Local Content Solutions

Solutions Briefing # 5

Do Local Content Regulations Drive National Competitiveness or Create a Pathway to Protectionism?

Dr Michael Warner, March 2011

Summary

Those formulating local content regulations face a challenge. Will their interventions to leverage economic growth from expenditure in the oil, gas and mining sectors lead to more skilled and competitive domestic suppliers, or will they serve to perpetuate inefficient and uncompetitive national industries? This article applies a critical test to determine which local content regulations are likely to be protectionist, namely, does the regulation break the core principle – The Golden Thread - that contracts be awarded on the basis of international competitiveness on price, quality and delivery. Three arguments are put forward to justify why this principle might be temporarily suspended in emerging markets: infant industry argument, market power argument, and social impact compensation. However, WTO rules argue that ultimately regulations will need to revert back to the principle of competitive procurement.

The Problem

In January 2011, the Folha de Sao Paulo newspaper in Brazil reported that Petrobras – the state-owned international oil company - might consider reducing its expenditure on locally-produced content in the supply of goods and services from 65% to 35%[i]. This claim was rapidly refuted by the company[ii]. The incident demonstrates the tensions that can exist around Local Content targets, and the question of whether they are a rationale public policy for development of nascent or re-emergent domestic industries, or on occasions too excessive and represent a form of unjustified protectionism.

Of course, as discussed in other articles in this series, it is not the setting of Local Content targets *per see* that carries the potential for protectionism. It is whether the targets themselves might lead to levels of local procurement that exceed the capability of national suppliers to win work on an internationally competitive basis.

To understanding this principle is to understand that the controversy over the Folha de Sao Paulo newspaper article is perhaps a signal to the Brazilian Government and Petrobras to look again at the basis upon which Local Content targets are being established.

The basis for setting Local Content targets is a choice between options. Either targets are established within the capabilities of domestic suppliers to win orders or service contracts against international competition. Or, targets are set knowing that local suppliers are not sufficiently competitive to win contracts on a level playing field, but that this is deemed justifiable as a public policy in order to protect domestic industry, create local jobs or develop local capabilities over time. Alternatively, regulatory authorities may genuinely (or disingenuously) believe that targets are being set on an internationally competitive basis, when in reality this is not the case.

Defining Competitiveness and Protectionism

It would be helpful at this juncture to define what is meant by international competitiveness and protectionism as these terms relate to local content in the procurement of goods and services in the oil and gas industry. In this article *competitiveness* is a comparative concept,

www.localcontentsolutions.com

specifically: the ability of a domestic supplier or contractor to supply goods or services in an international market. Importantly, this market could be entirely within the domestic economy, with foreign and local firms competing against each other in open competition. Or, it can mean a market in a foreign country accessible to domestic suppliers.

The term *protectionism* refers to the intended or unintended economic policy of restraining trade between countries through methods such as tariffs (taxes) on imported goods, or restrictive import quotas and regulations designed to discourage imports. The setting of Local Content targets would fall within the category of restrictive import quotas. Regulations that preference domestic suppliers over foreign suppliers (eg through domestic-only tender lists or price advantages to local suppliers) could be deemed a form of import discouragement.

Under World Trade Organisation rules for Trade Related Investment Measures (TRIMs), local content measures are explicitly prohibited if these oblige the purchase or use by an enterprise of products of domestic origin or from a domestic source, whether this be specified in terms of particular products, the volume or value of products, or in terms of a proportion of volume or value of local production. Similar prohibitions are contained in pan-regional and bi-lateral trade agreements.

This interpretation of protectionism as an anti-competitive obligation on an individual firm suggests the need for some further refinement of the aforementioned definition for competitiveness. The World Economic Forum refers in its annual Competitiveness Report to *"national competitiveness"*, and includes in this definition not only the capability of domestic firms in terms of their business sophistication and technological readiness to penetrate foreign markets and compete with imports in the domestic market, but also the competitiveness of the nation state as a whole, for example the quality of its education system and training institutions, extent of physical infrastructure, degree of macroeconomic stability and the general health of its citizens.

Table 1 compares the national competitiveness of oil and gas producing countries against the top twelve most competitive countries. (This ranking is based on a composite weighted average, and the reader is advised to refer to the detailed report for rankings associated with the different criteria on firm competitiveness).

Whether looking at international competitiveness through the lens of the individual firm, or the economic and industrial characteristics of an entire nation, an important test of a nation's competitiveness is whether domestic suppliers are able to win work in international markets on a competitive basis. In other words, if engaged in a full and fair process of contactor selection, are domestic suppliers able to beat the competition to win contracts.

