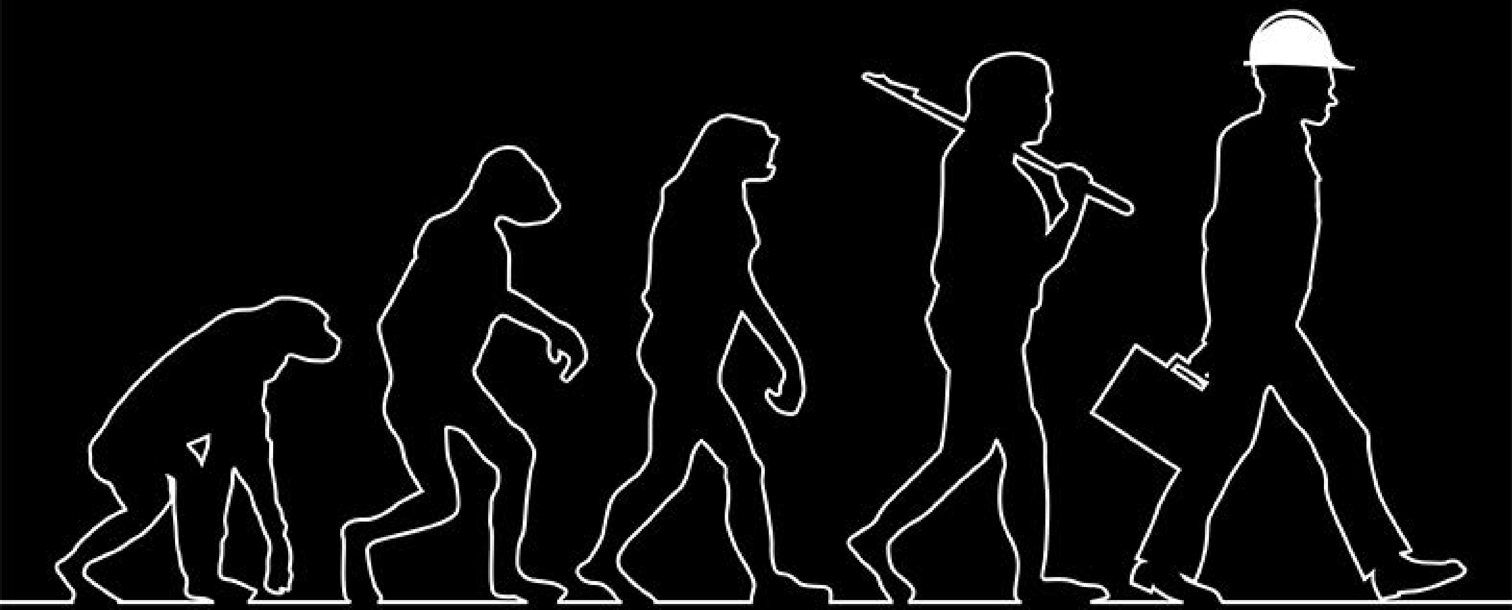

INFANT INDUSTRY ANALYSIS

Jaivime Evaristo from Contax Partners examines policy in the GCC energy sector, identifying unemployment and knowledge transfer as key drivers

At the core of the infant industry argument lies the proposition that young industries need to be protected from their older, more advanced rivals and that they should be allowed to build efficiency either through economies of scale or through a consequential learning process. Perhaps even both.

When the United States and Germany, in the late 18th and early 19th centuries respectively, championed the intellectual foundations of the infant industry argument, it was believed that the intent was to strategically insulate the two countries' nascent industries from the more developed industries of Britain. Seemingly rightfully so, the US and Germany ricocheted in light-speed trajectory well into and beyond the Industrial Revolution. This, however, came with mixed attributions as to whether or not the fundamentally protectionist premise of the infant industry argument deserved taking all the credit.

Sceptics to this argument suggest that the development of an industry would occurr anyway as a result of a gradual and sustained build-up of technological, physical and human capital. They make the point that even in the absence of an active, restrictive regulatory policy, industry growth would have happened as a result of natural progression. Yet, some empirical evidence suggests that government intervention, by protecting its vulnerable industries from usually more dominant foreign competitors, plays a crucial role in the development of sectors and industries, and even in social development.

"The private sector response to increasing pressure from the Saudi government has been varied"

A case in point was the notable success story in the creation of a petroleum industry cluster in Norway in the 1970s in which Norwegian oil companies, Statoil and Hydro, and key suppliers, Aker and Kvearner, were able to gradually build up their competence under the umbrella of an aggressive protectionist policy. Indias development of its low-cost pharmaceutical industry against the colonial patent law of 1911, which shackled the Indian market to the British, is another landmark example.

In contemporary times, and in the Gulf Cooperation Council (GCC) energy sector in particular, adopting the protectionist policies outlined above is done in the hope of developing the sector's indigenous service industries, with a particular emphasis on tackling a particularly pressing issue: unemployment.

SAUDI ARABIA CASE STUDY: UNEMPLOYMENT AS KEY DRIVER

Nationalisation programs, (Emiratisation, Qatarisation, Saudisation etc), have been in effect in the GCC labour market for years. While these national initiatives have been successful, they are not without its critics and remain a contentious social. political and economic issue.

