

# Government support for the Russian shipbuilding industry: Policy priorities and budgetary allocations

Some recommendations for the policy-makers

*By Elena Efimova and Sergei Sutyrin*

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## Abstract

For most maritime nations, shipbuilding is a strategic industry closely linked to geopolitical interests and national security. Russia is no exception. Until the end of the 1980s, the Soviet shipbuilding industry was one of the most powerful in the world. After the collapse of the USSR, however, it lost its prominence. Since the early 2000s, the Russian government has taken steps to revive it.

Our research reveals the key goals of state support for shipbuilding in Russia: the construction of competitive goods that can meet the needs of the domestic market and strengthen Russia's position in the world market, and the production of specialized equipment for the exploration of the shelf and the Northern Sea Route.

This Policy Briefing reveals the extent of the Russian government's support to the shipbuilding industry. With the help of federal budget funding, much research and technological development of civilian shipbuilding have been carried out, and re-equipment of domestic enterprises is underway. The government encourages ordering from domestic shipyards, as well as the use of ships sailing under the national flag. However, the goals set in government programs are not just numerous but also diverse. This results in substantial problems with coordination at various levels, and it often hampers sufficient and timely funding.

## Keywords

Russian shipbuilding, state support, federal budget funding

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### 1. Introduction

The Russian shipbuilding industry consists of shipbuilding and ship repair facilities registered in Russia, as well as technical institutes that design vessels and produce equipment for them. It also includes installations for extracting raw hydrocarbons and other types of raw materials in offshore shelf and other maritime activities in the Russian Federation ('Strategy for...' 2007). There are more than 600 economic entities in this shipbuilding complex. Among them, more than 180 are supervised by the Department of the Shipbuilding Industry and Marine Technology of the Ministry of Industry and Trade of the Russian Federation. Another 150 shipbuilding and ship repair facilities, as well as more than 300 facilities that traditionally participate in shipbuilding network, are governed by other regulators.

For the majority of maritime nations, shipbuilding is a strategic industry closely linked to the promotion of geopolitical interests and national security. Moreover, shipbuilding is a sector with significant technological and production potential that can influence technological development in related industries. Production cycles in shipbuilding are among the longest in the economy: from development of technical specifications to transfer of the vessel to a client, they can last up to 15 years. In this light, financial forecasting of the producers' activity is challenging. For this reason, leading maritime nations continually monitor the development of the industry and often provide significant support to national shipbuilding companies. Due to several reasons the listed factors are of particular importance for modern Russia.

The purpose of the present report is to evaluate the Russian Federation's policies related to the shipbuilding industry.

### 2. Russian shipbuilding industry under the state regulation: lessons from the past

At the beginning of the 20<sup>th</sup> century, czarist Russia was not among the leading shipbuilding nations. In particular, the government had no policies in place to stimulate or manage domestic shipbuilding, and it also had no programs to encourage and fund scientific research that might lead to advances in shipbuilding. The annual output of naval engineering graduates did not exceed 15.

In the early years of the USSR, the industry experienced substantial changes. The decree of the Council of People's Commissars dated March 24<sup>th</sup>, 1921, "On state shipbuilding", defined, for the first time, how the shipbuilding industry should be organized and developed. The general management of shipbuilding was provided by "Sudotrest". In November 1924, the Council of Labor and Defense ordered the construction of the USSR's first naval vessels: four lumber transporters, two refrigerated vessels, and one tanker. The choice of ship types was not accidental: the country needed foreign currency to purchase machinery, so it focused on building ships that could be used to export wood, oil, and meat and dairy products.

In December 1926, the Council of Labor and Defense approved a six-year program to build submarines, frigates, and torpedo boats, and to repair and finish a number of existing ships. For the years of the prewar five-year plans (1928-1942) the fleet had received 312 ships, including 4 cruisers, and 206 submarines. These ships rivaled the best foreign ships, especially in terms of armament.

