Accelerating Localization through Adjacent Cluster Sector Strategies in the MENA region

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Recent years saw the introduction and proliferation of Localization programmes in the MENA region. With the objective to drive in-country value State-Owned-Enterprises (SOEs) introduced Localization models by determining the local content contribution of their suppliers, scoring their individual baseline contributions, and then deciding percentage-based score targets to be achieved by the companies over time or determining target scores with respective CAPEX projects the company is engaged in to foster growth of the local value chain.

While overall generic Localization targets technically are deemed to be achieved, closer appraisal leads to suggest that Localization models applied to date have plateaued and there is a need for an evolution of these programmes.

With the current models mature – even with national-level Localization efforts - further enlarging Localization requires models to move away from the current project-centric model towards alternative vehicles that focus on adjacent cluster industry sector models for an extended and more encompassing drive on Localization. Required is a setting that instead of aiming at one particular investment project can envelop clusters with their components and sub-components and such maximize the impact of 100’s of billions in potential spend over next 10 - 15 years.

Unlike the project-centric model an adjacent cluster industry sector model provides a strategic view on interlinked industry value chains. Focusing Localization on adjacent industry clusters leverages and augments the Localization impact to boost economic growth.

To provide an example: Canada’s more substantial experience with clustering initiatives started with Quebec, drawing on France. Canada has recently scaled up significantly with a national cluster competition to select five Superclusters offering $950 million in co-funding over five years to the winners: the Digital Technology Cluster, the Protein Industries Cluster, the Next Generation Manufacturing Cluster, the Scale AI Cluster and the Ocean Cluster.

A recent model for a cluster in the energy sector is the Energy Cluster Denmark (ECD) established in July 2020. Energy Cluster Denmark is Denmark’s cluster organisation for the entire energy sector. For more information, please refer to https://clustercollaboration.eu/content/energy-cluster-denmark

The cluster strategy affects opportunities in three broad ways, namely by increasing the productivity of the companies as part of the cluster, driving the pace and direction of innovation, which will underpin the future productivity growth, and stimulating the formation of new businesses, which then expands and strengthens the cluster.

In addition, such a strategy calls for different governance, execution, and delivery models that allow a focus on selected value chains as a driver for Localization. Such governance models, moving away from project-by-project scoring, help consolidating and pooling cost- and risk mitigation aspects and allow for fitting execution and governance structures that merge resources, minimize organisational burden, and lift efficiencies and Localization synergies, a layout of which is presented below.
Evolving Localization models in the MENA region

Over the years most governments in the MENA region undertook efforts to expand economic and industrial development through a variety of FDI and Localization efforts. With the motives multiple and diverse, local sourcing of goods and services, economic diversification, local workforce development and improving in-country value creation are amongst the most prominent.

Localization efforts with SOEs

Following established models of Localization elsewhere, the MENA countries encouraged state-owned enterprises (SOEs) such as the national oil companies (NOCs) and later government entities to design and implement Localization programmes arresting their purchasing power to stimulate local value creation.

Since 2015 the region saw the proliferation of In-Country Value (ICV) or Localization programs. Saudi Aramco rolled out iktva in 2015, followed by ADNOC in 2018 and QatarEnergy in 2019 with their ICV and TAWTEEN programs respectively. While not the only programs in the region these three nevertheless draw most of the attention due to their purchasing power, impact on markets, local economic capabilities, and the investment volumes overall.

Initially designed by and for the respective NOCs (or originators), all programs over the years have seen their concepts elevated to the national levels. Conceptual designs of all three programs bear a great deal of similarity, with a country-specific focus attached reflecting requirements of the respective markets and local operations.

Overall, the programs are based on scoring and ratio formulas to identify local content, while giving different weightage to the formula components such indicating country-specific preferences to reflect operational models. The formulas saw modifications over the years, e.g. the introduction of an export factor, or in the weighting of formula components, partly to incentivise overall goals and partly to obtain higher local content percentages for a variety of purposes.

Applying the formula aims to obtaining the status quo of the company’s local content contribution (score) and use it as a base line for driving Localization goals. For the large investment projects to be eligible to participate respective bidders are presented with target scores or percentages to be achieved during project execution. Localization base lines across business segments are sometimes also defined or future target scores set for companies, normally requiring a significant increase in local content as it is e.g. with the iktva model.

