NEW INVESTMENT POLICY APPROACHES IN RUSSIA

Benefits of and bottlenecks in Investment Protection and Promotion Agreements

05 November 2020

In early October, the Russian Government approved a number of Resolutions required for launching a new investment tool – Investment Protection and Promotion Agreements *('IPPAs' or 'the Agreements')*. The documents were adopted pursuant to the IPPA Law enacted on 1 April 2020. The Law has not so far been enforced because no approved agreement signing procedures are in place (*by late October, no IPPAs had been signed).*

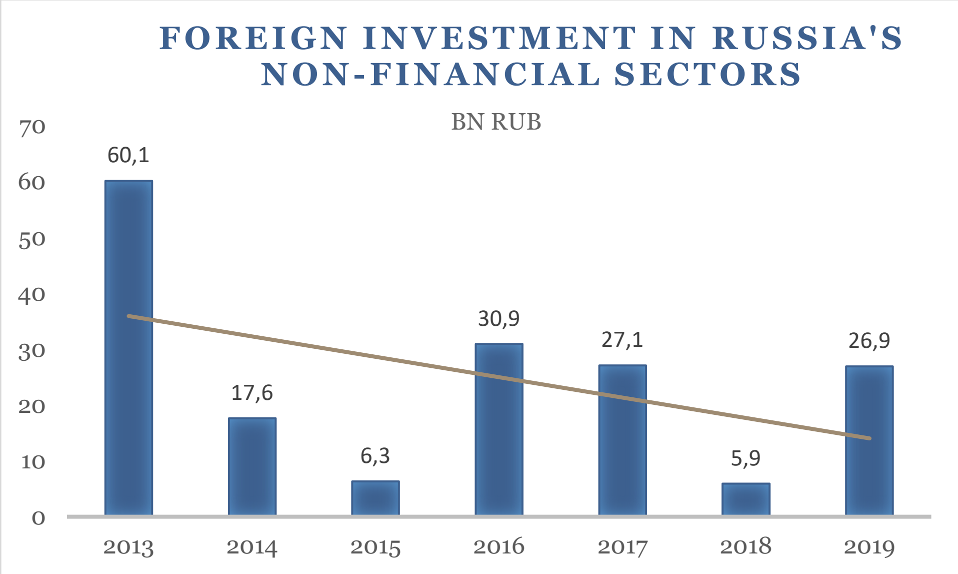
The existing regulations establish:

- the rules for signing, amending, and terminating the Agreements;
- the rules and timeframes for compensating investors for their infrastructural investments;
- a new stakeholder – the autonomous, non-profit Agency for Investment Development, introduced into the management framework for this new investment tool for liaising with businesses regarding IPPAs.

The Government views IPPAs not only as a long-term tool for directing investments into industrial capital but also as an anti-crisis measure for boosting incoming investments, which are dwindling against the background of the economic crisis and the growing risks of doing business in Russia.

Since 2014, Russia has seen a sharp drop in investments by foreign companies: foreign investment in non-financial businesses have yet to bounce back to the 2013 level *(prior to the Crimea and Donbass events).*[1] The influx of foreign investments then slowed dramatically in the first half of 2020 given the difficult situation of the pandemic and related restrictions.[2] This sharp decline in foreign investment comes on the back of the sustained, long-term capital flight from Russia: in 2008–2019, c. 800 bn USD left the country. So the IPPAs are being implemented against a background of an aggravated crises in the Russian economy.

[1] According to the CBR.
[2] According to the CBR, foreign direct commitments are 72% lower year-on-year.



Source: Central Bank of Russia

IPPAs may also be viewed as a way for businesses to offset the macroeconomic stabilisation measure previously adopted by the Government. So, the growth of the tax burden in recent years (*increased VAT rate, some export duties and excises, tax on cross-border dividend payments, etc.)* has resulted in big businesses restricting their investment programme and thereby reducing their tax payments. The lowering of projects risks and compensation for some of the costs by the Government in the form of previously paid taxes are aimed at reversing this negative trend.

