
A PwC Briefing on Investing in the Infrastructure Sector in India

Introduction

The world experienced a deep recession for most of 2009-2010. Despite this, however, India was able to post an impressive GDP growth rate of 7.4% for 2010, an increase on the 6.7% seen in the previous year. Over the span of a year the Indian economy was able to recover from the slowdown in financial inflows, giving an optimistic picture of the country's economic future in the medium to long term.

The most significant contribution to the growth rate came from the manufacturing sector, which had a 10.8% growth rate. Construction is the second largest economic activity in India after agriculture, and has been growing rapidly. The production of industrial machinery has also been on the rise – and the increasing flow of goods has spurred increases in rail, road and port traffic, necessitating further infrastructure improvements.

PwC's UK Macroeconomic team estimate India's GDP growth to be 8.7% for 2010 with forecasts of 8.4% and 8.5% for 2011 and 2012 respectively. As the Indian economy is still expanding significantly, substantial investment in infrastructure continues to be required in order to sustain India's economic progress. The country's capacity to absorb and benefit from new technology and industries depends on the availability, quality and efficiency of more basic forms of infrastructure including energy, water and land transportation. In some areas, roads, rail lines, ports and airports are already operating at capacity, so expansion is a necessary prerequisite to further economic growth.

The Indian Government recognises this imperative - the Eleventh Five Year Plan sets out that more than US\$500 billion worth of investment is planned to flow into India's infrastructure by 2012. Construction projects account for a substantial portion of the proposed investments, making the Engineering & Construction (E&C) sector one of the biggest beneficiaries of the infrastructure boom in India. The regulatory environment is relaxing to encourage further foreign direct investment (FDI).

Private sector participation is integral to these plans. PPPs have been identified as the most suitable mode for the implementation of projects – and indeed, are rapidly becoming the funding norm. Their share of the total planned infrastructure improvements is projected to be around 30% (US\$150 billion). Power and road projects top the list, and other transportation sectors such as railways, ports, and airports are also targeted for major investments.

Companies looking to capitalise on the situation need to plan their strategy for entering the market carefully. Understanding the local market, including selecting complementary local partners, is vital. Tax optimisation is a key cost component – while substantial tax benefits are provided for infrastructure projects, developers need to be savvy about structuring their contracts. Good tax planning can have a potentially decisive impact, especially in bidding situations, and help to avoid unnecessary litigation later.

Foreign Direct Investment (FDI) and the regulatory environment

During 2009-2010, foreign exchange reserves increased by US\$ 31.5 billion from US\$ 252.0 billion at the end of March 2009 to US\$ 283.5 billion at the end of January 2010, demonstrating that India is emerging as a preferred destination for foreign investors.

Major infrastructure development requires a substantial influx of investment capital. The policies of the Indian Government seek to encourage investments in domestic infrastructure from both local and foreign private capital. According to the ATKearney 2010 FDI Confidence Index (a regular assessment of senior executive

sentiment at the world's largest companies), India was rated the third most attractive location (after China & the US) for global FDI.

Currently, India has FDI of about US\$35 billion per year which is the target set by the government for 2009, having in previous years fallen short of targets due to the economic downturn. In order to increase FDI inflows further, particularly with a view to catalysing investment and enhancing infrastructure, the Indian Government has introduced significant policy reforms such as.

- It now permits 100% FDI under the automatic route for a broad range of sectors where only certain post-investment intimation is required. These include Greenfield airports, construction & maintenance of infrastructure like ports, harbours, roads and highways, power generation, transmission and distribution and power trading, mass rapid transport systems, townships, housing, built-up infrastructure and construction-development projects.
- Prior approval is still required for FDI in a few sectors such as existing airports and atomic minerals but this would typically take 6-8 weeks.
- The Indian Government continues to simplify the approval route process, including setting up several agencies to expedite FDI approval.

