

IMPLEMENTATION OF THE HELSINKI ACCORDS

Doing Business in Russia and the NIS: Opportunities and Obstacles

June 1994

**Briefing of the
Commission on Security and Cooperation in Europe
Washington, DC**

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Briefing on Doing Business in Russia and the NIS: Opportunities and Obstacles

Friday, June 3, 1994

Commission on Security and Cooperation in Europe

Washington, DC

The briefing was held in room 2359 of the Rayburn House Office Building at 10:30 a.m., Jane Fisher, Deputy Director, Helsinki Commission, presiding.

Present: Dr. Richard Rahn, Mr. Edward Chow, Mr. Joseph Barker

Also present: Bill Richard, Elka Lewis, Barry Wood, Matt Gersner, Adam Rappaport, Shannon Uplinger, Joe Lukich, Katrina Mazingi

Chairwoman **Fisher**. Good morning. I'm Jane Fisher. I'm Deputy Staff Director of the Helsinki Commission. We're very pleased to be sponsoring this briefing on trade in the NIS. This is the third in a series of briefings we have been doing on NIS. We've had one on Partnership for Peace. One on Ukraine. We're having this one trade and we'll be having a fourth briefing on Crime and Corruption in the NIS. The Helsinki Commission is probably best known for its work on human rights. Our mandate, however, is to monitor compliance with the Helsinki Accords in their entirety.

The Helsinki Accords cover human rights, security, and economic cooperation. And now that the countries of the former Soviet Union are making the transition to democracy, we are putting a greater emphasis on trade and economic cooperation. Russia and the newly independent states have a great potential market we feel. They have enormous natural resources, large consumer markets, and an enormous potential for trade and investment. Companies, large and small, are exploring this new market which, regrettably in spite of its potential, is not without its problems. Some firms have been successful. Others have run into the oft cited impediments such as, the absence of a coherent legal infrastructure, the lack of a physical infrastructure, grossly inefficient distribution system, arbitrary tax laws, limited working capital, rampant crime, and a difficulty in trying to identify who it is one should be working with in the NIS countries.

We're pleased to have with us today a distinguished panel of experts who have been directly involved in business development in the former Soviet Union. Our speakers will describe their experiences and share with us their views on the opportunities and hazards of doing business in Russia and the NIS.

Dr. Richard Rahn is President and Chief Executive Officer of Novecon Limited and Novecon Management Company. These companies operate businesses in Russia and Bulgaria. He is the former Vice President and Chief Economist of the U.S. Chamber of Com-

merce. Dr. Rahn has directed and participated in economic growth projects and studies in a number of countries including Estonia, Hungary, Mexico, the Philippines, and Thailand. He served as the U.S. Co-Chairman of the Bulgarian Economic Growth and Transition Project in 1990 and is currently a member of the U.S. Committee to assist Russian reform. Dr. Rahn received his B.A. in Economics at the University of South Florida, an M.B.A. from Florida State, and a Ph.D. in Economics from Columbia.

Mr. Edward Chow is the Director of International Affairs for Chevron Overseas Petroleum. Chevron is an integrated energy company with operations in over 100 countries with an annual revenue of 37 billion. Major international operations take place in Canada, Indonesia, China, Nigeria, Australia, U.K., Kazakhstan and, I'm sure, a lot of other countries. Mr. Chow joined Chevron in 1976. Prior to assuming his position in Washington, in 1991, he was Chevron's Manager in Beijing and has also been involved in Chevron's operations in South America, Europe, the Middle East, and the Far East. Mr. Chow received a Bachelor's degree in Economics and Government and a Master's degree in International Affairs from Ohio University. He was also a research fellow at the School of International Service American University.

And Mr. Joseph Barker is Vice President of Ryland Trading Limited and serves as the Executive Operations Manager for the international business activities of the company. Prior to joining the Ryland group, Mr. Barker was the Director of Manufacturing for the home building operations of the Boise Cascade Corporations. He later organized and managed the International Housing Division, Boise International, which exported and erected single and multi-family housing worldwide. Mr. Barker also managed the Factor Division of MA—

Mr. Barker. Kharafi.

