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LCS Briefing

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The Rising Spectra of Protectionism in the Global Oil and Gas Supplier Market: *An Opportunity for UK Export-Led Growth*

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The UK is the sixth largest manufacturer in the world. It is also the 10th largest global manufacturing exporter[i], and manufactured goods comprise 46% of all UK exports and support 2.5 million jobs[ii].

Within the oil and gas sector, decades of experience drilling in the North Sea, has positioned UK companies as leaders in developing oil and gas resources around the world. The export industry in oil and gas manufacturing and services alone is worth US$10 billion a year to the UK economy[iii]. Clearly this industry must play a critical part in the Government's plan for export-led growth as the route out of the current economic malaise.

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With the oil price passing $100 a barrel and wholesale gas prices resurging, global capital investments in oil and gas exploration and production are continuing apace, with diversity of supply the name of the game. The number of non-middle eastern and non-OECD economies taking a share of global oil and gas supply is increasing yearly. This includes production from the BRIC countries (Brazil, Russia, India and China) as well as from Mexico, Venezuela, Azerbaijan, Kazakhstan, Algeria, Angola, Egypt, Equatorial Guinea, Gabon, Chad, Libya, Nigeria, Indonesia and Malaysia, and now also Ghana and potentially Cambodia and Tanzania.

The Rising Spectra of Protectionism

But there is a challenge in the road ahead. Minimum targets are being set by oil and gas rich Governments to ensure that a proportion of the vast capital expenditures invested to develop oil and gas fields in their country are used to preference nationals over foreign workers and assure work for domestic suppliers. For example, the Brazilian Government, through its national oil company Petrobras, has set a minimum target of 65% 'local content' for the construction of production vessels for the giant off-shore oil reserves of the Santos Basin[iv] (part of the world's largest capital investment programme of $1000b over ten years[v]).

And in Ghana, Tullow Oil's recent production from the off-shore Jubilee field is taking place in the context of an aspirational Government policy for "*90% local content and local participation in all aspects of oil and gas industry value chain within a decade*"[vi].

As a policy for industrial development and jobs, these targets, and other more direct preferences to advantage domestic suppliers, is entirely rationale. State-owned companies now control over 80% of the worlds reserves of oil and natural gas[vii]. These companies are under a political and moral obligation to avoid the 'oil-curse'[viii] (whereby oil and gas discoveries foster revenue mismanagement and corruption instead of fuelling development). Part of the answer to this lies in directing oil and gas expenditure to grow domestic industries and thereby sustain and spread the creation of domestic wealth.

Consequences of Excessive Local Content

But domestic industries in Brazil, Nigeria, Kazakhstan and other countries do not always have the capability or capacity to meet demand; and even if they do, are not always internationally competitive on price, quality and delivery. In contrast, many international service contractors and equipment suppliers (often substantial companies in their own right) have, over decades, invested in the engineering and manufacture of oil and gas exploration and production equipment and have developed competitive sourcing arrangements through a network of global suppliers and sub-contractors.

Quite apart from the possibility of transgressing bi-lateral and multi-lateral trade agreements, the imposition of excessive Local Content targets and supplier preferences carries risk for many parties. Concern arises if the targets or preferences are too stringent; if they exceed the capability of domestic industry to supply goods and services on a competitive basis. In such cases the investing companies either face fines for non-compliance, accept higher prices, or

To maximise oil and gas expenditure with domestic suppliers, host Governments are setting increasingly stringent targets and preferences for local sourcing pay a premium to mitigate the quality and schedule risks involved.

Only recently, the Folha de Sao Paulo newspaper in Brazil reported that Petrobras might consider reducing its expenditure on locally-produced content in the supply of goods and services from 65% to 35%[ix]. This claim was rapidly refuted by the company[x], but the fact that the possibility of Local Content targets being too stringent had been reported does perhaps suggest a need to clarify the basis upon which these targets are being set.

Potential Revenue and Safety Impacts

In extreme cases, the consequence of being obliged to use less experienced local contractors and suppliers may, if the client is unable to manage the risks, delay the date at which a new field starts to produce oil or gas. In turn, this may mean the deferral of hundreds of millions of dollars in revenues for both investors and host Government. Moreover, with the increased focus on health, safety and environment in the industry as a whole, not to mention the dendrite effects of the US Foreign Corrupt Practices Act and UK Bribery Act, the question needs to be asked whether excessive targets for Local Content might not introduce risks to equipment safety and increase the potential for ethical misconduct.

The obvious solution to address these concerns is for national regulators, investing companies, international suppliers and local supplier organisations to get round the table and start talking. Undoubtedly, there will be an *optimum* level of Local Content for each category of expenditure - one that achieves the right balance between delivering local employment and building the capabilities and competitiveness of national industries, whilst concurrently protecting Government revenues, returning a profit for investors and maintaining worker safety.

