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IKTVA: increasing local contribution to Saudi Arabian economic growth

The promotion of local content in Saudi Arabia has gained prominence ever since the launch of the In-Kingdom Total Value Add (IKTVA) programme back in 2015. The programme introduced new Local Content Requirements (LCRs) in order to maximise the benefits to its own economy from its energy sector by increasing the capabilities and capacities of the domestic market. Recognising that this objective may be at odds with market realities, the Kingdom has taken steps to develop the industry and its workforce by investing in Research and Development (R&D), creating Joint Ventures (JVs) with foreign firms and embedding localisation into procurement. But the Kingdom will need to maintain an enabling environment to ensure that LCR initiatives are sustained. More, effective monitoring will help identify barriers and measure progress, which will then need to be addressed and communicated publicly.

The MENA region accounts for 46% of the world's oil & gas reserves; yet when the existence of such mineral wealth first became known, most of the countries, especially those in the Gulf, lacked the infrastructure and skills to monetise them. The extraction and development of oil and gas obviously has a huge impact on regional economic development, revenues, employment and the wider industries and services. However, the industry is capital intensive and relies on sophisticated machinery and equipment, as well as highly skilled labour. Historically, this was and continues to be sourced from overseas suppliers, but this of course means that the benefits of the hydrocarbon wealth on a country's economy will be correspondingly lower.

To maximise on the benefits from the oil and gas industry, countries in the region have therefore been adopting in some shape or form - local content requirements (LCRs). Whilst the definition and practice of these policies differ on a country-by-country basis, the objective is to give priority to nationals, domestic companies and locally produced material in the procurement of goods and services. More, LCRs have become a useful tool for oil and gas producing countries in particular as a means of creating domestic jobs and generating income, whilst at the same time furthering technological advancements and fostering economic growth.

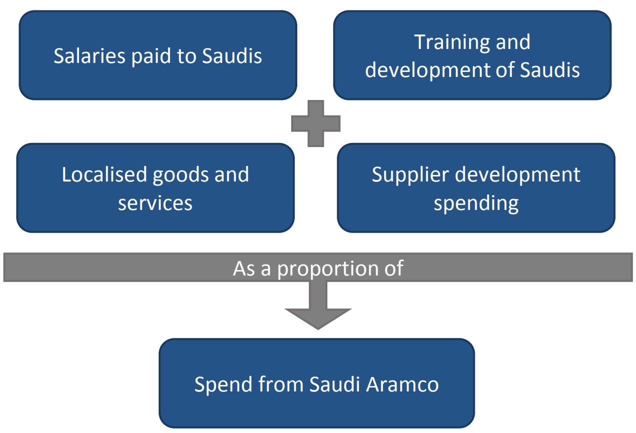
In December 2015, Saudi Arabia launched its IKTVA programme (translated as self-sufficiency in Arabic), aimed at boosting local content in the country. The programme seeks to maximise participation and value for Saudi nationals and companies. IKTVA applies to every Saudi Aramco supplier; in turn, the national oil company will maintain a central procurement database to monitor and evaluate value added.

In-Kingdom Total Value Add

Prior to the IKTVA launch, Saudi Arabia had existing agreements dating back to 1965 when the government signed concessions with the French state oil company AUXIRAP for exploration rights in Saudi Arabia and in participation agreements with major oil companies in 1972. Countries across the region have been implementing their own LCRs in order to maximise the economic benefits of oil and gas production, but also to develop other sectors in the economy. In the GCC, the policy of prioritising employment of its nationals has coined the terms Emiratisation, Qatarisation and in KSA – Saudisation, whereby companies and enterprises are required in some instances to fill up their workforce with a minimum percentage of nationals.

But not all LCR policies necessarily stipulate a threshold. In some instances the obligation is instead to give priority to local goods and services, but only when certain parameters such as timeframes, quality of services and costs are comparable. Some governments recognise that local content cannot immediately compete with what can be imported, and local firms are therefore offered a percentage buffer within which priority is given to them even if costs are higher. For example, Saudi Aramco, as part of its procurement criteria, incentivises its local suppliers by paying a 10% premium for local content.

Local content under IKTVA is defined as the total ($) spend on



However, the IKTVA programme was more comprehensive than this, with clear definitions on what constitutes local content. The programme is less flexible on its obligations, specifying timeframes and minimum requirements on local content. When the programme was launched in December 2015, Saudi Aramco LCR stood at 30% - a respectable figure by regional standards - and targeting 70% by 2021.

What is unique, though, is that Saudi Arabia has established an institution for monitoring and enforcing LCRs. This will help quantify and evaluate benefits in the long-run, ensure that all parties are abiding by their contractual obligations, as well as in identifying barriers along the way that may hamper local content targets.