From an exchange control perspective, India is moving towards full current account convertibility. Most revenue transactions are freely permitted, except certain transactions like royalty, consultancy fees which are subject to certain limits. Capital account transactions need prior approval, except where specifically permitted. In order to promote the construction sector, the Indian Government has relaxed some of the exchange control restrictions and is now allowing foreign nationals/citizens to acquire immovable property in India, subject to certain conditions and procedures.

To encourage funding to the infrastructure sector, the Reserve Bank of India has introduced a new category of Non Banking Financial Company ('NBFC') as Infrastructure Finance Company ('IFCs'). An NBFC, to qualify as IFC, is required to fulfill certain criteria with respect to minimum total assets deployed in infrastructure loans, minimum net owned funds of INR 300 crores, minimum credit rating, capital adequacy ratio etc. The prudent norms on credit concentration, applicable to an IFC, are less stringent and also, low risk exposures and higher lending limits granted to the banks financing such IFCs, gives flexibility to tap funds from banking institutions for on-lending to the infrastructure sector. Further, amongst NBFCs only IFCs can avail External Commercial Borrowings ('ECBs') for on-lending under the automatic route.

Hurdles to investment remain. Although India has a well-developed legal system, the current legal and regulatory environment sometimes acts as an obstacle to the necessary injections of foreign private capital into India's infrastructure. Major infrastructure projects are governed by the concession agreements signed between public authorities and private entities. Tariff determination and the setting of performance standards vary somewhat by sector. In the roads and highways sector, the ministry generally sets tolls, whereas in major ports projects, and many of those in electricity generation, an independent regulator will decide relevant tariffs. In the airport sector, a new independent regulator, Airports Economic Regulatory Authority, has been set up which is likely to play a major role in determining tariffs in concession agreements for the segment. In some instances, ministry or regulator control over potential proceeds can act as a disincentive to the private infrastructure developer.

As is the case in many countries, there is no single regulator which formulates the policy for all infrastructure projects. There is also no standardisation in the concession agreements across the different infrastructure sectors. As a result, the development of certain sectors in India may be hampered due to lack of adequate and co-ordinated planning. Projects which are approved may face difficulties if related projects are substantially delayed.

A summary of FDI for key infrastructure sectors:

Mass Rapid Transport System

FDI up to 100% is allowed under the automatic route in mass rapid transport systems, including associated commercial development of real estate, in all metropolitan cities.

Ports and Harbours

Up to 100% FDI is allowed through the automatic route for leasing of existing assets of ports, construction and maintenance of assets, leasing of equipment for port handling and leasing of floating crafts and captive facilities for port based industries.

Power

FDI up to 100% is permitted in the power sector under the automatic route for projects relating to the generation, transmission, distribution and trading of power, other than the generation, transmission and distribution of electricity in atomic reactor power plants.

Industrial Parks

FDI up to 100% is permitted under the automatic route subject to fulfilment of prescribed conditions.

Transport and Transport Support Services

100% FDI is permitted under the automatic route for:

- Pipeline transport, ocean and water transport, inland water transport;
- Transport support services.

Urban and Rural Infrastructure

100% FDI is permitted under the automatic route in construction and maintenance of:

- Roads, rail-beds, bridges, tunnels, pipelines, ropeways, runways, waterways and water reservoirs, hydroelectric projects, power plants and industrial plants;
- Roads and highways offered on a Built, Own and Transfer (BOT) basis including collection of toll;
- Rural drinking water supply projects, package water treatment plants, rain and rain water harvesting structures, waste-water recycling and re-use techniques and facilities, rain-water re-charging and re-use techniques of ground water.

Public Private Partnerships

Funding India's wide-ranging, US\$1 trillion programme of infrastructure expansion over this five-year period is likely to be beyond the means of total government funding, so policies have been designed to facilitate private investment to the maximum level possible.

If the Indian Government's targeted level of private sector involvement and investment are met (approximately 30%), the quantum of funding required would be around US\$300 billion – dwarfing the investment achieved over the past decade by comparison. Achieving this level of investment is ambitious. Several frameworks and plans are already in place, however, that may facilitate reaching these goals.

