IKTVA and its Impact on Doing Business with Saudi Aramco

Much has been reported about the Kingdom of Saudi Arabia's (KSA) attempts to diversify its economy and become less dependent from oil and gas. Investors engaging in business with Saudi Aramco will need to familiarise themselves with the IKTVA programme and its effects on their existing Middle East operations. The following newsletter shall give an overview of the effects and possible solutions.

1. *What is IKTVA?*

IKTVA stands for "*In Kingdom Total Value Add*" programme (www.iktva.sa). The programme is designed to drive domestic value creation and maximize long-term economic growth and diversification to support a rapidly changing Saudi economy. Ultimately, the programme aims at driving key activities toward localization and job creation. By 2021, a localization of 70% shall be achieved.

As IKTVA is a pillar of Saudi Aramco's procurement process, companies wishing to tender their products and/or services to Saudi Aramco will need to comply with IKTVA requirements. IKTVA lays out a two-tier process which consists of (i) identifying a baseline and (ii) defining an action plan:

- In order to identify the baseline, companies are required to complete special surveys which need to be certified by one of the approved audit firms.
- Based on the outcome of the survey and its certification, the company will be attributed a so-called IKTVA score. The IKTVA score is calculated based on the following formula:

*IKTVA score = [(A+B+C+D+r)/E]*100*

A. Localized goods and services
B. Salaries paid to Saudis
C. Training and development of Saudis
D. Supplier development spending
r. Research & Development
E. Company revenue (spend from Saudi Aramco only)

- The baseline score shall be based on a three-year history of the engagement.
- The IKTVA score will serve as a basis to define a five-year IKTVA action plan. In essence, it is a business plan that lays out which steps a company will take in order to increase its IKTVA score.

2. *Why now?*

The IKTVA program was launched on 1 December 2015. IKTVA goes hand in hand with KSA's "Vision 2030" which was announced on 25 April 2016. "Vision 2030" aims at reducing KSA's dependence on oil and diversifying its economy. Amongst other things, the measures are a reaction to the significantly negative impact of low oil prices on KSA's budget and to rising numbers of youth unemployment.

3. *How does IKTVA affect existing operations and structures in the Middle East?*

Engaging in business with Saudi Aramco will require extensive reporting on

- *Company Background*: Executive summary, Corporate structure etc.;
- *Goods and Services*: Company supply chain overview and a concrete action plan to increase procurement within KSA;
- *Human Resources*: Current and planned number of Saudis employed and training plans;
- *Supplier Development*: Development plans for suppliers within KSA;
- *Research and Development Initiatives*: In-kingdom technology roadmap and technology acquisition plans;
- *Exports*: Current and planned exports volume; and
- *Business and Market Challenges*: Major challenges with increasing IKTVA and global competitiveness challenge.

Within the procurement process, IKTVA is mainly relevant during two phases:

(i.) the pre-qualification phase; and

(ii.) the evaluation phase.

Apart from the technical and commercial evaluation, an IKTVA evaluation will be carried out during each sourcing process.

Therefore, IKTVA is one of the corner stones in Saudi Aramco's procurement process. The evaluation scheme applies to all awarded agreements, irrespective of supplies made and/or services rendered locally or from abroad. Based on that, companies not having localized their supplies yet may face disadvantages compared to players that have set-up production facilities in KSA, as they fall short of fulfilling IKTVA prequalification requirements and/or achieve a bad IKTVA evaluation/score within the procurement process.

In light of the above, re-export structures that have been working successfully in the past, e.g. by using one of the free zones in the UAE as a re-exportation hub for special machinery, equipment and tools required by Saudi Aramco, may no longer be compatible in the future.

4. *What is the solution, what are the obstacles?*

Players interested in doing business with Saudi Aramco will be required to set-up production facilities in KSA to offer local products in accordance with the IKTVA programme.

Unlike other jurisdictions amongst the Gulf states, KSA's foreign investment law does generally not require entering into a joint venture with a local investor (*e.g. 51% local and 49% foreign shareholding*).

Foreign investors will, however, be required to obtain an investment license. KSA's foreign investment authority, the Saudi Arabian General Investment Authority (SAGIA), however, sets certain capitalization and shareholding requirements with regard to business activities. According to the SAGIA General Rules, production operations may be established fully foreign owned with a minimal paid up capital of SAR 1 million (*approx. EUR 220,000*).

While such production license allows permits to distribute the products that have been produced locally (in KSA), additional licenses, may be required if after-sales services are performed in KSA. The same applies with respect to product lines that are imported and then to be distributed in KSA.

Structuring investments into KSA includes identifying the optimum shareholding structure. While GCC free zone companies may generally be used as a parent company of the new Saudi company, there are certain obstacles: SAGIA typically requires that the shareholder of an applicant has sufficient substance, which includes a substantial paid-up capital and commercial operations (revenues etc.).

Production licenses may be granted without showing any Saudi shareholding. On an operational level, investors shall, however, keep the requirements laid out in the Saudization system (Nitaqat) as well as the IKTVA programme in mind. Furthermore, experience shows that during the set-up phase including a Saudi national in the management may speed up certain processes that are necessary to get the company up and running (e.g. opening bank accounts etc.).

Furthermore, investors should take into consideration tax treaties for selecting the parent company. While, e.g., there is no comprehensive double taxation agreement in force between Germany and KSA (only with respect to Taxes on Income and on Capital of Air Transport Enterprises and on the Remuneration of Employees of such Enterprises), there is a tax treaty in place between the Netherlands and KSA.

The same applies with regard to investment treaties which usually include investor protection:

- fair and equitable treatment;
- protection from expropriation;
- free transfer of means; and
- full protection and security.

5. Conclusion

Foreign investors engaging in business with Saudi Aramco will need to keep in mind the following aspects:

- While it is not legally mandatory to set-up a local operation, IKTVA will cause a *de facto* necessity to set-up such operation;
- Since the IKTVA baseline is based on the three-year history of an applicant, newly established companies will have a low IKTVA baseline in the initial years of their operation;
- Even though it is not mandatory to include a Saudi shareholder in such production operation, the management should at least consist of one Saudi national for the purposes of setting-up the entity and getting it running;
- In case investors intend to distribute goods that have not been produced in the KSA, additional investment licenses may be required;

- Setting up and running an operation in KSA will increase the cost of doing business (e.g. KSA is not as business friendly as the UAE and ranks on rank 93 on the World Bank's "Ease of Doing Business Index"). Underlying rules and regulations tend to change frequently and at short notice; and
- Corporate, tax and investment protection structuring should be considered as early as possible to ensure an optimal structuring.

Keeping in mind the aforementioned issues and planning ahead, will increase the success of carrying out business with Saudi Aramco in the KSA.

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