Local Procurement Case Study of Kumtor Gold Company, Kyrgyzstan

Introduction

The Mining Shared Value venture of Engineers Without Borders Canada works to promote local procurement by the global mining industry in developing regions. It is the belief of Engineers Without Borders Canada that mining can only contribute to meaningful economic and social development under specific conditions. The presence of strong backwards supply chain linkages to suppliers in host economies, is one of the most important of these conditions.

Centerra Gold is a mid-size Canadian mining company based in Toronto. Centerra is the largest Western-based gold producer in Central Asia. Its wholly owned subsidiary, Kumtor Gold Company (KGC) operates in Kyrgyzstan. Its Kumtor mine has produced 9.6 million oz of gold since 1997, and the current-life-of-mine stretches to 2026.

KGC is the largest foreign investor and industrial employer in the country. It pays 14% gross revenue tax, which represents up to 12% of the country's GDP. KGC employs 3,000 people, 97% of which are Kyrgyz nationals. It is important to note that the company operates in a challenging political landscape and investment climate. The Kyrgyz Government has threatened nationalization of the mine, and the company is currently in negotiations with the Kyrgyz Government to restructure the project.

The following case study is based on research carried out by Mining Shared Value venture leader, Jeff Geipel, during his visit to Kyrgyzstan in July 2014. Interviews were carried out with management and staff of KGC, suppliers of the company, and other relevant stakeholders such as the European Bank for Reconstruction and Development (EBRD).

The purpose of this case study is to profile efforts made by KGC to increase local procurement from suppliers in Kyrgyzstan. KGC has made a number of efforts to purchase more goods and services locally in recent years, and is about to embark on a more comprehensive local procurement strategy that aims to further increase local procurement spending over the current-life-of-mine. The successes, impacts and challenges laid out below provide valuable learning experiences for other mining companies and industry stakeholders undertaking their own efforts to increase local spending.

Local Procurement Overview

Local Procurement and Development

Local procurement epitomizes the positive role that the private sector can play in development. Purchases of local goods and services create local jobs and income, transfer skills and technology, and help to create vital domestic business networks. If done right, local procurement can be harnessed to drive national development strategies.

There is awareness building within the mining industry that creating and maintaining a social license to operate requires more than just minimizing negative impacts. At the same time, government bodies in developing countries are working to increase the economic and social benefits of mining within their borders. Promoting and supporting local procurement initiatives is an effective way for mining companies and host governments to meet their needs.

Local Procurement and Mining

The scale of economic activity from mining operations means their procurement can be a major driver of development in host countries if spending is local. Mining companies' annual spending on goods and services locally at their mines is often significantly larger than many bilateral aid institutions' budgets for those same countries.

Mining industry personnel and international development practitioners should not be asking whether mining is good for development. Rather, mining industry stakeholders must question and explore *under what conditions* mining activities can contribute to desirable development outcomes.

The Business Case for Local Procurement

In addition to contributing to economic and social development in host countries, purchasing more locally is also strategically important for the bottom line of mining companies.

There are three main ways that adopting more comprehensive local procurement policies is in the interest of mining companies.

1. Lowers procurement costs

By tapping into local labour markets that have lower wages, and reducing shipping distances, a mining company's costs for many goods and services will fall in the long run as they use more local suppliers

2. Improves supply chain efficiency

The efficiency of procurement can also be improved, as delivery times are reduced and supply chains become more resilient as more supplier options become available

3. Strengthens social license to operate

Local procurement provides more economic and social benefits to the host economies where mining companies operate, leading to more healthy relationships with local communities and governments

KGC's Local Business Initiative

In order to increase purchases of local goods and services, KGC has created the Local Business Initiative (LBI). In its early stages, this initiative involves adapting procurement processes to favour local suppliers, proactively identifying businesses that could supply the company if they were provided training, and working with partners, including EBRD and the German development agency (GIZ). In the future this initiative will be expanded into a more comprehensive local procurement strategy.

Current Efforts

Flexible Supplier Payment System

One of the most effective ways that mining companies can help local suppliers in developing countries is to adopt more flexible procurement payment procedures. For example, traditional supplier payment procedures often involve companies paying suppliers up to a month after a good or service has been delivered. However, this practice can have the unintended consequence of disadvantaging smaller, lower capacity suppliers who cannot wait this long for payment. Therefore, mining companies can address this challenge by paying such suppliers in advance or as soon as possible. This allows smaller, lower capacity suppliers to more effectively plan budgets and manage their cash flow.

KGC has an established process of paying smaller suppliers as quickly as possible, and within a week of product delivery in most cases. Suppliers interviewed during case study research all stated that this policy greatly improved their ability to supply KGC. Several suppliers noted that prompt payment in Kyrgyzstan was rare, and for this reason KGC was a preferred customer. This shows how small, low cost procurement procedure changes can greatly help increase local procurement.