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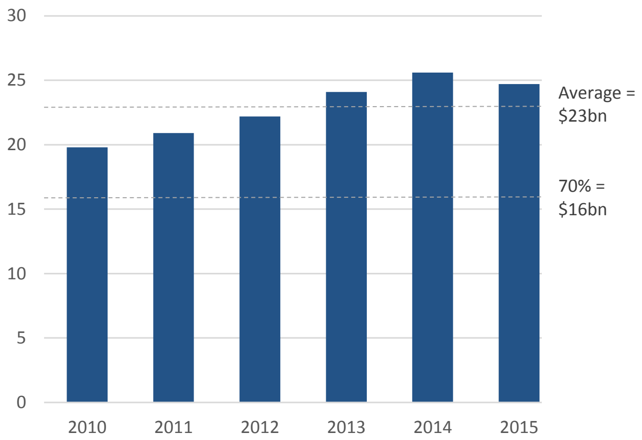
Benefits to the overall economy

LCRs are introduced to increase the proportion of local benefits by increasing domestic capacities and reduce dependence on foreign imports of goods and services. Saudi Arabia's IKTVA programme also aims to export 30% of its output from local energy goods and services industries by 2021, and over the long-term, deliver 500,000 direct and indirect jobs for Saudis. To put this into perspective, average spend on oil services alone by Saudi Aramco over the past five years has been approximately $23bn. A 70% target would crudely translate into a $16bn benefit per annum back to Saudi Arabia, assuming average spend remains the same.

Saudi Aramco spend on oilfield services ($bn)



Source: Rystad Energy

The promotion of local employment opportunities also provides broader economic benefits to the country. As with all LCRs in the region, IKTVA mandates preferences for qualified nationals where costs and skillsets are comparable to non-nationals. In turn, an increase in local jobs will enhance overall economic activity through greater consumption and investment. The wealth generation particularly for communities in oil and gas producing regions will help ease the negative sentiments often associated with the hydrocarbon sector and energy companies. Oil and gas developments can often have an adverse impact on surrounding communities and the perceived reliance on foreign labour gives off the impression of inequitable distribution of national wealth. Therefore, LCRs help the government demonstrate its willingness to create more local jobs, giving locals a role in creating linkages with the rest of industries and diversifying the economy and authority to maximise on the country's natural resource endowment.

In December 2016, two joint ventures were set up with US firms Rowan and Nabors providing opportunities to localise the drilling industry and enhance domestic capabilities. The aim is to invest between $6-7bn on onshore rigs and offshore jackups manufactured locally, to maintain in-country spending. The total initial value of the JVs is estimated at $2.2bn and could lead to the creation of up to 5,000 jobs.

Boosting local manufacturing

IKTVA attempts to follow the fundamental principles associated with the introduction of local content requirements. In principle, LCRs are introduced to ensure that overtime, imported goods and services, are substituted with those supplied domestically, as technology improves and the capabilities and capacity of local industry and workforce develops. In a speech last year, the minister of energy highlighted that localisation of the Saudi economy – which has similar targets to Saudi Aramco – had reached 35% in 2015 and was expected to reach 50% by 2021 and eventually 70% by 2030. Whilst in Saudi Aramco, the share of local manufacturers in 2016 had reached a company record of $2.6bn or 43% of total spend, a 16% increase on the year before.

LCRs help create a level playing field when competing with foreign firms, and reduce dependence on imports of goods and services. Saudi Aramco is pursuing an integrated programme to encourage suppliers to procure their goods and services locally. Following the launch, it immediately reached out to its top suppliers - 199 of which completed IKTVA surveys - evaluating their existing IKTVA scores and creating five-year plans to help them improve their ratio. This also creates a level playing field amongst domestic firms by adopting a uniform evaluation process, giving local suppliers access to project information.

Local sourcing is key

As with local hiring, mandating companies to source locally manufactured equipment and machinery – where price and quality are comparable to those available internationally - will accelerate technical progress. Saudi Aramco has outlined plans to spend $300bn on its supply chain over a 10-year period, to boost local manufacturing, and by December 2016, over $16bn worth of contracts were signed in compliance with IKTVA. The likes of Schlumberger and Halliburton were awarded the "IKTVA Excellence Awards" on categories including Saudi workforce training and development, in recognition of their contribution towards the IKTVA goals. Saudi Aramco also signed agreements with Jubail Energy Services and ArcelorMittal to develop the local manufacture of tubes used in oil and gas production. From the perspective of IOCs, this could also represent a cost saving, as there will be a lesser need to import goods and services from abroad, bringing down operational and capital costs.

Foreign firms are often required to bring some level of technology and perform R&D to boost competitiveness, encourage start-ups and increase technology patents. In 2011, Siemens Energy announced the founding of a specialist facility in the King Fahd University of Petroleum and Minerals (KFUPM), to provide collaborative R&D support for energy-related topics, knowledge-sharing, as well as training for local students and the Kingdom at large. Since then, Saudi and Siemens negotiated joint R&D agreements on renewable energy and digitisation as part of the Kingdom's efforts to diversify beyond fossil fuels as well as bringing in advanced analytics and the latest cloud technology.