Whether a process of contractor selection can ever be truly 'full' and 'fair' is of course

Table 1 Global Competitiveness Index Rankings, 2010 – To 12 against Oil and Gas Producing Countries[1]

Top 12 Rankings		Ranking of Oil and Gas Producing Countries (out of 139)					
Switerland	1	Norway	14	Vietnam	59	Syria	97
Sweden	2	Australia	16	Turkey	61	Libya	100
Singapore	3	Qatar	17	Russia	63	Ecuador	105
United States	4	Saudi Arabia	21	Federation		Ghana	114
Germany	5	UAE	25	Mexico	66	Venezuela	122
Japan	6	Malaysia	26	Romania	67	Nigeria	127
Finland	7	China	27	Colombia	68	Timor Leste	133
Netherlands	8	Brunei	28	Iran	69	Angola	138
Denmark	9	Tunisia	32	Kazakhstan	72	Chad	139
Canada	10	Oman	34	Peru	73	Gabon	x
Hong Kong SAR	11	Kuwait	35	Egypt	81	Yemen	x
United Kingdom	12	Thailand	38	Trinidad &	84	Republic of Congo	x
		Indonesia	44	Tobago		Equatorial Guinea	x
		Italy	48	Philippines	85	Iraq	x
		India	51	Algeria	86	Sudan	
		Azerbaijan	57	Argentina	87	Sao Tome and	
		Brazil	58			Principe	

open to challenge. Even if the contract award process itself is genuinely competitive, with pre-qualification and tender evaluation processes applied equally to all prospective bidders, and contracts awarded strictly on tender submissions, there is still the question of the advantages and disadvantages that lie outside of the immediate control of the supplier.

For example, foreign and domestic vendors may be exposed to very different tax regimes. A prospective foreign supplier may be subject to import tariffs and withholding tax, which disadvantages its price competitiveness. But then a domestic supplier may be disadvantaged because of local value added tax that is not applicable to the foreign supplier. The USA, for example, does not participate in a VAT system, and can argue to be disadvantaged when exporting equipment to countries that then add this type of tax to the sales price.

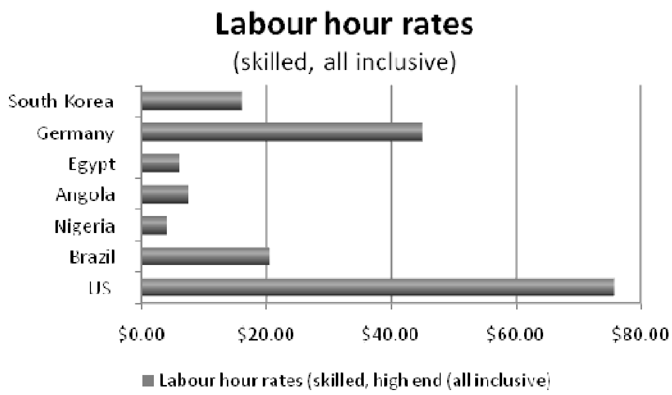
Conversely, a foreign supplier may be advantaged by export subsidies from its own Government, such as export credit guarantees, or by a public policy of the host Government to attract inward investment through relief on import duties. Likewise, local suppliers may benefit from access to subsidised sources of domestic credit, for example, from national development banks, or from subsidised energy costs.

These competitive externalities are difficult to overcome, and is why they often form key themes within international and bi-lateral trade negotiations.

There are also concealed advantages at the firm level, as well as the national level. Labour productivity is one area of obvious scrutiny. Figure 1 compares all-inclusive labour rates across a sample of countries. On the face of it, the figures suggests that labour rates in Nigeria are more competitive than the in the US (Gulf Cost). But this is misleading, since labour rates, even if 'all inclusive', are not always reflective of a firm's price competitiveness.

Comparative labour productivity – the ratio of output to labour input - is a more meaningful measure of competitiveness,

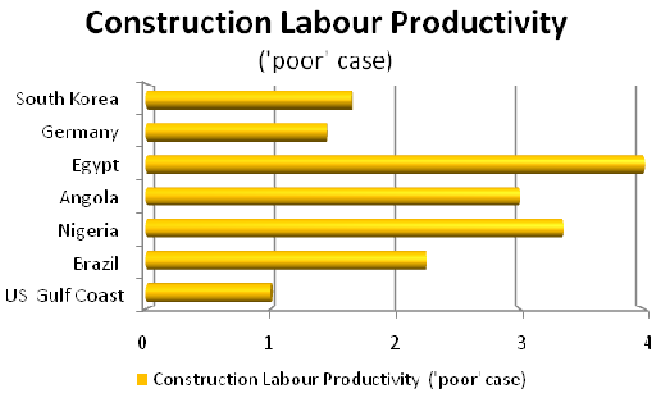
Figure 1 Comparison of Labour Rate



Competitiveness Across Countries[iii]

reflecting the overall efficiency of workers in producing a unit of output that meets the required quality standards. Labour productivity is influenced by many factors that lie outside the workers' direct influence and outside the all-inclusive labour rate. This includes the amount of capital equipment available to workers, the presence of new more efficient technologies, and the quality and sophistication of management practices. Figure 2 contrasts the same countries by labour productivity. This figure suggests that in Nigeria construction projects may take up to 3.35 times more labour to produce the same output unit as compared to US Gulf Coast.

Figure 2 Comparison of Labour Productivity



The Golden Thread through Procurement

These externalities (though less so the concealed internalities) are sometimes used by oil, gas and mineral producing countries to justify protectionist local content regulations. But whether they can also justify regulations that undermine a fair and competitive process of contractor selection within procurement is questionable.

In the oil, gas and mining sectors, procurement departments go to great lengths to assure that tender alerts, pre-qualification criteria, choice of tenderers, instructions to tenders and tender evaluation criteria, are equally applied to all capable vendors. Throughout the process of contractor selection, it is the rule of 'comparative advantage' that pervades key decisions and assures contracts are awarded on a competitive basis. This then is the key principle of procurement - *The Golden Thread* - that runs through all regulations on Local Content, and assures that the award of contracts to domestic suppliers is free of explicit protection.

