Local content
in Brazilian oil industry

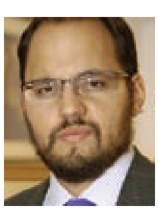
The Brazilian offshore industry transformation: (i) escalating domestic content requirements in contracts with ANP and Petrobras; (ii) foreign players compelled to establish and build up local manufacturing and operational capabilities

Buoyed by GDP growth often exceeding 3 percent annually since 2004, Brazil is currently frantically building new infrastructure to develop its vast reserves of natural resources – in particular, oil from the so-called pre-salt cluster in the Atlantic Ocean, part of a region that extends about 800km along the coast of Brazil from the State of Espirito Santo to the State of Santa Catarina. The cluster's oil has been found below water as deep as 3,000m and additionally as much as 7,000m below the seabed beneath a layer of salt. The area covers 112,000 square kilometers of deep and ultra-deep water reservoirs, of which 41,000 square kilometers have not yet been put up for bidding. It is the "most significant oil discovery in the past 20 years", according to Wood Mackenzie consultants.

Petrobras, the state-controlled oil giant of Brazil, will itself invest a whopping US$174bn through 2013. A total of 23 development and production projects are forecast to be up and running by then. By 2020, US$111bn will be invested in the pre-salt reservoirs alone.

Petrobras is about to start spending on a gigantic shopping list that includes 550 generators, 550 derricks, 350 turbines, 700,000 tons of structural steel for platform hulls, 550 wet Christmas trees, 500 wellheads, 80,000 pumps, 18,000 storage tanks, and 4000km of flexible lines. And it doesn't stop there. It goes on for 55,000 more items of which drilling packages and FPSO packages, sub-sea equipment, and compressors are considered to be the most critical. And there will be contracts for rigs and platforms that will be chartered under service agreements: 24 drilling rigs for 10,000-14,000 feet, mostly drillships and some semi-submersibles, 200 support vessels (especially pipelayers, AHTS's, PSV's, tug and tow boats, and line handlers), 18 FPSOs, and so on, and so on. The company will also renovate its oil tanker fleet with 26 ships already contracted and another 23 for bidding later.

Needless to say, Brazil will become a gold mine for suppliers and service providers in the offshore petroleum industry. But there is one catch. These vendors will likely be required to meet an ever-growing local content percentage established by Petrobras (which will probably control over 90% of the exploratory blocks). And Petrobras will have targets to reach with Brazil's National Agency for Oil, Gas, and Biofuels (ANP) regarding national content and will most assuredly pass on these requirements to its supply chain.



Heller Redo Barroso is the founding partner of Heller Redo Barroso & Associates, a Brazilian Rio-based boutique law firm specialized in Oil and Gas, Power, Shipping, and the Offshore Petroleum Industry.

Marcos Macedo is an associate lawyer at Heller Redo Barroso & Associates

Dutch Disease and Local Content Policy

The discovery of massive oil reservoirs can be both a blessing and a curse to a country. These windfalls can cause the so-called "Dutch Disease" experienced years ago by the country of Holland, when big petroleum finds triggered massive outside investment and currency exchange escalation that disrupted other industrial sectors as the country's economy became more dependent on hydrocarbons.

To avoid the Dutch Disease, Petrobras's contracts will all contain gradually increasing minimum local content requirements that could go as high as 95 percent for some equipment by the year 2020. This means that interested companies should scramble and start looking for local partnerships, areas to establish new facilities, bases for operations, and of course enrollment as bona fide supplier with Petrobras (CRCC).

In order to achieve such an audacious plan, Petrobras will rely on large capital infusion from shareholders, especially the controlling stakeholder, the Brazilian Government. Petrobras will further count on cheap and abundant financing from the government development bank, BNDES, and other state-owned banks.

In order to trim prices of equipment, while pushing for the gradual escalation of local content requirement in its projects, Petrobras is breaking up large EPC, service and supply contracts into smaller packages, emphasizing greater detail and standardization of orders. This will kick off with an ambitious program of eight FPSO's to be built locally, in a dry-dock chartered by Petrobras in the city of Rio Grande in southern Brazil. To aid in reducing prices, Petrobras is also planning to revise its standard contracts in ways that will reduce risks to suppliers.

All these changes, however, will now be carried out in tandem with the stepping up of domestic content requirements. Enrollment of Petrobras vendors on the service providers' list (CRCC) as well as significant domestic content will become gradually omnipresent in all new Petrobras auctions and contracts.