Supplier Capacity Building Initiatives

KGC has recently hired Jarasul Abduraimov, a specialist in industrial development and manufacturing, to identify potential local suppliers that require minimal assistance to improve their capacity. Abduraimov has over 30 years of manufacturing experience, including three tenures managing factories for the national army. Abduraimov is now using his knowledge to identify businesses for capacity building. Proposed businesses for capacity building include a tire recycling plant, a producer of lime, and meat processing facilities.

This process highlights the importance of bringing in partners who share the same goal of improving the quality of national businesses. For example, Abduraimov is proposing projects that involve assistance and financing from other partners in the country, such as EBRD. Companies like KGC do not have the resources, or the ultimate responsibility, for helping national businesses. However, KGC can play a vital leadership and coordinating role to harness host country resources, and help build local ownership over the development of local suppliers.

A Short-Term Willingness to Pay More for Local Goods

As mentioned previously, purchasing goods and services locally can reduce procurement costs in the long term. However, in the short term low capacity local businesses may not be able to offer prices competitive with international providers. Companies can help remedy this situation by demonstrating a willingness to buy from local suppliers in the short term, even though these goods and services can be procured internationally at a lower cost. Local suppliers can then use this revenue to invest in their businesses, to make them more competitive.

KGC's experience with Vulkan Plus is an example of this process. Vulkan Plus provides the steel balls (grinding media) for use in breaking up ore. Currently KGC is choosing to pay a higher price for the balls than they could obtain from an international supplier. Vulkan Plus is planning to use this revenue provided by KGC to purchase new equipment that will lower their price for the balls in the long term. By willing to pay more in the short term, KGC is not only working to lower its procurement costs in the long term, but is also helping to improve impacts on the Kyrgyz economy. This example is further expanded on later in the case study.

The Development Impacts of KGC Local Procurement

The research trip to KGC's Kumtor mine revealed three main ways in which KGC's local procurement is creating value within Kyrgyzstan. These are new, reliable sources of revenue, skills transfer, and formalization of local business. The following examples show how KGC's purchases have built capacity for individual firms and the economy of Kyrgyzstan as a whole.

Revenue

In 2007, Zhitnitsa Peasant Farms secured the contract with Kumtor Gold Company to be the primary egg supplier for the Kumtor mine site. The farm supplies approximately 30,000 eggs per week to the site. The revenue from this lucractive contract has allowed Zhitnitsa Farms to improve the egg collection and chicken coop system for the 8,000 hens at this farm. Since these changes have been made, the farm has doubled its total output. With this increased capacity, the farm is seeking new customers that they are now able to reliably supply in a way not possible previous to supplying KGC. The owner of Zhitnitsa Peasant Farms, Mr. Alexander Shtanko, is pictured right.

Skills Transfer

As a large multinational corporation operating in several countries, Centerra Gold and its subsidiaries follow higher standards of health and safety than most businesses in a developing country such as Kyrgyzstan. Because of this, local procurement from service suppliers who need to meet these requirements represents an opportunity for skills transfer.

Helper LLC has provided services to KGC for 18 years, and the mine is its main customer. When interviewed, the director noted that the health and safety procedures required by KGC are the highest they encounter in the entire country. KGC provides on-site training to Helper employees and also has a bonus system for exemplary performance. By supplying KGC, Helper has improved its health and safety procedures, not only providing better protections for its workers, but also by making the firm able to supply other enterprises that require high standards of safety. This represents new business opportunities for Helper beyond the life of the mine.

Tax Collection and SME Formalizing

One of the most overlooked benefits that local procurement brings to developing economies is the assistance provided in formalizing the economy. KGC will not purchase goods and services from firms that do not provide tax registered receipts. Kyrgyzstan has a large informal economy, and tax evasion is common even among larger enterprises. By forcing its suppliers to pay taxes and set up the necessary systems to pay taxes, KGC has an indirect effect of helping to formalize the economy. In addition to the increased tax revenue this provides the government, formalization helps both businesses and the government through better record-keeping and management.

Supplier Profile: Grinding Media from Vulkan Plus

Vulkan Plus represents one of KGC's most meaningful supplier capacity building initiatives. Mining companies operating in developing countries often target suppliers that produce low value added goods, such as food products, in supplier capacity building workshops because of the low level of skills and input costs required to produce them. The Vulkan Plus case is significant because it is an example of mining company supporting the development of a product that requires more technical skills and technology to produce.

Vulkan Plus produces grinding media – the steel balls that are used in the breaking up of gold ore. It currently supplies KGC with balls that are 25mm in diameter, but the company is currently working to produce balls that are 40mm and 50mm in diameter, and ultimately 100mm in diameter. Prior to purchasing from Vulkan Plus, KGC was purchasing its entire grinding media supply from suppliers in Russia and Kazakhstan.