The principle is codified in the oil and gas development industry through clauses in articles within concession agreements or production sharing agreements, and in mining through various forms of mining development agreements. These clauses then feed through into agreed tender procedures at the operational level.

Box 1 presents the typical clauses. What these provisions are essentially saying is that only when all else is equal should the buyer advantage domestic suppliers, and that in so doing the core principle of contract award on an internationally competitive basis is preserved.

In practice, to argue that such clauses give preference to domestic suppliers is perhaps a little disingenuous. To '*give preference so long as competitive with international performance and price'*, is to require the domestic supplier to meet minimum technical performance requirements and then also equal its international rivals on price. As such, the domestic supplier could be awarded the contract with, or without, the stated preference. (The maths is slightly different for contracts awarded on a 'value for money' basis, but the same core principle and outcome still applies).

What such a clause does do, however, is make clear which categories of expenditure are likely to be excluded from participation by domestic suppliers. This includes goods and services:

Box 1 Common Clauses Aligning Local Preferencing to the Principle of Competitive Contract Award

Typical clause on competitive procurement in production sharing agreement for oil and gas exploration and development

> *"Give preference to local contractors and locally manufactured materials and equipment so long as their performance, quality and time of delivery are competitive with international performance and prices"*

Typical clause on competitive procurement in a mining development agreement[v]

> *"The Company shall, when purchasing goods and services required with respect to Mining Operations, give first preference, at comparable quality, delivery schedule and price, to goods produced in [COUNTRY] and services provided by [COUNTRY] citizens or businesses, subject to technical acceptability and availability of the relevant goods and services in [COUNTRY]."*

- of a proprietary nature - sometimes called 'exotic' goods - unless domestic distributors are appointed;
- strategic to the functioning of operations on the grounds of schedule (eg long-led items) or health and safety; and
- those that are one-offs or procured on an indeterminate *ad hoc* basis, and which if procured locally would incur prohibitively high transaction costs.

Table 2 below contrasts different local content regulations in terms of their adherence to the principle of contract award on an internationally competitive basis.

Those regulations most at odds with the core principle include local content targets that breach the capacities and price competitiveness of domestic industry; requirements for minimum levels of participation by domestic suppliers in international contracts or participation of domestic firms owned by nationals; and the granting of a nominal price advantage to domestic suppliers.

Table 2 Adherence of Local Content Regulations to the Principle of Competitive Contract Award

Typology of Local Content Regulations	Adheres to principle of competitive contract award (Yes/No)
Minimum Targets	
1. **Blanket min Local Content targets** – intentionally exceeds price competitiveness of domestic supplier industry in order to drive inward investment	**No/Yes** (in some sub-categories of expenditure local suppliers will be competitive, in others not)
2. **Disaggregated minimum Local Content targets** – in each case exceeding price competitiveness of domestic suppliers in order to drive inward investment	**No** (but converging on 'Yes' if inward investment is forthcoming and successful in driving domestic competitiveness)
3. **Disaggregated minimum Local Content targets for expenditure** – within domestic limits of international price competitiveness	**Yes**
Local Supplier Preferences	
4. **Domestic-only tender lists** - benchmarked against 'capability', but not international competitive on price, quality and delivery	**No**
5. **Domestic-only tender lists** - benchmarked against internationally competitiveness	**Yes**
6. **Full, fair and reasonable access** to procurement opportunities for domestic suppliers	**Yes**
7. **Reduced pre-qualification criteria** for domestic suppliers	**Yes** (does not necessarily imply contract award on an uncompetitive basis)
8. **Mandated foreign/domestic consortia** or sub-contractor alliances	**Yes** (if presence of foreign suppliers assures whole of bid is internationally competitive, e g through additional supervision, training or upfront investment)
9. **Minimum participation of domestic sub-contractors/suppliers** in contracts awarded to foreign suppliers (by $ value)	**No** (if this leads to uncompetitive pricing)
10. **Minimum national ownership** of suppliers awarded contracts	**No** (if this leads to uncompetitive pricing)
Basis of Contract Award	
11. **Preference to domestic suppliers so long as** performance, quality and time of delivery are competitive with international performance and prices"	**Yes**
12. **Nominal price advantage** to domestic suppliers on award, e g 10% blanket	**No**
13. **Bid evaluation** on basis of 'where all else equal, preference local suppliers or highest levels of local content'	**Yes**
14. **Economically Advantageous** basis for contract award, e g application of 'K' Factor	**Yes** (applied equally to all bidders)
15. **Contract award veto** for Government authorities on Tender Board on basis of insufficient Local Content or inadequate Local Content Plan	**No** (if veto is applied to detriment of principle of contract award on an internationally competitive basis)
Contract Execution	
16. **Advance payments** to domestic suppliers eg 30%	**No** (need for advance payment is indicator of supplier having insufficient access to credit)
17. **Minimum training obligations for nationals**, eg first consideration to nationals, targets by cost or training hours	**Yes** (a form of 'off-set' applied equally to all bidders)
18. **Minimum obligations for growing competitiveness of domestic suppliers**, e g minimum investment requirements, minimum training obligations beyond that needed for contract execution	**Yes** (a form of 'off-set' applied equally to all bidders)
19. **Obligations to report on Local Content performance**	**Yes** (if not tied to mandatory minimum targets that breach domestic competitiveness)

Arguments for Protectionism

The types of regulations in Table 2 are commonly justified by host Governments with reference to established economic arguments.

