

# Local Content Policy | Upstream Guide | Deloitte Brazil



With the announcement, in 2007, of the discovery of economically recoverable oil reserves in the pre-salt layer of Campos and Santos basins, in the Rio de Janeiro and São Paulo states respectively, the Brazilian government faced a great opportunity to boost country's development, since the discovery would more than double the volume of its proven reserves.

One of the actions taken by the Brazilian government to meet these challenges was to intensify the implementation of a local content policy, which began in 1999 in the Exploration & Production (E&P) segment of the Oil & Gas industry (O&G).

## Local Content overview

The central idea of implementing a local content policy is to prioritize domestic suppliers of goods and services, given that they offer internationally competitive price, quality and delivery time. Increasing the competitiveness of the Brazilian industry would ultimately lead to social and economic development.

The local content policy is an instrument of industrial policy, traditionally used by many countries to promote economic development and retain a greater share of the value generated by the exploitation of natural resources. The Brazilian local content policy rules and guidelines have changed and evolved significantly over the years.

## Local Content concepts and procedures

According to the Brazilian National Agency of Petroleum, Natural Gas and Biofuels (ANP), the objective of the local content clause is to increase the share of the domestic industry of goods and services in the projects of exploration and production development of oil and natural gas, in a competitive basis. The expected result of this clause is to boost the technological development, the training of human resources, and the generation of jobs and income in this segment.

In the context of oil and natural gas, local content is the portion of the materials, equipment and systems produced and services rendered in the national territory, which the license holder (in exploration and production) acquire from suppliers established in Brazil. Local content requirements have been set up historically in each Bidding Round Tender Protocol. The local content rules have significantly varied over the fifteen bidding rounds held by ANP, but the final commitment are set up in the concession and production sharing agreements (PSA), signed by the winner concessionaire/consortia of each exploratory block or area at the end of the bidding round. The local investment is usually expressed in terms of percentage, compared to the total volume of investment.

The concessionaires supply Local Content Reports (LCR) to ANP annually, with information on a quarterly basis. The regulatory agency starts an audit of the local content clause upon confirmation of the following triggering events: (I) upon conclusion of the exploration phase, (II) upon the end of the production and development phases or any other inspection milestone set forth and (III) when the exploration block is relinquished and the concession / production sharing agreement is terminated. The ANP also audits the local content of the onerous assignment contracts. In all cases, the operator of the block must submit to ANP the documents in order to support its investments in local content. ANP imposes a fine if the operator does not comply with the local content percentage agreed in the contract for E&P.

## **Bidding rounds and local content policy requirements**

As previously mentioned, the ANP started promoting a series of licensing rounds of exploratory blocks after the liberalization of the oil and gas E&P sector. Since 1999, date of the first Bidding Round, the Agency established on the tender protocol that local content would be one of the award criteria for concession agreements. As a result, the companies were encouraged to offer higher percentages of acquisition of local goods and services. Later, the CNPE (National

Energy Policy Council) Resolution No. 8 of July 21, 2003 determined the establishment of minimum local content requirements. Thus, from the Round 05 (2003) on, offers were subjected to minimum local content requisites, expressed in percentages. It is worth mentioning that local content criteria have changed significantly over the bidding rounds. The most significant alteration took place in Round 07 (2005) with the introduction of the local content booklet and the certification process, which must be carried out by any certifying entity accredited by ANP that often audits these entities.

The CNPE Resolution No. 07 of April 11, 2017, defined the new model of local content and was submitted in the next bidding rounds. In addition to being no longer considered as the factor of punctuation of the offers, the requirement were simplified and the minimum percentages reduced. For the onshore blocks, only global commitments will be required for the exploration and for the production development phases, both of being 50%. In the case of offshore areas, a total of 18% will be required for the exploration phase and, in the case of the development phase, minimum commitments for three macro groups were established: well construction (25%); collection and drainage system (40%) and stationary production unit (25%).

