

# Regulatory Hotline

September 12, 2014

## EMERGING INDIA: RAILWAYS AND DEFENCE OPEN TO FOREIGN INVESTMENT

- FDI under the automatic route permitted for certain activities in the railways sector.
- The sectoral cap for FDI in defence increased, however it continues to be under the government approval route.
- Approval of the Cabinet Committee on Security may be required in cases of investment above 49% in both railways and defence sector.

### INTRODUCTION

The Department of Industrial Policy and Production (**"DIPP"**) has on August 26, 2014 raised the sectoral cap for the much-contended Foreign Direct Investment (**"FDI"**) in the defence sector. It has allowed FDI up to 49% under the government approval route along with several conditions that are required to be satisfied.

The DIPP has also introduced FDI in the railways sector on August 27, 2014. The railways sector was liberalized by the Ministry of Commerce and Industry (**"Commerce Ministry"**) earlier on August 22, 2014. FDI in railways is now allowed up to 100% under the automatic route.

These announcements have been made by way of press notes issued by the DIPP and have the effect of amending the Consolidated FDI Policy Circular 2014 (**"Consolidated FDI Policy"**) which has been in effect since April 17, 2014. These decisions have been brought into force with immediate effect.

### FDI IN RAILWAYS

FDI in the railways sector was a much necessary measure in order to improve the infrastructure of the cash-strapped sector which is one of the most widely used mode of transportation serving around 23 million passengers every day.<sup>1</sup> The revenue earnings of the railways sector are very low as compared to the expenditure incurred by it thereby leaving behind a very meager surplus. As per the budget speech of the railway minister for the year 2014-15, in the year 2013-14, the gross traffic receipts were INR 1,395,580 million and the total working expenses were INR 1,303,210 million, which works out to an operating ratio of almost 94%.<sup>2</sup> The minister had highlighted that the surplus, after paying obligatory dividend and lease charges is estimated to be only INR 6,020 Million in the current financial year. This meager surplus is inadequate to finance the extensive plan outlay for safety, capacity expansion, infrastructure, improving passenger services and amenities of the railways.

Considering the current cash crunch faced by the railways sector, permission for FDI was a much appreciated move for modernization and development of the railways infrastructure. The government of India by a notification numbered S.O. 2113 (E)<sup>3</sup> dated August 22, 2014 (**"Notification"**) has revised the list of industries reserved for the public sector and has permitted private investment in certain activities pertaining to the railways sector.

FDI has now been permitted in the railway transport sector, which was prohibited under the Consolidated FDI Policy (except for mass rapid transport systems, where it was permitted). In 2001, FDI up to 100% was permitted under the automatic route for mass rapid transport systems in all metropolitan cities, including for the associated commercial development of real estate.<sup>4</sup> Now, FDI has been permitted in railways subject to the following conditions:

- sectoral guidelines issued by the Ministry of Railways (**"Railway Ministry"**) (though no guidelines have been issued till date).
- proposals involving FDI beyond 49% in sensitive areas will have to be brought before the Cabinet Committee on Security (**"CCS"**) for consideration by the Railway Ministry from a security point of view.

The revised policy and Notification allows FDI in the construction, operation and maintenance of only the following:

- **Suburban corridor projects through Public Private Partnership ("PPP") model:** The revised policy has included suburban corridor projects in the list of activities permitted for FDI. Suburban corridor projects are the railway lines which enable the population living in the suburbs to travel to the city. The need for a PPP model for modernization of the railways sector was felt a few years ago.<sup>5</sup> It was decided to commission private investment in railways during the 12<sup>th</sup> and 13<sup>th</sup> five year plans for the redevelopment of stations, certain high speed and elevated rail corridors, private freight terminal other freight schemes, port connectivity projects, logistic parks, locomotive and coach manufacturing units etc.<sup>6</sup> A press release issued by the Railway Ministry on August 1, 2014 had communicated that a few of the PPP projects operating under Indian railways, such as the Surendranagar-Pipavav gauge conversion project, Hassan-Managalore gauge conversion project, Gandhidham-Palanpur gauge conversion project have been profitable.<sup>7</sup>

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- **High speed train project-** High Speed Rail Corporation of India Limited (HSRC) has been formed on the directions of Ministry of Railways, Government of India, for development and implementation of high speed rail projects. This Special Purpose Vehicle was incorporated in 2012 as a subsidiary of Rail Vikas Nigam Limited which is a Mini-Ratna public sector enterprise of Government of India. Currently there are no high speed train projects in India.