History of the Local Content Concept

Basically local content consists of contractual commitments, embedded in concession contracts (oil licenses, or oil lease licenses in some jurisdictions), whereby oil companies are required to procure a minimum percentage of equipment and services from local suppliers. By making such demands throughout their exploration and production projects, the country aims at fostering the development of a strong local petroleum offshore industry supply chain.

Naturally any obligation imposed on the concessionaires (license holders) will subsequently be mirrored in contracts with their suppliers and contractors.

However, in practical terms, the concessionaires (remembering that Petrobras is holder over 90% of all concessions) will require varying levels of local content from its suppliers and contractors based on the specific type of activity. Technology-intensive products and services will carry a lower local content percentage rather than low-tech activities. This is obviously because Brazil still lacks an installed capacity for high-tech work in the offshore industry.

Under Brazil's current regulatory framework, local content commitment is one of the judgment criteria applied in evaluating bidders' offers, together with the Minimum Exploratory Program and the Signature Bonus. In presenting their offers, bidders indicate a specific percentage of local content, which is turned into a number of points used to rank bidders' offers along with other parameters.

During bidding rounds 1 to 4 for oil concessions, there was no minimum requirement for local content commitment. The local content percentage had a cap and counted only for minor effects. Companies offered their local content commitment for both the exploration phase and the development stage, limited to the cap provided in the bidding.

In rounds 5 and 6, minimum commitment percentages were introduced. These varied depending on the blocks' locations (onshore, shallow waters, and deep waters). In these rounds, local content gained more weight in evaluating bidders' offers and percentages increased from the earlier 15% to 40%.

In ensuing rounds, up to the 9th and last offshore bid rounds (the 10th round auctioned only onshore blocks), the bidding indicated both minimum and maximum percentages of local content. Shallow water blocks were divided into two types (shallow water up to 100 meters, and shallow water from 100 meters up to 400 meters). In these auctions, the weight of local content was reduced to 20% of bids' final point evaluations.

Evolution of Local Content Policy

Local content policy is not expressly established in Brazil's current Petroleum Law (Law 9.478/97.) Development of local industry is mentioned only in the section on the main principles of the national energy policy.

In the first few bidding rounds conducted by ANP, local content commitment was mainly regulated by concession contract provisions. Later, ANP established (in Ordinance 180/2003) specific rules regarding the reporting and monitoring of local content.

In Bidding Round #7, ANP introduced major changes in concession contract provisions and created a guide book for concessionaires to use in monitoring the fulfillment of local content commitments. This was due to PROMINP (Programa de Mobilização da Indústria Nacional de Petróleo e Gás Natural – Mobilization Program for the Oil and Gas National Industry), introduced in 2003 and first applied to the licenses in Bidding Round #7.

Since its inception, PROMINP has significantly raised the participation of local industry in investments in the oil and gas sector from 57% in 2003 to 75% in the first half of 2009. This represents an additional value of US$14.2 billion for goods and services purchased in the Brazilian marketplace. Estimates say that 640,000 new jobs were created in this period. To sum up, investment in PROMINP significantly increased local participation from US$35 billion in the years 2003/2007 to US$190 billion expected for the years 2009/2013.

With this new scenario, Petrobras and other oil & gas players operating in Brazil will demand locally-produced goods and services in increasingly larger amounts. This offers a great opportunity for local companies (even those with foreign ownership) to supply locally in the most efficient manner materials, equipment, components, and services in a shorter period of time while meeting the industry high quality standards. Of course, they must be prepared to move quickly to become enrolled on the CRCC vendors list with Petrobras.

As far as regulation is concerned, ANP established the local content certification system to be applied in concession agreements between ANP and the concessionaires. This complies with contractual requirements established since Round 7. This regulation already constitutes a set of four administrative acts.

The "Local Content Certificate" is a document issued by a "certifier" that is pre-registered with ANP. The most important certifier is ONIP, which is also the one appointed by Petrobras in almost all their contracts. ONIP has 2,000 companies registered as members, all of them in the supply chain for the offshore petroleum industry.

The certification is conducted according to a template made available by ANP. It states the percentage of local content of the particular good or service hired for measurement. The "Local Content Certification" involves sets of activities developed by an entity duly accredited by the ANP (regardless of commercial relationship) to publicly certify, through issuance of a certificate, that a given good or service is in compliance with the requirements established in the Regulations of Local Content Certification.