### **Local content historic policy evolution**

Regulatory model	Round	Year	Local content rules	Weight in the award criteria	Evidence		
Concession contract	1	1999	No minimum requirements for local content commitment.Maximum percentages for purposes of award criteria (50% for exploration and 70% for development).Bidders offer global percentages for each phase (exploration and development).	15%(3% exploration and 12% development)	Required Declaration of Origin by supplier.		
	2	2000					
	3	2001					
	4	2002					
	5	2003	Bidders must offer global percentages for exploration and production phases in accordance with minimum requirements for local content commitment. Bidders may offer additional percentages for each listed activity included in the exploration and production phases with no minimum requirements. The sum of offered percentages will be considered for purposes of award criteria.	40%(15% exploration and 25% development)			
	6	2004					
	7	2005	Minimum global percentages defined by block location.Maximum percentages for purposes of award criteria defined by block location.Bidders must offer local content percentages for each item and sub-item in accordance with minimum requirements. The global percentage, object of computation in the offering, will be calculated from the offer for each item and sub-item.	20%(5% exploration and 15% development)			
	8	2006					
	9	2008					
	10	2013					
	11	2013					
	12	2015					
	13	2016	Local content was relaxed, the commitments were aggregated and its minimal percentage lowered. The offered percentages stopped being considered for purpose of award criteria.	0	Required local content certificates issued by certifying entities accredited by ANP.		
	14	2017					
Production Sharing Agreement	1st Pre-Salt	2013	Local content minimum requirements were set for exploration phase, and in the development stage, it was defined for modules with first oil until 2021 and for modules with first oil after 2022.	Local content percentages were not included as award criteria.			
	2nd Pre-Salt	2017	The minimum local content required in each unitized non-contracted area of the second round of bids under the PSA in the Pre-salt area was equal to the conditions required for this purpose in contracts in adjacent areas.				
	3rd Pre-Salt	2017	Local content was relaxed, the commitments were aggregated and its minimal percentage lowered.				
	4th Pre-Salt	2018					

Source: ANP (2018)

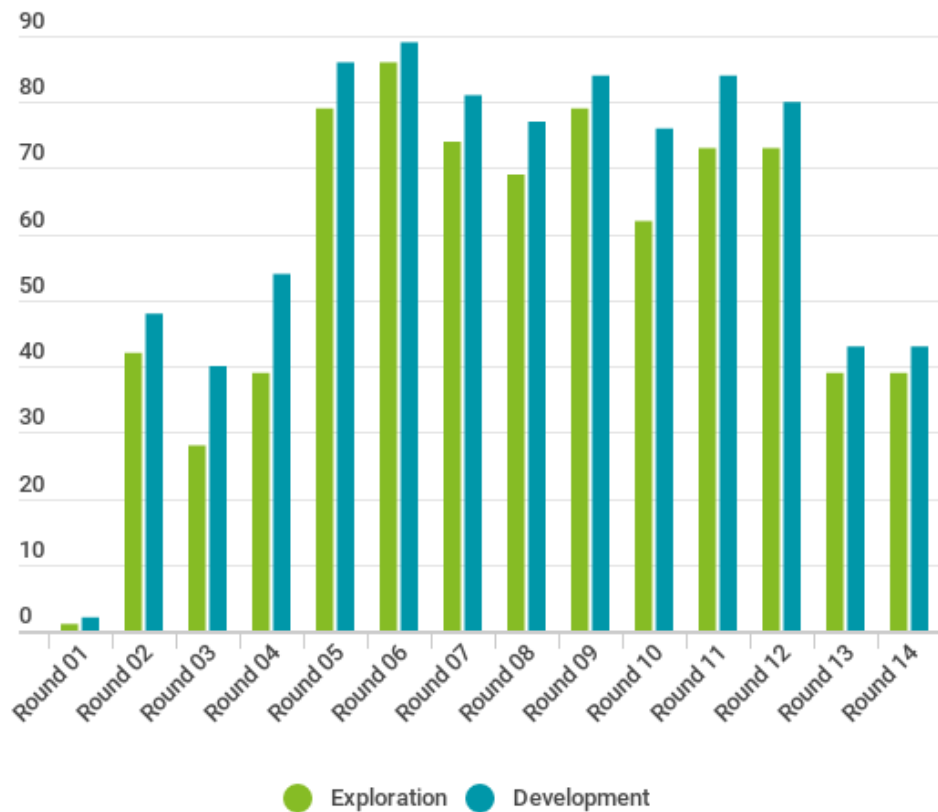
Variations in local content rules influenced in the average local content offered in each bidding round under concession contracts (Round 01 to Round 15). In the GRAPH 01 below, four waves can be detected:

- Round 01 (1999) to Round 04 (2002) - Without minimum requirements, the average local content commitments was 34% for exploration and 42% for development.
- Round 05 (2003) and Round 06 (2004) – The weight of local content commitment jumped from 15% to 40% in the award criteria and minimum requirements were introduced. As a result, local content

offers reached their records, with an average of 83% for exploration and 88% for development phase.