By the beginning of the Second World War, the Soviet maritime transport fleet comprised about 700 ships with an overall tonnage four times greater than that of the Russian fleet in 1914. The fishing fleet contained more than 6,000 vessels. The USSR also boasted the world's largest river fleet of about 2,700 vessels, including more than 650 passenger ships. Some of the ships built by Soviet shipbuilders were state-of-the-art at that time, in particular the powerful linear icebreakers of the "J. Stalin" type. During the Second World War, the shipbuilding industry produced more than 1,100 battleships ('The Soviet...' 1985).

The 1970s marked a significant stage in the development of Soviet shipbuilding. The largest ships in the world were built during this period: the nuclear icebreakers "Arktika" and "Sibir", the flagship "Cosmonaut Yuri Gagarin", and the fishery-depot ship "Vostok". Production of domestic marine drilling platforms began in 1975, following the development of offshore drilling.

By the end of the 1980s, the Soviet shipbuilding industry was one of the most prolific in the world. The annual orders supplied to the USSR's Navy alone amounted to some 50 units of submarines, battleships, and supply vessels. In the segment of civilian shipbuilding, the USSR was among the ten most developed countries in the world. It was capable of producing marine transport vessels with a deadweight capacity of up to 550,000 tons and catcher boats powered by 100,000 kW engines.

After the disintegration of the USSR, commercial ties between enterprises located in the former Soviet republics were severed. Political changes and the transition to the market economy led to a significant reduction in the number of orders for both military ships and commercial vessels, followed by economic deterioration of nearly all shipbuilding plants and by considerable increase of production costs.

The 2000s witnessed the creation of integrated structures in the shipbuilding sector. They were set up with the aim of consolidating the most valuable assets and increasing the competitiveness of domestic shipbuilding. The main objective was the coordination of participating research and industrial organizations in order to meet state requirements for design, construction, and repair of military ships, submarines, civilian vessels, and marine equipment for offshore development. The largest, but not the only, integrated structure was JSC United Shipbuilding Corporation. It absorbed a significant number of leading design bureaus and the largest plants. The corporation's priority activities are the development, design, production, supply, warranty and service maintenance, modernization, repair, and disposal of military shipbuilding equipment on behalf of the government and other customers, including foreign ones. All of JSC United Shipbuilding Corporation's shares are owned by the Russian Federation. The chief scientific organization in the segment is Krylov State Research Center (Federal State Unitary Enterprise). Its reputation is based on the high qualifications of its scientists and specialists, who have established universally recognized scientific schools.

Currently, 170,000 people, that is, 0.2% of the total national working population, are employed in the national shipbuilding industry (Efimova & Sutyryn, 2019). The segment consists of 71 shipbuilding plants and ship repair yards, as well as 46 scientific organizations. Shipbuilding enterprises are located in all regions of the country (see Table 1).

Table 1. Territorial distribution of shipbuilding industry enterprises in Russia, %

	Enterprises	Employees	Production volume
Northwest	39	59	66
Far East	18	12	13
Volga Federal District	15	12	9
Center	14	8	6
South	9	4	2
Ural, Siberia, Northern Caucasus	5	4	3

Source: 'Development of Shipbuilding for 2013-2030'

The share of Russian shipbuilding in the world civilian shipbuilding industry is only about 0.5% in terms of gross tonnage and 1.3% in terms of number of vessels. The largest Russian shipbuilding company, JSC United Shipbuilding Corporation, is ranked 80th in civilian shipbuilding in the world.



Russia's position in military shipbuilding is much stronger. The country accounts for 12% of the world's military shipbuilding (in 2nd place after the United States). JSC United Shipbuilding Corporation is the seventh-largest military shipbuilding company in the world ('Development of Shipbuilding for 2013-2030').

Russian shipbuilding enterprises lose out to their foreign competitors for a number of reasons, despite having high scientific and technical potential. Experts mention, in particular, the high labor intensity of Russian shipbuilding and the high cost of its products. This is largely due to unfavorable climatic conditions, which impose high energy costs on producers resulting from the need to build covered docks. In addition, the Russian tax regime and the ship financing system put domestic shipbuilders and shipowners at a disadvantage compared to foreign competitors.

