

Levers & Pulleys: Extractive Industries & Local Economic Development *Incentivising Innovation by Lead Contractors through Contract Tendering*

Lead contractors are currently an underused resource for enhancing the economic multiplier effect of extractive industry projects. The procurement process offers a mechanism for incentivising contractors to release these competencies, but there are risks, and managing these risks means also looking higher up the 'transaction chain'.

The Economic Benefits Gap in Extractive Industries

In 2002, around 25% of all foreign direct investment to Africa was in the extractive industries sectors (oil, gas and mining).¹ The dominant contribution of investments in these sectors to national economies is through payments to government, principally through a share of production revenues and profit tax. For natural resource-rich African countries, and in other low and low-middle income countries endowed with marketable mineral reserves, a range of factors limit the contribution of these revenues to local social and economic development. They include:

- ➔ inefficiencies in public sector expenditure management at national and provincial levels;
- ➔ the risks and volatility inherent in a public fiscal regime dependent on mineral revenues, eg. 'Dutch Disease', mineral price variability;
- ➔ large populations, for example, although Nigeria produced 2.23 million barrels a day of oil and gas in 2003, with a population of 124 million this equates to \$240 per person per year² (other emerging economies with comparable ratios include Indonesia, Philippines, India, China, Russia, Venezuela and Colombia); and
- ➔ long cost-recovery periods for capital investment in oil, gas and minerals development.

For countries as diverse as Equatorial Guinea, Angola, Venezuela, Indonesia, Kazakhstan, Congo (Brazzaville), Nigeria, Tanzania and Colombia, these obstacles suggest an 'economic benefits gap', where the anticipated distribution

of economic benefits via government to local communities, the operating region and the country as a whole are slow to materialise. Failing to bridge this gap carries with it very real risks for project and institutional investors, both in terms of the stability of local production, and in terms of broader political support within a country for the operating companies, joint venture partners and the oil and gas or mining industry as a whole. As concluded recently by the World Bank, "all stakeholders groups recognise that the distribution of benefits and costs is the crucial issue in EI [Extractive Industries]."³ This conclusion is supported by wealth of academic literature

on the development impacts of foreign direct investment (FDI). This argues that it can no longer be assumed that the best government policy is necessarily the one that aims to attract the maximum amount of FDI. The quality of FDI also counts.

Procurement as an Economic Multiplier

These conclusions, and the problems with revenue distribution, present a compelling reason to look more closely at other areas of the extractive industries where there might be potential for realising additional social and economic value. Most significant of these is procurement. In many instances the annual capital and operational expenditure of project operators on procurement of capital goods, consumables and services is greater than their total contributions to government. For example, for 2003 the ExxonMobil group reported \$70.7bn in contributions to governments and \$132.7bn to suppliers.⁴

Box 1

The Economic Importance of Local Content

"The Government of Trinidad and Tobago views the creation of local expertise in the energy sector which is transferable to other sectors of the economy, as critical... [and] has identified several strategies as the means of achieving this goal. Amongst these are... increasing local enterprises' share in projects with heavy capital inflows from Foreign Direct Investment.... I expect that this BHP Billiton initiative will be the first of many more to come."

On the occasion of BHP Billiton awarding a major fabrication contract to a local firm as part of a gas development in Trinidad and Tobago (Minister for Energy, 2004).

¹ ODI calculation based on UK Office for National Statistics.

² Myers, K (2005 forthcoming) Petroleum Production and Human Development in Low Income Countries, London: Chatham House.

³ OED/OEG (2001) Extractive Industries Review, Internal World Bank Group Assessment, Annex D, IFC Experience, p81.

⁴ Source: www.exxonmobil.com/corporate/files/corporate/Charts_and_Tables.pdf



Expenditure on procurement in-country can act as a multiplier for local economic development, contributing to employment, skills strengthening, supplier and local enterprise development (including technology transfer and more accessible local capital markets) and local infrastructure provision.

Beyond seeking to bridge the economic benefits gap, companies use procurement to contribute to local economic development for other reasons. First amongst these is compliance with 'local content' requirements. Employment and preferential supplier targets for nationals and nationally owned companies are common features of production and operating agreements with governments (or state owned enterprises). Second is 'deal-making'. Some companies view their support for local skills development and supplier marketability as a key 'value proposition', providing differentiation during negotiations with government for new business (Box 1).

