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THE PROSPECTS OF INVESTMENT IN THE MARITIME INDUSTRY OF RUSSIAN FAR EAST

(Prospects for Maritime Industry Investment)

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ABSTRACT

The article considers the current state of the merchant and fishing fleet of the Russian Federation carrying out domestic cargo transportation and fishery operations in the Eastern sector of the Arctic and the adjacent seas of the Far East. Taking into account the high degree of physical and moral wear of the greater part of vessels under Russian flag as well as the necessity to accomplish the goals set by Maritime Strategy of Russia, a mechanism for radical fleet modernization has been proposed. The leasing of merchant and fishing vessels from the Republic of Korea and the introduction of cooperative arrangements between shipbuilding enterprises of the two countries represent two possible options for this modernization program. Regional authorities in the Far East of Russia may act as the guarantees for the foreign investments utilizing recent changes in domestic legislation.

Keyword: merchant fleet, fishing vessels, investment, leasing of merchant and fishing ships.

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1. Introduction and Overview

Accelerated social and economic development of the Far Eastern regions is a priority for the Russian Federation. Strategic planning in this area is complicated by the huge spatial dimensions of the territories and the uneven economic, infrastructural and demographic level of development of its administrative units[1]. Insufficient scientific support is complicating the feedback mechanism creation for taking into account the priorities of the Center and the Periphery, the state and business interests [6]. At the same time, there is an understanding in the Russian Federation that the integration of the Far Eastern territories with the economies of the neighboring states of Northeast Asia is certainly a necessary condition for their development. However, there is no clear understanding exactly how such integration should be implemented, what measures of a regulatory nature should be applied to attract foreign investors to projects in the Far East of Russia. Accordingly, potential foreign partners are in no hurry to join the economic projects in the Far East, rightly fearing investment risks and uncertainties.

Maritime industry is an important element of Russia's economic system in the Far East, acting as a principal interconnecting transport artery (merchant fleet) and as one the main productive factor of regional economic (marine fishing fleet). It is likely that the development of international cooperation in this area may have the best prospects in terms of minimizing investment risks and the relatively fast commercial profitability achievement. Therefore, one of the possible mechanisms for mutually beneficial practical cooperation in the field of maritime activities between the Far East of Russia and the Republic of Korea is proposed in this article.

The North - Eastern provinces of the Russian Federation, namely Magadan *Oblast'*, Kamchatsky *Krai*, Chukotka Autonomous District, the coastal and Arctic regions of Sakha - Yakutia Republic and the coastal regions of Khabarovsky *Krai*, are located in extreme climatic and geographic conditions and lack land transport connectivity with the 'mainland'. There are practically no opportunities to produce vital food and energy resources in the required volumes necessary for the physical survival of the population and economic activities on site. Table 1 shows the data on the dependence of remote and island territories of the Russian Federation on the import of vital commodities and materials. (The data provided in this paper generally refers to 2014, exactly before the Western sanctions have led to a distortion of the normal course of economic processes.)

Historically, the operations for the delivery of cargo and materials to the North-East of Russia have been given the status of a national campaign code - named "Northern Delivery" [3; 8; 10].

1) Official Russian term for administrative territorial units is "Subjects of [Russian] Federation". We use "provinces" instead as the more understandable term in this paper.

Table 1. Import of products and materials to the North - Eastern regions of Russia(sample), 2014

Region	Commodities, % of total consumption									
	Food					Energy resources				Clothes, footwear
	Potatoes	Milk products	Meet products	Vegetables & Melons	Eggs	Coal	Diesel fuel	Gasoline	Heavy fuel oil	
Kamchatsky *Krai*	5,4	68,2	80,0	39,5	29,1	81,0	100,0	100,0	100,0	90,3
Magadan *Oblast'*	22,4	80,0	91.9	68,7	28,3	56,3	100,0	100,0	100,0	89,9
Sakhalin *Oblast'*	2,8	68,1	92,2	26,6	3,7	0,3	-	-	-	87,5
Chukotka Autono-mous District	93,5	86,1	29,4	78,6	74,3	27,2	100,0	100,0	100,0	94,8

Source: [14; 15]

The absolute majority of these commodities are delivered by water transport. Inland transport (along the rivers Lena, Kolyma, Yana, Indigirka) play an important role in the distribution of flows and the delivery of transit cargo to the end user. However, river navigation is limited in time and complicated by the presence of serious navigation restrictions. The main volumes of cargo and materials are delivered by sea. Also, the products of resource-producing enterprises are transported by, both for domestic and export consumers.