- Round 07 (2005) to Round 13 (2015) - Local content commitment weight in the award criteria was slashed down to 20%, and maximum percentages for purposes of award criteria were re-introduced. As a result, the average local content for these rounds was 72% for exploration and 80% for development.
- Round 14 and Round 15 (2017) – Local content was withdrawn from the award criteria and the minimum requirement lowered. Hence, the local content had its commitments also reduced in both bids to levels similar of the first four bids.

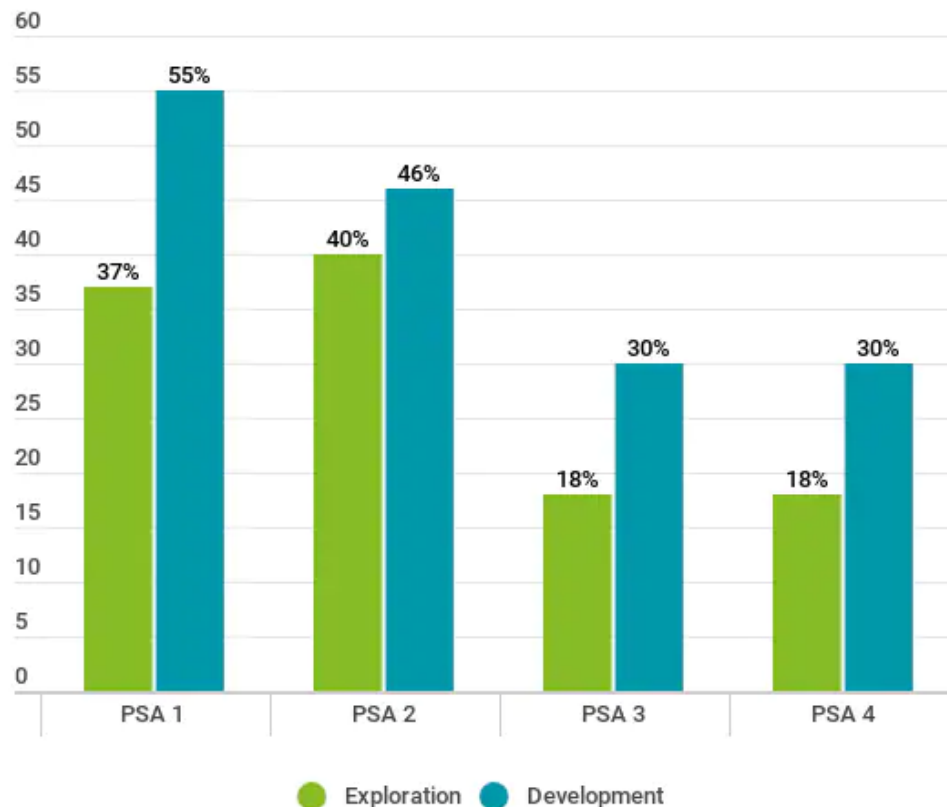
### Average LC offered by Bidding Round (Concession)



Source: ANP 2018

The average local content commitments for the pre-salt bidding round are displayed below:

## Average LC offered by bidding round (PSA)



Source: ANP 2018

## Local content current methodology

Aiming at establishing the legal terms and conditions for the implementation of procedures related to the local content clause, requirements introduced as from the Bidding Round 07, ANP created the Local Content Certification System, whose regulations were published on November 16, 2007. This system establishes the certification methodology and the rules for the approval of certification bodies by ANP. The accredited entities are responsible for measuring and reporting to ANP local content of goods and services contracted by oil companies for the exploration and development of oil and natural gas.