Chairwoman **Fisher.** Kharafi, thank you, Kuwait which manufactured and erected factory-built work camps and housing throughout the Middle East. Mr. Barker is a graduate of the University of Richmond and did graduate work at the Harvard Business School and Lehigh University.

I think, then, I will open it up to statements from our speakers and I think we'll go left to right starting with Mr. Chow.

Mr. Chow. Thank you, Ms. Fisher, for this opportunity to brief the Helsinki Commission on doing business in the newly independent states of the former Soviet Union. Although Chevron has been actively engaged in crude oil and petroleum product trading with the Soviet Union for quite some time, it was only in 1987 that we first started looking for traditional oil and gas exploration and production opportunities. That effort culminated in the signing of a Foundation Agreement at Blair House here in Washington on May 18, 1992, for joint venture development with the Republic of Kazakhstan of the super giant Tengiz oil field which is on the northeast shore of the Caspian in Central Asia.

The joint venture began operations on April 6th of last year and is just beginning to tap the potential of one of the 10 largest oil fields ever discovered in the world. Estimated to contain 25 billion barrels of oil in place, Tengiz is believed to have 6 to 9 billion barrels of recoverable reserves. Current production is restricted to about 30 thousand barrels per day because of the lack of infrastructure to take oil to market. But, we hope to increase production to 500 to 700 thousand barrels per day by the year 2010. In order to achieve this, the joint venture will be investing at a rate of \$1½ billion over the next

3 to 5 years or about \$20 billion over the 40 year term of the Joint Venture Agreement. Already the Joint Venture TengizChevroil have about 38 hundred employees over 90 percent of whom are national employees and about 200 western expatriots seconded from Chevron.

There are over 2,000 contract workers at Tengiz right now. We are serving about 20,000 meals per day in the barren steppes of Central Asia to both our employees and contractors. That gives you an idea of the scale of operations that are involved. It is because of this scale and the size of the investment and also the length of time that Chevron has devoted to pursuing oil and gas opportunities in the former Soviet Union that, in some ways, make Tengiz a bellwether project for the potential success of western investment in the oil and gas sector of the former Soviet Union. It is from this perspective that I would like to share some of Chevron's experiences in facing challenges that an international oil company operating in the former Soviet Union is confronted with.

First of all, the opportunity. Clearly, we, are in a natural resource business and we have to go where the resource is. The former Soviet Union was then and Russia is still today the largest oil producer in the world. In addition to that, there are numerous untapped, under-explored, or yet-to-be-producing regions that can be more fully exploited with western investment, western technology, and western management. However, the conditions are often very harsh. In Tengiz itself, we face, for example, temperatures that range from minus 30 degrees Fahrenheit to 125 degrees Fahrenheit. The reservoirs at Tengiz are deep, high pressure, and contains quantities of hydrogen sulfide that needs to be removed from the gas before the oil can be produced.

The technical challenges are precisely the reason why, even though the Soviets discovered the field in the late 70's, they were not able to fully exploit those fields. We, in the international petroleum industry, however, are used to facing technical challenges. That's nothing unusual. However, there are a number of non-technical challenges that are somewhat unique in working in the former Soviet Union. If you think back that we started negotiating some agreement in 1987, and think back through the history of the Soviet Union and the number of political changes that have happened since then, you can imagine the number of governments, political jurisdictions that we've had to deal with since we started in 1987.

Decision making and who has the right to make those decisions is a rather interesting process that we have yet to fully understand and it's always evolving, of course. You have, I'm sure, heard of export taxes that have been placed. Export taxes being canceled. It's one thing to have harsh economic terms. It's another thing to have unstable economic terms on which you have to base your business planning. That's a problem. Ownership of the natural resource, particularly in Russia, with the devolution of central power is also a problem.

Who has the right to make a deal with you? Is it the local authority? Is it the central authority? Or, is it a combination of both? That's often not clear. Do they really want us? This is an interesting question, particularly in the case of Russia. After all, Russia is still a very large oil producer and probably believes that it has the capability to continue operating on its own without western help. And, that's a reasonable case from their point of view to argue. Maybe all they really want is western capital but not western technology and management that we also bring.