According to Administrative Act ANP no. 36, the agreement executed between the certifier and contracting party will necessarily contain:

- Clear definition of the product, product for temporal use (goods used in rental agreements, charter party, tenancy, or operational or financial leasing, etc.), service, subsystem, system, or set of systems to be certified
- The schedule of certification activities
- A contract clause stipulating that all activities will be carried out according to present regulations
- Identification of certifier personnel involved in the execution of activities
- Identification of contracting party personnel responsible for conducting the activities
- Definition of access, examination, and analysis of:
  - the documentation to be analyzed
  - the productive processes necessary for the preparation of the product to be certified
  - the constituent components of the product to be certified
  - the outsourced and/or subcontracted components and relevant documentation
  - the imported components and relevant documentation
- Prices and commercial conditions of the certification agreement
- Agreement identification code.

Definitions, methods, and criteria for calculation of local content of goods, goods for temporal use, services, subsystems, systems and set of systems related to oil & natural gas exploration and production activities are those defined by the local content primer according to Annex III of Administrative Act ANP 36. English translations of all these Administrative Acts relating to PROMINP and national content can be downloaded in our web page (www.hrblaw.com.br).

For example, the local content (CLb) percentage for goods is applicable to equipment and materials and is calculated using the following formula:

CLb = (1 – x/y) x 100 where:

"X" stands for the price of imported components (in R$), including raw material"

"Y" stands for the sale price of product in practice, excluding IPI and ICMS.

In parallel, the Brazilian Government created the Fund to Ensure Shipbuilding (the "FGCN") to mitigate the risks of completion, performance, and credit connected with the construction of new yards and manufacturing facilities in the oil supply chain. FGCN will mainly support the credit risks of financing the construction of drilling rigs.

Petrobras will also negotiate with local banks a Special Program of Credit with certain conditions to fund the local offshore petroleum industry supply chain.

CRCC

The CRCC is intended to prequalify companies and products so that when Petrobras needs such products or services, bidding or negotiation will be simpler and faster, largely based on price and delivery capabilities. This will dispense with a thorough examination of products on a case-by-case basis, which currently is time consuming and counter productive for Petrobras.

The aim of CRCC is to build a database of service providers and suppliers organized according to their products or services, so as to expedite Petrobras's purchasing process.

On the basis of information contained in the CRCC database, Petrobras will invite companies to participate in biddings or direct purchase negotiations.

CRCC has existed for a long time but was largely dispensed with in international purchases and in most deals with the majors.

However, in a few months, companies without CRCC registration, will be prevented from selling or providing services to Petrobras. Moreover, there is a noticeable trend in making CRCC enrollment a requirement for qualification of companies for biddings. This is being especially pressured by the Petrobras Engineering Division.

CRCC may also be used as an instrument to control domestic content requirement. For example, the companies registered will also be prequalified considering their "local content". CRCC may then be updated from time to time as companies become more and more "Brazilian", or "tropicalized".

Achievements of the Local Content Policy So Far

In the early concession bidding rounds, the local content commitment was very soft – e.g., in BM-ES-1, the local content commitment was 5% in the exploration phase and 15% in the development stage. However, in the latest rounds we have noticed a major push in the offered percentages, some reaching as high as 80%. In view of this more aggressive scenario, oil companies, most notably Petrobras, have started to contract local suppliers for huge projects. Two such examples are the R$2.5 billion semi-submersibles P-51 and P-52, with a capacity of 180,000 barrels/day, to be built by Keppel and Technip with local content requirements of 65% and 55% respectively.

Other recent projects with sizable local content include part of the construction of FPSO P-54; modernization of FPSO P-34, and construction of the topsides of FPSO P-63.

In addition to these major capital-consuming projects, we could also cite other engineering projects involving the construction and installation of subsea systems, support vessels, and offshore cranes as examples of increasing local content.

Likely Changes in Local Content Commitment Introduced by the Proposed New Brazilian Regulatory Framework

A very sensitive point in currently proposed regulatory changes is the direct participation of the Government in managing E&P projects. According to the wording incorporated in the new proposed framework for hydrocarbons exploration in the pre-salt area, a new 100% public company (nicknamed "Petro-Sal") would have the right to name half of the operating committee members for all E&P projects in the pre-salt region, including the chairman, who would have a tie-breaking vote and veto powers.

Accordingly, the new public company would have control over any decision of the operating committees, including the contracting of services and goods. This would enable its representatives to require higher local content percentages -- or even to decide on contracting specific local suppliers.