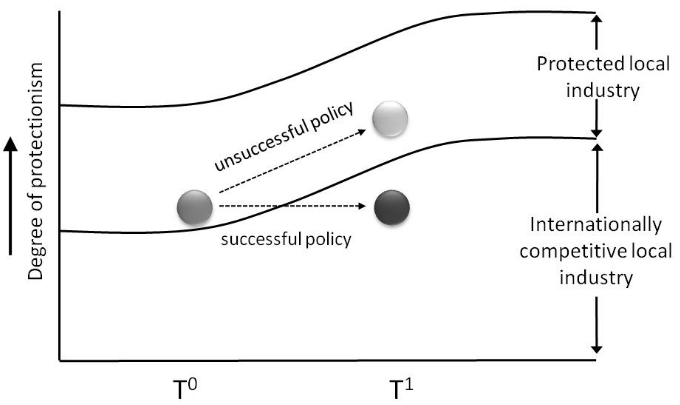
Specifically, those regulations that compel contracts to be awarded on a non-competitive basis may in fact have a economic or social rationale. Three of the most common arguments are the *infant industry* argument, the *market power* argument, and what might be described the *social impact* argument. These are discussed in turn below.

Infant Industry Argument

The infant industry argument was first espoused by Alexander Hamilton, a Founding Father of the United States and Secretary of the Treasury. Hamilton was an advocate of government intervention to support business in a fledgling country, and a strong opponent of free trade[vi]. The same argument continues today in many emerging and developing economies. The argument asserts that protectionism is acceptable where nascent industries do not yet have the economies-of-scale of foreign competitors, and thus need support (protection) until such a time as they can attain similar level of competitiveness.

Figure 3 is a schematic showing how, under the infant industry argument, limited protectionism is intended to lead over time to a domestic industry able to compete against international trade. It also shows what happens if the efforts of governments to intervene through education, training, sourcing preferences, capital investment, tax incentives etc. are unsuccessful (what is referred to as 'Double Market Failure' – see Box 2 for definition[vii]).

Figure 3 The Infant Industry Argument



> **Box 2 Double Market Failure**
>
> Double Market Failure is the failure of government interventions to correct failures in the free market.
>
> An example of Double Market Failure would be local content regulations that preference domestic suppliers over foreign suppliers in an effort to correct the 'unfair' global purchasing power of international suppliers, but which then has the unintended effect of entrenching production inefficiencies and contributing further to an internationally uncompetitive domestic industry.

Whilst this policy has benefited many countries, not least the United States, it has also been shown to be less than effective, with the result being inflation of the domestic products in question and lower quality, coupled with a failure of these firms to penetrate export markets.

To illustrate, during the 1980s, Brazil imposed controls on the import of computers with the intention of nurturing their own computer industry. This industry never materialised, with domestic production copying low-technology foreign computers sold at inflated prices.[viii]

But the infant argument is by no means obsolete. Indeed, only recently the Financing for Development initiative of the United Nations argued for limited, time-bound protection of certain industries by countries in the early stages of industrialisation, noting that *"however misguided the old model of blanket protection intended to nurture import substitute industries, it would be a mistake to go to the other extreme and deny developing countries the opportunity of actively nurturing the development of an industrial sector"*[ix].

Referring back to Table 2, certain local content regulations are more likely than others to lead to Double Market Failure, ie to the unintended fuelling of inefficient and uncompetitive domestic industries. For example, regulations that limit contracts for certain sub-categories of expenditure to the preserve of 100% nationally-owned companies, would, if such companies were currently uncompetitive and unable to attract new investment or benefit from technology transfer, be likely to fail the infant industry argument.

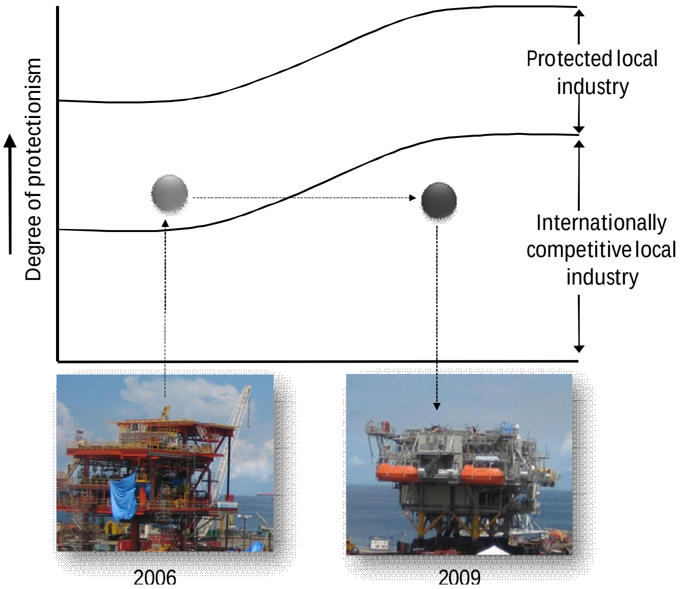
In contrast, regulations that limited the proportion of foreign content in certain expenditure, but concurrently encouraged foreign companies to form joint ventures with local firms, might stand a greater chance of fulfilling the infant industry argument. A case in point is the development of the TOFCO Ltd fabrication yard in Trinidad and Tobago. (Full details of this case are described in a separate article).