Conceptual challenges with current designs: Too much focus on a score-based Localization approach

The scoring instruments applied tend to be heavily prescriptive and overly formalistic. The tools in form of company score cards and project improvement plans quickly
became percentage-target-driven and moved away from being a methodical tool to identify and promote strategic local sourcing opportunities. For the suppliers the exercise became a score-chasing and box-ticking exercise where only the required score mattered never mind the viability and validity of the underlaying assumptions.

To facilitate achievement of pre-defined overall annual localization targets one originator allowed for generic assumptions as to what goods and services would be available in the future e.g. local steel production, which would allow for higher percentages in local off-take of steel, regardless of the real availability of such local readiness in the future. Another model allows for the use of local intermediaries for imports. Routing imports through local agents (industrial partners) with high scores helps bidders to generate additional percentages against a small handling fee. For this country this in part explains the discrepancy between what is calculated as Localization contribution overall through the projects versus the limited Localization that actually took place.

Challenges with company- and project-based scoring

In the case of iktva project implementation plan scores are now identical with project scores. These scores are based on pre-set industry sector score percentages by the originator, which do increase over the years in pre-determined steps. Here assumptions are made on the future in-country availability of goods and services. Compiling score cards companies therefore apply the potential future local offtake up to a level where the requested score is achieved. If e.g. local steel is said to be available from year three onwards the company, then simply assumes x% of the steel then procured locally.

In case a multi-year business plan at company level is required companies simply add up projects under operation and/or potential wins in the future and run the numbers until they fit the required score. As many assumptions as to the future availability of goods and services have yet to materialize, delays in availability will render scores void at some point in the future.

With the ICV concepts in the UAE and Qatar company-based score cards are required as are ICV improvement plans for projects. ICV target settings for specific projects are opaque and have little relation to the industrial reality on the ground.

In KSA and the UAE the baseline company scores are only available to the originators and therefore do not provide for competitive transparency in the market. Only the QE Tawteen ICV is transparent on the scores through the publication of all scores and the dissemination of related company information on the Tawteen website.
Challenges with project-centric improvement plan approaches

A shortcoming of Localization programs is their fixture on CAPEX projects. From an application and execution perspective the concepts struggle with calendar year vs. project year imbalances, lack of guidance for the execution phase, and inconsistencies in the score review and evaluation process during project execution. Applications of penalty payment systems for non-compliance on target achievements or application of brittle sanctions further complicate Localization execution for investment projects.

Companies are overwhelmed with reporting complexity and supervision during, or ex-post of project improvement plans. This is due to either the absence of reporting guidelines for project improvement plan supervision or the disproportionate reporting requirements, which then are very rigid and audit-driven and do not allow for consideration of external factors beyond control by the project.

Overall, the Localization concepts are overly auditing-focused and accounting standards-driven.

While investment projects can be a major driver for Localisation their immediate impact is constrained by the time-bound limitation of the CAPEX phase. However, one should also consider the scope of CAPEX programs in the region and the number of projects over the next 10 to 15 years, which create a steady stream of potential Localization work. Across industry sectors – energy, water, mining, renewables, chemicals and green fuels, the sustained capital investment over the next decade in the region could exceed 500 billion USD.

With this vast CAPEX investment volume overall, Localization requirements for a single CAPEX project however has its limitations insofar as the project can only achieve Localization of what will be localized within the respective CAPEX duration period. A potential bidder will not engage in local content commitments prior to contract award and / or allow for a lengthy build-up of Localization opportunities. No adjacent supply base will be built around one specific project, regardless of the potentially massive capital expenditure.

OPEX is another matter. Localization opportunities for suppliers are driven by future local market expectations and not by a specific CAPEX project. Even with multiple investment projects, a focus on the specific project score does not lift local sourcing opportunities in the absence of a focus on wider supplier opportunities. Each project is regarded as a single new opportunity with a focus on the score, disconnected from wider Localization opportunities.

