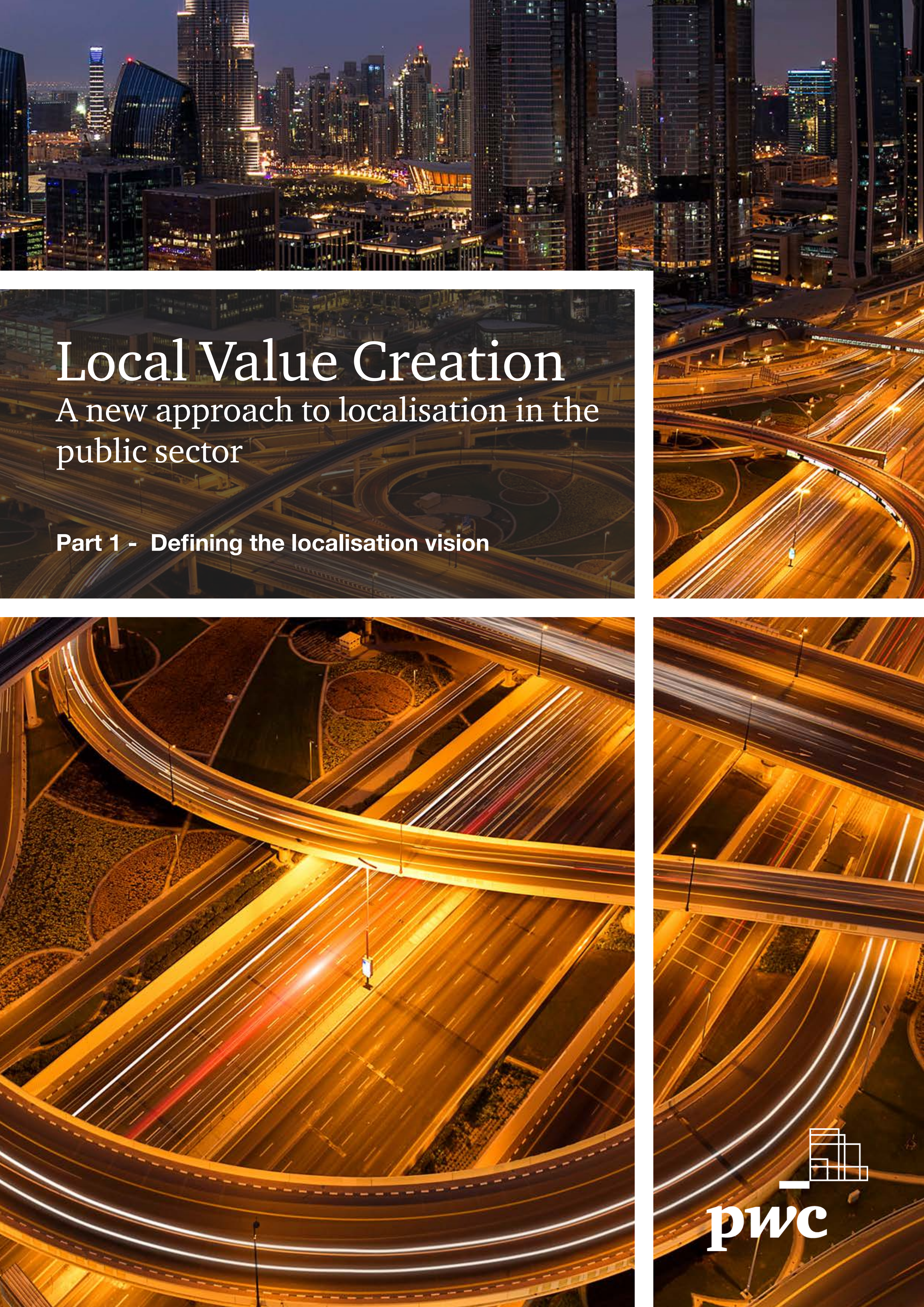

Local Value Creation

A new approach to localisation in the public sector

Part 1 - Defining the localisation vision

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About the authors

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PwC's Middle East Local Value Creation series aims to provide a clear framework for governments in the Gulf Cooperation Council (GCC) countries when designing, implementing and managing their own national localization agendas. Through a series of papers that break down and explain each component of PwC's Localisation Framework, we will lay the groundwork for the design of localisation programmes from top to bottom, covering the complete value chain from conceptual design to implementation across the public sector.

In this edition of the **Local Value Creation** series, we will focus on the first step of designing a successful localisation programme: defining the Localisation Vision. We will explain how governments can identify the key strategic objectives of their localisation programmes and build a localisation formula that allows them to stimulate value creation and capabilities development in key areas of strategic importance.