The PPP/PFI market in India is still at a relatively early stage. However, over the past decade or so, there has been an increasing trend at the central as well as state government level to use PPPs for meeting critical infrastructure gaps. The results have been quite encouraging. Establishing a PPP is now considered to be the default option for major infrastructure projects in sectors such as roads, railways, airports, ports and other transport segments. First preference will be given to the PPP model, and only in cases where projects are expected to fail to attract private sector interest will more traditional models be considered.

India has become an attractive PPP market and its attractiveness is likely to increase in the future. Contractors able to negotiate and partner with the relevant ministries should find excellent opportunities, particularly companies with a longer-term view.

The tax environment for Engineering & Construction companies investing in India

Engineering and Construction companies looking to invest in India need to consider a variety of tax issues. Overall tax rates can be relatively high, so careful tax planning is vital. Some of the relevant taxes applicable to E&C companies are listed below:

Nature of Tax	Governing Authority	Rate of tax
Income Tax ¹	Central Government	up to 33.22% for domestic companies up to 42.23% for foreign companies
Dividend Distribution Tax ²	Central Government	16.61%
Customs Duty	Central Government	up to 26.849% (for non-agricultural goods)
Excise Duty	Central Government	up to 10.30%
Service Tax	Central Government	10.30%
VAT	State Government	4% to 15%
Central Sales Tax ('CST')	Central Government ((collected & retained by State Government))	2% (if C form is issued, else prevailing local VAT rate)

Notes: The proposed rates under the proposed Direct Taxes Code Bill, 2010 ('DTC' or 'the Bill') are as under:

Income Tax: domestic companies – 30%, foreign companies – 30%

Dividend distribution tax : 15%

Transfer pricing regulations were introduced in India in 2001. The transfer pricing provisions generally follow the relevant Organisation for Economic Co-operation and Development (OECD) guidelines, with certain fundamental differences.

The Government's strong focus on promoting infrastructure development also extends to tax policy, with a number of policy measures and incentives now in place for the construction of infrastructure facilities, including a number of tax holidays, although Minimum Alternate.

Tax (MAT) of up to 19.93% may be payable on book profits during this period. Relevant tax holidays, their applicability, and the eligibility of each infrastructure sector can be provided by PwC.

On 30 August 2010 the government placed before the Parliament the DTC which is proposed to replace the existing direct tax legislation from 1 April 2012 with an objective to moderate the tax rates and simplify tax laws. In addition to changes in the tax rates, some of the other aspects proposed in the DTC include introduction of General Anti-Avoidance provisions, Advance Pricing Arrangements and Safe Harbour rules for international transactions, etc. For certain sectors like infrastructure, there has been a shift from profit-based tax holiday to expenditure / investment-based tax holidays. However, existing eligible projects under the

existing tax regime will still continue to enjoy profit linked tax holiday. The Bill has now been referred to the Standing/Select Committee of the Indian Parliament for further deliberation.

From an indirect tax perspective, India has proposed to transition to a national integrated Goods and Services Tax ('GST') for levy of tax on goods and services. The Government is yet to finalise the date of implementation of GST. The proposed dual GST model will comprise Central GST and State GST on the supply of goods and services. The dual GST proposed by the Government will herald India to an efficient indirect tax system and create a common market on a pan-India basis. The draft legislations are yet to be issued by the Government.

International tax considerations

Effective tax structuring into India is vital as this impacts on how attractive a project is to target investors and has a direct influence on the net internal rate of return. It is therefore particularly important that international investment opportunities are structured appropriately to take into consideration tax, accounting, regulatory and legal aspects. Some key areas to consider are briefly listed below.

Entry and exit strategy

Holding company location – Appropriate planning in respect of a holding company jurisdiction is necessary to optimise Indian withholding tax and Indian capital gains on the sale of shares in Indian companies.

Financing – In order to introduce debt into India, there are various issues that need to be considered such as the Indian External Commercial Borrowings rules, withholding tax issues on distributions out of India and the availability of a tax deduction for the distribution at the Indian level.