In this case, encouraged by a general industrial policy of local participation by nationally-owned firms, and supported by a specific public policy on local content that encouraged oil and gas companies to develop local capability and competitiveness[x], BP Trinidad and Tobago contracted the TOFCO fabrication yard to construct a series of off-shore platforms. The protectionist component took the form of premiums, which elevated the cost of local fabrication above what might have been achieved through international competition. The first of the series of similar-specification platforms - the Cannonball project – received a premium of US$9 million, from a total cost of US$54 million[xi].

The combination of public policy and strategic procurement by BP can be considered a successful market intervention. Over time, as productivity in the fabrication yard improved, the premiums for subsequent platform were able to be reduced. By the third platform, another foreign operator in the country - BG Group - was able to procure the services of TOFCO to construct a far larger platform. This time contract award was on a fully internationally competitive basis for cost, quality and schedule. Subsequently, the overall project – the Poinsettia project - won the Overseas Project of the Year Award 2009 from the UK-based Association of Project Management (APM). Justification for the award cited that the contribution of the project to developing the fabrication industry in Trinidad was a deciding factor. As recorded by the General Manger of the TOFCO, Shuresh Gangabissoon, at the award ceremony, the contract "*raised the capability of TOFCO and local companies to an altogether higher, more competitive level*"[xii].

Figure 4 offers a schematic showing how the aforementioned BP platforms constructed in Trinidad paved the way for the nascent local fabricator to build its competitiveness over a finite time period.

Figure 4 Realisation of the Infant Industry Argument in Trinidad



Market Power Argument

A second rationale for justifying protectionist local content regulations is where foreign suppliers are charged to be unfairly using market power to compete with domestic industry. From one viewpoint, this is simply an extension of the infant industry argument, in that if domestic companies could achieve the same purchasing power as international suppliers, then they too could negotiate the same global sourcing arrangements to compete on price. But there is a difference here. Whereas under the infant industry argument, local content targets and local preferencing regulations seek to advantage domestic industry, under the market power argument local content regulations are designed, not to 'advantage' local industry, but to ensure that this industry is not 'disadvantaged'.

The policy rationale is that the market power of some international suppliers means they inadvertently behave in an anti-competitive manner. This charge most commonly arises when international contractors commit to long-term global sourcing deals and bulk purchases to supply their large portfolio of client's around the world. These commitments and volumes enable the negotiation of substantially lower pricing. Such deals might be viewed as anti-competitive if they disadvantage capable domestic suppliers, who, given the opportunity to bid directly and individually against these global suppliers, might be able to compete. Of course, the domestic suppliers are unlikely to be competitive on base price, since they would have sufficient capacity to negotiate the same bulk deals. But their geography and lower labour costs may well mean they are more competitive on delivery, reliability and on total outturn cost, for example, if factoring in logistics costs and labour costs in repair and maintenance services.

Just such a scenario is beed played out recently in Queensland, Australia, in the context of a number of large Liquid Natural Gas projects (see Box 3[xiii]).

Social Impact Argument

A third argument for imposing protectionist local content regulations is as a form of compensation for the adverse socio-economic impacts of oil, gas and mining investment on local communities and vulnerable groups.

The regulatory requirements of ministries of environment for Environmental Impact Assessment studies, and similarly those of development finance institutions and commercial banks, increasingly recognise that communities close to infrastructure projects may need to be compensated for a temporary or permanent loss of economic livelihoods. Preferencing employment and procurement opportunities to these individuals and to community-based vendors can play a part in this compensation.

The international benchmark standards for environmental and social impact assessment are the Performance Standards of the International Finance Corporation[xiv] (the private sector arm of the World Bank Group). These standards, adopted by over sixty commercial banks, including Citigroup and Barclays, provide principles for compensating individuals for the loss of potential to earn an income. Among the principles are compensation and benefits for:

- **persons physically displaced** by an investment project, including "*assistance to help them improve or at least restore their standards of living or livelihoods*", and "*opportunities to displaced persons*

Box 3 Local Content Regulations based on the Market Power Argument, Queensland, Australia

As a member of the World Trade Organisation, Australia carries obligations on competitiveness and anti-discrimination. Project proponents in Australia are prohibited from preferencing domestic suppliers over foreign suppliers, and may not instruct a first tier supplier to use particular domestic suppliers or sub-contractors as a condition of doing business.

However, in recognition of the Market Power argument (see main text), project proponents must adhere to the Australian Industry Participation National Framework[xiii] when procuring goods and services. The Framework is a policy for ensuring **full**, **fair** and **reasonable** opportunity for Australian industries to participate in significant public and private sector activity. The core definitions are as follows:

- **Full**: domestic industry has the same opportunity afforded to other global supply chain partners to participate in all aspects of an investment project (eg design, engineering, project management, professional services, IT architecture);
- **Fair**: domestic industry is provided the same opportunity as global suppliers to compete on investment projects on an equal and transparent basis, including being given reasonable time in which to tender; and
- **Reasonable**: tenders are free from non-market burdens that might rule out domestic industry and are structured in such a way as to provide domestic industries the opportunity to participate in investment projects.