The local content legislation is aggregated in three groups of target audience:

- **Suppliers of goods and services, certifiers and concession holders:**  
ANP Resolution No. 19/2013 - Local Content Certification (updated):

Annex I - Local Content Certificate Model and Annex II - Local Content Primer (Updated)

- **Certification Bodies:** ANP Resolution No. 25/2016 - Accreditation of Local Content Certification Bodies
- **Concession holders:** [ANP Resolution No. 27/2016 - Local Content Reports](#) and [ANP Resolution No. 20/2016 - Regulates the neutralization of weight variation between the moment of the offer \(bid round\) and the time of verification \(inspection\) of local content](#)

The oil companies have to submit to ANP the Local Content Reports (LCR) that will assist the verification of the local investments performed in the exploration and production development phase, for concession contracts since Round 07, as much as for Production Sharing and Onerous Assignment contracts. Based on this Report, ANP carries out the local content audit process. However, it is worth highlighting that only Local Content Certificates - document issued by the certifier entity stating the percentage of local content for goods and services hired for measurement - demonstrate local content investments.

Operators have the obligation to request their goods and services suppliers the necessary approvals of their products, and suppliers may, at their own initiative, seek the certification of their products. Operators must also seek the certification of their own goods and services.

Certification activities must be performed by entities appropriately qualified and accredited by the ANP, based on criteria previously set by the Agency.

According to ANP Resolution No. 19 of June 14, 2013 “any item purchased and used by concessionaires, assignees or hired parties in the execution of the Concession Contracts, Onerous Assignment Contracts, and Sharing Contracts, in the exploration phase or production development stage, provided it fits the definitions of Goods, Material, Goods for Temporal Use, Set, manpower Service, System for Temporal Use or System, and if there is the need of proof for the purpose of compliance with the contractual local content, it must be certified in accordance with the guidance set forth in this Resolution”<sup>1</sup>. (Case 01).

The same Resolution provides for that “If the Goods, Goods for Temporal Use, Material, Set, System or System for Temporal Use intended for certification, is from the own concessionaire, assignees or contracted parties<sup>2</sup>, or if the manpower Service is carried out by labor of the own concessionaire, assignees or hired

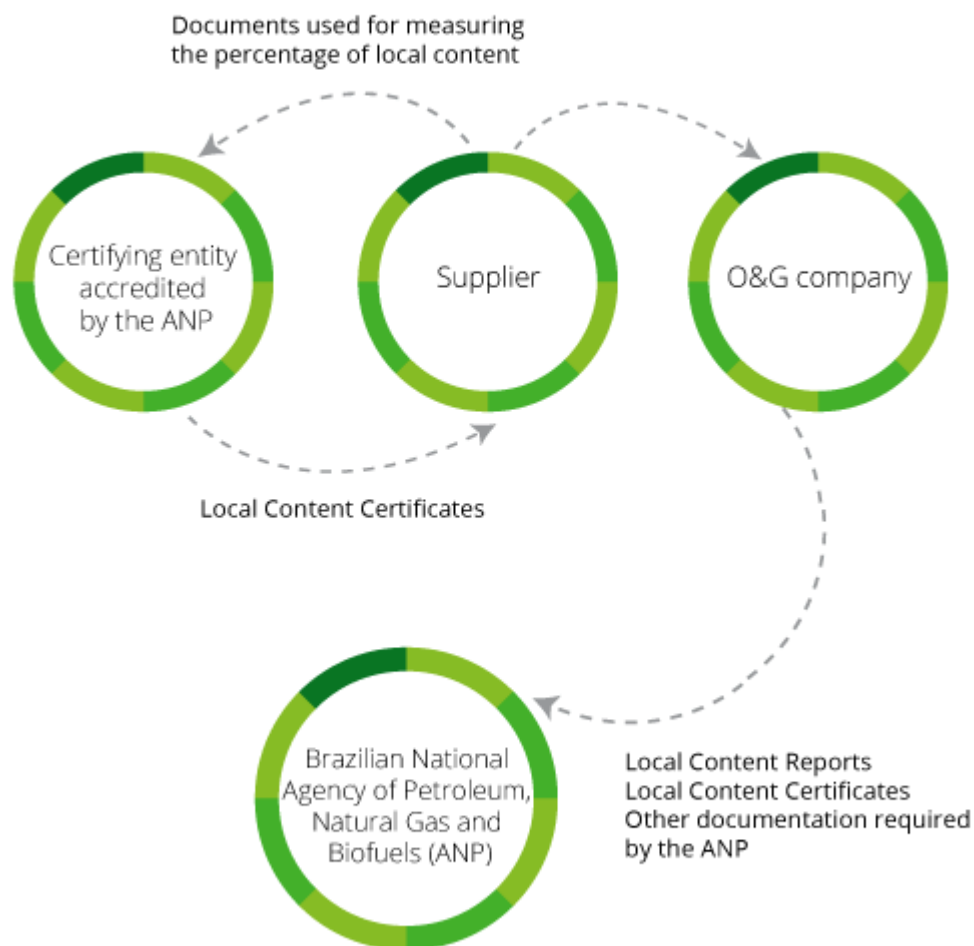
parties, it must hire the certifying agency for the issuance of the Certificate of Local Content”<sup>3</sup>. (Case 02).