To better understand how GCC countries can adopt more value-based, dynamic, and effective types of localisation policies we need to first understand where these types of policies came from, how they have evolved, and why they have been an important policy tool for GCC countries.

PwC's Localisation Framework

Background

The GCC countries are transforming as never before. Realising the need to build local capabilities, stimulate sustainable economic growth and diversify economies away from oil and gas sectors, several GCC countries have launched a series of transformative national development strategies. Perhaps the most well-known example is Saudi Arabia's Vision 2030, which seeks to help reduce the country's reliance on oil and gas revenues by developing sectors such as manufacturing, tourism, defence, and logistics. Oman also recently released its Vision 2040 document, placing a strong emphasis on education and human development. Common to all of these strategies is an emphasis on development of local capabilities, strengthening of the private sector, high-quality employment opportunities, and development of new and promising industries. Localisation initiatives will play a key role in realising these objectives, providing opportunities to leverage local assets and develop local capabilities.

Initially focused on employment of locals, the concept of localisation has been around for decades in GCC countries. In the latter part of the 20th century, Gulf countries were largely reliant on foreign expertise, technology, and skilled labor, depending on western countries for technical know-how in areas ranging from infrastructure development to oil and gas production. Faced with concerns over national economic security and autonomy, these countries eventually realized the need to reduce reliance on expat labor in critical state institutions like national oil companies and government ministries. To address this issue, the GCC governments started to impose restrictions on the number and type of positions available to foreigners while at the same time promoting the employment of nationals in critical technical, managerial, and leadership positions.

As GCC countries began to develop at a quicker pace following increased government revenues resulting from the high oil prices of the 1970s, they sought to further expand localisation efforts by implementing Local content (LC) policies. LC policies aimed to increase the amount of goods and services procured from exclusively locally owned companies, primarily in the oil and gas and government sectors, by providing a competitive advantage to locally-owned companies in the procurement process. However, these policies were limited in scope and lacked a comprehensive approach to localisation, which resulted in weak governance and difficulties in measuring their effectiveness. Today, GCC governments are looking to transform and expand their localisation agendas by adopting more dynamic and comprehensive approaches to local content policy.

In the United Arab Emirates, Saudi Arabia, Oman, and Qatar, governments have already begun to transform existing LC agendas, moving away from the model of preferential treatment for locally owned companies towards the more dynamic concept of overall local value creation. For example, Petroleum Development Oman (PDO), a government-owned oil and gas exploration and development company, launched its In-Country Value (ICV) programme, targeting Omanization of oil and gas sector jobs, an increase in procurement of local goods and services, and the development of local suppliers that provide inputs into the energy sector. Abu Dhabi National Oil Company (ADNOC), Saudi Arabian Oil Company (Aramco), and Qatar Petroleum (QP) have also implemented similar programmes, seeking to drive localisation in their energy and industrial sectors.

