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Investment Protection & Promotion Agreements

Navigating Russia's New Investment Code for Government Relations

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On April 1, the Law "On Investment Protection and Promotion Agreements in the Russian Federation" (IPPA) was adopted, aiming to support and encourage large-scale investment projects in Russia, as the country looks to grapple with the twin pressures of a sustained fall in inward investment and the economic impact of the pandemic crisis. Over the last two months the Government has intensified the development of the necessary by-laws, as it turns attention to the implementation of the new program ahead of its true launch in 2021[1].

The new law unveils a set of incentives aimed at both existing and potential future investors. IPPAs will take a similar form to SPICs (Special Investment Contracts), first launched in 2014 and updated last year, but with some crucial differences (discussed below). This document examines some of the key criteria and features of the new regulation surrounding IPPAs, as well as their potential impact on the investment climate.

Overview & Background

An IPPA will effectively be a bespoke contract between a company and the State that outlines a range of state support measures dedicated to a particular investment project, whether directly (via compensation from the state budget) or indirectly (via regulatory adjustments). The new mechanism is applicable both to new and existing projects (as long as they have commenced after May 2018), although the first wave of IPPAs are expected to be signed no earlier than 2021 and a range of sectors are excluded (including retail, construction, gambling, tobacco, alcohol – see below for full list). There are three potential state parties to an IPPA - governmental bodies at the regional level, although both federal and municipality agreements may also form part of the overall support. In reality, of course, all decisions on major investments will require blessing on the federal level as before.

Formally, the stated objectives of the new IPPA regulations are to[2]:

[1] Please see the timetable for adoption of the by-laws necessary to implement the law in Appendix. Table 3.
[2] Interestingly there were no calculations published on whether other investment instruments previously launched in Russia like SPIC 1.0 etc. managed to achieve the objectives set for them.

- increase the share of investment in GDP (from 20% to 25% according to President Putin's decree in March 2018);
- intensify the investment infrastructure the Government has been relying on in recent years to stimulate economic growth;
- attract long-term investments by improving the investment climate.

The law was originally conceived as an entire new investment code, intended to reconfigure a new range of instruments between the State and businesses involved in large investment projects. However, the new policy has been diluted solely to the introduction of the IPPA, thus losing "investment code" status and suggesting that additional investment promotion measures may well be introduced later on.

As such, it appears that the **Government will remodel its inward investment policy incrementally**, rather than in one systematic and holistic move. It is important to note, therefore, that IPPAs may be used alongside other, pre-existing investment support mechanisms (such as SPICs, public-private partnerships, special economic zones, etc).

Kesarev's analysis of the new legislation reveals it to be quite a complex policy move, both in form (there is no executive legislation) and content. It has been drafted over the past two years and originally focused on a set of objectives which have since largely become irrelevant, particularly so since the onset of the pandemic crisis. The State's needs have also changed dramatically in recent months: **the challenge now is less one of attracting immediate investment, rather one of preventing outflow and maintaining current levels**.

The current wording of the Law fails to reflect this new agenda, proving again that economic instruments alone will not transform the Russian investment climate. Far-reaching cultural changes around the sanctity of the rule of law, an independent judicial system and protection for intellectual property are just a number of the remaining, significant hurdles for investor confidence. Without major political will and support from the highest levels, it remains to be seen how much of an impact the IPPA mechanism can be expected to make.

Despite these and other significant reservations, though, it is clear that a new investment infrastructure in Russia may be formed primarily around this law, possibly to be complemented by a set of other options (connecting financial and development institutions, the Central Bank, etc.). Earlier this year, the Ministry of Finance announced it intends to use the new mechanism to attract 30 trillion rubles (approximately $424bln) of inward investment, concluding 100-150 IPPA agreements annually. This creates a window of opportunity and certain incentives for companies considering large investments into Russia.

Understanding and engaging with the IPPA program, therefore, will now be crucial for potential investors. In the following sections, we analyse in more detail some of the key features of the new regulations.

# # #

1. What is an IPPA?

An Investment Protection & Promotion Agreement will take the form of a tailored contract between the State and the investor, outlining regulatory and other key commitments on a particular, qualifying investment project. Such measures are divided into both indirect support (regulatory adjustments) or direct support (via compensation from the state budget), the key features of which are outlined below.

The key, indeed obligatory, party to an IPPA will be a regional government, although the law allows additional support at both federal and municipal levels. The IPPA mechanism is intended to intensify the conclusion of new agreements not necessarily dealing with innovations (as opposed to SPICs) and also to simplify the procedures for concluding such agreements: SPICs, Public-Private Partnerships (PPPs) and concessions have notably difficult procedures, although it seems investors may be abe to combine them with an IPPA moving forward.

