IDFC

Seventh

Annual Report

2003-04

Metamorphosis

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Every institution, in its early evolution goes, through periods of transformation. IDFC is in one of these periods. Many choices are possible; the one least traveled will perhaps deliver the most interesting outcomes.

Over the years, IDFC, has traveled a lonely road, a path that needed to be forged rather than followed. The destination had to be defined, direction determined and fellow travelers in the pursuit of creativity identified. All this was done and the beginnings of this new journey has been charted and executed.

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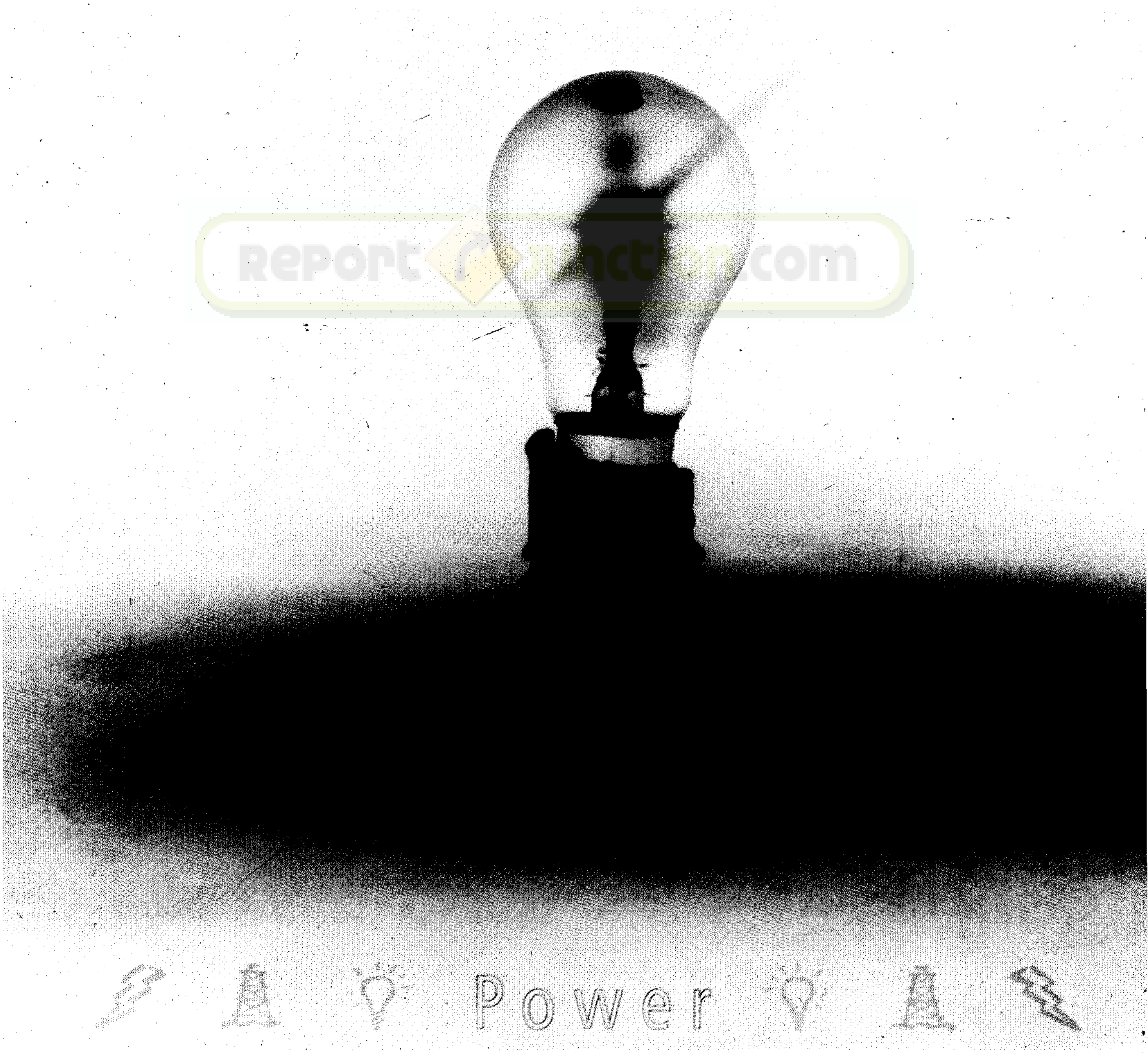
The challenges for tomorrow are whether we will stay on this path, take our fellow colleague along with us and add many new companions to a complex and unknown journey. Or will we choose a different path, one that is well traveled, predictable and less creative? This decision will be a function of leadership. This will determine, as our cover this year suggests, whether coal transforms into diamonds or diamonds into coal.