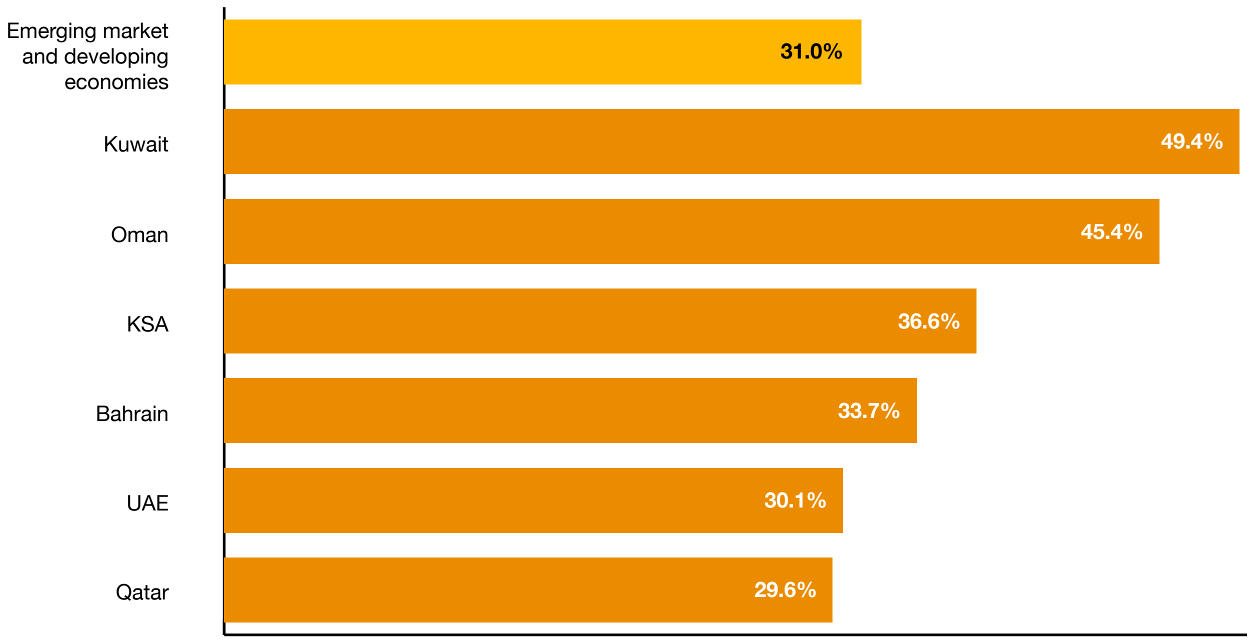
Given the large share of oil and gas activity in GCC economies, these programmes are almost exclusively focused on the energy sector; however, there is great potential to further expand the localisation agenda into the public sector. Government organisations, including ministries, public-private partnerships, and state-owned enterprises, are in a great position to further drive the localisation agenda in GCC economies. To do so successfully, they will need to learn from the experience of the oil and gas sector and adopt the same concepts on a larger scale, across a diverse body of organisations, and each with different mandates, missions, and objectives. But first, it would help to understand the imperative for the public sector to transform and expand existing localisation policies in the region.

The localisation imperative for the public sector

Well-allocated government spending is key to the functioning of a healthy society and productive economy. Governments provide critical public goods and services such as fire protection, water treatment, policing, education, and the infrastructure upon which modern society operates. Furthermore, well-managed government expenditures support sustainable economic growth, where government spending and procurement activity can provide new business opportunities to suppliers in the private sector, increasing overall employment and business activity.

In GCC economies, governments are the main drivers of spending and investment. Public organisations in the region spend billions every year on new capital projects across healthcare, education, security and defence, utilities, and transportation. In turn, governments also pay hefty sums to maintain and operate their assets, ensuring that key public goods and services are delivered to the citizens and residents whom they serve. In most GCC countries the public sector is far larger in economic terms than the private sector. While some countries have been successful in creating a greater role for the private sector (as in the case of the UAE), overall public sector spending still averages thirty eight percent in the region, not to mention activity of state-owned enterprises and other semi-governmental organisations that may not necessarily be recorded as government spending.

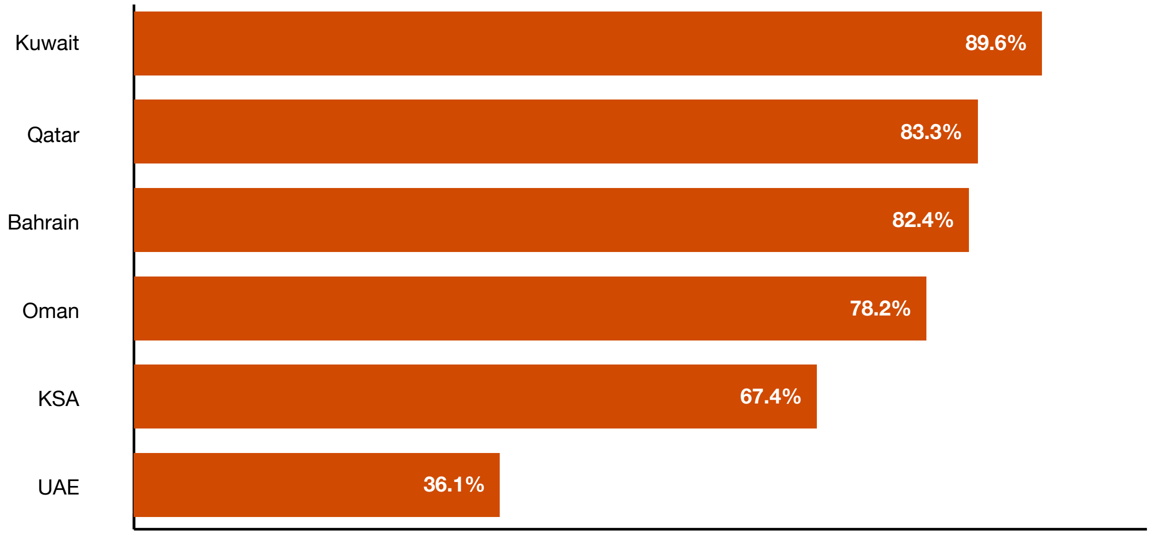
Exhibit 1 - General government total expenditure (as % of GDP) 2018