The issue looms largest in Saudi Arabia, where the government estimate of unemployment amongst male Saudis was at around 10 percent in 2009. Estimates from the private sector range between 10 and 25 percent. The total jobless rate – the proportion of people without jobs whether or not they are looking for one – however, was estimated to be as high as 45%.

While the availability of jobs per GCC national in 2009 was not much of an issue in some countries like Qatar (12 jobs per Qatari), the UAE (11 jobs per Emirati) and Kuwait (6 jobs per Kuwaiti), the proportion of available jobs in Saudi was much lower at less than 2 jobs per Saudi national.

To combat this issue, US$93m was spent during the first half of 2009 to provide training and jobs for Saudi nationals in the private sector. However, it is safe to say that the quest to provide jobs for Saudis is far from over yet.

Given the sheer scale of the unemployment challenge, the Saudi government has tightened, and is expected to further tighten, its grip on local industries and foreign players in the Kingdom, urging a more stringent application of employment quotas for Saudi nationals. Strategic capital spending plans in the hydrocarbon sector are directed to projects that provide more jobs. This entails exporting less crude oil, while more refining into high value products or petrochemicals will take place in the Kingdom. Oil and gas will also increasingly be used domestically as feedstock for materials such as aluminium.

The private sector response to increasing pressure from the Saudi government has been varied. While the overriding objective of the Saudi government's regulatory interventions seems to be employment rather than development, it is comforting to see some clear signs of innovative and developmental thinking.

In January, Saudi Aramco is believed to have received nine bids from joint ventures of foreign and local engineering firms in an initiative called General Engineering Services Plus (GES+). The initiative aims to improve the engineering skills of local players by forming integrated, locally-registered entities with equity ownership between GES contractors and international partners thereby forming a GES+ entity that could undertake pre-FEED, FEED, PMC and EPCM contracts for Saudi Aramco. A similar initiative is targeted at the development of In-Kingdom EPC (IK-EPC) partnerships in which Japan's JGC has recently been awarded a contract worth between US$90-100m in relation to the Jubail Refinery Project for Sasref.

These developments among others are

The Saudi Arabian government wants more homegrown engineers in its upstream energy business.

driven by the need to address the unemployment issue in the Kingdom and create an indigenous knowledge base. The resulting value added of these initiatives could very well exceed the foreseeable benefits of reduced unemployment, provided governmental oversight and proactive private sector support is sustained.

NORWAY CASE STUDY: DRAWING PARALLEL

Drawing from the "birthing pains" of the Norwegian petroleum system between 1977-80, one may expect to see a hefty labour and training price being paid in the ongoing and planned Saudi initiatives. Conversely, the same could eventually result in a highly innovative petroleum system in Saudi Arabia as was the case in Norway some 30 years ago.

When all companies in Norway were required to choose Norwegian nationals during this period, a bureaucratic, labour-intensive management model emerged. It proved costly to develop and train Norwegians. Nevertheless, socio-political considerations and strategic foresight appeared to have overwhelmed the huge, yet transient, economic implications of Norway's infant industry policy. Needless to say, unemployment, like in the case of today's Saudi, was also one of the key drivers of Norway's then protectionist policy. The debate, however, did not end at meeting employment quotas but instead moved on to include the strategic importance of building internal competence in the assimilation of knowledge from extrinsic sources – another key driver in the Saudi initiative.

The emergence of Aker and Kvearner as main suppliers to the industry implies an increasing emphasis on the development of internal sources of innovation. The scheme resulted in an increasing absorptive capacity by Norwegian players allowing them to identify, assimilate and utilise technology and knowledge being brought in by international players. With sustained government intervention that called for an expanded Norwegian participation in technology production, development and supply over the following years, it became apparent that a growingly independent and innovative petroleum system of Norway was on its way. Today, Aker Solutions operates successfully internationally and is highly regarded in the Saudi Arabia market and expected to participate in the GES+ initiative – a real example of growing up.

SAUDI ARABIA: THE FUTURE SCENARIO AND IMPLICATIONS TO INTERNATIONAL PLAYERS

It appears highly likely that the Saudi economy will continue to rely on expatriate skills over the coming years, albeit in an increasingly regulated fashion. International firms that wish to retain and grow presence in the Kingdom should have the strategic foresight in dealing and complying with regulatory changes that may arise. There is no doubt that the economic prospects reserved for international players in the Kingdom's energy sector will remain attractive, and this will form part of the incentive system necessary for the evolution of regulatory frameworks.

Having a 360-degree view of the market landscape and full understanding of the capabilities of key players across functions and disciplines in capital project development are paramount requisites to a firm's successful business development in the KSA. As the prospects for further industry consolidation increase, players should carry out exhaustive due diligence on potential opportunities and partnership options.

Elsewhere in the GCC, a growing popularity of the infant industry argument amongst policymakers is inevitable. As such, firms that are equipped and highly adaptable to change are likely to make the list of the next generation of players in the GCC energy sector. **Oil&Gas**

To further discuss how the Business Advisory Team can help you fully understand your growth opportunities and the associated key success factors, please contact Ann-Marie Carbery Antoun at AnnMarie.Carbery@contaxpartners com. We look forward to speaking with you!

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