Exercise #3

Handout 1.4

Local Content Policy Trade-Off

The Project Scenario

This is a hypothetical case of a **sub-surface natural resource development**[1], located on-shore in a remote coastal province of an emerging economy. The first capital investment phase of the development has been successful, and **a second phase is being considered.** The volume of economically recoverable minerals for this second phase is already known, and once the project concept has been finalized, the development company, on behalf of its investors (which includes a 10% stake by a state-owned company), can proceed to project engineering and then to execution.

Road and rail links to the concession area are good, and there are two towns, one 20 km away with 50,000 inhabitants, the other of 300,000 and 40 km away. The larger town is located on the coast with mature port facilities. There is an **established local supplier industry** in both towns, with ten years' experience in providing goods and services to the Phase I project and a similar sized and configured natural resource investment 100km further inland.

The project concept for **Phase II involves US$3 billion** of capital investment over five years, comprising in-house engineering design, sub-surface engineering works, construction of on-site power generation and processing facilities, and evacuation via transportation infrastructure to the local port for further processing.

For the Phase I development, Government policy towards Local Content can be described as 'Laissez Faire', with local content targets agreed in the Development Plan lying within the capacity of local suppliers to meet on a competitive basis, and set of agreed tender procedures that afford preference to local supplier, but only if internationally competitive on price, quality and delivery.

Recent slippage in the country's international ranking in national competitiveness has resulted in a **new 'Jobs and Industrial Competitiveness' Government policy.** More Local Content is the key policy lever. The Ministry for Minerals and Energy is proposing **higher Local Content targets for this Phase II development**, intended to 'stretch' local capability so that new investment flows into the country to build the import substitution potential of the industrial base, and, eventually, to export to other countries in the immediate region.

---

[1] The case is intentionally non-specific about the type of extraction involved, so as to be of relevance to participants from both the mineral/metals and hydro-carbon sectors.

General Principles for Local Content on Phase II

All parties agree to:

Support Government's policy on Job Creation and Supplier Competitiveness:

- Make all reasonable efforts to deliver, in aggregate, 35% Local Content in capital expenditure across Phase II, and 50% in operational expenditure within five years' post.

- Maximize direct and indirect sustainable employment, with good career prospects and transferable skills.

- **Attract new capital investments in supply chain industries** and incentivize **international/ domestic alliances** that develop manufacturing and professional services of local industrial base to international standards of competitiveness

- Government **public expenditure** to be targeted prior to start of project to overcome inward investment constraints: quality of professional engineers; affordable risk capital for local suppliers; clusters of local construction sub-contractors to increase domestic inter-firm competition; fiscal incentives that drive local content (eg waivers on import duties, tax breaks for training in critical skills)

Adopt the Following Principles for Procurement and Tendering:

- **Scope of work for Phase II unbundled** within technical and commercial limits, with emphasis on enabling suppliers based in the two local towns to access opportunities to supply minor services and standardized goods *directly* contracted or procured by the Development Company.

- Preferencing of local suppliers **if not competitive** on price, delivery and schedule must first meet the following **three tests:**
  1. avoid introducing critical risks to project delivery: HSE, asset integrity
  2. be targeted at expenditure sub-categories with high potential for competitive import substitution and export to pan-regional markets;
  3. lead to long-term cost reductions

- Local Content Development Plans within **major tenders** to be materially weighted in bid evaluation

- Development Company will **disclosure forward procurement plans**, within limits of commercial confidentiality

Minimize Impact on Commercial Returns and National Revenues:
- Minimum 11.0% IRR. Less than 10.0% IRR is show-stopper for investment in Phase II
- 10.0% to 11.0% IRR triggers compensation equivalent to loss of revenues (details to be negotiated).
- The maximum level of national income that the Government is willing to forgo over the life of Phase II is $90 million