Indirect measures of support

"Stabilization obligations" ensure that the regulatory conditions of a project will remain the same for a certain period defined at the outset. These are tax and other guarantees to ensure that business conditions for the investor do not worsen over a project's lifetime. It is not a question of reducing taxes, but rather of keeping the rate, taxable items and payment procedures the same under certain conditions.

Direct measures of support

- Reimbursement of an investor's expenditures on the construction of infrastructure up to the amount of taxes paid during the implementation of a project;
- Long-term supply conditions for goods sold by natural monopolies within the investment project;
- A minimum acceptable rate of return is guaranteed under certain conditions.

2. Who Will Qualify for an IPPA?

Both foreign and domestic entities and individuals may apply for an IPPA (and are given equal status under the law), as long as they are implementing new investment projects *(see below for definition)* of sufficient value (200 million rubles/approx. $2.7m) and with a significant "infrastructural component" (e.g. transport projects, projects in metallurgy, petrochemical industry, forest processing, ecology, as well as agro-industry and the digital economy).
Specific qualifying criteria differ across sectors and regions (see table 1 below), and the following industry sectors are excluded:

- Gambling;
- Manufacturing of tobacco, alcohol, liquid fuel (except for coal from oil refining plants);
- Wholesale and retail trade;
- Activities of financial institutions under the supervision of the Central Bank;
- Construction (renovation) of residential buildings and commercial real estate.

Table 1. Public Parties to IPPAs

Party	Application/Area	Minimum Investment RUB (approx. US$)
Constituent entities of the Russian Federation	Moscow, St. Petersburg	RUB 200m ($2.7m)
	Other regions	RUB 200m – RUB1bn ($2.7m - $13.6m)
Russian Federation involving constituent entities of the Russian Federation	Healthcare, education, culture, physical culture and sports	RUB 250m ($3.4m)
	Digital economy, ecology, agriculture	RUB 500m ($6.8m)
	Manufacturing	RUB 1.5 bln ($20.5 m)
	Other areas	RUB 5 bln ($68m)
Municipal units	The same as for federal-level IPPAs	Similar to the investment amount under federal-level IPPAs

According to the law, all IPPAs assume the region in which a project is being implemented will be party to that IPPA on behalf of the State: a key advantage for investors is that if their project meets the requirements, regions will have no grounds to refuse their investment. The Federal Government and municipal units may participate alongside regions in individual IPPAs.

The new regulation defines a *new investment project* as follows:

- A project with its capital expenditure budget approved after the enactment of the Law (an entity may apply for the agreement within one year following its budget approval);
- A project with its capital expenditure budget approved before the enactment of the Law, but no earlier than 7 May 2018 (when President Putin's third term started). Such IPPAs

may be entered into before the end of 2021 (to be fully deployed before 2024 when the next Presidential elections are held).

These strict time limits for entering existing projects into agreements may stem from both technical considerations (the final stage of development of the law fell in the pre-crisis period) as well as the Government's attempts to accelerate decision-making on entering into IPPAs by investors as an anti-crisis measure.

3. Applying for an IPPA

The Law currently stipulates two procedures[3] for entering into an IPPA:

3.1 Private project initiatives:

- IPPAs may be entered into at the initiative of private investors and unlike SPICs, private project IPPAs will not require a competitive bidding process. To make an agreement, an application must be filed with the authorised federal executive body. Applications must include:
  - application for the conclusion of the IPPA indicating the parties to the contract;
  - draft of the IPPA;
  - business plan;
  - financial model of the investment project;
  - decision on approval of the capital expenditure budget;
  - building permit and other relevant documents;
  - other relevant documents.

- The procedures and modalities for dealing with such applications are not yet in place and must be determined by executive legislation of the Government (see table 3). Those projects with a pre-approved capital budget may be eligible for IPPA conclusion by the end of 2021, while for new projects it will be possible to agree up to January 1 2030.

3.2 Public project initiatives

- IPPAs may be entered into at the initiative of federal and regional executive bodies. In such cases, the relevant authorities will publish a declaration on the implementation of an investment project and hold a tender to select the implementing entity.

- The public project initiatives are expected to become widespread as a toll for the implementation of national project activities at regional and federal levels.

[3] Details of the procedures and order for entering into and termination of an IPPA must be specified in by-laws.

4. IPPA Support Measures: An Overview

The IPPA Law provides a number of State support measures aimed at providing legal and regulatory stability for investors. The Law does not provide stability with respect to the technical regulation and tariffs, and nor does it refer to reduced tax rates (as is the case, for instance, when entering into special investment contracts). Rather, it guarantees that existing conditions at the outset of a project will not worsen[4] (the so-called Stabilisation Clause – see below), a focus seen as a pre-emptive response to the forthcoming recession on the back of both the oil price stand-off and the pandemic crisis.

