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Contract and Toll Manufacturing under ICV and IKTVA – The Easy Way Out?

LEGAL BRIEFING (25 February 2019)

The Abu Dhabi National Oil Company (ADNOC) and Saudi Aramco have implemented localisation programs (ADNOC: In Country Value or ICV and Saudi Aramco: In-Kingdom Total Value Add Pro-gram or IKTVA). ADNOC announced that its ICV spend for 2018 will amount to over AED 18 billion (approx. EUR 4.3 billion). Saudi Aramco plans to spend more than SAR 1.5 trillion (approx. EUR 350 billion) on its IKTVA program in the next 10 years. Since the ICV and IKTVA programs do not allow mutual recognition, suppliers cope to comply with several localisation programs in the region. This legal briefing gives an overview of contract and toll manufacturing models and their respective pitfalls in light of the ICV and IKTVA requirements.

1. What do localisation programs require?

Localisation programs follow a general localisation trend in the region, in particular in the oil & gas industry. They are typically a part of the countries' national vision and are launched by the country's respective National Oil Company (NOC).

Petroleum Development Oman's (PDO) ICV program was launched in 2012 and goes hand in hand with the Sultanate's longstanding commitments towards localisation. Similar to its workforce nationalization program, Oman has served as a trend setter in the region in this respect.

Saudi Aramco's IKTVA program was launched in December 2015 with the aim of leveraging the relationship between Saudi Aramco and its suppliers to support the company's goals to increase local content to 70 per cent by the end of 2021. IKTVA also seeks to develop a diversified and sustainable ecosystem that is capable of competing in the energy sector in the Kingdom, which will provide the labour market with 360,000 graduates from 30 Saudi Aramco training centres and institutes by 2030.

ADNOC's ICV program focuses on local supplier selection, the development of UAE nationals, and the localisation of critical functions in the oil and gas industry. The program was first announced in November 2017 and implemented on 1 January 2018, took full effect on 1 April 2018 and was revised in September 2018. Until now, around 1,500 local suppliers have obtained ICV certification.

2. How are suppliers affected by localisation programs?

Under localisation programs suppliers will need to source locally in order to obtain high localisation scores. The respective impact on the localisation score, however, depends on the localisation program's specific formula. The score may increase chances for a contract award or in case of sub-suppliers of being subcontracted.

Localisation programs typically require that suppliers set-up a corporate vehicle in the respective jurisdiction in order to apply for a localisation score and get this score

certified by an accredited certifying body. Overseas suppliers – lacking a local set-up – will not be able to get localisation scores certified. Suppliers without a localisation score will either be disregarded or admitted participating in the tender procedure with a localisation score of 0%.

As an alternative and to save costs, manufacturers can delegate the manufacturing and supplying process to a business partner in the respective jurisdiction, e.g. by contract and toll manufacturing. Ultimately, in this scenario the business partner would need to comply with the NOC's localisation programs requirements instead of the manufacturer.

3. What is contract and toll manufacturing? What are the key differences?

Contract manufacturing (CM) and toll manufacturing (TM) are two relatively similar forms of supply chain.

a. Contract Manufacturing

Legally speaking, CM is an arrangement between a manufacturing firm (also referred to as the contract manufacturer) and a hiring firm for parts, components or products.

A contract manufacturer produces certain products under the label or brand of the hiring firm. CM is an outsourcing model which is heavily utilized in the mobile phone industry. The manufacturer provides the plant, machinery and labour force required to manufacture the relevant product but also sources and supplies the necessary raw materials.

b. Toll Manufacturing

In a TM arrangement, a company provides its raw materials or semi-finished goods to a third-party service provider. The service provider often has specialized equipment or infrastructure and provides a subset of manufacturing processes on behalf of the company using those materials or goods for a fee. In contract manufacturing, however, the third-party company hired to produce the goods is supplying the manufacturing process as well as sourcing all of the raw materials. Under TM, the manufacturer is not involved in the sourcing of raw materials.

4. What are the benefits, what are the obstacles of such models?

Typically, CM and TM are used as outsourcing forms to lower costs and expenditures. Ultimately, the hiring firm has an interest to market and sell its products, thereby retaining control over the distribution process. CM and TM models do not necessarily require an own set-up. However, there may also be other reasons behind opting for such models: e.g. reduction of manufacturing time, entering new markets through established distribution channels by the contract manufacturer/toll manufacturer, etc.

Respective obligations (e.*g. registering as a vendor and getting a certified localisation score*) can be passed on to the local business partners. In this scenario, the operator can either sell directly to the NOCs and/or EPC contractors.

The investor would need to ensure that he chooses a reliable partner, being able to fulfil both the technical and the distribution related aspects. Experience shows that manufacturers specializing in the manufacture of a specific component are preferable. Depending on the product, these manufacturers would ideally also have a long-standing connection with the respective NOCs and/or EPC contractors.

From a quality assurance point of view, investors would need to put in place

safeguarding measures to prevent a loss of reputation and intellectual property. This should be reflected in the underlying agreements accordingly. In any case, clauses governing the termination of the agreement would need to be included as well.

Investors should keep in mind the risks associated to such models:

- Risk of hiring an incompetent manufacturer;
- Risk of losing valuable know-how to competitors in case of breach by the manufacturer;
- Limiting the de-facto control of the production and distribution process; and
- Not having an own footprint/localisation score in the respective jurisdiction (*which may have a negative impact, should the investor wish to enter the market with a full-scale set-up at a later stage*).

5. Conclusion

Suppliers to NOCs should keep in mind the positive and negative effects localisation programs have on their operations. Currently, there is no mutual recognition between the different programs in the GCC. Based on this, suppliers are faced with the difficulty of complying with several programs in this region.

CM and TM can serve as attractive mechanisms to circumvent such requirements. Before entering into such agreements, investors should, however, answer the following questions:

- How important is the respective market in the overall strategy?
- What are the costs of setting-up and administering a set-up in the respective jurisdiction?
- What degree of commitment do the respective localisation programs require (e.g. IKTVA Action Plan, ICV Improvement Plan)?
- Are reliable manufacturers (technically and from a distribution point of view) available?
- How can the outsourcing suppliers' legal position be best safeguarded (e.g. quality assurance, protection of intellectual property, termination of agreement, etc.)?
- Can quality assurance and supervision be properly administered (man-power, work permits etc.)?

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