

Opportunities for Western Companies in the Former Soviet Union

*By Thorleif Enger**

The opportunities for international companies in Central and Eastern Europe (CEE) and the Former Soviet Union (FSU), is a theme high on the agenda of most companies and this is also the case for my company, Norsk Hydro. Norsk Hydro has been active in this area for several decades. During the last 2 to 3 years, however, we have substantially increased our involvement, both in trade and domestic investments.

Benefits of Internationalization

International trade and economic cooperation is vital to the generation of wealth among nations. The diversity of natural resources throughout the world, as well as the uneven distribution of capital and skills, have encouraged the development of international trade, cooperation and investment. The challenge for governments is to provide a level playing field that allows fair opportunities both for the national and international participants.

The host country should capitalize on the presence of international companies in its economic development; internationalization provides more competition and, hence, a more cost-effective industrial development. However, governments as well as domestic companies may have objections to the establishment of international companies in their country. For domestic companies, this may entail increased competition and lower margins, while for governments, internationalization may be perceived as a threat to their national sovereignty of domestic resources.

Therefore, the long-term success of any international cooperation is dependent on the mutual benefits of the parties involved. The investment must provide benefits both to the host country, the international investor and the cooperating companies in the host country.

Opportunities for Western Companies in CEE and FSU

Resources, Markets and Other Advantages

The different countries in this large region each have specific characteristics. They are also in distinct stages of transition, and the investment climate for international companies differs widely. I will, therefore, deal with this subject in general terms.

In Russia and the region of the Caspian Sea, the huge reserve base of oil and gas represents interesting opportunities. Besides the region offers a huge market potential. As the centrally-planned regime is gradually diminishing, the growth potential within the private sector is substantial. In this respect, the general economic improvements are particularly evident in several of the countries in CEE. From a market perspective, this part of the region is of special interest. However, the market potential is not only found within the region. Following a successful restructuring, the region should become a price-competitive and high-quality supplier to the nearby markets in Western Europe as well as the general world market.

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Besides there are several area specific advantages. There is generally a high level of education and labor costs are low compared to countries in Western Europe and North America. Another positive feature is the well established industrial setting in the region. The availability of inexpensive energy may still prevail. However, with most energy prices gradually escalating to international levels, this may only serve as a short-term phenomenon. For a long-term investor, one should bear in mind that some of the attractive market features in CEE and FSU, like inexpensive energy and low labor costs, may not be everlasting.

Opportunities in Oil and Gas Production in FSU

Russia possesses about 5 percent of the world's proven oil reserves and about 34 percent of the proven reserves of natural gas. The country's large oil and gas provinces are also likely to include a substantial base of undiscovered fields. Within some of the main old oil provinces in Russia, like Western Siberia, the Urals and the Timan Pechora, there is an abundance of well-appraised but underdeveloped fields. The region of the Caspian Sea also provides a large potential of proven and unproven reserves. The geological risk in these areas is considered to be less critical compared to several other exploration opportunities available for international companies.

Many of the international oil companies have their main activities in more mature oil regions in the western part of the world. Entrance to these large oil and gas provinces in the FSU, may serve as an attractive opportunity to expand their business. It is also important to remember that the Russian oil and gas industry is generally characterized by relatively high technical competence.

Most international oil companies in Russia have not yet started development and large-scale production. Relations with central and local authorities as well as Russian partners are generally good. However, the political risk is still considered to be too high.

The passing of the federal law on Production Sharing Agreements, in January of this year, is regarded as a major step in the right direction. The law, however, has some fundamental shortcomings regarding the safeguarding of the investors' rights and obligations, which has to be corrected before western oil companies are willing to make major investments. The most important problem is that many of rights and obligations are not regarded as contractual rights, but are rights deriving from administrative laws which can be unilaterally changed by Russian authorities in the future. The requirement of a well-defined jurisdiction prior to major investments has been a strong concern to the international oil industry. The shortcomings of the PSA have to be solved before foreign investors are ready to proceed with large commitments. The situation is somewhat different in other countries, such as Azerbaijan and Kazakhstan, where the securing of reliable transportation outlets is the main problem.

Market Opportunities in CEE

For the first time since the late 1980s, recorded economic output is growing in most countries in transition. In some countries, real GDP has surged far above its low point, while in others, economic recovery has been slow. As the reform process and economic recovery gathers pace, companies with

their main activities in the more mature markets in the west will show greater interest in the market opportunities in CEE. However, the rapid economic developments in other regions, such as parts of Asia, the Middle East and South America, will provide ample opportunities for international companies and create strong competition for internal resources.