Below we introduce an outline of the key categories of measures as they are currently defined.

4.1 Stabilisation Clause (Tax Burden Guarantees)

- Tax laws introduced after an IPPA agreement is recorded in the dedicated register will not apply to IPPA participants.
- However, the stabilisation clause does not cover new taxes and levies if they are imposed on similar objects[5], and are introduced instead of taxes and levies that existed as at the date of recording the agreement in the register.
- The stabilisation clause scope varies depending on the public party to the IPPA. Overall, IPPAs entered into with a Russian region only are characterised by the minimum volume of "stabilisation" guarantees, while agreements involving the Russian Federation and municipal units (together with regions) provide for the maximum support (see table 2 below).
- Therefore, if a project meets certain parameters, involving all three levels of public participants would be the most beneficial option. However, an extended composition of participants on the part of the Government may entail additional risks and expenses for project administration.
- The duration of the stabilisation clause may not exceed the IPPA term and depends on the amount of investment[6]:
    - 6 years (<RUB 5 bn / $68m);
    - 15 years (RUB 5-10 bn / $68m – $136m);
    - 20 years (>RUB 10 bn / $136m).

[4] As the tax stabilisation clause only applies to an IPPA project, the separate tax accounting requirement is imposed on the private party to the agreement. The Law also enables the creation of a separate *project company* engaged in the implementation of the IPPA investment project only.
[5] Taxation of similar objects is to be clarified in by-laws.
[6] Furthermore, the duration specified may be extended on a single occasion for 6 years if the investor meets either of two conditions:

1. the investor undertakes to reinvest at least RUB 1 billion ($13.6m) of income received from the investment project into this project or another investment project;
2. the investor enters into agreements with SMEs for the total value amounting to at least 18% of the project expenditure side over the duration of the stabilisation clause less one year.

Table 2. Applications of the Stabilisation Clause

Party	Stabilisation Clause Target
Russian region, Russian Federation and Municipal Unit	• Income tax (taxable item, tax base estimation procedure, tax period, tax rates, assessment procedure, payment procedure and due dates); • Property tax and transport tax (tax base, tax rates, tax benefits, payment procedure and due dates). • Land tax (tax rates, tax benefits, and payment procedure). • VAT (in terms of due dates and refund). • Non-application of new taxes (the restriction does not apply to the new taxes introduced to replace the similar old ones).
Russian Federation involving regions	• All of the above except for the land tax clause.
and Municipal Units	• Stability of tax treatment with respect to property tax, transport tax and land tax.
Constituent Entities of the Russian Federation	• Stability of tax treatment with respect to property tax and transport tax.

4.2 Compensation for Infrastructure Expenses[7]

- The Law provides for the compensation for expenses for the creation of infrastructure:
  - Enabling infrastructure (necessary for the project only): up to 50% of expenses are compensated out of the budget;
  - Supporting infrastructure (necessary both for the project and for other purposes: motor roads, utilities, etc.):
    - up to 100% of expenses are compensated out of the budget;
    - the ownership of the supporting infrastructure created is generally transferred to the Federal (municipal) Government.
- Compensation may be provided subject to a range conditions and a range of criteria:
  - Compensation is provided by results of the assessment of alternative funding options (similar to the financial and economic audit);
  - The maximum amount of expenses to be compensated for is limited to the amount of taxes and levies to be received at the federal, regional and municipal levels.

[7] Obtaining any compensation from the State could prove difficult and time-consuming and this may become even more challenging due to the economic constraints caused by the COVID-19 pandemic.

- Compensation may only be provided after the investment stage of the project has been completed and the private entity has made the proposed investment in full.

4.3 Guarantees, Benefits & Preferences for Especially Large Projects

- For especially large federal-level investment projects (over RUB 10bn/approx $136m), a range of special preferences are provided:
  - No increase in export customs duties;
  - No increase in the environmental impact fee, fee for the use of water bodies, utilisation and environmental fees (the guarantee covers the first 3 years following the enactment of the regulation that entail changes);
  - No increase in rates of the forest withdrawal charge and rent for the use of forest areas.

- In addition, investors of the largest projects (transport projects for over RUB 300 bn/approx. $4bn) are entitled to demand that the Government compensate them for damages and lost income if the Russian Federation or its constituent entities implement alternative projects that directly threaten the original project.

4.4 Other Guarantees & Benefits

- The rules that extend the time limits for procedures, set additional requirements, and increase of project payments will not apply to the signed IPPA agreements or those projects subject to an IPPA;
- Investors may also claim subsidies, concessional loans and long-term delivery of goods by natural monopolies[8];
- Another provision stipulating an opportunity to have the guaranteed minimum income set as part of the project also requires clarifications in by-laws.