There are two proposed projects which are in a nascent stage.<sup>8</sup>

In February 2014, Economic Times reported quoting Alstom, builder of France's TGV high-speed trains, that India is at least 5–10 years away from high-speed trains. According to him, India cannot just jump into the trains with average speed of above 350 kmph, before upgrading the trains to the average speeds from 80 to 120 kmph. Indian trains do not have a good track record in average speed though trains have maximum operating speed of 130-150 kmph.<sup>9</sup>

- **Infrastructure in industrial park-** The revised policy has also revised the definitions of infrastructure and common facilities in relation to industrial parks in the Consolidated FDI Policy to include railway line / sidings including electrified railway lines and connectivity to the main railway line. Railway sidings are low speed tracks which connect the main tracks. They are used for lower speed or less heavy traffic.
- **Freight lines, rolling stock including train sets, locomotives/coaches railway electrification, signaling systems, freight terminals, passenger terminals:** Freight lines are the specialized lines only for the movement of freight in order to reduce the burden on passenger lines. Rolling stock are the locomotives, cars, coaches and wagons.
- **Mass rapid transport system ("MRTS"):** MRTS are means of transport for quick travel within the city for a large number of people. The Urban MRTS includes metro projects in cities such as Mumbai, Bangalore and Delhi.

## FDI IN DEFENCE

India is one of the largest importers of arms in the world and thus incurs huge expenditure on defence. The expenditure on defence as a percentage to the GDP of India for the period from 2009-13 was 2.4%.<sup>10</sup>

While the defence sector was liberalized in 2001, FDI in defence had been permitted only up to 26% under the government approval route. The erstwhile conditions relating to the defence sector failed to attract sufficient foreign investment. The contribution of the defence sector to the total FDI inflows of approximately INR 10,870,684 million is only INR 243.6 million for the period from April 2000 to June 2014.<sup>11</sup>

While the Commerce Ministry had mooted raising the level of foreign investment in the defence sector, the Ministry of Defence ("**Defence Ministry**") was opposed to it. On one hand it was contended that FDI in defence will enable India access to modern technology and reduce the level of imports, on the other hand, it was believed that FDI in defence will affect the internal security of the country and may also not actually result in transfer of technology to India because of the restrictions imposed on such transfer by the host government. Finally, the level of foreign investment in the defence sector has been raised by the ministry.

## KEY CONDITIONS FOR INVESTMENT

| Condition                                | Old Policy  | Revised Policy   |
|--|---|--|
| <b>Cap on investment</b>                 | FDI was permitted only up to 26% under the government approval route. Proposals above 26% were to be considered on a case to case basis by the CCS if the investment was likely to result in access to modern and 'state-of-art' technology in the defence sector.  | The revised FDI policy (" <b>Revised Policy</b> ") permits FDI up to 49%, but continues to be under the government approval route. Proposals above 49% will be considered on a case to case basis by the CCS if the investment is likely to result in access to modern and 'state-of-art' technology in the defence sector.  |
| <b>Portfolio Investment</b>              | Investment by foreign portfolio investors was prohibited by a press note issued on August 22, 2013. Prior to that there was no such restriction. Therefore on account of the press note, the Consolidated FDI Policy provided that portfolio investment in companies holding defence license as on the date of the press note would remain capped at the level existing as on the said date and no further investments would be allowed through portfolio investment. | <ul style="list-style-type: none"> <li>■ The FDI limit of 49% is composite and includes all kinds of foreign investment such as Foreign Portfolio Investors ("<b>FPI</b>"), FDI, Foreign Institutional Investors ("<b>FI</b>"), Non-Resident Investors ("<b>NRI</b>"), Foreign Venture Capital Investors ("<b>FVC</b>") and Qualified Foreign Investors ("<b>QFIs</b>").</li> <li>■ Though portfolio investments are permitted under the automatic route, the portfolio investments by FPIs/FIIs/NRIs/QFIs and by FVCIs together are not permitted to exceed 24% of the total equity of the investee/joint venture company.</li> </ul> |
| <b>Applicant management to be Indian</b> | <ul style="list-style-type: none"> <li>■ The applicant should be an Indian company<sup>12</sup> or partnership firm.</li> <li>■ However the company would need to be 'owned and controlled' by resident Indian citizens and Indian companies, which are owned and controlled by resident Indian citizens.</li> <li>■ The management of the applicant company should be in Indian hands requiring majority representation on the Board.</li> </ul>                     | <ul style="list-style-type: none"> <li>■ The applicant seeking permission for FDI up to 49% has to be an Indian company owned and controlled by resident Indians. However this condition will not be required to be satisfied for proposals seeking investment beyond 49% and in such cases the applicant should be an Indian company or a foreign investor.</li> <li>■ The requirement of the applicant management to be Indian has been retained.</li> <li>■ The Chief Security officer of the investee/joint venture company is required to be a resident Indian citizen.</li> </ul>  |
| <b>Other applicant requirements</b>      | CEO of the company/partnership to be resident Indian.   | No change <ul style="list-style-type: none"> <li>■ Additionally, the investee/joint venture company should be structured to be self-sufficient in areas of product design and development. It is also</li> </ul>   |

required to have maintenance and life-cycle support facility of the product being manufactured in India.