Transitioning Localization concepts from the company to the national level

With the introduction of Localization concepts in the MENA region a quick proliferation of programs can be observed in the downstream petrochemicals sector as well as with SOEs in e. g. energy, health, and
mining and the wider public procurement sector.

Governments now attempt to support Localization efforts at ministerial level and through dedicated government entities with the distinct mandate of establishing and coordinating Localization. The ‘Local Content & Government Procurement Authority’ (LCGPA) in the KSA and the United Arab Emirates ‘Ministry of Industry and Advanced Technology’ (MOIAT) should be mentioned here. Localization objectives at the national level also find alignment with respective National Development Plans.

However, all concepts face challenges in transitioning the concept in a coherent and consistent way to the national level. Part of the challenge lies in the transitioning from a company’s commercial perspective to a national and industry-wide level that now requires coordination and engagement with a multitude of stakeholders that in the absence of a strategic industry focus all have different levels of localization exposure and interests.

Further, the national level is challenged with the alignment of procurement strategies, policies and regulations across the various business and industry sectors as well as establishing consistency in the conceptual approach, while at the same time there is an absence of common standards for methods, applications, and execution models, etc. Consistent data collection and processing is another problem at the national level.

Equally, as the national level Localization champions have a representative participation structure consisting of various technical ministries, relevant governmental entities, supervisory bodies, and sometimes the private sector institutions, orchestrating the national localization strategy becomes a very challenging task.

From a strategic view the Localization concepts are swayed by the absence of a focused industry sector perspective with particular attention on business segments that are commercially viable while localised. Concepts tend to treat all sectors equal regardless of criteria such as Current Local Content, Technical Limits, Years to achieve Technical Limit, Efficiency of “switching” to Local Content, Sub Sectors Cumulative Savings, and e. g. Spend vs. Implementation Barriers. Without a commercially viable cluster- or sector strategy Localization data assembled is a mere compilation of individual sourcing decisions and bar any supply- and value chain insight, as there is no build-up of future supply chain network structures and little connectivity to strategic purchasing forecasts. Equally absent is the involvement of the strategic supplier industry itself in the exercise of strategic forecasting and in the formulation of Localization strategies overall. This results in missed opportunities as to the identification of sectors and clusters that have a high potential for localization and that can be executed by industry.
Applying Adjacent Cluster Sector Strategies for the positioning of Localization concepts

The following part aims to make a case for using adjacent cluster sector strategies to drive Localization thereby replacing the project-centric CAPEX focus and its inherent limitations. It further tries to build a case for direct and indirect levers for industrial development.

Exhibit 1 also makes a case for a more holistic view on relevant intervention phases and the leverage options provided by a comprehensive toolbox. Given e.g. the focus on projects and their relatively narrow CAPEX timeframes, emphasis on a ‘future-proofed’ Localization execution and delivery model that supports the vitality of cluster-based Localization prospects. Localization efforts long seen in a stand-alone capacity should be viewed as but one element of a set of a wider range of industrial policy instruments. Exhibit 1 below correctly shows Localization as but one lever that should connect to a portfolio of direct and indirect levers for industrial development.

Localization with a view on the OPEX phase is more desirable due to the longevity of the project operation that might be part of a wider industrial setting. Bottom-line, the approach requires a diligent Localization and Supplier Development Strategy (SDS) and a focus on clusters to build industrial capacity.

For doing so BCG in their research point to five elements that are of relevance here:

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1 For the following part please also refer to the publication BCG As Supply Chains Localize, Industrial Policy Springs Back, Nov. 2021. 

- **Measurement and targets:** measure the strategy contribution, set targets, and define the strategy
- **Incentives in government procurement:** develop incentives to be included in the procurement plans
- **Support of the private sector:** support best practice exchange across firms
- **Support of large projects:** help identify localization opportunities in large investments
- **Global Experience:** Help localization efforts across continents with international firms. The strategic focus should be on clusters around specific large industry investments. This in return can link to vision plans or similar direct industrial policy concepts.

Localization measures as *direct levers*, and supply-side policies as *indirect levers* depend on the respective intervention phase with supporting, incentivizing, and managing growth. Incentives and subsidies do play an important role here together with support to national champions and procurement strategies of government and SOEs. The levers require a continued synchronisation to become effective.