Financial conditions in the Russian market differ significantly from those in foreign markets. In the former, a loan with a tenor of 5-6 years is available at an annual interest rate of, at best, 12-14%, and it typically covers a maximum of 60% of the vessel's value. Such a short period is insufficient for the payback of a ship, while the cost of the loan often makes the entire project unprofitable. It is almost impossible for shipowners to obtain a loan for the construction of river ships on acceptable terms. At the same time, because of international economic sanctions imposed on Russia, which extend to ships built in Russian shipyards, even the largest domestic shipowners cannot access funding in global financial markets.

The situation in the military shipbuilding sector is different. The effective demand for military shipbuilding products is determined by the current State Armaments Program and by government defense contracts. Products manufactured for the Navy, the Border Guard Service of the Federal Security Service, the Ministry of the Interior, and the Ministry of Civil Defense's Emergencies and Disaster Relief department are included in the contracts.

Along with the US, the UK and France, Russia is one of four countries that can build all classes and types of ships. The total water displacement of ships in the Russian Navy is about 700,000 tons, which is 12% of the world total. At present, in the frame of the State Armaments Program for 2011–2020, the design of a new-generation lead ships have been completed and the transition to their serial production has been prepared. Unlike previous state armament programs, which envisioned the construction of one or two nuclear submarines and up to five small surface ships in a five-year period, the current program provides a transition to serial ship production. As a result of this program, the Russian Navy's share of world tonnage will rise to 16%.

Today, Russia's share of the military shipbuilding market is about 20% of the global order book. Russia even exports equipment that its own Armed Forces and Navy do not have. The volume of export deliveries could increase by 1.5–2 times over the entire product and services range, provided that appropriate measures for developing scientific and technical knowhow are adopted ('Strategy for...' 2007).

### **3. The role of the state**

#### **3.1. Strategies and programs**

The 2000s heralded a new phase in the development of the Russian economy, in particular related to the ceasing of "market fundamentalism" and reconsidering role of the state as a regulator. In case of shipbuilding this is not just establishing of the "rules of the game". In addition to that, the state operates as a main client for the industry.

The current and future plans of the state in the area under review are determined by the development strategies of the shipbuilding industry itself, as well as of those sectors in the economy that are consumers of its products ('Strategy for...' 2007; 'Russia's energy strategy...' 2009; 'Transport strategy...' 2008; 'Water Strategy...' 2009; 'Development Strategy of the Fisheries Complex...' 2009; 'Development of shipbuilding and equipment...' 2017; 'On the implementation...' 2012). In particular, the necessities of the Russian market are determined in accordance with the program documents. Potential customers of ships and marine equipment are approved at the state level. The lack of domestic capacity in shipbuilding and related industries has resulted in some orders for ships and equipment being placed abroad.

In other words, the Ministry of Industry and trade and Ministry of Defense evaluates the national need for marine equipment, and then generates an order for the construction of ships and other vessels for various purposes, including defense, nuclear icebreaking, research, and so forth. Ministry of Industry and trade also creates friendly business environment for the development of shipbuilding in terms of energy and transport policies. In military shipbuilding, the State Armaments Program is approved on the basis of the military-technical cooperation between state institutions, design bureau and business entities. It determines the medium-term outlook and the demand for naval equipment.

The Russian government has three priorities when formulating policies that concern the shipbuilding sector. The first is the creation of competitive, specialized marine equipment, including what is needed for the exploration of the continental shelf and for the development of the Northern Sea Route, and the production of high-tech, medium-tonnage transport and supply vessels, high-tech fishing ships, and marine and river research vessels. The second is the implementation of institutional changes in the industry, including a clusters in its development, introduction of integrated structures for the production of marine equipment, and leasing mechanisms for marine fishing equipment and river equipment. The third is bringing Russian leading manufacturers back to a world-class standard.