A third commonly-cited reason — that supporting local supplies makes for a more financially competitive local contracting base — has less basis. Given the low labour costs of poor regions and close proximity of local suppliers to a project, there should in theory be savings in delivery and price. However, attaining the necessary quality thresholds can be expensive. Technical, business management, financial support and risk guarantees may all be necessary. For example, to continue the theme in Box 1, the operations of bpTT in Trinidad and Tobago calculated a \$3.3 million premium as the cost of requiring their lead contractor Fluor Daniel to work in a joint venture with a local firm to undertake engineering design on the 'Cannonball' gas field project (as compared to undertaking the same work in Houston without the joint venture).⁵

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Technical Limits to Local Content

There are quite clearly limits to what companies can do to use procurement to contribute to local economic development. Beyond the high cost of supporting local suppliers, a further constraint is the trend, particularly in the oil and gas industry, towards global strategic sourcing. This tends to favour low cost/high quality suppliers who frequently lie outside the country of operations (such as in China or India). Further, short lead times for tendering and high technical specifications act as barriers to market entry for

local firms and local job seekers. Lastly, due to short-term and/or fixed price contracts, contractors sometimes lack the freedom to participate in their client's social policies and strategies.

The Role of Service Contractors

Although many operating companies have their own training, employment and supplier enhancement programmes, the focus of the remainder of this paper is on the role of large, often international, energy service companies who lead the engineering on a project. The rationale for this focus is as follows:

- ➔ during both construction projects and asset operations and maintenance, the majority of employment and procurement opportunities are managed, not by the operator, but by their lead contractors (up to 95% during the construction period for some development projects);
- ➔ lead contractors are frequently the ones 'on the ground', in day-to-day contact with suppliers and local communities;
- ➔ many lead contractors have good track records in meeting 'local content' requirements, a trusted in-country supplier base, and expertise in deploying competency development systems and supplier support programmes;
- ➔ lead contractors are frequently specialists in project management and in designing and delivering engineering solutions — competencies highly relevant to the development of local economic infrastructure and the

strengthening of technical and management capabilities and other aspects of human capital development.

Social and Local Economic Enhancement Strategies

Given the right incentives, lead contractors have a capacity to innovate beyond the requirements for social impact mitigation and 'local content' that normally form conditions of contract. Table 1 summarises the main strategies, divided into three categories: on-project; projectlink and off-project. Each strategy draws in different ways on a lead contractor's considerable range of competencies, re-focusing them not only on delivering the terms of the immediate contract, but also on ways to enhance the social and local economic benefits of the project to wider society.