That said, the protracted launch of the new mechanism *(the Law and the regulations took over two years to prepare)* demonstrates that businesses and the Government have serious differences over the potential support measures (*government bodies' loss of direct control over the regulatory framework)*, which calls into question the likely effectiveness of IPPAs in practice.

So far, the IPPA signing procedures and the mechanisms for compensating investors for their costs look cumbersome and costly for investors. Despite this, however, the existing regulatory framework already supports pilot agreements. The current agreement signing method is paper-based and will be in force until 1 April 2021. According to the Government, 20 IPPAs worth a total of 900 bn RUB (11 bn USD) are now in the process of signing. Among the applying companies are those from engineering (TransMashHolding), agrarian (Miratorg), chemical (Akron) and metallurgical holdings (Novolipetsk metallurgical plant) as well as logistics & transport (NovoTrans), retail (Wildberries) and others.

Subsequently, a new regulation will make Agreement signing digital.[3] By the end of this year, the IPPA mechanisms are likely to undergo some substantial changes.[4]

In particular, it is planned:

- to extend IPPAs to a broader circle of potential investors;
- to facilitate the investor compensation procedure; and
- to regulate the public project initiative procedure (*when the Government at the federal or regional level initiates a project)*.

[3] A new government Resolution setting out the rules for IPPA signing, amendment and termination is to be prepared by the end of 2020.
[4] The existing regulations do not reflect all the aspects of the Law. Plus, compensation procedures are to be improved.

In this memo, we address the main benefits and disadvantages of IPPA agreements from the perspective of foreign businesses and describe the stakeholders to be potentially involved in their preparation and signing.

WHY FOREIGN INVESTORS NEED IPPAs

Foreign investors consider the volatility of the ground rules as a key barrier to doing business in Russia.[5] **Investment protection and promotion agreements aim to guarantee these ground rules – if not completely, then temporarily for certain investment projects. In this respect, IPPA implementation sends a positive message to businesses, considering that the past few years have seen no meaningful reforms for ensuring sustainable investment growth.** At this point, however, it is not yet possible to comprehend which real practices this tool will develop for collaboration between companies and the government.

What is an IPPA?

An IPPA is a contract between a company and the Government (please click here for our earlier memo on IPPA Law) setting out the investment project parameters and applicable government support measures, based on government commitments implying fixed basic regulatory conditions (the stabilisation clause) for the duration of the project.[6].

IPPAs are mostly focused on big infrastructural projects. The costs of developing the infrastructure, either for the project alone or related facilities that may be used for other purposes, are to be compensated directly from the Treasury.[7]

IPPA proponents believe that the Agreements should not only serve as another investment promotion tool but, with time, absorb the other business-government collaboration mechanisms (PPPs, concessions, etc.), while the relevant law should become a new 'investment code'.[8]

Unlike special investment contracts (SPICs),[9] investment protection and promotion agreements:

- target a broader range of potential investors *(SPICs are signed for industrial facilities using modern technologies from a government-approved list)*;
- do not imply tax benefits (only fixed tax terms);
- are signed upon application (tenders are only held if the investment project is initiated by the government), while SPICs are always preceded by a tender.

Main IPPA risks

- **High investor costs for preparing the IPPA documents with no guarantee of project approval**
  - Most of the preparatory work is done by the investor;

[5] According to the EY 2020 annual poll, half of companies see the constantly changing regulations as the main problem for investments.
[6] The tax conditions (profit, property and transport tax, VAT refund deadlines and rules, new taxes and levies), land use rules, and (for projects with budgets starting at 10 bn RUB) non-tax payments and export customs duties in force at the time the agreement is signed.
[7] The costs of building the supporting infrastructure are reimbursed within 5–11 years, depending on the project.
[8] The author of the idea was First Deputy Prime Minister Andrei Belousov. President Putin participated personally in the discussion on the launch of IPPAs.
[9] SPICs are industrial policy tools for incentivising hi-tech investments in the production of globally competitive goods. Launched in 2014.