We are not bankers, of course, but an oil company that takes equity risk in order to make an equity return on that investment. If you look at the terms, and now I'm going

to focus specifically on Russia, that the Russians offer the oil and gas sector, it's some of the worst terms in the world. Petro Consultants, which is a well respected international oil and gas consulting firm, does an annual review of petroleum fiscal terms around the world. In 1994, in ranking 70 countries, based on the size of government take, the net present value, and internal rate of return an investor would make from a venture looking at marginal fields, economic fields, and fields with big up-side potential, Russia ranks variously as either 67th or 70th out of 70 countries. That gives you a perspective of how much they really are trying to attract western oil and gas investment.

Poor infrastructure, Ms. Fisher referred to earlier, which is certainly true. The lack of telephones, transport, banking, a legal infrastructure are all problems. The other problem that's relatively unique or that's different about working in Central Asia is under the former Soviet Union all the logistical systems for oil and gas all went through the Russian Republic. So, there is no independent way of getting oil to western markets, at least, without first going through Russia if you want to use existing infrastructure. A better understanding of western economic concepts is also lacking. Simple concepts that are second nature to a western investor or businessman such as the time value of money, opportunity costs. Chevron as a company not only goes to where there's a resource but has to compare the relative returns from investing say a billion dollars in Russia versus Nigeria versus Indonesia versus elsewhere. And this lack of a sense that they are competing in an international market place is a problem in negotiating to us, favorable terms.

The relative value of petroleum products is also not recognized. For example, it's typical in Russia to have ton for ton petroleum crude oil exchanges. Whereas in the west, we trade oil in barrels not only because that's the physical volume that we deal with but because lighter crudes generate the higher value products, such as, jet fuel, gasoline, and kerosene in a typical refining structure. While the Soviet exchange penalizes those people who produce light crude oil at the expense of people who produce heavy crude oil. This is not particularly discriminatory to just western producers, they do that to their own producing associations as well. It's a lack of recognition of economic value in a pricing system that prices products according to the value that it generates. That is a problem. Also, the political system is not yet mature enough to distribute general economic well-being or benefit of a western investment throughout the country or in its various sectors.

In order to somewhat take care of that, in our own case, we have set aside 50 million dollars as a local community fund for local community development projects in the Atyrau Oblast where we're working in Kazakhstan. Because it is important for us as good corporate neighbors to show an immediate benefit to our neighbors in whose midst we're working in and not just wait for the central government to distribute that economic well-being. We may make a deal with the Petroleum Minister and that may accrue to the Central Treasury but the Railroad Commissioner may ask what have you done for me? Because the system doesn't really distribute that across the board. There's also a need to value true partnerships. And, in the former Marxist thinking, value was determined more by input than by output.

In the first year of our Joint Venture, the local partner is much more interested in the rate that we are spending money as opposed to the rate that we are making money even though we are half of a 50-50 Joint Venture. That kind of conceptual problem reminds me a little bit about a Joint Venture story that I believe I first heard when I was working in China. Which is a chicken and a pig walking down the road. And the chicken saying to the pig, why don't we get into the bacon and eggs business and have

a breakfast stand? And the pig says to the chicken, that's easy for you to say. You're making a contribution. I'm making a commitment. Better—more commitment and contribution from both sides would certainly contribute to the potential success of western ventures in the former Soviet Union.

Thank you, Jane.

Chairwoman **Fisher**. Thank you, Mr. Chow, that was very interesting. There are some seats up here in the front row if anybody would like to take a seat.

And, now, we'll hear from Mr. Barker.