IMF World Economic Outlook Database

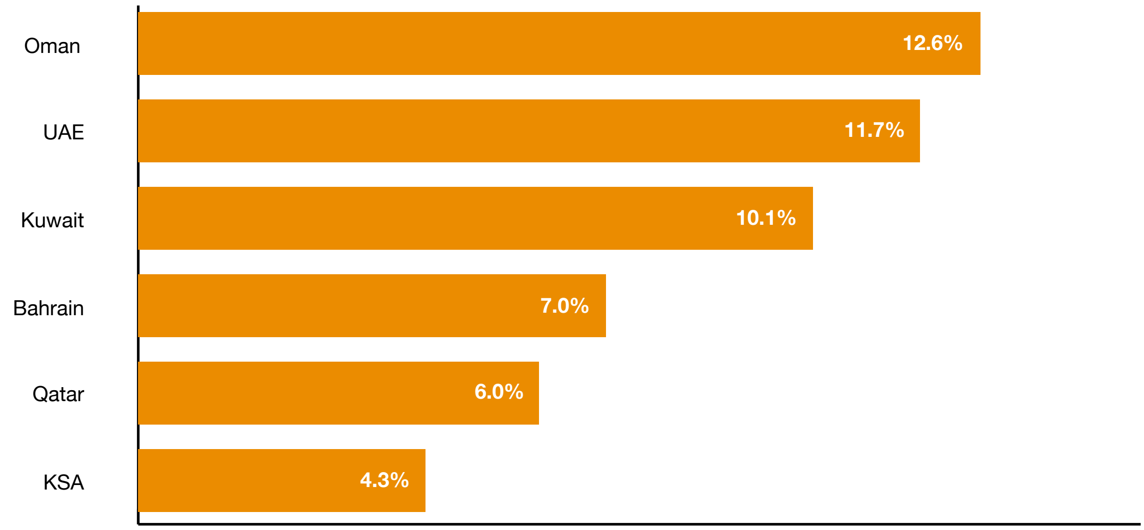
High government spending and investment, sustained almost exclusively by oil and gas revenues, has helped transform these former desert oases into modern, highly developed metropolises. Yet, there remains a great opportunity to leverage this spending to create more value for the local economy and develop domestic capabilities to sustain it. Much of regional government spending is leaked out of the local economy to foreign businesses and individuals, with a high reliance on foreign skilled labor and imports of manufactured goods and high-skilled services. GCC countries are also largely dependent on imports of things like food, automobiles, electronics, advanced machinery, professional services, and pharmaceutical products, possessing limited capability to produce these goods locally. Localisation initiatives provide an avenue through which governments can promote local value creation and development of the capabilities necessary to produce such goods and services domestically.