- IPPA applications are to be accompanied by a number of documents *(business plan and design data, technology and price audits, construction permits, the municipality's consent to become party to the agreement, etc.);*
- No guarantee of the IPPA being signed; substantial preparation costs undermine the agreement's appeal, especially for relatively small investment projects (starting from 250 m RUB).

The subsidy is limited by the investor's costs, on one side, and on the other by the taxes paid under the project

- Compensation is not guaranteed and depends on the success of the investment project;
- the Government does not pays the investor anything while the project is underway, only doing so upon its completion *(starting from 1 January 2023)*;
- De facto, the investor effectively grants the Government a loan for the duration of the project, which can also be seen as an IPPA risk.

Complex mechanism for calculating investor project costs and the subsidies to compensate for them

- regulations set out complex formulae for calculating the subsidies meant for compensating investors for their costs;
- there is also a long list of general requirements for verifying the essential nature of investment project costs (with specific rules yet to be approved by the constituent entities of the Federation);
- the requirement to prove that any costs are essential and provide documentary evidence of the operations could increase the administrative costs of a project, undermining its feasibility.

Overall, the Government will likely endeavour to shape a major share of large investments as IPPAs, while any investments outside this framework will be exposed to high risks of regulatory change.

The announced scale of IPPA applications by 2024 is at least 1,000 agreements with an aggregate investment value of around 14 trn RUB (180 bn USD). This number is commensurate with the 2008 (130 bn USD) or 2014 (156 bn USD) capital flights from Russia.

In its assessment of the effectiveness of investment incentives, the Ministry of Economic Development will be guided by the Presidential Decree on national development goals, implying a minimum 70% growth of fixed-asset investments over 2020.

The dynamics of the first wave of IPPA agreements' implementation will be crucial. If the tool proves effective, it will become popular with investors, including foreign ones, while procedural bureaucratisation or unfair evaluation of investor costs will discredit IPPAs and deepen the investment slump.

PITFALLS FOR INVESTORS SIGNING IPPAS

Signing an IPPA requires significant legal and communications homework on the part of the investor.

According to the rules, in addition to the standard set of documents (registration information, financial records, etc.), an IPPA application must be accompanied by, i.a.:

- the project business plan;
- the financial model with projected data (turnout/export/etc. volumes);
- a construction permit (for projects implying capital construction);
- a list of central and regional laws and regulations with fixed conditions when the agreement is signed;

- application for any contracts previously signed with the Government to be recognised as related agreements (concession, PPP or other contracts establishing preferences for the investor).

To obtain subsidies, an investor needs to engage, at its own expense, an expert organisation to conduct a technology and price audit and to obtain a state expert review certificate. This makes the preparations for the signing time-consuming and costly.

A prerequisite for receiving maximum preferences is work by the investor with key stakeholders at three levels:

- Federal
  - Ministry of Economic Development (*signs IPPAs on behalf of the federal authorities*);
  - autonomous non-profit organisation Agency for Investment Development *(supports signing, amendment and termination of IPPAs);*
  - ministries and agencies directly or indirectly involved in preparing for implementation of projects *(agencies to be involved depending on the nature of the project and the permissions required).*
- Regional (constituent entities of the Federation)
  - regional authority authorised to sign agreements *(the constituent entity of the Russian Federation where the investment project is to be implemented is a mandatory party to the IPPA);*
  - other authorities at the regional level involved in the preparations for the IPPA *(depending on the nature of the project);*
  - local legislature (administration, competent commissions, expert boards, etc.) – *for project agreement, required approvals, etc.*
- Municipal
  - deputy councils (permanent and ad hoc commissions, deputy corps, etc.). *Land allocations and other permits;*
  - city mayors *(key negotiators for project municipal support measures);*
  - NGOs *(public hearings on projects, where necessary).*

AGENCY FOR INVESTMENT DEVELOPMENT AS THE KEY STAKEHOLDER

The Agency for Investment Development is an organisation founded specifically for supporting IPPA projects.[10] In October 2020, First Deputy Minister of Economic Development Andrey Ivanov took over the Agency.