All men occasionally stumble over the truth but most hastily pick themselves up and hurry on as if nothing had happened - Winston Churchill.

India is still struggling over the power sector. Many of the ingredients are in place (thanks in part to IDFC) to facilitate reforms in this crucial Sector and thereby transform the candle as a necessity to a decorative ornament in a home.



Chairman's Statement

Last year, reviewing the first five years of IDFC, I had said that the law of the farm dictates much in life. We need to think carefully about the crops we want, prepare the ground, sow the seeds, water, protect and nurture the plants and only then we can reap the rewards. I also said we have a long way to go. Looking to this year's harvest, I think we have done some of farming well and travelled a bit along the path. This year we increased disbursements by 185% and approvals by almost 150% while posting a strong growth in profits. Our efforts have started yielding dividends for the country in general and your Company in particular.

When IDFC was established in 1997, power projects meant Independent Power Projects (IPPs) like Dabhol, cellular service cost Rs. 16 per minute, four lane divided carriageways were a rare sight, the only private port operator was P&O in Jawaharlal Nehru Port Trust (JNPT) and the only water project being conceptualised in the private sector was in Tirupur. How different the situation is today in some sectors - but, unfortunately, how similar too in others.

Telecom has undoubtedly been a real game changer. A service once considered the preserve of the few *is now definitely of the masses. At current rates of* growth, the number of wireless subscribers will exceed the traditional wired subscribers by the end of the year. Our teledensity has more than tripled; from less than 2 to over 7 today. The sector has attracted funds from non-traditional foreign investment sources, such as Hong Kong and Singapore, from established business houses in India such as Tata and Reliance and has bred new entrepreneurs such as Bharti. Many factors have played a part in this outcome, but perhaps the most important was an enlightened government policy and light-handed consultative regulation that addressed early missteps relatively quickly. First by introducing revenue-sharing in the New Telecom Policy (NTP) in 1999; then the introduction of competition and forbearance on tariff regulation by Telecom Regulatory Authority of India (TRAI) and finally the introduction of a unified access licensing regime and resolution of the Wireless in Local Loop (WLL) issue late last year. A remaining discordant note is the restriction on foreign investment. Telecom shows us what can happen if the forces of private participation are unleashed in a competitive environment nurtured by a supportive government policy that focuses not only on revenues for the budget but also service to the consumer.

IDFC was fortunate to be an active participant in this revolution. We were privileged to be part of the evolution of policy in the sector at almost every turn, for example, through providing inputs into the formulation of the NTP in 1999 and to the Group of Ministers on Telecom Matters in 2003. We were also the first to support new entrants to the sector, through debt and equity, and in providing financing to consolidate and expand the networks. Telecom, both this year and cumulatively, accounts for the largest share of *our disbursements; its share constrained only by* our prudential norms.

Another success story that is not as widely reported is that of ports. While we accepted the need to develop new ports at select locations, the early years saw us push hard to focus the policy on getting more out of our existing ports by involving the private sector, improving their connectivity to the rest of the transport network, converting old bulk berths to container terminals and modifying

Telecom remains India's success story. It demonstrates how high growth can be accomplished if we create competitive conditions for private investment in infrastructure. IDFC helped in the transformation of the sector from the problems of high license fees to revenue share; later, we helped resolve the WLL dispute and foster transition towards a licensing regime.

policy to permit new entrants. Today, our major ports are being linked to the Golden Quadrilateral through National Highways Authority of India's port connectivity project; major port trusts have awarded concessions for container terminals to global port majors such as P&O (JNPT and Chennai) and PSA (Tuticorin) and new international players are entering, viz., Dubai Port Authority in Cochin where it has emerged as the highest bidder, and Maersk in JNPT and Pipavav. New domestic entrants have also emerged, such as Concor in JNPT and J.M Baxi in Visakhapatnam. Simultaneously, some strategically located new ports, such as Mundra, promoted by the Adani group, where P&O have just invested in a container terminal and Pipavav, where Maersk is taking over from Seaking, have thrived too. Today, after many years, our port capacity exceeds our demand, even though our trade has been rising sharply. Even publicly operated port terminals have risen to the challenge of private operators and improved their efficiency by multiples. Ports are another success story for competition and supportive government policy.