Exhibit 2 - Oil and Gas revenue (as % of total government revenue) 2018



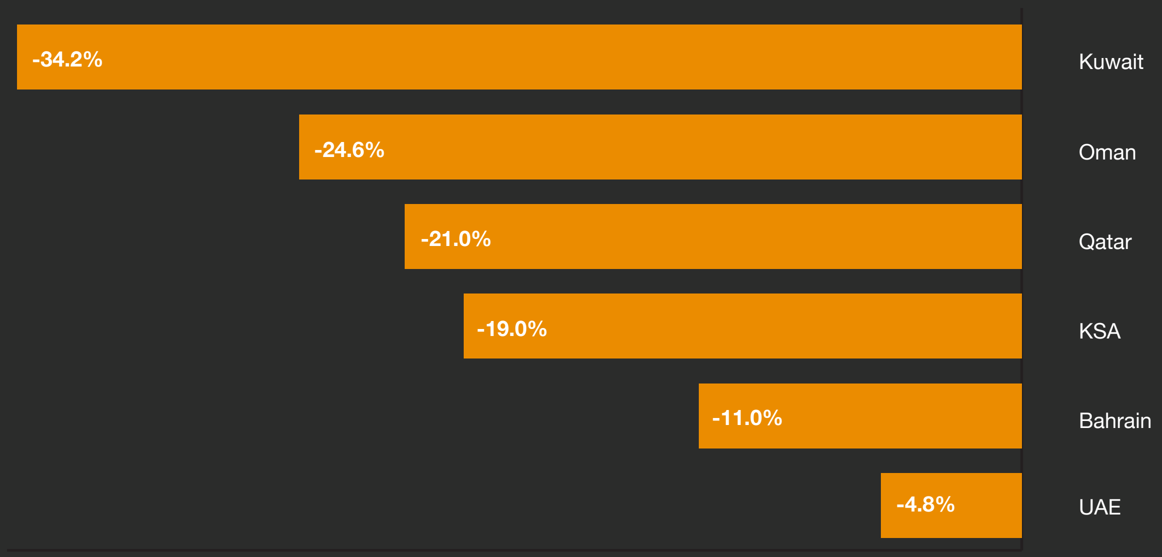
GCC Countries Ministries of Finance

Exhibit 3 - Remittances outflows (as % of GDP) 2018



World Bank, IMF
*2018 data for UAE and Bahrain are not available; numbers presented are from 2017.

Exhibit 4 - Trade balance excluding petroleum products exports (as % of GDP) 2018



IMF World Economic Outlook Database October 2019

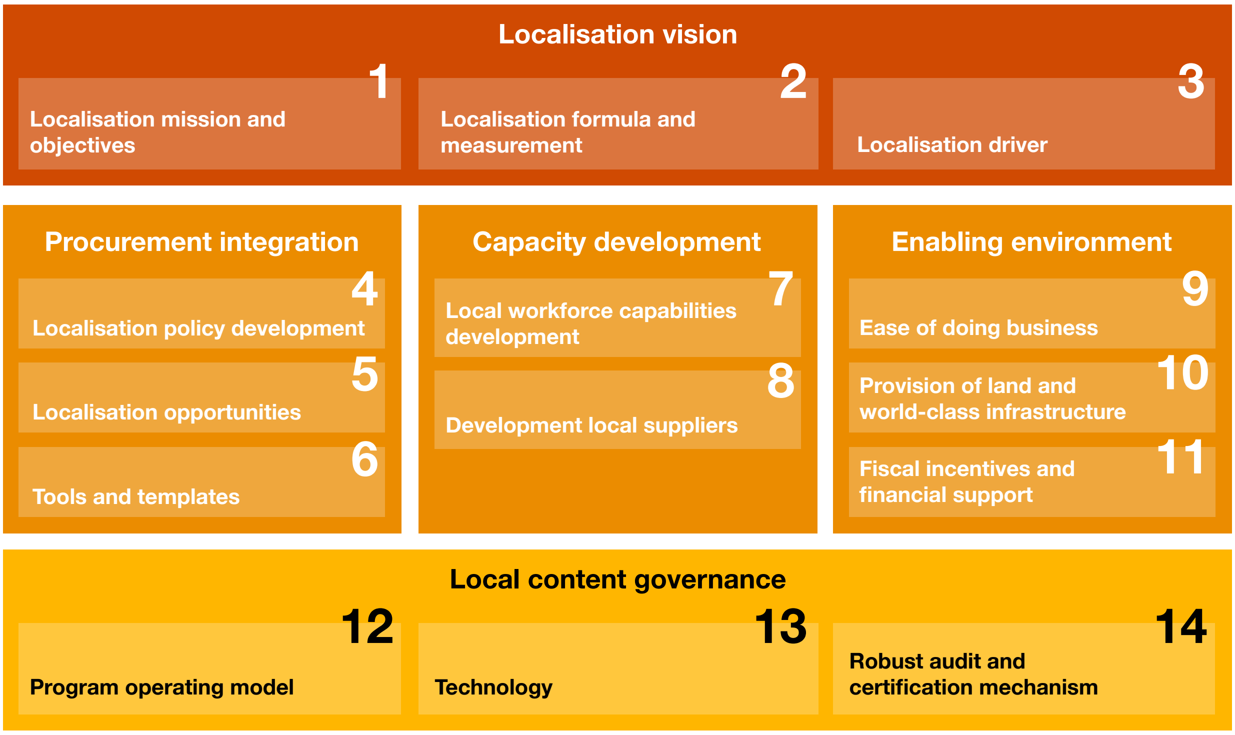
While each country will define its own vision and strategic objectives based on its unique characteristics and development goals, the concept of localisation aims to achieve several high-level objectives, including:

- Diversifying the economy and driving sustainable economic growth
- Improving competitiveness of the economy and creating a greater role for the private sector
- Contributing to the formation of a skills-based knowledge economy, and investing in research & development and new technologies
- Strengthening economic resilience and self-reliance in the national supply chain
- Fostering innovation and entrepreneurship essential for a robust private sector