The existing transport and logistics infrastructure of Russia in the Far East is attracted to the southern non-freezing ports linked with the Trans-Siberian Railway (TSR) and the international transport corridors 'Primorye-1' and 'Primorye-2'. It is no coincidence that the ports in Southern Primorye are considered to be the "entrance gates" of both the "Northern Delivery" and the Northern Sea Route (NSR). Hence, internal maritime transportation originating from the ports in Primorsky *Krai* ensure the livelihoods of the North - Eastern regions of Russia with food by 65-70 %, coal - from 30 to 85 %, liquid fuel (gasoline, fuel oil, diesel fuel, etc.) - almost 100 % of total consumption [4; 7].

Thus, the peculiarity of maritime transportation in the Far East of Russia and in the Eastern sector of the Arctic is its huge spatial extent (for example, the distance between Vladivostok and Tiksi ports is 4,133 nautical miles) and complicated navigational conditions (heavy ice, insufficient hydrographic support and emergency rescue capacity, communication problems in high latitudes). This dictates the serious requirements for the qualitative parameters of the freight and auxiliary vessels used.

The maritime fishing fleet in the Far East annually catches about 3 million tons of marine biological resources, which is more than 2/3 of the total Russian catch [5; 14].

Meanwhile, the maritime industry in the Far East of Russia is facing serious infrastructural challenges from an engineering standpoint. Let us illustrate this with examples, analyzing the current ship composition of both merchant and fishing fleet assets.

The structural and quantitative indicators for the merchant ships under the Russian flag in the Far East are shown in Figure 1 and Table 2 (based on the data provided by Russian Maritime Register of Shipping).

Figure 1. Merchant fleet assets structure

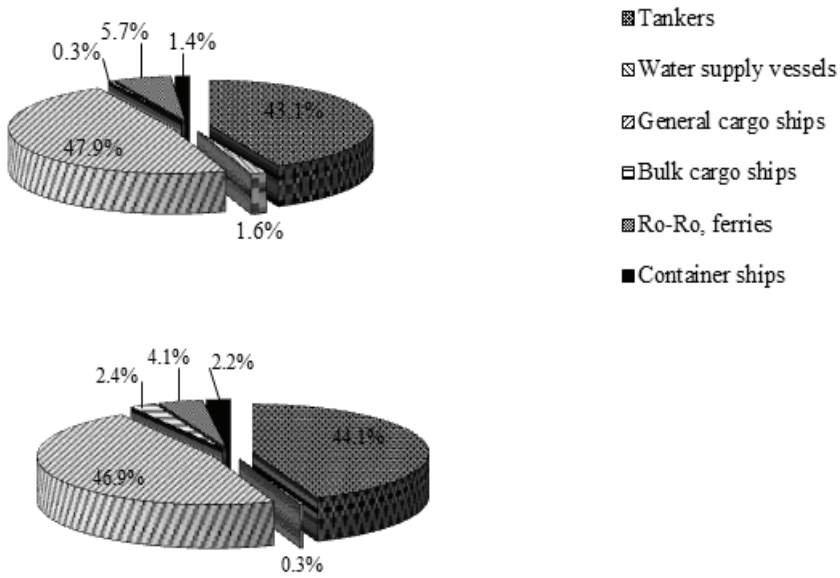
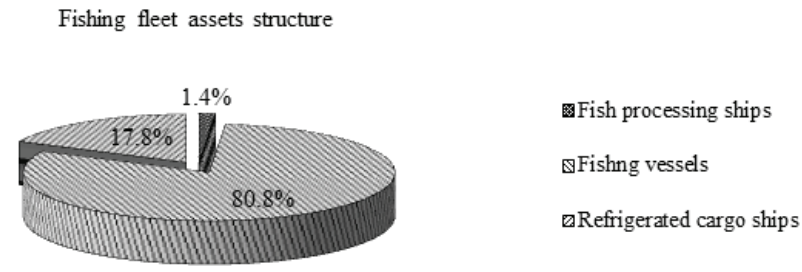


Table 2. Merchant fleet assets: quantitative indicators [13]

Ship type	Number of ships	Combined deadweight, thousand tons	Average deadweight, thousand tons	Average age of ships, years
Tankers	143	555,1	3,9	28,5
Water supply vessels	6	3,8	0,6	32,7
General cargo ships	159	590,2	3,7	28,1
Bulk cargo ships	1	30,0	30,0	27,0
Ro-Ro, ferries	19	52,0	2,7	25,6
Container ships	4	26,4	6,6	32,2
Total:	332	1257,5	3,8	29,0
For reference:	*173 companies including 23 registered abroad have been accounted as shipowners.*			

The indicators for the fishing fleet assets are generally similar.



