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India's Supreme Court Nails the Guilty, but Steps into Policy Making

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On February 2, India's apex court, the Supreme Court ruled that the 2G telecom licenses granted by the Indian government in 2008 were arbitrary in nature and hence should be scrapped. According to the order, all of the 122 licenses that were granted by the Telecom Ministry under the stewardship of A Raja will have to be canceled and the freed up spectrum will have to be auctioned.

The Supreme Court came down heavily on the former telecom minister A Raja, holding him solely responsible for "virtually gifting away the important national asset at throwaway prices". The court said the conduct of Raja was "wholly arbitrary, capricious and contrary to public interest, apart from being violative of the doctrine of equality", and held him guilty of favouring some real estate companies with no experience of telecom.

With the current ruling government hurtling from one controversy to another, the Supreme Court ruling adds further to their embarrassment and could possibly be a final nail in the coffin for the government, as failure of governance becomes amply clear:

- Their failure to manage the coalition partners became evident when they raised hopes of allowing FDI in retail in India, only to scupper the plan subsequently as even their allies went against them.
- Last month, the Supreme Court set aside the order of the Bombay High Court (on the basis of application filed by the Indian tax authority) directing to pay Vodafone taxes to the tune of Rs.112.2 billion (~ US\$2.5 billion) over its purchase of Hutshison Essar Telecom services in April 2007, in an off shore deal. The government contended that since the deal was for purchase of Indian assets, Vodafone is liable to pay tax. The Supreme Court's verdict again showed the government in poor light. The decision by the government of trying to tax a transaction for a deal carried out overseas and between two entities incorporated outside India was looked at adversely by the foreign investors.
- The latest verdict fuels further concern about how deep corruption is embedded within the government and how opaque the government dealings are.

While this historic decision is hailed in many quarters as vindication of neutrality of Indian judiciary and a possible ushering in of greater transparency in governmental actions, there are downsides that need to be considered:

- With the voice against corruption reaching a crescendo and the government having been found wanting on many occasions – policy paralysis has become evident in India. Projects are getting inordinately delayed due to a lack of clearances (land, environment etc). The latest verdict could lead to a further slowdown in the decision making process.
- Sentiment of the foreign investors would be dampened as their faith in the government would nosedive, given the government's inability to manage its coalition partners and increasing evidence of corrupt and opaque practices.
- The verdict impacts foreign investors like Telenor (Norway), Etisalat (Abu Dhabi) and Sistema (Russia). They partnered with Indian companies that benefitted from the largesse of the then government. Given the attractiveness of the telecom sector, the Indian realty company Unitech, for example, obtained the

license with the objective of making profit by selling partial stake to foreign companies at a stratospheric premium. With the scrapping of the licenses, the investments made by these foreign companies would be at risk. This is likely to make foreign investors jittery, especially those who are eying to invest in India's physical infrastructure. It is important to note that India is aiming to attract US\$ 1 billion as foreign investment in infrastructure.

- The Supreme Court seems to believe that natural resources like telecom spectrum should be auctioned off to ensure resource maximisation. What it ignores, in the process, is the runaway success of the telecom sector post the 2G licenses issuance. The lowering of tariff and large penetration might not have been achieved had there been high license fees and less competition. This is clearly evident from the fact that 3G service offerings post the licenses (which resulted in a windfall gain for the government) issued in 2010 is yet to pick up to the extent desired. The economic benefit of high telecom penetration can hardly be exaggerated. From the government's point of view, there has to be a fine balance between revenue maximisation and overall economic benefit. There's no doubt that corruption should be weeded out and the guilty punished, but scrapping of the licenses send a signal to the foreign investors that their investment in the economy might be at risk if the court decides to scrutinise future policy decisions.

A bigger question here is whether the Supreme Court is right to step into the jurisdiction of policy making and start questioning the policies of the government. First-Come-First-Served (FCFS) is not a policy unique to India. The decision of whether to adopt a policy of auction or FCFS should be best left to the policy makers. Implementation can be questioned by the judiciary if there are reasons to believe that these are steeped in corruption, but surely not the policy in itself. If we now have a series of petitions questioning many government policies of the past, would all the past policies be scrapped and the Supreme Court suggest the best policies forward? This development is likely to put a question mark on the stability of India's policy and hence impact the attractiveness of India as an investment destination.

For those interested in the background, please read on.

Background:

In early 2008, India granted 122 licenses for various telecom circles to various telecom operators including a few realty companies who had no exposure to the telecom sector, prior to the receipt of the licenses. A fixed price mechanism was used on the basis of prices prevailing in 2001, and the total license fee collected was to the tune of Rs. 123.9 billion (approx US\$ 2.8 billion). The licenses were granted on a first come first served policy.

In November last year, the Comptroller & Auditor General (CAG) came out with its audit report which exposed the flaws in the licensing process. According to the report, the minister disregarded repeated warnings to use the auction mechanism and conduct the licensing with transparency and more equity.

According to the report, the telecom ministry under A. Raja allotted the spectrum licenses at rates that were prevalent in 2001 when the market was at a nascent stage, thereby defying market logic. The ministry also ignored government directives and the rules did not care for transparency. They ignored the decision of the Telecom Regulatory Authority of India (TRAI) to replace fixed license fees with a pricing mechanism that would more accurately capture market prices (essentially a combination of a nominal license fee and a market-determined "spectrum fee" through competitive bidding). While the transition to the market-based regime was planned over two phases from 1999, that was abandoned midway to retain the fixed-price mechanism. As per CAG's estimate (using the 3G spectrum auction of June 2010 as the base), the revenue that could have theoretically been collected would have been to the tune of Rs.1,766.5 billion (US\$40 billion).

The report also highlighted the fact that, although the telecom ministry talked about a first-come, first-served policy in allocating the spectrum, it actually favored a few bidders who seemed to have been privy to advance information. On September 24, 2007, the ministry's department of telecommunications (DoT) issued a press release saying it would stop accepting spectrum applications from October 1 (a week later). This meant an artificial cap on the number of licenses. But later it advanced the cut-off date to September 25 – which was essentially about a day after the date of the press release. This sudden change in the cut-off date was rationalised by the DoT as having been necessitated by a huge rush of applications.

Less than three and half months after the first press release was issued (January 10, 2008 to be precise), the telecom ministry issued 122 licenses – a surprisingly fast pace as compared to earlier practices of taking several months to decide on applications. In this case, 575 applications were received, of which 408 were filed after the September 24 press release – such a huge number of applications very clearly reflected the huge unsatisfied demand for scarce spectrum. Things became interesting when another press release was issued giving the applicants less than an hour to collect the licenses, for which they had to submit bank guarantees. Some licensees “who could proactively anticipate such procedural changes were ready with the demand drafts and could avail of the benefit of first right to allocation of spectrum, having jumped the queue,” the CAG report says. “The entire process lacked transparency and objectivity and has eroded the credibility of the DoT.”

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