PwC’s localisation framework

We have designed a localisation framework to help government officials and decision makers drive localisation across the public sector. PwC’c localisation framework, which is made up of the following components, has been designed to help government decision makers drive and execute successful localisation strategies:

- **Localisation Vision:** A clear, unified localisation vision and strategy, identifying the strategic focus areas and targets, along with a formula tailored to each country’s unique social and economic objectives.
- **Procurement Integration:** An analysis of localisation potential across an organisation’s categories of goods and services procurement, including design of a mechanism to incentivise procurement of local goods and services, and development of the tools and templates required.
- **Capacity Development:** Initiatives to build the skills of the local workforce and develop the capabilities of local suppliers.
- **Enabling Environment:** A host of policies and initiatives that seek to improve a country’s business environment and enable localisation, including fiscal incentives, ease of doing business, and infrastructure.
- **Localisation Governance:** Development of the localisation governance model, enabling technologies, and monitoring and evaluation approach.



Formulating the localisation vision

The following sections of this edition of PwC's **Local Value Creation** series will focus on the first component of the Localisation Framework; namely, the Localisation Vision. The Localisation Vision provides the basis upon which the rest of the localisation framework components are developed. It entails several elements, including definition of the localisation strategic objectives, creation of the formula and calculation mechanism and identification of the localisation champion.

1. Definition of localisation strategic objectives

Identifying the high-level objectives of a country's localisation programme will differ from one country to another depending on each one's unique challenges and development objectives. For example, faced with the challenge of high demand for youth employment, a large local population, and a limited presence of women in the workforce, Saudi Arabia decided to focus one of its localisation strategic objectives on increasing overall employment of women in the workforce. In Kuwait, however, where there is a much smaller local population and a high per-capita GDP, the government may decide instead to focus on employment of nationals in certain key positions, primarily in public sector organisations. To determine the correct strategic objectives, the government should rely on its existing national development strategies and vision documents.

These strategy documents will contain a tailored set of goals, targets, and key performance indicators to help guide the process of selecting and customizing the localisation strategic objectives. While these will often differ from country to country, the following list of objectives tend to be present in many GCC countries' development strategies:

Enhance economic resilience and self-sufficiency

Supply chains in the GCC tend to be heavily dependent on goods imported from overseas. Dependency on imports leaves these countries more exposed to several risks, including commodity price fluctuations, global economic crises, political instability, natural disasters, and other factors that can obstruct imports of essential commodities and adversely affect import-dependent industries. GCC countries can increase economic resilience and sustainability by localizing activities critical to the continuity of domestic production, such as manufacture of spare parts, production of essential raw materials, critical maintenance and repair services, and provision of agricultural products.

Diversify the economy

Given regional economies' reliance on oil and gas revenues, nearly every national development plan in the GCC countries highlights the importance of economic diversification in one form or another. Localisation can help drive economic diversification in a couple different ways, including promotion of value chain linkages and development of promising nascent supplier industries:

- **Backward Linkages.** Those linkages and interdependencies that exist between a government organisation or company and the suppliers that provide the inputs of goods, services, information, or material to it. Diversification can occur when a government organisation or company sources inputs from local suppliers in different industries, such as from IT services, construction, engineering, and management consultancy. By providing business opportunities to these suppliers, new and diversified industries are established and strengthened.

- **Forward Linkages**. Those linkages created when a government organisation or company invests or spends on projects and operations that produce further output and investment in subsequent stages of the value chain. An example would be a government investment in a port free zone, where investments in such infrastructure incentivize companies to set up business in the free zone and conduct further value added activities.

- **Supplier Development.** Localisation initiatives can help to promote the development of new and existing local suppliers in a range of industries. This can help expand the local supply base and enhance economic diversification.

Provide employment opportunities

Growing demand for high-skilled employment is a persistent challenge throughout GCC countries. As a strategic objective of the localisation agenda, regional governments may decide whether to focus on employment in absolute terms or target high-skilled and high-paying jobs in specific fields such as engineering, data analytics, cyber security, or project management. In Oman's ICV programme, for example, efforts were focused on increasing overall employment (Omanization) of Omani locals, whereas in Qatar, which has a larger expat population relative to locals, employment targets focused more on increase of high-skilled employment for both locals and expats above a certain minimum salary, aiming to further enhance the local knowledge economy.

Build local workforce capabilities

Related to the issue of demand for high-skilled employment is local workforce capabilities. A mismatch between labor market needs and available skills is one of the root causes of unemployment in GCC countries. Localisation can play a key role in increasing local workforce capabilities. Not only can it designate a preference to locals for high-skilled job opportunities, but also provide upskilling and development programmes aimed at increasing the technical, managerial, and leadership skills of the local workforce.