To operationalise the Framework, project proponents are incentivised through the Enhanced Project Bylaws Scheme (EPBS), whereby goods that are not deemed to be manufactured in Australia may be imported and eligible for a 5% tariff relief. The scheme is administered by AusIndustry, part of Department for Innovation, Industry, Science and Research (DIISR). Eligibility for tariff relief is predicated on approval of an Australian Industry Participation Plan (AIP Plan) in accordance with the Australian Industry Participation National Framework.

To gain approval for an AIP Plan, evidence is required demonstrating that consultation has taken place to determine whether there are Australian manufacturers capable of participating in tenders to supply the required goods. To this end, AusIndustry encourages project proponents to work with the quasi-Government organisation Industry Capability Network. Criteria to be satisfied in the approval of an AIP Plan, includes details of[1]:

- Employment creation
- Skills transfer
- Regional economic development
- Technology transfer and R&D
- Full fair and reasonable opportunities for Australian suppliers to tender
- Strategic partnering and consortia building
- Integration of domestic suppliers into global supply chains
- Adoption of global best practice standards

and communities to derive appropriate development benefits from the project"; and

- **persons economically displaced**, including additional "*targeted assistance (e.g., credit facilities, training, or job opportunities) and opportunities to improve or at least restore their income-earning capacity, production levels, and standards of living*"

In practice, this could involve project proponents directly tendering opportunities to suppliers who source labour or materials from affected-communities, or it could mean obliging their major contractors to meet targets for employment of displaced and affected persons.

This type of local preferencing may be covenanted as part of the approval of environmental and social management plans by regulatory authorities, or it may be an entirely voluntary undertaking by the company. For example, regarding the latter, it could be undertaken as a means to support permitting applications to local Government authorities, or as a form of *soft* security – local goodwill affording the company and its workers protection from local hostilities.

World Trade Organisation Rules

Determining whether or not countries are justified in applying protectionist measures to domestic expenditure on goods and services is a key part of the mandate of the World Trade Organisation. The WTO describes itself as "*the only global international organization dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments*"[xv]

Three of the most relevant agreements of WTO members with implications for local content regulations are the agreement on Trade-Related Investment Measures (TRIMs), the General Agreement on Trade in Services (GATS) and the agreement on Government Procurement (GPA). Each is discussed in turn below.

TRIMs Agreement

The TRIMs Agreement is Article III of the General Agreement on Tariffs and Trade and is an agreement pertaining to trade in goods. It applies to all WTO members, ie it is 'multilateral'. The rules under the TRIMs Agreement prohibits local content requirements that oblige particular levels of local procurement by an enterprise. The rules also prohibits trade balancing requirements that restrict the volume or value of imports that an enterprise can purchase to an amount related to the level of products it exports. In essence, the rules require a host country to extend to foreign investors treatment that is at least as favourable as the treatment it accords to national investors in like circumstances.

Importantly, the Agreement contains transitional arrangements. These allow WTO members to maintain certain (protectionist) measures for a limited time following their entry to the WTO. The period of grace is two years in the case of developed country members, five years for developing country members and seven years for least-developed country members.

As of 2011, of the 153 WTO members, 27 are developing country oil or gas producers, with another three producers classified as Least Developed Countries[xvi]. Of the 27, all except Vietnam acceded to the WTO prior to 2006, which would suggest that their eligibility for transitional arrangements under GATT have expired. The same is so for the three least developing countries - Angola, Chad and the Republic of Congo - who all acceded prior to 2004.

Notwithstanding negotiated extensions to the transitional arrangements, it is questionable whether some of these governments might already be in breach of their obligations under the WTO, should they apply local content requirements that afford protection to their domestic industry. For example, just such questions have been raised recently about the Nigerian Oil & Gas Industry Content Development Act 2010 (the "Local Content Act")[xvii]. In this case, should a foreign company conducting business in Nigeria, or another WTO country member, raise this issue through the WTO dispute settlement facility, it seems likely that the Nigerian Government would proffer the infant industry or market power arguments in its defence.

General Agreement on Trade in Services

With regard to services as opposed to goods, Part III of the General Agreement on Trade in Services (GATS) contains provisions on access for foreign suppliers to WTO member markets and the treatment of nationals.

In the case of market access, all WTO members should accord services and service providers from other WTO members treatment no less favourable than that provided for under the common terms, limitations and conditions mutually agreed within the WTO. The intention of this provision is to progressively eliminate certain types of protectionist measures, including limitations on:

- numbers of foreign service providers allowed to compete with domestic providers;
- the total value of service transactions of foreign providers;
- the total number of foreign service operations or foreign people employed;
- the type of legal entity or joint venture through which a service is provided; and
- maximum levels of foreign capital participation.

In the case of the rules for treatment of nationals, the objective of the WTO here is to oblige member countries to treat foreign service suppliers and domestic service suppliers in the same manner.

As with GATTs, under GATS there are provisions for the 'special and differential treatment' of developing countries (SDTs). These provisions include:

- longer time periods for implementing agreements;
- measures to increase trading opportunities for these countries;
- provisions requiring all WTO members to safeguard the trade interests of developing countries;
- support to help developing countries build the infrastructure for WTO work, including handling disputes, and implementing technical standards; and
- specific provisions relating to Least-Developed Country members, including flexibility to encourage foreign suppliers to assist in technology transfers and training through 'offsets' for example (see Box 4[xviii]).