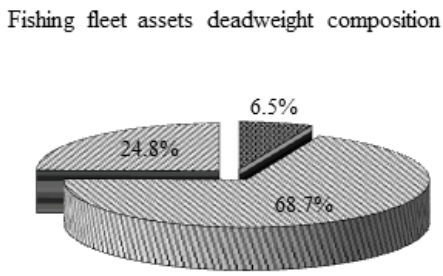


Table 3. Fishing fleet assets: quantitative indicators [13, 14]

Ship type	Number of ships	Combined displacement, thousand tons	Average displacement, thousand tons	Average age of ships, years
1	2	3	4	5
Fishing fleet vessels total: Including:	699	1483,5	2,12	26,5
- Fish processing ships	10	96,0	9,6	24,4
- Fishing vessels	565	1018,8	1,8	27,8
- Refrigerated cargo ships	124	368,7	2,97	27,4
For reference:	*254 companies have been accounted as shipowners.*			

Note: deadweight is indicated in columns “Combined displacement, thousand tons” and “Average displacement, thousand tons” for refrigerated cargo ships.

As a result, it is obvious that an absolutely largest part of merchant and fishing vessels have been operated beyond the normative period. This creates threats:

- Disruption of internal maritime traffic, which entails interruptions in ensuring the livelihoods of the North - Eastern regions of Russia and forms prerequisites for a humanitarian catastrophe in these territories;
- Reduction in marine biological resources extraction which entails a decrease in export earnings to the budget of the Russian Federation, and may adversely affect the economy of the East Asian countries which are the main consumers of these products.

We must admit that these problems have not yet been fully recognized by the federal government of Russia as well as the leadership of the Far Eastern provinces,

which is confirmed by the absence of any policy documents whose content is aimed at preventing these challenges. It should be noted that the long-term plans for the development of the Russian Federation maritime fleet as a whole are more oriented toward ensuring the export of Russian raw materials and do not specifically consider the development of the internal shipping and fishing fleet in the Far East [10].

The low level of financial self-sufficiency and heavy dependence on federal budget subsidies predetermines a practical inability of the Far Eastern provinces to solve the problem of fleet modernization independently. According to authors' estimations, the budgets of these entities are formed at the expense of their own incomes by 36.7% - 58.5% only, and the periodically arising budget deficit is covered by subsidies and subventions from the budget of the Russian Federation [4; 15].

Table 4. Indicators of the budget system of North – Eastern provinces of Russia (sample, 2014).

Territory	Consolidated budget revenues, billions Rubles:		Budget self-sufficiency, %	Consolidated budget expenditures, billions Rubles.	Deficit (-) / Surplus (+) of the consolidated budget, in percent of income
	Total	- including at the expense of the federal budget and other third-party sources			
Kamchatsky Krai	62 399,8	39 466,2	36,7	63 527,1	- 1,8
Magadan Oblast'	26 831,5	11 172,1	58,4	31 189,4	- 16,2
Sakhalin Oblast'	155 477,8	8 431,9	94,5	132 371,5	+ 14,8
Chukotka Autonomous District	21 385,4	10 557,6	50,6	22 339,8	- 4,4
Sakha – Yakutia Republic	172 332,9	71 407,0	58,5	177 367,4	- 2,9
Khabarovsky Krai	98 449,4	24 614,0	75,0	113 628,5	- 15,4
For reference: Far Eastern Federal District	704 640,3	210 592,8	70,1	725 174,8	-2,9

Note: budget self-sufficiency is the proportion of the budget's own revenues in its consolidated revenues. Source: [14]

Note that the current economic development of the Russian Federation is based on the principles of public - private partnership and program - targeted development.

Public - private partnership implies cooperation of the state and business in solving any large-scale social and economic tasks. The state is responsible for the creation of various conditions and favorable environment for the implementation of the projects and awarding of benefits to project participants, while the business entities accomplish the commercial activities for implementation of the project goals.

The program - targeted development presupposes that the solution of the tasks of social and economic development of regions and industries is carried out on the basis of program planning of activities adequate in its composition to business planning process.