Drive entrepreneurship and private sector growth through SMEs

The private sector's share of gross domestic product (GPD) in several GCC countries is significantly lower than in other parts of the world. For example in Saudi Arabia and Kuwait non-oil private sector contribution to GDP in 2018 was around 44% and 26% respectively, less than most other developed countries around the world where the private sector constitutes the bulk of national economic output. Furthermore, there are only a limited number of SMEs in the GCC, while globally SMEs make up around 90% of businesses and provide upwards of 50% of employment. To target development of SMEs, measuring the participation rate of local SMEs in government procurement could provide a way to measure and incentivize the use of local SMEs.

Other objectives

There are numerous other strategic objectives that countries may consider as part of the localisation agenda. These may include investment in research and development, sectoral development (health localisation, defence localisation, etc.), technology and intellectual property transfer, and others. Regardless of which strategic objectives each government chooses, it is key that each one be directly related to and derived from existing national strategy and vision documents.

2. Creation of the formula and calculation methodology

After identifying the strategic objectives, the next step in the localisation framework is to translate these objectives into a clear localisation formula and associated calculation mechanism. The formula is at the heart of the localisation programme and is used to measure to what extent a supplier company or organisation's operations are localized. The formula should be simple yet effective, and easy to administer and evaluate. It should also be flexible enough to capture shifts in macroeconomic conditions and adjustments to the country's strategic objectives. Governments can utilize it to determine the local content generated, and indirectly, the impact on GDP and other macroeconomic metrics.

The formula consists of multiple components, each of which will help drive the desired outcomes of the localisation agenda. For example, if employment of nationals is one formula component, then capturing the value of salaries paid to employees will help measure and incentivize employment of nationals by suppliers working in the country. This will then contribute to meeting the strategic objective of reducing unemployment of locals. Similarly, if one of the formula components is spend on in-country research and development activities, then capturing the amount spent on these activities will allow the government to track and promote further spend on in-country research and development activities.

Below is a table that highlights some of the key formula components from localisation programmes around the region and internationally.

	Category								
Value Creation	**In-country value of goods**	■	■	■	■	■	■	■	■
	In-country value of services	■	■	■	■	■	■	■	■
	Investment in fixed assets	■	■	□	□	□	■	□	■
Supplier and competitiveness	**Spend with SME**	■	■	□	■	■	□	■	□
	Supplier development	■	■	□	□	□	□	■	■
	R&D	■	■	■	■	■	□	□	□
	Value of export	□	■	□	□	■	■	□	□
Workforce	**Training of workforce**	□	■	□	■	□	■	■	■
	Local workforce	■	■	□	□	■	■	■	□
	Female workforce	□	■	□	□	□	□	□	□

Each formula component should be derived from an individual strategic objective, thus providing a way to measure to what extent these strategic objectives are being met through the localisation agenda. For the localisation programme to be effective, countries should prioritize components that are closely linked their development needs, leaving out less urgent areas to avoid diluting localisation efforts.

Formula calculation

The first element of a typical localisation formula is the total in-country spend. It is calculated by aggregating the supplier's in-country spend on each of the formula components. The total is then divided by either revenues or costs of operations in-country, depending on which is most applicable, to produce a localisation score. Countries may choose to assign weights to certain formula components depending on their priorities and how urgent the outcomes linked to these components are.

$$\frac{\text{Total In-Country Spend}}{\text{Revenue or Costs}} = \%\ \text{Localisation Score}$$

For example, if 'Company X' enters into a contract for \$350 million and spends a total of \$200 million in-country on different formula components, then the localisation score for the contract would be calculated as follows:

Spend on goods and services	90.0
Spend on workforce training	50.0
spend on research and development	60.0
Total revenue from contract	350.0

$$\frac{90.0 + 50.0 + 60.0}{350.0} = 57.1\%\ \text{Localisation Score}$$

The formula will determine total local value added by suppliers participating in public sector contracts by giving them a "percentage score". Suppliers will be evaluated in each government organisation's procurement process based on their bid prices in addition to their localisation scores. A balance between bid prices and localisation score will still be required, but a higher localisation score will make a supplier more competitive in the bidding process.

3. Identification of the localisation champion

Another key element of the localisation vision is identifying the high-level governance and ownership of the localisation programme. To effectively drive localisation in the public sector, government executives must designate a champion and appoint a governing body to develop the programme from strategic objectives all the way to implementation across the public sector.