### 3.2. Specific instruments of state support

Comprehensive state support to the Russian shipbuilding industry began in 2007 with the development and approval of a “Strategy for the development of the shipbuilding industry for the period up to 2020 and beyond”. Creating conditions for the development of the industry includes a legislative and regulatory framework. The supportive measures are divided into “systemic” ones applicable to industries with a long production cycle, and “special” ones aimed directly at the development of shipbuilding.

Initially, the “systemic” measures included:

- No VAT on imported equipment that have no analogous products manufactured in Russia;
- Subsidizing of interest rates on loans from domestic commercial banks, as well as of costs associated with the use of other financial instruments for the manufacturing of ships in Russia;
- Co-financing of investment projects related to the modernization of production facilities.

“Special” measures included:

- Development of a set of measures to secure the priority right of Russian companies to construct sea shelf exploration equipment;
- Restrictions on the use of foreign ships and ships built abroad for coastal shipping and on inland waterways;
- Creation of a mechanism to stimulate the manufacture of fishing vessels by domestic enterprises;
- Development of a leasing system for shipping companies acquiring Russian river vessels.

Subsequently, in order to implement the adopted strategies for development of the shipbuilding industry, the Ministry of Industry and Energy proposed additional “special” financial measures in 2008, as follows:

- Exemption from VAT and import duty for ship components that are not produced in Russia, as well as reduction of VAT to 10% for vessels produced by domestic shipyards;
- Exemption from property tax and land tax for shipbuilding enterprises;
- Reimbursement from the federal budget of part of the interest on loans received by Russian shipping companies for the purchase of ships and marine equipment from Russian shipyards, and by Russian shipbuilding companies for investment in technological re-equipment of their shipyards;
- Use of federal budget funds to increase the authorized capital of a specialized leasing company that will lease out domestic river and fishing vessels;
- Use of federal budget funds for the acquisition, by Russian shipbuilding companies, of licenses on advanced foreign technologies for the manufacture of ships and ship equipment not previously produced in the Russian Federation;
- State guarantees to investors who provide loans for the construction of new shipbuilding facilities or for capital modernization of existing shipbuilding facilities in Russia.

The main instruments of current government support are described in the state program “Development of Shipbuilding and Facilities for Offshore Fields, 2013 – 2030”. Three main activities are covered:

- Stimulating development of innovative production in the shipbuilding industry;
- Assistance in the development of leasing arrangements for ships and offshore structures built in Russia;
- Establishing utilization funds for particular types of vessel (fishing, passenger within river navigation).

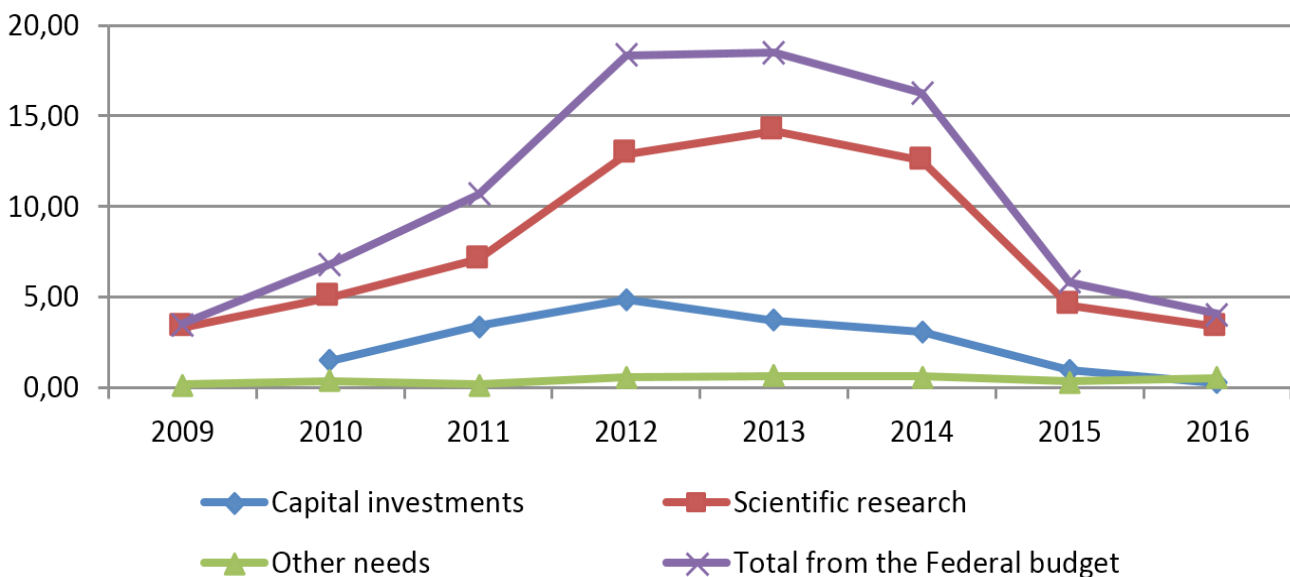
Since 2011 certain restrictions regarding the use of foreign-made vessels and ships sailing under foreign flags have been discussed and introduced. In particular, only ships built in domestic shipyards are allowed to extract (catch) aquatic biological resources in the Russian Federation’s internal waters. In 2016, the government proposed to grant vessels sailing under the Russian flag the preferential right to transport and tow within the continental shelf (‘On Amendments to the Merchant Shipping Code...’ 2016). At the same time, the national government planned to preserve the possibility of carrying out this transportation and towing by ships under foreign flags.