Furthermore, the new regulatory framework has introduced the concept of "sole operator": it sets forth that Petrobras will operate all pre-salt areas. Since Petrobras is essentially controlled by the Government, Government officials will therefore pull the strings at Petrobras so as to make it the chief instrument for implementing national local content policy (e.g., by making Petrobras's vendor's list – CRCC enrollment – a requirement in future biddings and contracts).

First Come, First Served

In light of recent Government statements, local content requirements will undoubtedly climb, thereby forcing interested international suppliers to establish Brazilian subsidiaries in order to participate in the massive oil revenues that will begin to flow from the pre-salt region.

As previously mentioned, in the pre-salt area, the Brazilian government has already signaled national content requirements of 85 to 95 percent for some items by the year 2020. This means that whichever player wants to have a piece of the pre-salt pie will have to establish significant local presence. In particular, equipment suppliers will likely need to build production facilities in Brazil.

The new policies will affect, without limitation, activities such as the purchase and sale, construction, conversion, upgrade, and chartering (bareboat, time, and voyage charters) of ships and offshore units. This would include a lengthy list of vessels such as Jack-Up's, Spars, TLP's, Pipe-layers, ROVs, Floatels, Semi-Submersibles, Drillships, FPSO's, FSO's, as well as support vessels (PSV's, Line Handlers, AHTS), seismic vessels, and coastal-trade and long-haul Bulk-Carriers, Chemical and Oil-Tankers, and LNG vessels (including FSRV's and SRV's). Equipment supply will probably be the hardest hit: drilling packages, topsides and the sub-sea systems, and equipment "by the piece" such as offshore cranes, manifolds, turrets, derricks, cantilever, umbilicals, risers, wet x-mas trees, thrusters, power modules, compression modules, and hydraulic pumps.

Consequently, some major international major offshore contractors and suppliers are jump starting their competitive position by establishing operational and manufacturing facilities in Brazil. This is the only way these companies will be able to have contracts with Petrobras or Petrobras contractors in the near future. Even direct association with local Brazilian companies will become insufficient in the very near future, as the lack of local content from a foreign supplier or contractor could jeopardize a project even if the company is an established subcontractor to a contractor of Petrobras.

The CRCC and the new procurement department at Petrobras's Engineering Division will certainly be two very powerful instruments for realizing the ambitious domestic content targets within the very short time-frame set out by the Brazilian Government.

Due to the lack of local installed capacity of the major international players in the offshore petroleum industry, bidding and direct negotiation invitations are currently going mostly to Brazilian contractors, who in turn will procure from abroad technological partners, operators, financial partners, and project managers.

Most of these Brazilian contractors are unfamiliar with the finer details of the offshore petroleum industry and somewhat "illiterate" in the high-tech end of it. So they are quite dependent on associations with international companies. This is a huge opportunity for international suppliers and contractors to begin opening the door into Brazil: first with association But players should always bear in mind, as mentioned before, that associations should only be a first a step toward future independent standing achieved through the construction of local presence and infrastructure. For those companies that do not know, a company is deemed to be a Brazilian company for local content purposes if it is incorporated in Brazil. For the purposes of quantifying local content, certifiers will certainly check on how many Brazilian employees the company has, what are its local assets, and what is the percentage of imported items. Although this somewhat oversimplifies the process, the message is clear.

By becoming established in Brazil, foreign companies may be directly invited to participate in auctions where high national content is required, therefore allowing it to compete with native Brazilian contractors.

But the early birds are already chasing the worms. New ports and shipyards are already under construction. Every major global shipyard is already involved in Brazil, negotiating the construction of their own yards here, all of them in association with the biggest Brazilian conglomerates. All the Korean yards are here, for example.

Despite these challenges, the Brazilian pre-salt region, also nicknamed as the "blue rump steak" due to its shape, still represents one of the best business opportunities for E&P services and goods providers throughout the world.

Newcomers to Brazil's oil and gas marketplace are usually dismayed by what seems to be an overly-complex, heavily-regulated, and bureaucracy-prone legal system. Companies worry about corruption and about securing their assets against unlawful seizure or nationalization. However, these are somewhat far-fetched concerns in today's Brazil.

The hard facts are: (i) Brazil boasts a booming economy that weathered the worldwide financial meltdown; (ii) Brazil is an investment-grade country; (iii) Brazil blossoms among the BRICs; and (iv) Brazil is clearly poised to become the huge next safe hub for the world's smart money.

Companies ready to come and establish local manufacturing capacity in Brazil and strategic associations will be well-positioned for a head start in the run for black gold. ■