But who should drive the localisation programme? The answer depends on the structure and composition of each government. Considering the typical structure of a GCC government, a few options exist:

A new localisation authority

The government may decide to establish a new authority that oversees and drives development and administration of the localisation agenda. For this to work, such an authority should be independent and hold a mandate from the highest levels of government. The authority could be part of the ministry of finance - typically the most powerful economic governing body in GCC countries - or fully independent as a new localisation or local content governing entity.

Expanded from an existing governing body

Alternatively, the authority could either remain with or be spun off from the energy sector, if an existing local content programme exists (typically an element within the national oil company or ministry of energy). This would allow for continuity of existing programmes but potentially limit the span of authority given national oil companies' limited mandate within the energy sector.

Led by an existing government ministry

In some cases, it may make most sense for an existing government ministry to design, implement, and manage the localisation agenda. Obvious candidates would be national-level economic and industrial policy making ministries, such as the ministry of commerce and industry or the ministry of finance.
In several GCC governments the ministry of finance is the most important government organisation responsible for economic management and policy making. Furthermore, ministries of finance are often responsible for overseeing state procurement operations, providing them more authority to mandate changes to state procurement policies and processes. Alternatively, some countries may decide to have the ministry of commerce, economy, or industry lead the localisation agenda. Given the role these ministries play in managing commercial activities in the state it may make more sense for them to lead such an effort. Decision makers should carefully determine which government ministry or organisation is most appropriate to lead the localisation agenda.

Regardless of which entity is selected to drive the localisation agenda, a decision must be taken on what role it wants to play for the implementation of the localisation programme. The degree of involvement and control will depend on each country's localisation objectives and unique characteristics. The table below highlights three different roles the localisation champion could play, with example benchmarks from countries around the world, mapped against key LC programme elements.

	Center of Excellence	Catalyst	Sectoral Champion
1 Localisation strategy and formula	• Set the localisation strategy elements/ guidance and identify potential synergy opportunities	• Put in place localisation strategy framework and coordinate synergy efforts amongst stakeholders	• Design the strategy, objectives and define the formula; drive synergies amongst stakeholders
2 Localisation opportunities	• Set forth the approach and guiding principles	• Identify cross-synergies, provide additional insights on opportunities	• Drive the analysis for opportunity identification, lead coordination with ministries, harmonize tools and templates
3 LC policy, procurement integration, and tools	• Set the policy requirements • Provide benchmarks and lessons learned from regional/ global programs	• Develop policy framework elements, identify integration requirements, oversee implementation efforts	• Establish LC policy, drive integration of LC in implementing entities, and standardize LC tools
4 LC capacity (local supplier and talent) development	• Identify guiding principles and establish key success factors for LC capacity programs	• Develop supplier and talent development framework • Establish baseline of current efforts	• Design and implement the LC capacity programs • Establish governance and KPIs
5 Enabling environment	• High level identification of enabling entities • Set forth principles for incentive scheme	• Provide high level analysis of ecosystem capabilities, set forth roadmap and engagement approach	• Lead efforts with potential enabling entities, establish incentive schemes, execute on MoUs
6 Technology	• Identify digitization opportunities • Provide benchmarks and lessons learned from regional/ global programs	• Define digital approach, assess current ecosystem, design digital roadmap	• Design digital ecosystem for program, identify software vendors, implement and operate digital solutions
7 LC audit and certification	• Set the policy requirements for audit and certification of LC	• Develop the framework, tools, and templates for the audit and certification scheme	• Design the end-to-end scheme • Operate the audit and certification of LC for the program

Conclusion

With high levels of government spending in the region likely to continue for years to come, GCC countries can benefit from implementing new or transforming existing localisation policies to achieve their national goals. As previous initiatives implemented by GCC countries have no longer proven adequate to drive the localisation agenda, the need for comprehensive and carefully designed localisation policies for the public sector has become more urgent.

While some GCC countries are yet to start developing their own localisation programmes, countries that have already established local content initiatives are well positioned to take localisation beyond the energy sector and expand it to the wider public sector.

In this first edition of our Local Value Creation Series, we have focused on the drivers of local content policies for GCC countries and explained how to establish a successful localisation programme starting from objectives to designing the right localisation formula. In coming editions, we will continue exploring the remaining elements of PwC's Localisation framework.

PwC localisation service offerings

- Localisation vision and strategy
- Category localisation roadmap
- Local content programme and framework development
- Supplier development
- Government incentive schemes
- Local content certification
- Supplier localisation strategy development
- Local workforce capabilities development
- Localisation digital portal
- Localisation feasibility studies