IDFC has been fully involved in all these developments, from developing the model concession agreements for major port trusts, managing the bid process in Cochin and financing new development in Visakhapatnam.

Ports and Telecom are blessed in one aspect. They have consumers who are willing and able to pay, who perceive value in the services provided. There are other sectors where this is a problem, such as electricity and urban infrastructure, which I turn to later. But there are situations where extracting the full payment may not be good public policy. Roads meant not to relieve congestion but to foster the spread of economic development by improving connectivity in those regions are a good example. A blind application of "the user pays" principle, through tolls that recover full cost, in projects with large positive externalities can slow down the rate at which the population can absorb benefits.

Today, India is on a road building spree - be it the ubiquitous National Highways Development Project (NHDP), or the Pradhan Mantri's Gram Sadak Yojana (PMGSY) or the many State road initiatives made possible by the fuel cess and the mechanism of the Central Road Fund, which makes resources available to the states. IDFC was privileged to be the Secretariat to the Prime Minister's Task Force on Infrastructure that conceptualised this boom in road building and has since financed a number of private sector road projects across the country. It is equally gratifying to note that many other road projects that were appraised and sanctioned approvals by IDFC have received financing from banks.

But integrated logistics is not just roads and ports. IDFC is also intimately involved with Ministry of Civil Aviation's Committee on a road map for the civil aviation sector - to make air transport affordable and enhance air connectivity across various regions of the country. The Government has reduced excise duty on aviation turbine fuel, abolished the Inland Air Travel Tax and invited Expressions of Interest for private participation for modernising Delhi and Mumbai airports. Similarly, following its participation in the Expert Group on Indian Railways, IDFC is now playing a major role in the National Rail Vikas Yojana, to enhance the competitiveness of India's rail network. We have also financed container parks, From its inception, IDFC has played a major role in the road sector. As secretariat to the Prime Minister's Task Force on Infrastructure we have illuminated new ways of financial roads - from the concept of annuities to collecting proxy user charges through fuel cess and ring fencing them into a dedicated road fund. Roads have transformed logistics and will continue to do so.

pipeline networks, logistics providers and India's largest private airline, Jet Airways. The India Development Fund, managed by IDFC Asset Management Company Limited, is now looking at investing in a major cold chain network spread across the country. What is even more heartening is the manner in which a number of these transportation projects are attracting finance from the commercial banks. This is truly one sector where capital is being led to infrastructure projects.

However, many of these initiatives, laudable as they are, still do not have an effective mechanism to provide for maintenance. The neglect of maintenance has been the Achilles heel of our transport network. It was in order to address this and to ensure that the benefits of private participation were not limited to sectors with user payment mechanisms that IDFC developed a performance based payment system for the procurement of services that has popularly been called the annuity scheme. It ensures that the Government gets value for money, by making payments conditional on maintenance. No maintenance, no payment. Mind you, this is not a maintenance contract. No payment means that the private investor does not recover his initial investment in building the facility, a big risk that provides a big incentive for him to maintain it. Today, the concept, originally used for parts of the Golden Quadrilateral, is being adapted for use in urban road networks, the first contract having already been awarded in Kerala with the help of iDecK, an IDFC associate company. It is perhaps time to compare the experience of the annuity projects with other projects on the NHDP to see whether we should expand it substantially.