Holding the investment

Permanent Establishments – One of the risks with managing investments in India is managing the Indian permanent establishment position, where if the Indian tax authorities successfully argue that there is an Indian permanent establishment of foreign operations in India, then there may be significant adverse tax implications. It is therefore important to carefully manage the operations carried out at the Indian level. In practical terms in the E&C industry, activities generally take a long time to complete, and hence PE clauses (especially fixed base and service PE) come into play in this industry more often.

Cash and profits repatriation

Profit repatriation – There are various options on repatriating profits from the structure, such as dividend distributions, share sale, capital reductions, all with differing tax impacts.

Engineering, procurement and construction (EPC) contracts – onshore versus offshore

In the E&C industry, the execution of projects is undertaken substantially by way of an engineering, procurement and construction (EPC) contract. A typical EPC contract will have the following scope of work in a single project:

- Supply of equipment (offshore and onshore)
- Installation/commissioning
- Services (offshore and onshore)
- Software/technology transfer (offshore and onshore)

Under a typical EPC contract, a non-resident contractor performs a multitude of activities. The scope of work under an EPC contract would include both onshore and offshore activities. Taxability of payments received by foreign companies under EPC contracts has become a matter of great debate and litigation. The Indian revenue authorities often attempt to bring the entire EPC contract, including the offshore supplies and services, within the range of taxes in India.

The tax authorities may cite a business connection in India, and also note the presumed indivisibility of EPC contracts.

Indirect tax issues

The majority of the E&C services rendered by a company in India are subject to either service tax, VAT, or both, depending on whether the services rendered by E&C companies are in the nature of a construction contract or service contract. Apart from the above, there are certain other indirect tax issues like multiplicity of taxes, double taxation, differential rates on goods and services which need to be addressed appropriately, especially relating to contract structuring. Companies need to ensure that indirect taxes are taken into account as they make decisions around how to structure a particular project so as to make the project tax efficient. Further, in order to reduce the tax cost it is important to ensure that all the indirect tax benefits are availed.

Also, with the proposed introduction of GST, it is imperative to review the strategies for structuring of EPC contracts as change in tax rates and taxable base may have an impact on each of the projects. Revisiting the pricing mechanism of the existing contracts and change in law clauses is also critical.

Challenges for local players and foreign companies looking to enter the market

Without doubt, there is huge opportunity in the Indian infrastructure space in the short and medium terms at least. The policies of the Indian Government, which have been evolving very rapidly in recent years, continue to encourage the private sector in taking on a larger and more diverse role – from being an infrastructure builder (under a publicly financed arrangement) to an infrastructure developer (under PPP structures which include private finance). These developments have led to a large number of infrastructure projects open up as opportunities for the private sector.

Considering the liberal FDI guidelines, these lucrative projects present both an opportunity and a threat to local players. In many cases, foreign players are believed to have greater technological expertise and more experience compared to domestic companies. These advantages could mean overseas companies winning work at the expense of local players, or partnering with them. Domestic E&C companies may therefore look at foreign entrants in the market as tough competitors – or as strong potential partners.

Domestic production of equipment and machinery is ramping up fast, but in the short term, a foreign partner may be able to help fill in any gaps. There are many factors that influence the role of the local players vis-à-vis foreign players – for example, the criteria used for the selection of developers is an important influencer on what role the foreign players will take.

Risk-sharing on a PPP project also needs to be carefully considered. The revenues of most infrastructure projects in India will be denominated in the local currency. Foreign players will need to consider the currency and tax issues already mentioned in some detail, particularly on a PPP project where significant private investment is also sought.

International EPC contractors are already leading players in India. At the same time, many Indian companies have either scaled up their skill sets or extended their operations to overseas projects.