In 2017, the government proposed to grant Russian vessels an exclusive right to transport and store hydrocarbons in the waters of the Northern Sea Route. This proposal gave rise to vigorous debate. As a result, on December 30th, 2018, amendments to the Merchant Shipping Code came into force, according to which Russian ships have the exclusive right to transport hydrocarbons produced in Russian territory and loaded onto vessels in the Northern Sea Route area. Exceptions to this rule are allowed only by intervention of the government. The amendments do not apply to contracts as well as international treaties signed before December 30th, 2018.

### 3.3. Allocated financial resources

Targeted financial support to particular market players in the framework of “systemic” and “special” measures is an effective government policy instrument. Based on available data, it is impossible to determine accurately the total amount of financial resources allocated for these purposes. As an estimate, however, we note that some 84 billion rubles were allocated to the Federal Target Program “Development of civilian marine equipment for 2009–2016”, which is already complete (see Figure 1).

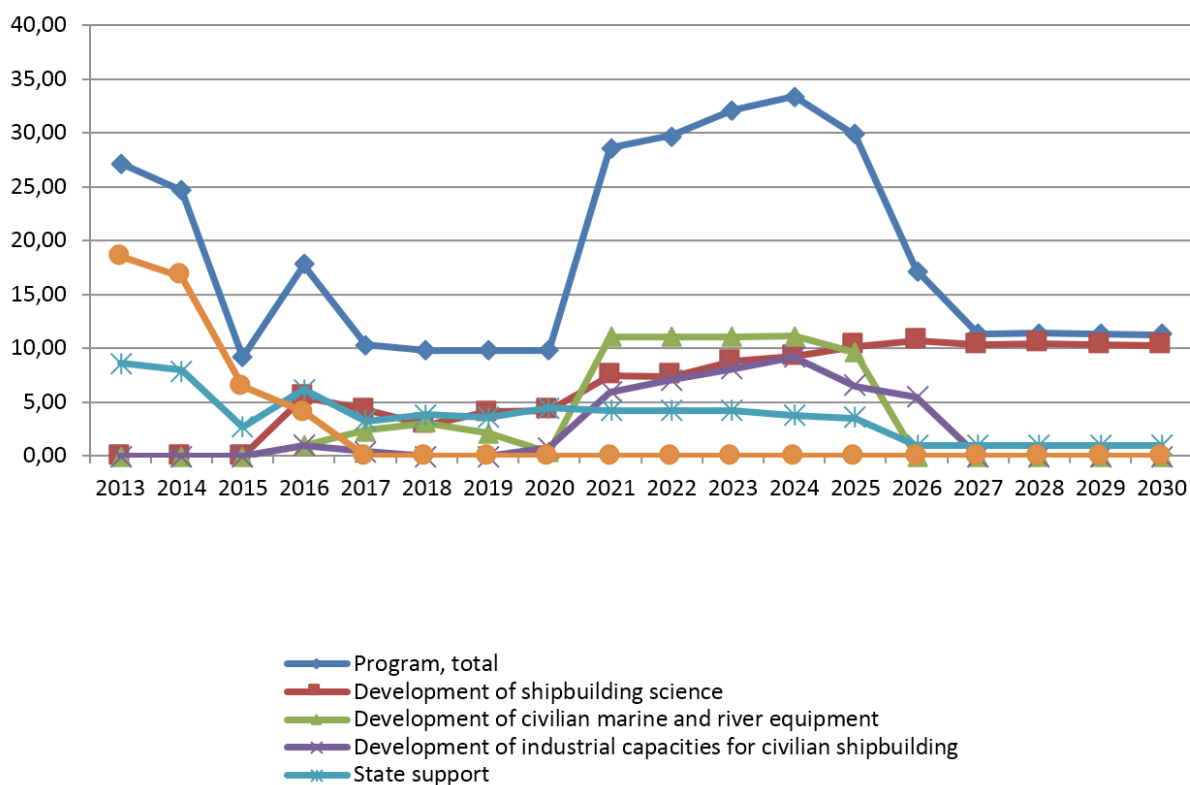
Figure 1. Budget financing of civilian shipbuilding (billions of rubles)