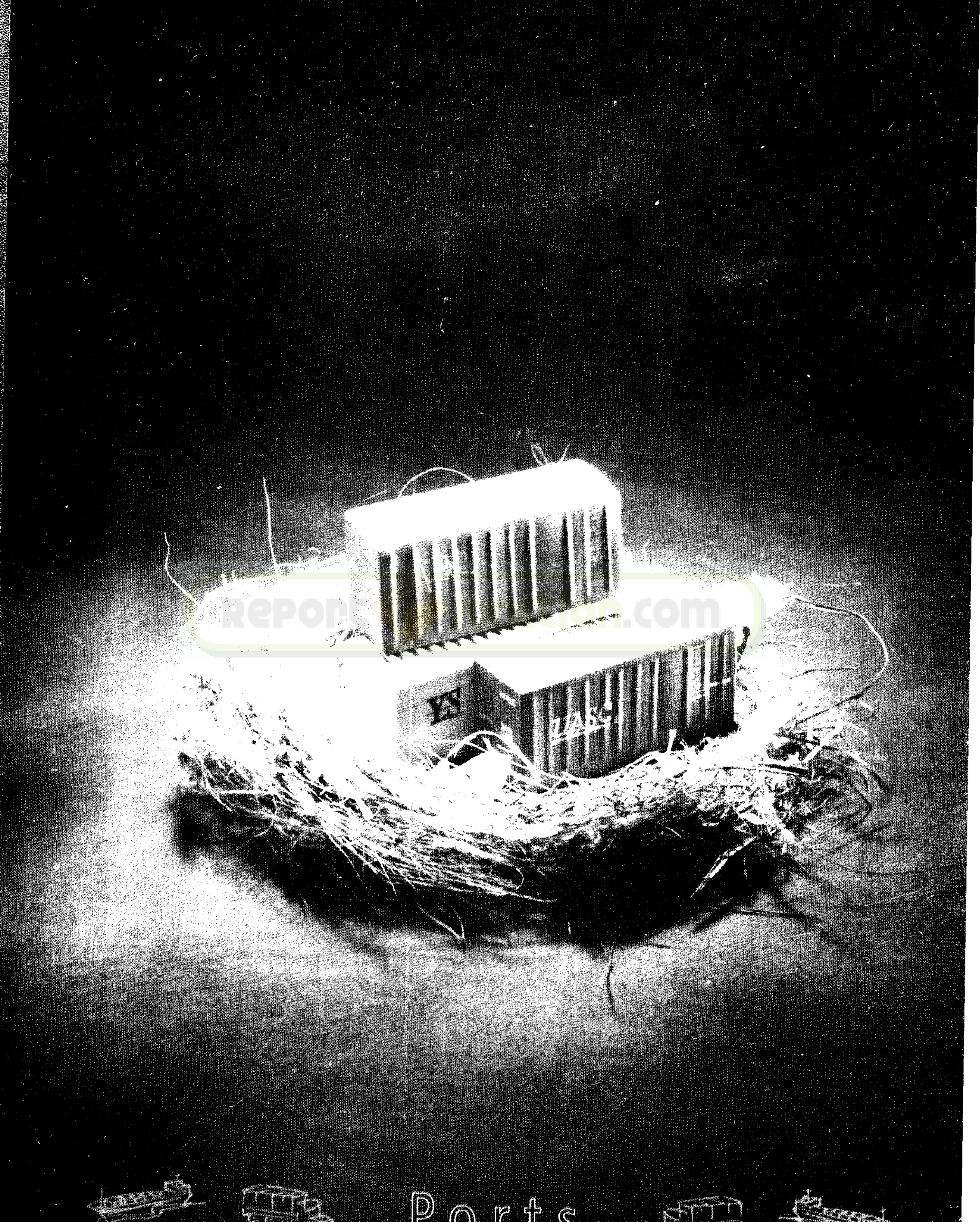
In rural roads too, IDFC has tried to push for greater community involvement to ensure maintenance. Recently, we were fortunate to be able to structure an MoU, between the Ministry of Rural Development, the Government of Maharashtra and the Warana Cooperative, to rehabilitate and maintain 1,000 kilometres of rural roads in three districts of the State, with performance based payments by the Government and significant investment by the Cooperative. This opens up a whole new way of looking at investment in this area.

IDFC's new initiatives in tourism, healthcare and education have given us reason for both celebration and concern. Celebration because we have already begun to lend to hospitals, hotels and schools. Concern because, given the framework conditions in these sectors, we do not yet see investments that will bring broad based value to the consumer in the manner of telecom, ports and roads. Yes, we will have a few more hotels, but there is little progress on delivering a visitor experience. We will have a few more large hospitals but the overwhelming majority of our population still suffers from lack of awareness and access to decent healthcare. We will have a few more schools but illiteracy and dropouts still loom large. Last year I had argued that these areas could benefit substantially from public private partnerships. We have made little progress since.

Let me now turn to electricity and urban infrastructure.

In 1997, the buzzwords in power were IPPs and escrows. IPP after IPP were sanctioned loans, but little disbursement took place as State Electricity Boards (SEBs) failed to demonstrate "escrowable capacity" to the financial institutions. For IDFC, this was not an option that was available. Locked as we

The commercialisation of Indian Ports (for which IDFC created the model documentation) has transformed container movement in the country as well as the efficiency of port management.



Ports