In July 2020, Andrey Ivanov joined the Ministry of Economic Development, leaving the Ministry of Finance, where he had worked on investment matters. Previously, the differences between the two ministries had prevented the IPPA Law from being developed. Ivanov is considered one of the people responsible for the draft document.

The Agency is supposed to act as a de facto contractor of the Ministry of Economic Development, processing IPPA applications and supporting documentation. Such a model had previously been used by the Ministry of Industry and Trade with the Industrial Development Fund, with mixed results, which were at times not fully effective for investors.

[10] Registered in September 2020 as an affiliate of autonomous non-profit organisation Investment and Technological Development.

Although the full scope of the functions and mandate of the AID are yet to be determined, it is to act as the main screener of potential agreements and no IPPA will be signed by the Ministry of Economic Development without the Agency's approval.

AID is also likely to liaise with the regional offices of the competent authorities, thus fully overseeing the agreement preparation procedures.

AID may also act as the 'middleman' for arranging loan financing and additional preferences for investors from development institutions. It is co-founded by:

- The Industrial Development Fund (IDF)
    - offers co-funding for projects focusing on developing hi-tech products, import substitution, industrial machinery production, digitalisation, etc. SPIC operator
- The Skolkovo Foundation
    - Russia's biggest innovation hub developing and commercialising new technologies
- VEB.RF
    - government corporation funding major infrastructural and industrial projects, including as part of the National Projects.[11]

The Agency for Investment Development is therefore the key stakeholder for investors looking to sign IPPAs.

POTENTIAL CHANGES IN THE INVESTMENT LAW

The Government has announced its plans to improve the IPPA legislation in the coming months.

The amendments are aimed at:

- Adjusting the investment thresholds for IPPAs:
    - lowered thresholds will aim to make IPPAs attractive to small and medium-sized businesses, which have been experiencing a much bigger slump in investment than large companies.[12] In reality, however, it is highly unlikely that this mechanism will be of much use to small businesses.
- Expanding the preference range:
    - among other things, investments in R&D, design and experimental work are to be included on the compensation list;
    - another possible measure is to stabilise the tariffs of natural monopolies (e. g., Russian Railways).
- Modifying the procedures for investor cost compensation:
    - gradual transition from subsidies to tax deduction mechanisms.[13]
- Introducing public project initiatives:
    - the existing regulations do not cover public project initiatives (investment projects to be initiated by the Government), even though such an option is envisaged by the IPPA Law.

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[11] Federal-scale projects adopted in Russia in 2018 in 13 areas, to be implemented by 2024.

[12] SMEs account for almost 21% of all investments in monetary terms. According to some assessments, small-company investments dropped by 36% in QII 2020.

[13] A tax deduction is an amount by which the tax base is reduced or partial return of previously paid tax in cases envisaged by the law.

CONCLUDING THOUGHTS

While the blueprint IPPA apparatus clearly appears convoluted and incomplete, it is clear that the Government is assigning this instrument a central role in attracting investment in the crisis and post-crisis periods. The largest Russian companies from various sectors of the economy have already shown interest in IPPA and the overall level of pre-agreements signed is intriguing. The Government is clearly looking for opportunities to use IPPA to attract foreign capital as well.

Existing gaps in the legislation framework, excessive bureaucracy in the application procedures and the time and money involved in preparing an agreement, however, still pose risks for investors. Nevertheless, these kind of agreements may prove a means of securing competitive advantages for companies already doing business in Russia, and as well as those potential new investors weighing up a route into the market.

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