Mr. **Barker**. Thank you very much for allowing me to address you this morning. I am with Ryland. We are one of the largest home builders in the United States. We have four manufacturing plants which makes us different from competitors like Centex and Poulte. In 1990, we were approached by Rosagromstroi, which is the Agriculture Ministry, or the construction arm for the Agriculture Ministry in Russia. And we were invited to go to Barnaul, which is in the Altai region in Siberia and look at one of their factories and make recommendations as to how this factory can quickly produce 2,000 houses a year. It had been purchased earlier—an adjacent factory had been purchased earlier from the Swedes with the capacity of 1,500 houses and it had never produced over 700 houses in 18 years. The solutions to the problem were basically technical. But, as I pointed out to them, you've got a building season of maybe six months in the area that you're trying to build.

So, why don't we figure out how to build 2,000 houses a year and then worry about the factory. The mentality that I faced then and still face now is what I call "the field of dreams" mentality about a factory. If we build a factory, somehow or other these houses will pop up. I've been into housing for 30 years. I've been in international housing for 22. I haven't been able to figure that one out yet, but that's what I'm constantly up against. By the way, that project went on. We negotiated that for two and a half years. We went through the Putsch. Through techno-export. It was approved by Ex/Im Bank. It was in the Federal budget. Gaidar stamped it. It never happened for a multitude of reasons. But, on that trip, we became very interested in the potential of Russia. I spent some time in Moscow and spent some time in St. Petersburg. And, at that time, I had the capacity of being the Manufacturing Manager for Ryland.

Also, at the same point in time, there was the immigration of Russian Jews to Israel and we became very active in that. We built 1,300 houses in about 9 months and shipped them into Israel. And we were profitable in what we did. And, our Chairman, at that time, decided what we needed to do is become an influence in worldwide housing and let's branch out and begin to develop. Our strategy or our tactics, at that time, were to go in-country and become in-country builders in a multitude of places. We have approached Argentina, Mexico, Poland, Germany. I've just finished a project in Senegal and we're actively building in Africa right now, I mean in Russia right now. To go in-country means that you have to know what's going on. The approach that we took was the Joint Venture approach.

We bring to the table three things. We bring a marketing and design concept. We bring a manufacturing concept. And we bring a field operations construction concept. What I tried to find were partners who could bring 1, 2, 3 of the same things as opposed to Joint Venturing with a bank that didn't really understand what was going on. We were fortunate in both St. Petersburg and the Moscow Oblast to find partners of that capacity.

All of them were builders. None of them had marketing experience as we currently know. Some of them had—two of them had on-site construction experience. Two of them were manufacturers.

Let's jump to the end of the story. We now have, in Moscow, a truss operation. Those little pointy triangles that go on top of roofs. And we're the only truss operation in Russia west of the Urals. We are beginning to introduce a technology. To give you an example. It takes, now, on a house that's approximately 9 meters, I mean, yes. 9 meters by 9 meters. It takes 4 men about a month to put a roof on. The Russian way. Using modern—not modern. But, using truss technology, they can do it cheaper and they can do it in about two days. In St. Petersburg, we have just completed a townhouse project. Now, as we were approaching the market and this was pre-Putsch, there was no mortgage program. There were—these alleged people with briefcases of dollars or rubles did not appear at our door so we had to figure the best way to finance this.

So, we built for the expatriate market, the western market. The strategy was we would learn our trade by building in-country for the expatriate market. And we have just completed a project and this advertising piece is out front if anybody wants a townhouse, I can negotiate a deal now that'll do that. I sent American supervisors and trainers over. I did not send American crews because you can't become a builder in-country if you do all the work. So, to build our townhouses which are the exact same townhouses we are building in Montgomery and Prince George county up here, we have used Russian plumbers, Russian electrical, Russian carpenters and everything. It's been bumpy along the way but I will tell you right now the finished product is as good as anything that's standing in this area. I'm very, very, very pleased with it. In fact, we had our grand opening two weeks ago and I hosted the Housing Committee from the Consulate and I was standing in the other room as the committee people were in the dining area. And two women said to each other, I believe we have just entered the twilight zone which was very, very complimentary.