4.5 State Support Inventory System

One key provision of the new regulations not directly associated with the IPPA program concerns the unification of State support measures provided to the business community. For instance, the Law contains provisions on the formation of a *single electronic register for State and municipal support measures* – the so-called "investment navigator":

- The information system to support the maintenance of the register will be launched within one year of the publication of the Law, i.e. by 1 April 2021;
- The information system will be operated by the Federal Treasury and upon its launch, all IPPAs and supporting documents will be converted into electronic formats.

[8] These parameters are to be clarified in by-laws.

Thus, a general system of State control over liabilities of budgets at all levels – Federal, regional and municipal – is being shaped. In the foreseeable future, we may therefore expect to see an integrated system for evaluating the performance of the State investment policy, the basis of which is enshrined in the IPPA Law.

5. Prospects for the IPPA Program Launch & Concluding Remarks

The new law around IPPAs is not yet applicable in practice due to the lack of executive legislation outlining a number of procedural issues, without which it cannot operate. According to the schedule of Government measures required for the launch, the key issues should be resolved by October 1 of this year *(see table 3)*.

It is fair to assume, therefore, that the law may yet undergo significant changes, given the executive legislation will largely determine procedural aspects of the agreements' conclusion and practical aspects of investment accounting. Moreover, the process of the law's implementation will add to these changes when the economic ideas behind IPPA run into the political reality of the current investment climate in Russia. The investment accounting system[9] (likely to be handled by the Ministry of Finance and Federal Tax Service) could turn out to be cumbersome, resource-intensive and therefore inefficient from the point of view of private companies.

If one then factors in the fairly strict timetable for the conclusion of IPPAs on existing investment projects, as well as likely future additional measures to alter the investment landscape, then it is clear that a thorough and complete evaluation of the IPPA mechanism is not yet possible. However, it does constitute a clear statement of intent by the Government, which should encourage long-term potential investors (particularly due to the potential for stability guarantees, related tax incentives and long-term government contracts).

Further monitoring of the IPPA mechanism as it evolves and is implemented, therefore, will become a major focus of both potential and existing investors.

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[9] The law provides for the establishment of a state information system «Capital Investment», which will contain information about IPPAs.

APPENDIX

Table 3: Timeframe for Adoption of IPPA Executive Regulations

<table>
<tr><th>Provisions of the IPPA law which are regulated by executive legislation</th><th>Type of a legal act and a responsible federal authority</th><th>Timeframe</th></tr>
<tr><td>Provisions concerning the conclusion of IPPAs, monitoring the implementation of agreements and liability for violations:
• Procedures for the agreement conclusion, i.e. procedures for carrying out competitions within the framework of the public project initiative.
• Procedures for modifying and terminating the agreements, details on disclosure of information concerning beneficial owners of the investing company.
• Agreement template.
• Procedures for the implementation of monitoring phases of the investment project.
• The form of a declaration for an investment project carried out under a public project initiative.
• An authorized executive body that concludes IPPAs on behalf of the Russian Federation.
• Procedures for keeping of the IPPA register.
• Liability for violation of the IPPA terms and conditions, including the methods of assessing damages that are to be reimbursed by a project investor and/or the Russian Federation or a Russian region</td><td>Government decree.

Ministry of Finance, Ministry of Economic Development.</td><td>Before July 1 2020.</td></tr>
<tr><td>Provisions concerning infrastructure construction as part of the IPPA projects and cost reimbursement
• Procedures that determine the level of cost reimbursement for the money spent on associated or supporting infrastructure and reimbursement rates.
• Grounds for classifying an object as associated or supporting infrastructure.
• Procedures for the assessment of options for financing the costs of infrastructure construction or modernisation.
• Procedures for interaction with regulated organizations in order to verify that there is an "infrastructure" component outlined in their investment projects.
• Procedures for providing the information on taxes, charges and customs duties paid by an investor in process of project implementation.</td><td>Government decree.

Ministries of Finance, Economic Development, Industry and Trade, Construction Industry, Housing and Utilities Sector, Energy, Digital Development, Communications and Mass Media, Health, Natural Resources and the Environment, Education.</td><td rowspan="2">Before October 1 2020.</td></tr>
<tr><td>Provisions on keeping of the state support measures register
• Procedures for keeping the register of state support measures.
• Creation and operation of the state information system "Capital Investment".
• Procedures of submitting applications for investment projects in the framework of a private project initiative.
• Etc.</td><td>Government decree.
Ministries of Finance, Economic Development, Digital Development, Communications and Mass Media.</td></tr>
</table>

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About Kesarev

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