Most important is the synchronisation of the supplier industry involved and their active support at the respective levels. Procurement models should be attractive and commercially viable.

Following the above, a Localization strategy thus is part of an industrial development strategy. With Localization efforts ongoing and industrial development strategies continuing a merger of the respective strategies, concepts, and instruments would seem logical.

**Develop an Adjacent Cluster Sector Strategy**

Combining Localization and direct industrial development requires a strategy that allows for programmes to be tailored. Rationales for localization footprints vary and mandating subscription to a Localization programme alone will not necessarily induce firms to actively participate in Localization efforts. A firms’ business model should fit within the framework of the wider policy initiative and industrial development programmes might be more realistic for a select group of investors only. Hence addressing a limited number of selected firms should result in a higher acceptance than inviting a broad range of firms that are active in a business segment.

Recent events such as supply chain shocks or geopolitical disputes may provide a greater attractiveness to regionalize a value chain and increase the value chain resilience by shoring closer to clients. Such considerations do still come at a cost but Localization with an industrial development policy, such as a cluster sector strategy approach, can help creating profitable and commercially viable opportunities. Increasing focus on green energy solutions and related investments in the MENA region serve as an example here. It would be only logical to build green-field supply chains around the investments.
Such an approach should comprise of a review of suppliers and their ecosystem including aspects that include a review of the supply mix, resilience, and qualification of new suppliers, etc.

A light manufacturing sector network should focus on assessing the own manufacturing facilities footprints and identify manufacturing capabilities. Channels and customers should be assessed in view of inventory and distribution for delivery optimization.

An Adjacent Cluster Strategy, while focusing on Localization should also envisage export promotion opportunities and importantly the integration into value chains. As the Exhibit 3 shows an incentive strategy should cover all levers of support and use the CAPEX to drive the OPEX opportunities. An adjacent cluster e. g. in fuel renewables not only can be an investment in export promotion for the core product but also establish the supplier support levers that drive the value chain.

Clusters as an agglomeration of interconnected companies and associated institutions are not new. Neither are strategies for their design and operation.

Cluster examples are plenty and success stories across countries show that clustered firms can achieve high and sustained rates of growth and competitiveness. However, many clusters show a sluggish performance and are unable to shift from initiation to growth. As a result, their development potential remains largely untapped. When examining stagnant clusters findings indicate that inter alia the institutional environment is unresponsive to the needs of the cluster or unable to provide customized services and assistance.
The Adjacent Cluster Strategy should therefore take into consideration right from the design phase the institutional environment for execution and operation to be applicable, feasible, and successful.

The following part aims to present an institutional model for execution and delivery that subsequently aligns stakeholders, objectives, and key activities.

In a cluster anchoring tier-level suppliers to core firms will increase acceptance of Localization amongst market participants that are usually reluctant to share sensitive information around supply chain issues. While incentives can be an important lever, procurement strategy decisions need to track cost-benefit trade-offs. It is necessary to mention that a cost increase must be accepted for the short run, but this should be regarded as an investment, not a cost.

At the same time, it is important to frame the strategy in a way that suppliers will be declined the opportunity to game and pre-empt increases. Involving the core firms and the tiers in the design as well as in the supervisory and managerial structure – including taking financial commitments – is a proven way to mitigate these aspects.

Establish a ‘future-proofed’ execution and delivery model that aligns stakeholders, objectives, and key activities

Current project-based execution models delegate the delivery of the pre-defined localization percentage targets to the contractor. Compliance is achieved once the designated target percentage is achieved. Verification of achievement is through an audit-driven exercise that normally says little about actual localization achieved on the ground. This execution model does not foster the build-up of a local capacity. Other than proofing that compliance of auditable targets have been achieved very little is achieved in actual localization of sourcing. Hence the Localization footprint is very limited.

Unlike the existing Localization execution models an Adjacent Cluster Sector Strategy model calls for a delivery and execution model that at the core has a strong governance structure that can deliver supervision and management with a clear mandate to the implementation entities that deliver on Localization.

The model suggested here offers a ‘future-proofed’ approach as the concept supports all stakeholders through an effective governance structure. With all parties - governmental entities, associations, SOEs, and key company stakeholders as well as oversight and execution functions - inside the implementation structure the model allows for the design and execution of Localization strategies, programs and activities with agreement and alignment of all parties.