Challenges to the Kingdom

As with any country's plans to increase the share of nationals in the workforce, LCRs can have an adverse effect on the economy if they are not implemented correctly.

First, introducing targets without adequate support from government and the provision of the necessary tools to implement strategic objectives could hinder a company's development, and day-to-day progress. For example, a company operating below the local workforce target may opt to hire the cheapest form of national labour, simply to meet the quota, and in effect incur added expenses with little value to the company; not only that, but it would also contribute very little towards the country's plans for developing human capital. Likewise, imposing minimum LCRs on companies may result in hiring individuals or contracting local firms that will produce lower quality outputs, and in turn affect the overall performance of the company, profits, domestic services and its competitiveness on a global scale.

Governments need to ensure that when LCRs are introduced, the country has taken the necessary measures that will provide companies and their workforces with the means to grow and develop, enabling them to support LCR targets in the long-run. Rather than simply offering new local candidates jobs, the aim should instead be to prioritise suitably qualified nationals who are already employed and who have skillsets comparable with their foreign counterparts. At the same time, they need to ensure that adequate training is provided. Siemens has committed to help develop vocational education and training with the Saudi Colleges of Excellence. Similarly, IKTVA has already partnered with the Technical and Vocational Training Corporation, aiming to increase the number of national training centres from 12 to 28 by 2030, allowing them to graduate around 360,000 young Saudis in a wide range of disciplines.

Second, a degree of flexibility should be introduced to create the right incentives. This is important in order to maintain quality especially in the absence of adequate locally manufactured goods and services. Collaborating with foreign firms is a positive first step in enhancing domestic products and labour due to the transfer of skills and knowledge. Earlier this year, Siemens completed the first "made in KSA" gas turbine, the largest turbine in the GCC and the first in the Kingdom.

But misaligned incentives and unrealistic targets could tempt foreign firms to shirk or even forgo certain contractual obligations. This was the case in Iraq, when international oil companies gave less priority to the extraction of gas during the production of oil; the same was true in the hiring of local talent. The Technical Service Contracts for example stated that preferences should be given to Iraqi entities, and the procurement process included assessment of the bidder's local content strategies. But the lack of involvement from international oil companies during the procurement process, the absence of a legal obligation for companies to report back on local content progress and a failure by government to establish monitoring institutions, meant that the benefits to the country were not observed or maximised, as companies were driven purely by output targets.

Third, the role of government and its ongoing support and engagement with operators, both domestic and foreign is crucial. A flexible approach allows operators to better align LCRs with market realities. Local content laws with clear guidelines should be established to provide institutional support to international firms in the design and implementation of local content plans across the project life cycle. From the outset, as early as contract negotiations, a clear definition of what counts as success in terms of local content needs to be agreed by all parties.

Not only will this help with the monitoring process, but by collaborating and demonstrating a degree of flexibility, it ensures that interests are aligned and will result in higher levels of transparency and thus LCR success.

In February 2017, Brazil underwent a major revamp on its local content requirements, in a bid to revitalise the oil and gas industry. But complex and strict requirements, unrealistic minimum thresholds and hefty premiums for local content over international prices, led to delays, cost overruns and hefty fines for operators who could not meet the LCRs, which reached as high as 77% for onshore development. Operators were forced to anticipate the levels of local content they might be able to secure at the bidding stage with little information about the reservoirs or the technology available. After several discussions between government and industry, the decision to relax LCRs and simplify the process was taken in order to encourage foreign firms to reconsider prospects in Brazil.

Ensuring success and sustainability

While progress on local content development in the region has historically been slow, the IKTVA programme attempts to adopt a more comprehensive approach. This is especially important now, given that the squeeze on government budgets and the need to diversify economies and reduce dependence on oil revenues has prompted the importance of reinvigorating LCR laws and implementing them more effectively.

Key to the successful implementation of a local content policy will be the creation of an enabling environment for both local and foreign firms. Localisation plans need to be coordinated and reflect the current state of the industry. Therefore, targeted investment from both government and foreign investors is required to ensure the development of human capital as well as technical progress. The success of the programme will hinge on the establishment of effective monitoring institutions in order to evaluate progress, identify risks and assess whether the capabilities of the workforce and the industry are adding value over time. For this, you need to have the tools to measure progress, demonstrate results and communicate them publicly.

IKTVA has laid the foundation, by establishing clear targets, creating a registration process and pooling together local suppliers. It has already partnered with several international firms in a series of joint ventures that will see a greater proportion of locally manufactured goods, investments into R&D to help accelerate technological progress, and supporting employment of locals by developing specific and industry focused jobs. Effective monitoring will ensure that where there are gaps in capacity, they can be addressed, including the alignment of talent development initiatives with employment needs. This will help put firms, particularly foreign firms at ease, knowing that the country has the domestic capabilities required

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