We have already witnessed considerable interest from western oil companies in establishing gasoline stations in CEE. The prospects of increasing car ownership in the region offers an opportunity to develop new markets. However, in some countries an overcapacity in gasoline retailing may already be evident. Domestic refineries in the region, designed to serve the predominant heavy industry, are on the other hand not able to meet the growing demand for gasoline. At the same time, West European refineries are plagued by overcapacity, particularly in the light end of the barrel. Thus, by entering new retail markets close to their refineries in the west, they can secure outlets for their gasoline production at reasonable transportation costs.

Domestic demand for products from energy-intensive industrial segments, like petrochemicals, including fertilizers and metals, has dropped dramatically. For some of these products, the market potential in the domestic sector is considered to be substantial as the economy and the standard of living improve. The increase in food production and the development of infrastructure and housing, should in particular provide substantial market growth. The considerable rise in energy prices has burdened many of these industries with high production costs, particularly due to inefficient energy use. Western companies possessing capital, technology and management expertise will have the opportunity to gain access to the growing domestic market as well as the world market for these products through direct investment.

The privatization process in several of these countries is moving slowly, and the legal framework for privatization and business transactions is not always sufficient in ensuring acceptable risk. The shortage of indigenous energy supply and the uncertainty of future energy supply and the uncertainty of future energy prices may also cause problems. The securing of long-term energy deliveries to the plant at initially agreed terms is one of the keys to success. Also, access to distribution and transportation systems may prove to be difficult and expensive.

Norsk Hydro's Experiences in the Region

Norsk Hydro as an International Company

As an international company, Norsk Hydro is present in more than 100 countries. Energy is the basis of Norsk Hydro's activities. In addition to being a producer of oil, gas and hydro-power, Norsk Hydro is also a substantial consumer of energy. The company has developed a world-wide network for the production and marketing of fertilizer, and is the leading supplier of fertilizers in Europe. The company is a leading producer of aluminum metal and produces different lines of semi-fabricated products. Norsk Hydro is also one of the two largest magnesium producers in the western world. Natural gas liquids from the North Sea provide Norsk Hydro with raw materials for the production of plastic materials. The company is a major supplier of PVC in Scandinavia and the United Kingdom, and has a firm foothold in the Asian VCM markets.

Norsk Hydro's Activities in FSU and CEE

Long before the fall of the Berlin Wall, Norsk Hydro had well-established trade relations in both FSU and CEE. In CEE, fertilizer and aluminum trade accounted for the major part of the activities. Norsk Hydro was a major importer of fertilizers from the FSU as well as raw materials like apatite and ammonia for the fertilizer industry. Furthermore, the company exported alumina and other input material for the aluminum industry to the area and bought aluminum for further marketing. Norsk Hydro also imported Russian crude oil. Apart from these trading activities, Norsk Hydro technology was licensed in several of the fertilizer plants in the region.

As a result of the progress in the region's economic and structural transition, Norsk Hydro's trading and investment activities have increased substantially. Today, Norsk Hydro has offices in most countries in the region, and the company is involved in several cooperative projects.

An important reason behind our engagement is to obtain good relations with interesting local companies as well as with central and local authorities. Due to our early local presence and gradual development of activities based on a long history of cooperation, we are today evaluating a number of investment projects either as a part of the privatization process or as a participant in new projects.

Major Investment Projects in Russia

As of now, Norsk Hydro has decided to concentrate its oil and gas effort in the Barents Sea and the Timan Pechora area in the northwestern part of Russia. We are cooperating with both Russian and Western partners in order to find economically viable solutions for the development of the huge Shtokman gas field in the Barents Sea and for several oil fields in the Timan Pechora region. Over the years, Norsk Hydro has spent significant resources in the appraisal of the geological and commercial potential within these regions. This is done in close relation with local and central authorities as well as local and international companies engaged in exploration and production activities in the region. Norsk Hydro is also actively considering participation in specific fertilizer and aluminum plants in Russia.

Development of Agriculture in Ukraine

Ukraine, once the "bread basket" of Europe, has a larger arable area than any other European country. However, the productivity of the agrarian sector has been low compared to Western Europe. Since the break-up of the Soviet Union, the Ukrainian agricultural sector has suffered a major depression. Fertilizer consumption has fallen dramatically, and is presently around 25 percent of the peak at the end of the 1980s. However, with political stability and a successful restructuring of the agricultural sector, Ukraine has a huge potential for increased agricultural production and significant growth in fertilizer consumption. Our aim is to become a full-scale distributor and supplier of high-quality products and services, and we are taking the first steps to position Norsk Hydro for the transition and growth in this market.