KGC helps Vulkan Plus in a number of ways, including advising management, providing quality assurance, and by working to bring in partners to help build the company's capacity. KGC also is currently purchasing the steel balls above the market price, in order to help provide the revenue needed for Vulkan Plus to purchase new equipment (which will lower the price in the long run). Importantly, KGC has made it clear that this willingness to pay more is only temporary.

Accessing and securing financing is another significant challenge that Vulkan Plus faces. Currently the method they use to make the balls involves casting steel into the ball shapes. However, there is a more sophisticated manufacturing process that is cheaper and produces a higher quality product. This process involves using pressure and heat to form the balls out of steel rod stock. The challenge for Vulkan Plus is that the machine required for this process costs as much as $500,000 (USD). In a country where interest rates for suppliers like Vulkan Plus are routinely 20% or above, accessing capital is a major challenge holding it back.

KGC is working to help overcome this challenge by trying to help Vulkan Plus secure finance from the EBRD. This shows how a company can help its suppliers not by providing its own financing, but by helping to facilitate loans from other sources for suppliers.

While there are still challenges ahead to ensure the long term sustainability of Vulkan Plus, grinding media represents a manufacturing opportunity that, with financing and technical assistance, suppliers in many developing countries can realistically pursue.

Challenges to Address

Many of the challenges outlined below will be familiar to procurement and community development staff from mining companies operating in other developing countries. These challenges are outlined in order to stimulate debate amongst industry stakeholders on the strategies that mining companies can take to address issues related to local procurement. KGC's revised local procurement strategy, which will start to be implemented in 2015, will work to address these challenges.

Copycat Competitors and 'Robbing Peter to Pay Paul'

One of the common problems identified by KGC management was the tendency of local suppliers to attempt to produce the same good or service that is already being locally sourced by KGC. Interviews with KGC management revealed that shortly after a new contract with a local supplier had been formalized, KGC would be flooded with phone calls from nearby suppliers offering the same product.

This is time consuming as KGC procurement staff have to spend time dealing with disgruntled competitors to their suppliers. This led Leslie Louw, head of KGC procurement, to state that suppliers were pressuring procurement personnel to "rob Peter in order to pay Paul". He explained that switching to another local supplier of the same product just takes money from one supplier and gives it to another, without increasing the overall benefits to the local community. Interviews also revealed that current suppliers often face verbal abuse and threats from rival firms after securing new contracts, or even appearing to be close to securing one.

This scenario shows the need for mining companies to work hard to proactively set expectations with local businesses. Competition is healthy, but too many businesses supplying the same thing has the potential to cause suppliers to waste time at best, and outright conflict at worst. Having local suppliers understand that they need to focus on products currently being bought abroad is a crucial but challenging step to take.

Import Duties and VAT for Local Resellers of Imported Goods

KGC pays a higher revenue tax than other companies, compensating for certain tax exemptions on imported goods. This means that the company usually does not pay import duties on goods it imports, or value added tax (VAT). This tax incentive is meant to help KGC operate and lower the paperwork it must carry out. However, this incentive results in a disadvantage for domestic businesses that try to sell imported goods to KGC.

Reseller businesses sell imported goods, and sometimes they act as the official licensed seller of an international company's products. While purchasing imported goods from local suppliers does not create as many benefits for the economy as purchasing products that are locally manufactured, it still provides employment and revenue to the local economy. Being able to purchase imported goods from a local supplier instead of having to wait for them to be directly imported to KGC also helps the company in a number of ways (see chart on the following page).

Unlike KGC, local suppliers of imported goods have to pay import duties and charge VAT. This means that if KGC purchases from local suppliers, they have to pay a higher total price than if they import directly, as the supplier has to pass both the VAT and import duty onto KGC.

This scenario hurts local suppliers. A tax policy designed to attract and support foreign investing companies can have an unintentional consequence on domestic businesses. This is a situation that occurs in other developing countries as well, and shows the need for regulators to be careful to understand the consequences of their tax policies.

Advantages of purchasing from local resellers

- Companies can lower their inventory costs, as needed equipment can be sourced from local resellers holding it
- Companies can reduce lead times for deliveries due to their close proximity to local resellers
- Resellers can provide maintenance services and spare parts for certain types of equipment
- Resellers can be certified to provide training on the use of many types of equipment, such as power tools

Conclusion and Next Steps

Kumtor Gold Company is committed to improving the quantity and quality of goods and services that it procures locally in Kyrgyzstan. With guidance from the Mining Shared Value venture of Engineers Without Borders Canada, KGC is implementing a more comprehensive strategy that will formalize and build on its current local procurement processes and supplier capacity building initiatives. KGC's new local procurement strategy will help ensure that its mining activities create significant social and economic benefits for the people of Kyrgyzstan.

Produced by Mining Shared Value, a venture of Engineers Without Borders Canada, January 2015

The Mining Shared Value (MSV) venture of Engineers Without Borders Canada helps the mining sector and related stakeholders maximize local procurement of goods and services. MSV's mission is to increase local procurement by the global mining industry so that host countries gain more economic and social benefits from mining activities.