Source: Russian Federal Target Programs

Budgetary allocations for the implementation of another government program, “Development of shipbuilding and equipment for the exploration of offshore fields for 2013–2030”, are shown in Figure 2. The most intensive funding of the program is planned for 2013–2015 and 2021–2025. Variations in the funding schedule are due to the need to complete the previous program and to implement a priority activity, namely, the construction of civilian marine and river equipment. Funding from the federal budget amounts to a total of 334.63 billion rubles.

Figure 2. Budgetary allocations to the shipbuilding sector (billions of rubles)



Source: 'On Amendments to the state program...' 2018

It is worth mentioning that the state directs a large share of its allocations to the development of shipbuilding technology, suggesting that the creation of competitive high-tech products is a priority.

Currently, subsidies for the reimbursement of interest on loans for the construction of shipbuilding complexes are provided on the basis of Decree No. 253 of March 14th, 2018, under the program "Development of shipbuilding and equipment for the exploration of offshore fields for 2013–2030". This type of state support is available to Russian organizations that received loans after January 1st, 2017 for projects larger than 100 billion rubles in value. The subsidy can cover up to two thirds of the outstanding interest. The measure discussed in this report aims to achieve the government's strategic priority – the construction of high-tech vessels and marine equipment for the extraction and transport of liquid hydrocarbons from Arctic offshore fields. The federal law "On the federal budget for 2018 and for the planning period of 2019 and 2020" provides 800 million rubles for these purposes.

In the draft of the new "Strategy of shipbuilding industry development for the period up to 2035", the amount of financing is determined within the framework of three scenarios. The basic idea is as follows: the higher the growth rate of the industry, the more actively the state will fund it.

In the conservative scenario, support is provided to key shipbuilding enterprises to fulfill the orders from the state defense order, as well as to implement only top-priority investment projects. This scenario provides a low level of state funding and support.

The innovative scenario assumes a neutral level of state funding and support, provided demand for shipbuilding products is high and human resource development is at an average level. Significant funds are allocated for the development and restructuring of manufacturing plants. Projects intended to update fixed assets in the industry are linked to available budgetary and non-budgetary funding.

The target (boosted) scenario provides for the large-scale creation of new production facilities and modernization of existing ones, as well as a significant increase in labor productivity. High levels of state funding, state non-financial support, demand for shipbuilding products, and human resource development are assumed. The vast majority of effective demand for civilian vessels and marine equipment by domestic customers is satisfied by domestic enterprises.