A couple of side issues. There is a difference. Home building around here is not rocket science. It's not high technology but there are some basic rules that you have to follow in order to make the house stand up and be of reasonable quality. And we understand hollow wall timber frame technology because we all live in one. In Russia, they do not understand it because they don't live in one. The dachas that are there are basically log cabins or they're basically cobbled together and dacha literally means second home. The primary buildings are all cement and stone and it's not unusual to have a cement wall 18 inches thick with a styrofoam block in the middle of it for high thermal efficiency, which I haven't understood yet either. So, when it came time to build, we had to begin at the very, very basics. For example, our first foundation, now we're building a two-story townhouse.

Our first cement foundation is 24 inches wide. Here, in the United States, it's 6 to 8 inches wide. We built the second phase of our project with a major technological compromise. We are now using a 12 inch foundation. And it's because there's not an understanding. The same thing in plumbing. The same thing in electrical. But, I will give everybody credit that I have worked with. They are like sponges to this new technology. They have this—one hand is out saying no, we can't do it. But, the other hand is out taking the technology from you. And we have had a very, very good time.

At our dedication, the Fire Marshall was there. Two chief people in a construction industry over there are the Health Officer who handled sewer and water and the Fire

Marshall who handles everything else. We had a hard time convincing him that wooden buildings were safe. I finally did. During the dedication, the caterer in the kitchen caused a small degree of smoke while he was warming up the hors d'oeuvres and the fire alarms in the building went off. And I mean I could have not planned it better. We were successful after that. Infrastructure was a comment that was made. When we began with all of the good faith cooperation of the city of St. Petersburg, this was pre-Putsch. With the Putsch that came along, suddenly all of their resources went away. So, we had to run our own sewer one kilometer. We had to run our own gas. We had to run our own water. We have to now negotiate strongly for telephones. And, getting it done is still a series of blue stamps on a piece of paper and a long, long time, and education all along the way.

The land issue remains a major, major problem in Russia. We hear, we read, we see in the paper where they now have the right of land ownership. Well, it reads well in the paper but when it comes down to being a practical experience it's very, very difficult. We are opening up our townhouses with "we have the right to build" and now we have the "right to occupy." And this is still on a long-term lease, a 49 year lease, with the city of St. Petersburg. They tell us in several years that we will then have the right to buy. And at that time we will do it. We have in our structure, legal structure there, set everything up on a fee simple basis. But fee simple means absolutely nothing in Russia at this point in time. Hopefully, it will come along. Hopefully, we'll be able to move to it. In summary, it has been—we've been building there three years.

It has been an enjoyable but very, very difficult experience. It's been very rewarding. It's been personally and professionally rewarding to this date and by the end of this year, it will be financially rewarding for Ryland as we move over our project. But, it's taken a long time to get there. I encourage all of my builder friends to go to Russia to look. But, to go to Russia (one), with a very long term perspective in everything that they do; and, be very, very careful with whom you associate. And I don't mean that you're going to associate with people that are going to be dishonest. I mean they're going to be associating with people that are going to commit to things that they cannot deliver, particularly in the building area. So. I found Russia to be very, very successful and we were glad we were there and we're beginning to move into our next phase.

Chairwoman **Fisher**. Thank you, very much, Mr. Baker. Dr. Rahn?

Dr. **Rahn**. Well, thank you. It's a pleasure to be here today. We're doing things a little bit differently. We established the Novecon company's, basically to establish joint ventures, between American business enterprise and the new private enterprises in Eastern Europe and the former Soviet Union. We've got two companies now operating profitably in Russia. We have a helicopter company called Novecopter where we sell American helicopters and other high tech equipment. And we have a technology company called Novecon Technologies. We acquire Russian technology and market it here in the U.S. We are working on a number of other projects in Russia. I've listened to my colleagues here and I can identify with the trials and tribulations of all of them.

Now, to get into Russia, all of us who are doing this, you have to be optimistic by nature and a lot of people think we're a bit foolish but I think that we are overcoming many of the impediments. And they are enormous. First of all, the Russian economy. For those of us who have been going there for a number of years, it is astounding in the rapidity of the progress. Right now, more than 50 percent of the Russian economy is private. More than 50 percent of the people are employed in private enterprise or cooperatives. This has virtually all happened in eighteen months. It has been the most rapid tracked