These principles reinforce the essential role of private initiative, the participation of private investors in the implementation of social and economic development of the regions, at least theoretically. Russian legislation allows foreign investors to partic-

ipate in solving social and economic problems on the territory of the Russian Federation in the manner and under the conditions provided for by the federal law No. 160-FZ "On Foreign Investments in the Russian Federation" dated July 9. 1999 [1]. This law has introduced a set of guarantees to foreign investors, including a guarantee of legal protection for the activities of a foreign investor, free transfer of profits and revenues obtained here to the outside financial institutions, property rights, etc.

Now about the authors' view on the ways of solving the problems with fleet modernization, utilizing the available legislative preferences and potential interests of investors from the Republic of Korea.

Logically following the above mentioned situation analysis and projecting its results in the perspective of 10-15 years, Russia will have to update the structure and composition of both internal merchant and fishing fleet assets in the Far East, building dozens of freight ships and at least about a hundred large and medium fishing vessels. Taking into account that domestic shipbuilding industry in the region is not ready to solve this task, it is proposed to acquire these assets from Korea.

The implementation of this project may be carried out according to the leasing scheme within the framework of the UNIDROIT Convention "On International Financial Leasing". Wherein:

- The Korean side builds and delivers maritime freight and fishing vessels, acting as a lessor;
- Russian shipping and fishing companies act as customers of sea vessels, being a lessee;
- State bodies of Far Eastern provinces act as guarantors of fulfillment of obligations on the part of Russian lessees - shipping and fishing companies.

As mentioned earlier, the Russian Federation officially welcomes foreign investments, providing foreign investors with various benefits. In particular, a system of tax and customs privileges is provided for leasing operations, the Far Eastern provincial authorities are empowered to grant individual preferences to foreign investors, for example, permitting payments for the leasing of fishing vessels by targeted supply of fish products.

It is also feasible to propose the creation of medium-tonnage shipbuilding production enterprises for constructing sea-going freight and fishing vessels on the Pacific coast of Russia, on the basis of production cooperation with clear distribution of functions. Similar production scheme has long been successfully used on the Baltic Sea between Russian and Finnish shipyards. Implementation of this scheme in the Far East with Korean partnership based on the 'Free Port of Vladivostok' residents' mechanism [2] will guarantee a substantial package of benefits for both sides.

The organization and coordination of the proposed forms of cooperation can be carried out at the regional level. Though power control mechanisms in modern Russia tend to be hyper - centralized to a large degree, the Far Eastern provinces still have the appropriate power capacity fixed by law. This allows trimming and adjusting of the implementation investment processes in relation to the needs of a specific region, as well as testing the mechanism of investment on relatively small projects, which significantly reduces risks and raises reliability.

The economic results of investments in the above-mentioned projects seem quite promising to us. Thus, the renewal of the sea freight and fishing fleet provides for the supply of several dozen cargo ships and hundreds of fishing vessels (preliminary assessment). This provides long-term workload for South Korean shipbuilding companies. Another income aspect for Korean investors is the maintenance (warranty repair) of the constructed ships, its technical modernization. Other forms of income generation by South Korean investors are possible too, for example, training of service personnel for ships' equipment. The substantive content of other forms of income sources may be determined by interviewing representatives of the Russian maritime industry.

Minimization of risks for Korean investors is achieved through the use of a leasing scheme, in which payment for ships supplied by Korean factories is carried out (according to an agreed plan) by Russian leasing organizations. The risk of untimely payments by Russian shipping and fishing companies operating vessels in leasing will be assigned to Russian leasing organizations.

A possibly important role in implementing these tasks may belong to the Korea - Russia Research Center jointly created by the Korean Maritime Institute and the Admiral Nevelskoy Maritime State University (Vladivostok, Russia). This is explained by the large scale of preliminary on-site research and coordination activities between Korean investors and regional Russian actors (federal and regional authorities, business, environment protection NGOs, public opinion makers) needed for successful cooperation projects.

As indicated above, there are 173 shipping and 254 fishing companies in the Far East of Russia, whose activities are supervised by the administrative bodies of seven provinces. To organize and maintain successful cooperation between the Russian and Korean sides it is obviously necessary first to establish direct contacts with:

- shipping and fishing enterprises of the Far East of Russia, to analyze their financial and economic situation, identify their needs in new vessels and technical equipment;
- provincial administrative bodies in the Far East supervising maritime related activities, to evaluate their interests, priorities, competence and readiness for cooperation.

We should also take into account the existing and possible restrictions on the part of national and international legislation concerning the import of Hi-Tech products, including vessels and sophisticated ship equipment.

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