#### 4. Results achieved thus far

Political and economic support of shipbuilding by the federal government has led to a revival of the industry. Experts emphasize that the Federal Target Programs have contributed to the economic development of the Russian Federation by improving the competitiveness of civilian products for the domestic market and expanding the ability to export. They also have had a positive social effect by maintaining the number of high-quality jobs in shipbuilding and increasing them in related industries.

In general, the measures implemented by the state had a positive impact on the development of the industry. The industrial growth rate data in the segment of shipbuilding are shown in Table 2. Note that the calculations are in terms of value. The share of civilian products remains insignificant.

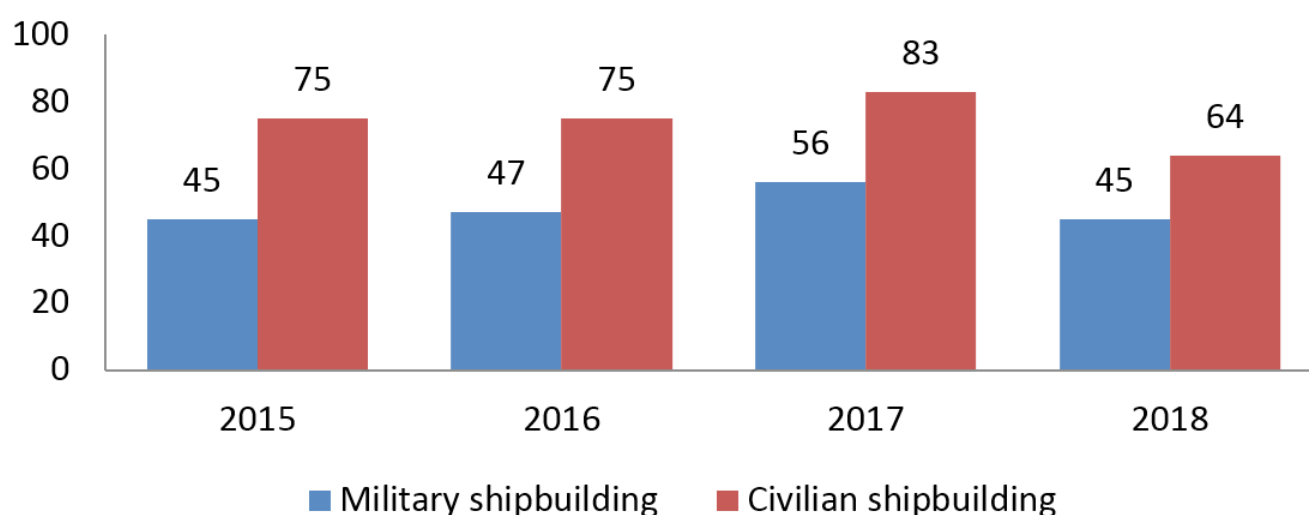
Table 2. Annual growth rate of the Russian shipbuilding industry, %

	2015	2016	2017	2018
Total	114.7	100.6	110.9	105.8
Military products	118.1	96.3	110.9	105.2
Civilian products	90.4	141.9	110.6	110.3
Share of civilian products	9.4	13.3	12.4	n/a

Source: 'Report on the goals ...', p. 75

From 2015 to 2018, the number of ships built remained approximately the same (Figure 3). This is due to the limited effective demand from Russian customers and to modest export deliveries (only seven military ships and eight civilian vessels for the specified period).

Figure 3. Construction of ships and floating facilities, in units



Source: 'Report on the goals ...', pp. 75-76

The project "Establishment of Zvezda shipyard" is an example of effective co-financing of investment projects. It is currently being realized by a consortium of investors that includes PJSC Rosneft Oil Company, JSC Rosneftegaz, and JSC Gazprombank. Its goal is the construction of ships of all existing types and classes. The project will put into operation a new high-technology dockyard to build supporting ships for drilling platforms, hydrocarbon transportation vessels (including those of high icebreaking class), and land-based oil and gas installations and drilling platforms. With an open heavy fitting-out berth, it is possible to build vessels and marine equipment up to 300 m long, 50 m wide, and 26 m of height of the vessel, and with launch weight of up to 36,000 tons. In drydock it is possible to build ships of all types up to 460 m long and 110 m wide. The total investment in the Zvezda shipyard is estimated to be as large as 202.2 billion rubles ('Development of Shipbuilding and Facilities...' 2017).