The Tipping Point

But we are close to the tipping point here. The countries that hold the future of global oil and gas production in their hands appear to be driving oil and gas companies to deliver more and more Local Content. And yet the setting of targets and preferences appear to afford little regard to the wider economic consequences, should these exceed the capacity of the local supplier market.

More stringent regulations on Local Content may well fulfil political commitments by creating jobs and filling local order books. But economic history teaches us that the same regulations can also lay the foundations for protectionism: for uncompetitive domestic industry, unable to compete with imports without protection, and unable to translate internal growth into exports.

At the other end of the trade routes, we are probably already seeing the cost of Local Content targets factored into the investment decisions of international oil and gas companies. It may not be long before the obligation to deliver excessive levels of Local Content becomes a decisive factor in a foreign oil or gas company deciding to withhold investment in a producing country altogether.

Implications for UK Export-Led Growth

So why does this all matter to the UK oil and gas manufacturing sector? It is because Local Content targets are being transmitted down supply chains to UK and other international suppliers. Where these targets are excessive, this means that either manufacturers need to invest in plant and skills in the host country to overcome the capacity constraints, or face fines for not meeting their obligations on Local Content. This begs the question: for how long will UK manufacturers be able to meet the rising targets for Local Content – targets increasingly material to a successful tender for new contracts?

If the UK Government wishes to rejuvenate the economy through export-led growth, and if oil and gas manufacturing is to play a significant role in this, then whether Brazil, Mexico, Kazakhstan, Russia, Nigeria and Ghana set realistic targets for Local Content is of critical importance.

Assuming the different stakeholders in these countries do get together and talk, and assuming that common sense prevails and optimum Local Content regulations emerge, then it is likely that the door will be left open to UK manufacturers. But the smart manufacturers will not just sit around and complain about protectionist Local Content regulations. They will be proactive and find ways to leverage the regulations for competitive advantage. They will conduct internal audits to understand what Local Content they can and could deliver. They will look for opportunities to invest in the next link in their value chain. They will see the commercial sense in building businesses in Africa, the Middle East, Brazil that transfers technology and skills in ways which cement long-term demand for their products and services. And they will

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continue to grow their own businesses in the UK as world class E&P suppliers through a focus on high-tech engineering and by exploiting the education and knowledge-base that is the core of the UK economy.

End Notes

[i] Source: Financial Times, March 2 2010 - http://cachef.ft.com/cms/s/0/f4e95372-24c4-11df-8be0-00144feab49a.html#axzz1CtRqydgh

[ii] BSI Website - *Manufacturing in the UK,* Sept 2010/Office for National Statistics, June 2010/OECD STAN Database, cited in Cassley, C (2010) CBI Manufacturing in the UK, CBI Voice of Business - http://www.cbi.org.uk/pdf/cbi-manufacturing-in-the-uk-oct2010.pdf

[iii] UK Trade and Investment, site accessed Feb 3, 2011 - http://www.ukti.gov.uk/export/sectors/energy/oilgas.html

[iv] Oil and Gas Journal, Jan 7, 2011, site accessed Feb 3 2011 - http://www.ogj.com/index/article-display/8969823069/articles/oil-gas-journal/drilling-production-2/production-operations/offshore-projects/20100/01/petrobras-approves.html

[v] Source: Financial Times, March 16th Brazil, Platform for Growth, by Joseph Leahyl

[vi] Ghanaian Ministry of Energy, Local Content and Local Participation in Petroleum Activities, (Draft Final, Version 2), Nov 4th, 2009, p5: http://www.g-rap.org/rao_convention_2009/local_content_policy.pdf

[vii] Yergin (2009) The Prize, p. 770, cited in Wikipedia - site accessed Feb 3 2011 - http://en.wikipedia.org/wiki/Petroleum_industry#cite_note-0

[viii] The scenario where oil rich states fail to exploit their non-renewable natural resources to the economic benefit of the general population, either because public expenditure of oil revenues does not drive economic growth (revenues may be siphoned-off, mismanaged or invested on white elephants); and/or because expansion of the oil sector leads to 'resource movements', 'crowding-out' and damage to the non-oil tradable sectors; and/or because of a failure of the local labour force and supplier industries to capture expenditure and thus create jobs and grow competitive local industries.

[ix] Folha de Sao Paulo newspaper, 24th Jan 2001, sourced from Upstream online – site accessed Jan 24 2011 - http://www.upstreamonline.com/live/article242378.ece

[x] Dow Jones Newswires; 55-21-2586-6085; Jan 24 2011, sourced from Morning Star - site accessed 03/02/2011: http://news.morningstar.com/newsnet/ViewNews.aspx?article=/DJ/201101241405DOWJONESDJONLINE000262_univ.xml

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