the asset management company or any of its associates hold tenancy or lease rights;
11. Real estate mutual fund scheme will not undertake lending or housing finance activities; and
12. The amended regulations have also specified accounting and valuation norms pertaining to real estate mutual fund schemes.

6.3 MUNICIPAL BONDS[77]

Municipal bonds are the innovative instruments to leverage capital market resources to finance the urban infrastructure projects[78] thus attracting a very new class of investors such as pension funds and insurance companies thus providing a long term stable returns. For the investors municipal bonds and pool finance funds are the source of high returns in a part because they are often tax-exempt[79] the MOUD has recently proposed to raise the limit and make the raising the funds up to 100 per cent through issuing the tax free municipal bounds.[80]

[77] A bond issued by a city or other local government, or their agencies to fund public capital projects like roads, schools, sanitation facilities, bridges.
[78] Soumyadip Chattopadhyay, "Municipal Bond Market For Financing Urban Infrastructure", Economic and Political Weekly, June, 2006, p 2787.
[79] India Infrastructure report 2006.p243.
[80] Indian infrastructure, August 2008, p 96.

The Central Government had announced the guidelines[81] for regulating issue of tax free municipal bonds issued by Municipal / Local Governments such bonds will be issued for raising resources for capital investment in creation of new infrastructure as well as augmentation of existing systems.

---

[81] Guidelines were issued by Ministry on 8.2.2001

CHAPTER 7

CONCLUSION AND SUGGESTIONS

In conclusion, it is evident that the New Economic Policy launched in India in 1991-92, did see several important initiatives in the urban sector designed to encourage investment participation in urban infrastructure. These initiatives would need to be taken to their logical conclusion.

The new industrial policy of 1991 brought in substantial reforms, which have reduced the industrial licensing requirements, removed restrictions on investment and expansion and facilitated easy access to foreign technology and Foreign Direct investment into almost all sectors except a few.

Through one can hope to reverse the declining standards of urban infrastructure in the country. A series of new reform measures must be put together for implementation of the next generation reforms:

- There are a host of local government laws which impact the urban infrastructure development in India cities. The Inappropriate Policies, Laws and Regulations affecting private activities tend to create several types of barriers to the development of the private investment in urban sector. Whilst the guidelines state that local laws need to be followed, in almost all cities in India, the local laws may not be appropriate at all for developments involving FDI. In such cases, cross subsidization needs to be done from other uses; legislations like The Rent Control

Act and the Urban Land Ceiling Act and Stamp duty are still major bottlenecks for investment.

- Innovative approaches like REITS and Urban Development Funds, Pool Finance funds would attract more investment and create a new segment of investors in urban infrastructure making urban infrastructure investment a safe and profitable investment.

- The provision of social amenities is very much transferring necessary and free social amenity transfer needs to be insisted upon. Whilst the government has permitted FDI, free social amenities are a small and legitimate return to expect from the foreign investors/private sector. In fact, quite a few social amenities can be retained by the developer.

- The 'public' properties' which need to be maintained would become the responsibility of the local bodies. In such circumstances, one need to see the question of the state of fiancés of local bodies, their executive expertise and capacity to undertake asset management, etc. without the creation of appropriate systems in this context, the assets created would become very expensive in the long run to maintain.

- In the cities of India, there are a host of organizations which would come into play. It may not be possible for foreign investor companies to liaison with all these. There is thus an urgent need for apex Local Regulators to be designated, so that they can act as a 'single window' for clearances, monitoring, clarifications on rules and procedures, especially with regard to PPP and development of capital market and related institutions that provide funds etc.

In the ultimate analysis, it can be seen that the guidelines prescribed by the government are too preliminary and general. A detailed set of guidelines need to be evolved for mitigating; Conventional barriers to entry and exit which limits potential investment.

BIBLIOGRAPHY

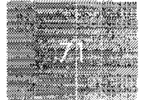
Books

- Booth Rachel, "Real Estate Investment Trust- A Global Analysis", Globe Law & Business Publication. 2006
- John d. Hanrahan, "Government for Sale, Contracting Out The New Patronage", American Federation of State, Country and municipal Employee, 1983.
- Keshav, S Vanita Danait, "FEMA, Foreign Exchange Management In India", 2nd edi , Show White Publication, Mumbai.
- Patricia Clarke Annez, "Urban infrastructure finance from private Operators: what have we learned from recent Experience?" World Bank Policy Research Working Paper 4045, November, 2006.
- Rajiv Jain's Investing in India", India investment publication, 2nd edi, New Delhi, 2004-05.
- Ravi Puliani & Mahesh Pulani, "Foreign Exchange Management Act, Rules and Regulations, RBI Circulars with Allied Acts", 6th edi, Bharat Publication House, New Delhi.
- SEBI Manaual, 9th edi, Taxman Allied Publications Ltd, New Delhi 2007.
- Taxman, "Manual of RBI Notifications", Academic Foundation, New Delhi. 2002

- Timothy Irwin, "Dealing With Public Risk In Privates Infrastructure", World bank , Washington D.C ,1998

Articles

- Ashwani Luthra, "Public Private Partnership: A Tool for Integrated Urban Development", Vol-38, Nagarlok, 2006.
- Dr. Sasi Kumar, "Public - private partnerships in urban infrastructure", Kerala Calling, February 2004.
- Dr.Sanjiv. Agarwal, "Investment Opportunity In Real Estate Mutual Funds", Tax And Corporate Reference, Vol-38(06), 2006.
- J.K.Gupta, "urban infrastructure development-need for innovative approaches", Nagarlok, vol-34(03), 2002.
- Maqnish raj, "The Future of Real Estate Investment Trust in India", SEBI & Corporate Laws, vol84, 2008.
- Nand Dhameja and Rakesh Gupta, "Urban Infrastructure Financing: Innovative Tools", Nagarlok, Vol-32(03), 2000.
- P.S.N.Rao, "FDI For Real Estate Development In India", Nagarlok, Vol 25, 2003.
- Pragya Awasthi, "Real Estate Investment Trusts", Lawz, October 2008.
- Shailesh. Pathak, "Urban financing", Indian infrastructure, February, 2009.
- Sarada and Lla Singh, "Public-Private Partnerships For Infrastructure Development", Nagalok.vol-36, 2004.



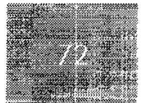
- Soumyadip Chattopadhyay, "Municipal Bond Market For Financing Urban Infrastructure", Economic and Political Weekly, June, 2006.

Journals and Reports

- Compilation of Foreign Direct Investment in India, Report 2002
- Economic and Political Weekly, June, 2006.
- India Infrastructure Report 1996, 2001
- Indian infrastructure, August, 2005
- Indian infrastructure, November, 2005
- India Infrastructure report 2006
- Indian infrastructure February, 2006
- Indian infrastructure, August, 2008
- Indian infrastructure , February, 2009
- Lawz, October 2008.
- Nagarlok, 2000.
- Nagarlok, 2002.
- Nagarlok, 2003.
- Nagalok. 2004.
- Nagarlok, 2006.
- SEBI & Corporate Laws, 2008.
- Tax and Corporate Reference, 2006.
- World Development Report, 2002

Websites

- www.cutlercapital.com



- www.finance.indiainfo.com
- www. iic.nic.in
- www. indiabudget.nic.in
- www.investmentcommission.in
- www.pib.nic.in
- www.planningcommission.nic.in
- www.pppinindia.com
- web.sebi.gov.in
- www.thehindubusinessline.com
- www.urbanindia.nic.in