India has a very well established infrastructure developer market. Local firms have evolved in recent times into fully-fledged national players (and in some cases international players). In certain sectors, such as highways, power and water, local firms also have significantly progressed on the technological front. Some India-based are very active in the international markets and thus, can no longer be deemed 'local' E&C companies. Indeed, they are global organisations based out of India. These and other large firms clearly look at foreign players as both partners and competitors. However, smaller and medium-sized infrastructure construction companies are often happy to partner with foreign players without necessarily considering them as competitors.

The recent guidelines issued by the Indian Government for the selection of PPP developers have also led to a slightly distorted behaviour in the local marketplace. The guidelines favour larger players, even when the project investments and execution can be easily carried out by mid-sized companies. This has led to situations where many of the small/medium-sized local players are looking at partnering with the foreign players primarily for the purpose of getting qualified and winning the job, rather than to actually bring in investment or expertise. It is expected that such behaviour will soon change as the guidelines become more reflective of market dynamics and mid-sized Indian companies mature.

Foreign players looking to enter into the Indian marketplace and team with local players need to evaluate carefully the cost competitiveness of their prospective participation. India has witnessed huge interest from a number of foreign infrastructure companies in the past, but not many have really been able to offer a cost-competitive proposal. Since India has evolved its own model of cost competitive delivery in many sectors (for example, in telecoms), local players have an incentive to work with foreign companies only if the partnering offers a competitive edge over other bidders. There have been few such success stories so far where the foreign player has offered a particularly cost-competitive product or service. In instances where we have seen the successful entry of foreign players (such as in the port sector), foreign companies have often been able to bring technology or management advantages or expanded their reach into international markets to supplement the capabilities of local partners.

Building a sustainable future in India

Whilst the need for greater infrastructure investment is clear, equally important is the need to sustainably manage such investments. The Indian Government's success in infrastructure provision will be measured not by the quantum of funds invested, but on how infrastructure contributes to the achievement of India's economic, social and environmental objectives. Importantly, infrastructure investment should be considered as a means to an end, not an end in itself.

Challenges in infrastructure provision are not unique to India. Uncertainty, scarcity of available funds for investment and competing priorities present challenges to all governments in infrastructure planning and delivery. Sustainability requires that future generations are not compromised by the investment decisions of current generations. Sustainably managing infrastructure through the appropriate pricing, funding and prioritisation frameworks is important to ensure the benefits that accrue from the significant investment that India is currently making in key social and economic infrastructure are maximised.

E&C companies looking to bid on major projects need to ensure that they are taking a holistic approach which incorporates sustainability issues into the design of the project, both in the planning and the delivery stages. Those that do so have a unique opportunity to make a major difference in a growing economy while enhancing their own bottom line.

Concluding thoughts

Although it may not always be easy to navigate the plethora of views, opinions and perceptions expressed by various local stakeholders, a vast opportunity exists for foreign contracting companies looking to invest in Indian infrastructure. Already, a number of contractors from Europe, Australia, China, Malaysia and Korea have made their presence felt in India. Further, many E&C companies, particularly from Japan, Spain, France and the UK are also now aggressively looking out for opportunities to enter India for business.

Overall, the opportunities to develop a significant business in India are extremely promising for E&C companies, if they have carefully selected strong local partners, structured contracts sensibly to maximise tax benefits where appropriate, and taken a long-term, sustainable perspective. Foreign companies who do not acknowledge the opportunity in good time may miss out on a critical opportunity to establish a long-term presence in one of the world's largest growth markets.

PwC expertise in the E&C industry in India

PwC has extensive experience of working with E&C companies in India and has a dedicated group of professionals advising clients in the industry. The infrastructure team works closely with our Real Estate, PPP & Government practices. Our knowledge management programme focuses on the building of close networks and the sharing of information and expertise. Our assignments in all regions of the subcontinent have included both private and public sector clients.

Key contacts for PwC Engineering & Construction in India:

India Infrastructure Specialist:

Nripesh Kumar
nripesh.kumar@uk.pwc.com
+44 (0) 020 780 46184

International Tax Structuring:

Raj Julleekkea
raj.julleekkea@uk.pwc.com
+44 (0)1895 522 398

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