<sup>1</sup> Art. 5 of ANP Resolution No. 19 of June 14, 2013

<sup>2</sup> Art. 21 of ANP Resolution No. 19 of June 14, 2013: “It is understood as labor of the very concessionaire, assignees or hired parties, for certification and ownership of local content, directly used in operations for the exploration and production development, excluding those relating to expenses of administrative nature”

<sup>3</sup> Art. 20 of ANP Resolution No. 19 of June 14, 2013

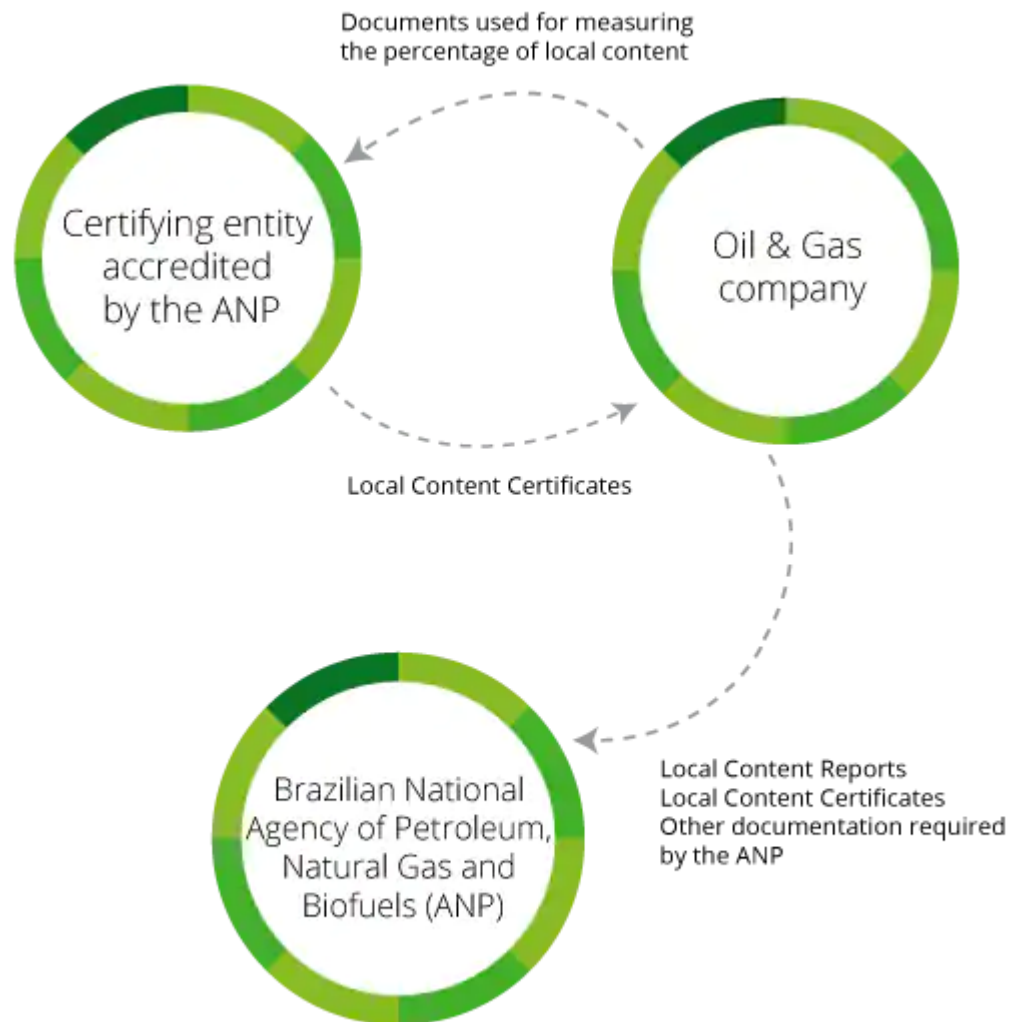
### **Local content: from certification to audit (case 01)**