If the localization target is achieved by simply routing the procurement of imported goods and services through a local industrial partner and hence credited accordingly no actual localization took place. Merely spend with a 0-% contribution gets converted to a x-% contribution because of the %-score of the local industrial partner.
Key elements of the model are:

**Governance structure**: An execution and delivery structure that brings all actors and parties together through a governance structure that delivers a coordinated and consolidated effort with jointly agreed functions and responsibilities across the stakeholder spectrum while mandating all participants through dedicated contributions – including financial ones.

**Commercial viability**: Operating a feasible Localization mechanism that is commercially viable and sustainable, both for the industry cluster and the contractors. Localization investments are strategically focused, based on risk valuations, strategic sourcing requirements, have agreed KPIs, and bring about improvements for the business lines and supplier practices with operations.

and its management by using targeted tools and matrix-based systems and instruments for supplier assessment as well as understanding issues with industry cluster procurement and operations requirements.

**Investigate opportunities**: Enhances the licence to operate and the bottom line of contractors by investigating opportunities to increase Localization and sustainable off-takes without increasing risk in sourcing.

**Operational risk**: Reduces operational and reputational risk and improves the resilience and sustainability of the governance structure through instruments that provide formalised management and execution agreements with all stakeholders while embedding the local content practice.

*Localization and supply chain risk*: Provides insight into sustainable supply chain risk.
throughout, thereby leveraging the existing stakeholder pool.

**Support structure:** Provides consistent horizontal and vertical information sharing, cross-sector engagement through a broad range of technical and business development support tools.

Illustrated above is a Localization interface structure that allows management, design, and execution of Localization programmes with several participating entities addressing institutional, strategic, and functional elements:

The interface structure serves as the primary means of communication and information-sharing for internal and external stakeholder groups and centralizes managerial & administrative activities related to the multiple Localization programme activities.

Strategically, the setting works as a risk- and cost-mitigation tool, while minimising individual company-level exposure and assures close cooperation & coordination with partner structures (key companies, industry associations & governmental institutions).

The structure allows for a clear functional division of responsibilities, while maintaining consistent oversight through the steering committee structure.

*A governance structure for managing cluster-based Localization*

With the suggested and tested governance structure representing all parties involved the model provides a broad supervisory element overseeing the Localization mandate. The management and execution design provides a direct feedback loop for a successful implementation of a cluster

**Governance structure for managing cluster-based Localization**

<table>
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<tr>
<th>Localization Programme Activities</th>
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<tr>
<td>• Cluster-based Localization strategies, policies &amp; procedures</td>
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<td>• Localization engagement programmes</td>
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<tr>
<td>• Execution, management and monitoring of Localization activities</td>
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<tr>
<td>• Technical tools &amp; sourcing assessment practice</td>
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*SOEs / Govt. Entities*
- Functional units & funding

*Industry Partners*
- Functional units & funding

*Institutional Partners*
- Co-funding & technical expertise

*Technical / External Partners*
- Engagement as required
strategy approach with results beyond current models.

As the Localization drive widens encompassing a wide range of economic and industrial sectors, governmental actors need to find a new way to further build in-country value add.

Adapting industry sector-focus adjacent cluster sector strategies and executing them through industrious and inclusive governance and delivery structures elevates the Localization drive to a more comprehensive and more sustainable level.

Conclusion

It is undeniable that cluster development is one of the dimensions of how economies can convert their knowledge-generating potential into new markets and productivity gains. The government sector, both local and national, should ensure the supply of high-quality inputs and set the competition rules so that productivity and innovation will govern success in the economy. On the other hand, the private companies and developers should work with the government to reinforce and build on existing and emerging clusters rather than create entirely new ones. This is because booming new industries and clusters often grow out of the established ones. Clustering helps governments and industries direct their economic development and transformation efforts.

Michael Hackenbruch has a proven track record of senior advisory and business development roles in the energy industry sector. His focus is on Localization & In-Country Value strategies, sustainable supply chain integration, ESG responsible sourcing, sustainability and governance, DE&I and SIA design and delivery.

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