Box 4 Offset Transactions

Offset transactions are contractual conditions that require the seller (usually a foreign supplier) to transfer additional economic benefits to the buyer (usually a host government or domestic company) as a condition for the sale of a base good or service. It is a popular mechanism in the purchase of military equipment by Governments. Offsets are also the basis of a number of local content regulations, such as the obligation in the conditions of a service contract to place a portion of contract value with domestic sub-contractors; the licensing of technology to domestic manufacturers; and requirements for minimum inward investment by international equipment suppliers.

Use of Offsets is explicitly excluded under Article XVI of the WTO Agreement on Government Procurement (GPA)[xviii]. Exceptions are made for developing countries, who, at the time of accession, may negotiate conditions for their use. Under GPA rules, use of Offsets – such as requirements for the incorporation of domestic content - is to be "*used only for qualification to participate in the procurement process and not as criteria for awarding contracts*", and even within qualification processes, the request for off-sets must be "*objective, clearly defined and non-discriminatory".*

Within tender document, certain instructions to tenderers on local content could be considered Offsets. These include:

- preferential hiring and training of nationals
- preferences for local sourcing
- encouragement of inward investment
- encouragement of support to domestic suppliers to develop future competitiveness
- encouragement for operational infrastructure to be made available for public use, eg roads, power, water supply

A limiting factor in the use of Offsets to drive local content (be that within government regulations or as a feature of the procurement strategy of a client oil, gas or mining company) is whether the costs involved for suppliers can be charged back to the client, and then whether the client can subsequently recover these costs against production revenues or tax. With regard to cost recovery, a dilemma arises if the economic benefits arising from the Offsets are not able to be '*directly' related* to an approved work programme – this being the usual criteria for cost recovery eligibility.

Agreement on Government Procurement

The plurilateral Agreement on Government Procurement (GPA) was negotiated in the Uruguay round and came into effect in 1996. These are rules for government procurement and apply only to those WTO members who are party to this particular agreement, in this case the countries of the European Union and thirteen other countries, including Norway, USA, South Korea and Chinese Taipei.

The GPA rules are intended to counter internal political pressure to discriminate in favour of domestic suppliers of goods and services over foreign competitors, and thereby open up government transacted business to international competition. A large part of the rules concern tendering procedures for contracts above specified financial thresholds, and include the following[xix]:

- **Selective Tendering** - procedures for supplier selection (qualification of suppliers to tender, and tendering processes) are not allowed to discriminate against foreign suppliers, for example, criteria for qualification and tendering must be limited to those essential to fulfil the contract, and not include Offsets (see Box 4). Nor may technical specifications be used to discriminate against foreign suppliers, but should be based instead on international standards.

- **Tender Award** – procuring entities are obliged to award contracts to the tenderer who has been determined to be fully capable of meeting the essential requirements of the contract; and either

    - o is the lowest priced tender, or

    - o the tender deemed to be the most advantageous in terms of a combination of evaluation criteria set forth in the tender documentation

- **Limited Tendering** – restricted tender lists (presumably including domestic-only tender lists and sole and single sourcing) is closely circumscribed, limited to: (i) situations of "extreme urgency"; (ii) goods or components that are "not interchangeable" with those from other suppliers; (iii) cases where extensions to construction contracts using a different service provider would be difficult for technical or economic reasons and cause "significant inconvenience" (up to 50% of original contract value); and (iv) to the award of contracts for repetition of "similar" construction services, assuming that such a possibility was clearly indicated in the original notice to tenderers.

- **Rules of Origin** – parties to the GPA are not allowed to apply rules of origin to products or services which are different from the rules of origin applied in normal source of trade.

In recognition of the economic development, financial and trade needs of poorer countries, the GPA carries time-limited exemptions for developing countries. Of the world's main oil and gas producers, those developing country members and Least Developed Country who are members of the WTO are listed in Table 3.

The GPA has direct relevance to the oil and gas industry. Most critically, 'coverage' of the rules - meaning the types of public entities to which the rules apply - is determined by each member country, and can include state-owned entities and public utilities in the energy sector.

For example, South Korea includes the Korea National Oil Corporation in its list of entities obliged to procure in accordance with the GPA[xx], and Taiwan includes the Chinese Petroleum Corporation of Taiwan. This may partly explain the reluctance on the part of the Brazilian Government and other Governments of oil and gas economies to join the GPA, since presumably, unless able to negotiate exemptions, they would then be prohibited from requiring minimum levels of domestic content in the award of contracts[xxi].