Source: Deloitte’s Center for Oil & Gas Solutions 2018



## Local content: from certification to audit (Case 02)



Source: Deloitte Center for Oil & Gas Solutions 2018

If there is any evidence that local content percentage is lower than that set in the contract, the operator will incur a fine. As well as the local content policy's criteria, fine criteria have also varied through bidding rounds. Hereunder is a description of the fine criteria provided for 15<sup>th</sup> Bidding Round.

The noncompliance of Local Content is to subdue the Concessionaire to a fine, the fine shall be calculated on the non-complied monetary amount, subject to the following percentages:

- If the noncompliance of local content is equal to or greater than 65% (sixty-five percent):

$M(\%) = NR(\%) - 25\%$ , in which  $M(\%)$  is the percentage of the fine to be calculated on the undrawn monetary value and  $NR$  is the non-performed local

content; and

- If the noncompliance of local content is lower than 65% (sixty-five percent), the fine will be 40% (forty percent) of the value of the local content not performed.

If there is a simultaneous noncompliance of more than one commitment to the macrogroups previously described and defined by the CNPE Resolution No. 07 of April 11, 2017, the fine shall correspond to the sum of the fines for each macrogroup.

Twenty-two concessionaires were fined 127 times (roughly 30% of the cases), for noncomplying with local content, totaling circa of R\$ 600 million of penalties until 2016, considering only the auditing of the exploration phase.

Local content requirements become even more important when prices drop. Lower margins require cost efficiency and the obligation of acquiring costly services and equipment to comply with local content commitment affects companies' profitability, potentially undermining the economic viability of ongoing projects, and ultimately decreasing the attractiveness of the national oil and gas market for investors.

Considering this scenario and a much higher volume of fines for local content predicted by the Government, when the production development stage are audited, relevant changes were implemented related to this matter, not just for future bidding as described, but also an option was open to contract addendum of the local content clause of contracts of the past the bids.

## Upcoming changes

ANP Resolution No. 726/2018 allows concessionaires to opt for the addition of the local content clause for all contracts in force, with effects for the phases not closed.

The additive terms state that the new local content commitments in the added contracts become the following:

### **Projects onshore:**

For exploration and development: 50%

## **Projects offshore:**

For exploration: 18%

For production development:

- 25% for well construction;
- 40% for collection and disposal;
- Commitments to UEP (Stationary Production Unit) divided into three segments: 40% in engineering, 40% in machinery and equipment and 40% in construction, integration and assembly.

The possibility of adding to the local content clause of the contracts refer to contracts for exploration and production of oil and natural gas of concessions from the seventh to the thirteenth bid round, onerous assignment. The first production sharing round, and the contract for the second production sharing round referring to the utilizable area adjacent to Gato do Mato.

As general provisions, once the contracts are added:

- The parties agree that the execution of this addendum will be effective as of its signature, and the acts that occurred in the past will be governed by the rules in force at the time, including any fines that the contractor has already incurred, even if they have not yet been audited.
- The concessionaire recognizes the validity of the previous local content regime and waives any claim that may have against the ANP, due to fines already applied for noncompliance with the local content obligation.
- The conclusion of the contractual addendum extinguishes the possibility of requesting exemption from compliance and adjustment of the commitments of local content of the exploration phase and the development stage or module, leading to automatic extinction and respective archiving of the formulated requests.