Ukraine is also a large producer of fertilizers, based on imported Russian gas. As a partner, Norsk Hydro has been actively involved in the trade of Ukrainian fertilizers and

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to the quantity of energy demanded, unless otherwise specified.

³ Primary commercial energy comprises coal, oil, gas, nuclear power, and hydroelectricity.

⁴ China's total oil consumption still grew in 1994, but the growth rate was considerably lower than in 1993. Indonesia's decline of oil consumption in 1994 was mainly caused by a sharp decrease of fuel oil use. The oil demand status of China and Indonesia will be further discussed.

⁵ In both cases, the direct burning of crude oil is excluded from total petroleum product consumption when the share of gasoline is calculated for Japan and China here.

⁶ For further discussion, see "Update of the Indonesian Oil Sector: Declining Demand in 1994, Future Imbalances, and Deregulation Outlook," by W. Prawiraatmadja and F. Fesharaki, Energy Advisory No. 158, 27 July 1995, Program on Resources, East-West Center, Honolulu, Hawaii.

⁷ International bunker fuel oil and bunker gasoil consumed in Singapore are included in total demand.

⁸ The crude export availability is defined as the gross exports of crude oil from a producing country, and it is the difference between domestic crude production and the demand of domestic refineries for these crudes.

⁹ Part of the Timor Gap is jointly developed by Australia and Indonesia.

¹⁰ Import dependence is defined as the share of net oil import requirements (total petroleum product consumption minus regional crude production) in the region's total petroleum product consumption.

¹¹ If the intraregional imports were excluded, the Middle East accounted for over 90 percent of the Asia-Pacific region's actual imports of oil (crude and products combined) in 1994.

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ammonia. We recently purchased an interest in an import/export terminal in Yuzhny by the Black Sea, and plan to increase the company's trade of ammonia and fertilizers with both Ukraine and Russia.

Participation in Slovalco

In 1986, Norsk Hydro and the Slovakian aluminum producer ZSNP signed a know-how agreement that required Norsk Hydro to contribute electrolysis technology. In 1993, based on the agreement, Hydro Aluminum and ZSNP formed a joint venture, in which Norsk Hydro was responsible for the replacement of ineffective and polluting production units. In addition, Norsk Hydro would also provide management assistance during the period of production testing as well as in the plant's general operation. The agreement also involves an accord with the Slovakian authorities to develop an extensive plan for environmental improvements in the aluminum production process.

Today, Norsk Hydro owns a 10 percent interest in Slovalco, and is responsible for managing the company's sales and marketing operations. In addition, Norsk Hydro is responsible for marketing Slovalco's export tonnage. This project has been extremely positive, and is an example of cooperation that can be copied in other places.

Fertilizer Production in Rostock

In early 1991, Norsk Hydro acquired 100 percent of the Rostock fertilizer plant in former East Germany. The plant's technical standard was good, but a major turnaround was required to make the plant a world-class performer. Since the takeover, fertilizer production has more than doubled to 1.6 million tons per year, while the number of employees has been reduced from roughly 900 to 320. With the introduction of efficient production and marketing, the Rostock plant is now very competitive.

This illustrates some of the pains - and the eventual rewards - of such a restructuring process. As prices of energy and salaries rise to West European levels, the securing of long-term and cost-efficient production will imply major restructuring.

Norsk Hydro is presently working on several other projects in both the FSU and CEE. Our main aim is to participate in the production, distribution and marketing of aluminum and fertilizers, as well as participate in the production of oil and gas.

Recommendations and Conclusions

The FSU and CEE have a tremendous potential for economic development. The gradual transition to an economy with productivity at the OECD level will surely bring with it pain, as has already been observed. Nonetheless, the long-term benefits for the countries and the population at large are obvious.

From a business point of view, a successful transition will require: compensation; state-of-the-art technology and know-how; and large investments.

International companies can meet each requirement. But to attract such companies, the overall conditions for the international investor must be acceptable. This means, among other things: fair sharing of the economic surplus between the host government and the investor and reliable and stable legal framework and taxation.

To attract high-quality, long-term investors, i.e., those companies which intend to stay in the country and be an integrated part of the economy, it is important to have a high degree of transparency. By this, I mean transparent and fair rules and regulations for the industry. If this is not the case, unjust discrimination and corruption may result. This will attract people or companies which are mostly interested in making a quick profit without long term considerations.

Norsk Hydro is prepared to meet the challenges in the countries in economic transition. Let us hope that the progress in market liberalization in the region will continue, and that it proves to be of the utmost benefit for the countries involved. We believe this will require strong participation by international companies and we are, therefore, pursuing a number of business opportunities within our core business areas.

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