Table 3 Oil and Gas Producing Country Members and Observers of WTO

Developed County TWO Members	Developing Countries WTO Members		Least Developed Country WTO Members	WTO Observer Status Developing Countries
Switzerland	*UAE*	*Romania*	*Angola*	*Yemen*
Sweden	*Malaysia*	*Colombia*	*Chad*	*Azerbaijan*
Singapore	*China*	*Peru*	*Republic of Congo*	*Russia Federation*
United States	*Brunei*	*Egypt*		*Kazakhstan*
Germany	*Tunisia*	*Trinidad &*		*Syria*
Japan	*Oman*	*Tobago*		*Libya*
Finland	*Kuwait*	*Philippines*		*Sudan*
Netherlands	*Thailand*	*Argentina*		*Iraq*
Denmark	*Indonesia*	*Ecuador*		*Iran*
Canada	*India*	*Ghana*		*Algeria*
Hong Kong SAR	*Brazil*	*Venezuela*		*Equatorial Guinea*
United Kingdom	*Vietnam*	*Nigeria*		*Sao Tome and*
Norway	*Turkey*	*Gabon*		*Principe*
Australia	*Mexico*			
Qatar				
Saudi Arabia				
Italy				

Conclusion

This article has sought to demonstrate that it is not inevitable that local content regulations should lead to protectionism; but nor is it so that they invariably lead to a more skilled, capable and competitive local industrial base, as governments might believe. The challenge facing those who formulate local content regulations is how to ensure expenditure in the oil gas and mining sectors drives forward industrialisation of their country without trapping the local supplier industry in a cycle of protectionism.

The article offers an important test of impending protectionism, namely, whether a local content regulation will break the core principle that, regardless of externalities and Offsets, a contract should be awarded on the basis of international competitiveness in price, quality and delivery.

Three arguments have been forwarded to justify some limited protectionism for domestic suppliers in developing countries. However, an analysis of WTO rules shows that under these agreements such arguments are acceptable only if time-limited, and that invariably procurement should in due course return to the core principle –The Golden Thread – of contract award on an internationally competitive basis.

Author: Dr Michael Warner, Director, Local Content Solutions
(a trading arm of SNSI Ltd)

Contact: LCS@localcontentsolutions.com;
Tel: +44 (0) 1491 830421;
Website: www.localcontentsolutions.com

End Notes

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

[ii] Dow Jones Newswires; 55-21-2586-6085; Jan 24 2011, sourced from Morning Star - web site accessed 3rd Jan 2011: http://news.morningstar.com/newsnet/ViewNews.aspx?article=/DJ/201101241405DOWJONESDJONLINE000262_univ.xml

[iii] Compass (2010) The 2010 Construction Cost and Reference Yearbook, 10th Annual Edition: Pennsylvania: Compass International Consultants Inc

[iv] ibid

[v] International Bar Association (2010) Model Mining Development Agreement - www.mmdaproject.org,

[vi] Source: Alexander Hamilton, Wikipedia, site accessed 16th February 2011 - http://en.wikipedia.org/wiki/Alexander_Hamilton

[vii] Zerbe, R and McCurdy H (2000) The End of Market Failure, Vol 23, No. 2 Regulation Journal - http://www.cato.org/pubs/regulation/regv23n2/zerbe.pdf

[viii] Eduardo, L. (1996) *The microcomputer industry in Brazil: the case of a protected high-technology industry.* Santa Barbara: Greenwood Publishing.

[ix] Zedillo, E (2001) Technical Report on the High Level Panel on Financing for Development, p9 - http://www.un.org/reports/financing/full_report.pdf

[x] Government of Trinidad and Tobago (2005) Local Content Policy and Local Participation Framework, Ministry of Energy and Energy Industries, Permanent Local Content Committee - www.energy.gov.tt

[xi] University of the West Indies (2005) BP Trinidad and Tobago Limited, Arthur Lok Graduate School of Business, University of the West Indies, Trinidad, MCS-CSR-05-05 - http://www.menasborders.com/elib/bptt.pdf

[xii] Source: Rigzone web-site, web site accessed 17th February 2011 - http://www.rigzone.com/news/article.asp?a_id=82055

[xiii] Commonwealth Government (2001) Australian National Industry Participation Framework, DIISR - http://www.innovation.gov.au/Industry/AustralianIndustryParticipation/Pages/AustralianIndustryParticipationNationalFramework.aspx

[xiv] International Finance Corporation (2006) Social and Environmental Performance Standards, Washington DC: IFC

[xv] WTO 'What is the WTO', web site accessed 23rd February 2011 - http://www.wto.org/english/thewto_e/whatis_e/whatis_e.htm

[xvi] WTO 'Members and Observers', web site accessed 23rd February 2011 - http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm

[xvii] Business Day newspaper, 1st December 2010, The Local Content Act: A Breach of Nigeria's WTO Obligations, Ayodele Oni, web site accessed 25th February 2011 - http://www.businessdayonline.com/NG/index.php/law/legal-culture/16459-the-local-content-act-a-breach-of-nigerias-wto-obligations-

[xviii] WTO (1996) Article XVI Agreement on Government Procurement, Uruguay Round Agreement, World Trade Organisation - http://www.wto.org/english/docs_e/legal_e/gpr-94_02_e.htm#ftnt7

[xix] WTO (1996) Article I to XIII Agreement on Government Procurement, Uruguay Round Agreement, World Trade Organisation, - http://www.wto.org/english/docs_e/legal_e/gpr-94_02_e.htm#ftnt7

[xx] World Trade Organisation, Appendices and Annexes to the GAP. South Korea - Annex III of Appendix I - http://www.wto.org/english/tratop_e/gproc_e/appendices_e.htm#appendixI

[xxi] WTO (2009) Trade Policy Review, Brazil, Record of Meeting, WT/TPR/M/212 - http://www.wto.org/english/tratop_e/tpr_e/tp312_crc_e.htm