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|---|---|--|
| <b>Lock-in requirements</b>                         | 3 year lock in period for transfer of equity from one non-resident investor to another non-resident investor with prior government approval.  | There is no such restriction. Equity may be transferred from one non-resident investor to another without the approval of the government.  |
| <b>Approvals</b>                                    | <ul style="list-style-type: none"> <li>Proposals which were within the limit of 26% but involving inflows in excess of INR 12,000 million were required to be approved by the Cabinet Committee on Economic Affairs ("CCEA").</li> <li>However, proposals which result in FDI beyond 26% and involve inflows in excess of INR 12,000 Million did not require the approval of the CCEA and the approval by the CCS would have sufficed.</li> </ul>   | <ul style="list-style-type: none"> <li>Proposals which are within the limit of 49% but involving inflows in excess of INR 12,000 million will have to be approved by the CCEA.</li> <li>Similarly, proposals which result in FDI beyond 49% and involve inflows in excess of INR 12,000 million will not require the approval of the CCEA and the approval by the CCS will suffice.</li> </ul> |
| <b>Approval of Department of Defence Production</b> | Examination of the application by the Department of Defence Production ("DoDP") may be required in case of applications seeking FDI beyond 26%.   | No such approval required.   |
| <b>Other technical requirements</b>                 | <ul style="list-style-type: none"> <li>The applicant is permitted to import equipment for pre-production activity including for the development of prototype.</li> <li>The standards and testing procedures for equipment to be produced under license from foreign collaborators or from indigenous R &amp; D are required to be provided by the licensee to a government nominated quality assurance agency under appropriate confidentiality clause.</li> </ul>  | No change  |
| <b>Minimum capitalization</b>                       | No minimum capitalization requirement. However the management of the applicant company has to conduct a proper assessment and also the licensing authority would satisfy itself about the adequacy of the net-worth of the non-resident investor.   | No change  |
| <b>Who can the arms be sold to</b>                  | <ul style="list-style-type: none"> <li>The arms and ammunitions produced by the private manufacturers are required to be primarily sold to the Defence Ministry or they could also be sold to other government entities under the control of the Ministry of Home Affairs and state governments with the prior approval of the Defence Ministry.</li> <li>Non-lethal items would be permitted to be sold to persons / entities other than the central or state governments.</li> <li>Purchase preference and price preference may be given to public sector organizations.</li> </ul>   | No change  |
| <b>Details of the license</b>                       | The capacity norms for productions will be provided in the license, based on the application and the recommendations of the Ministry of Defence which will also look into existing capacities of similar and allied products.   | No change  |
| <b>Application requirements</b>                     | <ul style="list-style-type: none"> <li>Particulars of the directors and chief executives should be furnished along with the application.</li> <li>The government may reserve the right to verify the antecedents of the foreign collaborators and domestic promoters including their financial standing and credentials in the world market. They may give preference to original equipment manufacturers or design establishments and companies which have a good track record of supplying to armed forces, space and atomic energy sections and having an R &amp; D base.</li> </ul> | No change  |

## CONCLUSION

FDI in defence and railways was a much awaited measure for modernization, improvement of infrastructure in these

sectors and to ensure technology transfer. However, due to the presence of conditions which may restrict FDI, especially in the defence sector, and the levels of approval that may follow, we are unsure of the impact that it may create to attract foreign investors.

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You can direct your queries or comments to the authors

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<sup>1</sup> [http://www.indianrailways.gov.in/railwayboard/uploads/directorate/finance\\_budget/2014-15\\_Final/English%20-%20Railway%20Budget%20Speech%202014-15.pdf](http://www.indianrailways.gov.in/railwayboard/uploads/directorate/finance_budget/2014-15_Final/English%20-%20Railway%20Budget%20Speech%202014-15.pdf)

<sup>2</sup> Para 12 of the Budget Speech 2014

<sup>3</sup> [http://dipp.nic.in/English/acts\\_rules/Notification/industries\\_Act\\_1951\\_28August2014.pdf](http://dipp.nic.in/English/acts_rules/Notification/industries_Act_1951_28August2014.pdf)

<sup>4</sup> [http://dipp.nic.in/English/policy/changes/press4\\_01.htm](http://dipp.nic.in/English/policy/changes/press4_01.htm)

<sup>5</sup> [http://www.indianrailways.gov.in/railwayboard/uploads/directorate/infra/downloads/Main\\_Report\\_Vol\\_I.pdf](http://www.indianrailways.gov.in/railwayboard/uploads/directorate/infra/downloads/Main_Report_Vol_I.pdf)

<sup>6</sup> <http://www.pib.nic.in/newsite/erelease.aspx?relid=87017>

<sup>7</sup> <http://pib.nic.in/newsite/erelease.aspx?relid=107814>

<sup>8</sup> <http://www.hsnc.in/projects2.html>

<sup>9</sup> [http://articles.economictimes.indiatimes.com/2014-03-01/news/47799622\\_1\\_bullet-trains-high-speed-trains-alstom](http://articles.economictimes.indiatimes.com/2014-03-01/news/47799622_1_bullet-trains-high-speed-trains-alstom)

<sup>10</sup> <http://data.worldbank.org/indicator/MS.MIL.XPND.GD.ZS>

<sup>11</sup> [http://dipp.nic.in/English/Publications/FDI\\_Statistics/2014/india\\_FDI\\_June2014.pdf](http://dipp.nic.in/English/Publications/FDI_Statistics/2014/india_FDI_June2014.pdf)

<sup>12</sup> 'Indian Company' means a company incorporated in India under the Companies Act, 1956

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