Implementation of the project will result in about 7,000 new jobs – a positive note for the development of the Far East region in general. It will also generate additional budget revenues. About 100 employees from the Zvezda shipyard have completed training in the Republic of Korea and in France.

The state not only provides co-financing for shipbuilding enterprises, but also encourages industrial companies to order vessels from Russian shipyards. The specific regulatory measures currently applied in Russia induced companies to revise their strategy regarding the purchase of transportation vessels. This has affected the largest

private gas company, Novatek, in particular. The Arc7 tankers for the Yamal LNG project were established before the adoption of a law prohibiting cabotage under a foreign flag. Novatek defended its right to carry out LNG cabotage along the Northern Sea Route with ships sailing under non-Russian flags. As a result, 28 foreign-flagged vessels will be allowed to carry LNG along the Northern Sea Route until December 30th, 2043. Nevertheless, the introduced legislative restrictions have influenced Novatek's future strategy. Documentation for the construction of 15 Yamalmax-class LNG tankers has been transferred to Zvezda shipyard already. The shipyard and PJSC Sovcomflot have signed a contract for the construction of a pilot gas transporting vessel for the Arctic LNG 2 project. The vessel will meet the technical requirements for ships of the "Christophe de Margerie" type ordered in 2013 for the Novatek project in the Korean shipyard for year-round transportation of LNG in hard ice conditions in the Kara Sea and in the Gulf of Ob. According to the contract, the ship will be supplied in the first quarter of 2023 (Shipbuilding Complex Zvezda, official web site).

## 5. Conclusion

This study analyzed some of the peculiarities of Russia's regulations and policies pertaining to the shipbuilding industry. It has revealed key goals for the industry's development: the production of competitive products that can meet the needs of the domestic market and strengthen Russia's position on the world market, and of special equipment for the exploration of the sea shelf and the Northern Sea Route.

The government provides substantial assistance to the shipbuilding industry. As a result of budget funding in recent years, research and technological development in the field of civilian shipbuilding have progressed, and the re-equipment of domestic enterprises is underway. The state encourages Russian firms ordering from domestic shipyards, as well the use of fleets sailing under the Russian flag.

At the same time, there are several problems being actively discussed in the expert community. We will point out only a few of them. First, it is not always possible to align the interests of major stakeholders. For example, the measures taken by the government with respect to the transportation of hydrocarbons by the Northern Sea Route threaten both the activities of the largest Russian oil and gas companies, and legislative initiatives aimed at implementing the President's order to develop the cargo flow on the Northern Sea Route to 80 million tons annually by 2024, of which LNG will account more than 50%. Moreover, the adopted amendments to the Merchant Shipping Code restrict the use of ships for coastal shipping between Sabetta and the LNG transshipment complexes that are to be built in Murmansk and the Kamchatka Peninsula. In turn, this will complicate implementation of key national logistics projects. Thus, resolving the shipbuilding industry's problems may damage enterprises in other sectors of the economy. An increase in the profitability of shipping and shipbuilding companies may increase tax revenues, but it could also lead to the deterioration of the economic situation of other economic actors and reduce their tax payments

Second, the goals set forth in state programs are not only numerous but also excessively diverse. This results in problems with coordination at various levels and hampers adequate and timely funding, especially when programs are supervised by different government institutions. At the same time, budget financing tends to be inflexible because any significant changes must be accompanied by relevant amendments to the Budget Code of the Russian Federation.

Third, the government's support to the shipbuilding industry is aimed at meeting a wide range of needs in the domestic market. This renders the application of niche development strategies, often used by leading shipbuilding powers, problematic. Although emphasizing on the offshore segment is a significant step in niche direction. The future will show whether one will find an adequate solution of the existing problems and how soon it will happen.

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