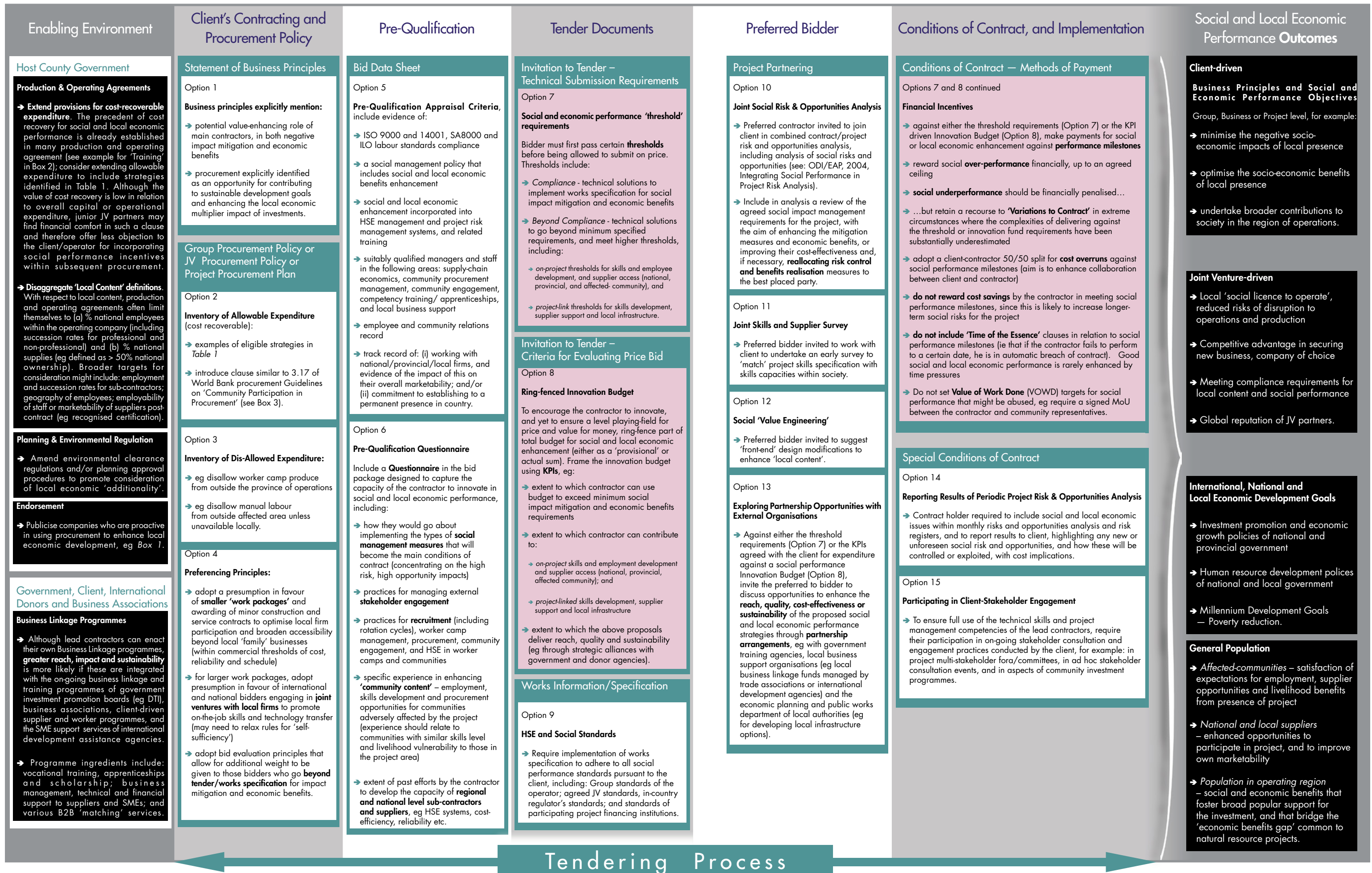
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⁵British Petroleum plc (2004) Putting a Premium on Local Content, source: www.bp.com/genericarticle.do?categoryId=2012451&contentId=7002543

Table 1. Strategies for Innovation in Local Economic Performance by Contractors: Extractive Industries

Category	Strategy
Strategies for Enhanced Mitigation of Negative Social and Local Economic Impacts ⁶	
On-Project	During the contract term, lead contractor delivers beyond the conditions of contract for mitigating negative socio-economic impacts (as specified by local regulators or the client), eg assist sub-contractors to progress beyond HSE requirements of contract, to attain internationally recognised standards such as ISO9000 and 14000.
Project-Link	Lead contractor aligns delivery of contract conditions for impact mitigation with related initiatives in wider society, eg extend programme of bridge strengthening to accommodate construction vehicles to include rehabilitation of bridges outside project area (possibly in partnership with district authorities)
Off-Project	Lead contractor engages in social and local economic performance activities unconnected with the project, eg seconding occupational health staff to provide training to local health clinics and orphanages.
Contractor Strategies for Enhanced Social and Local Economic Benefits	
On-Project	Strategies that utilise project employment specifications, works schedules, or quality and HSE performance standards as the basis for strengthening the competencies of individuals and local enterprises. These strategies are usually a response to 'local content' requirements that compel contractors to recruit individuals who are below the necessary skills levels, or the sub-contracting of firms that cannot deliver the quality standards of the project. In 'on-project' strategies, training and supplier support programmes are essentially geared towards the needs of the project, with marketability improvements for employees and suppliers a likely, yet unintended, consequence (ie conventional Backward-Linkage).
Project-Link	<p>Strategies that treat the project as a 'spring-board' to other economic opportunities:</p> <ul style="list-style-type: none"> ➔ <i>inward linkages</i> — where employment or supplier requirements of the project frame an external, outreach, programme of recruitment, skills development or community enterprise development by the lead contractor. Some, but not all, of the beneficiaries of this programme will go on to secure contracts with the lead contractor or client. Others will benefit by being able to better access external markets. From the lead contractor's perspective, the ultimate aim of inward strategies is to service the needs of the contract and the wider project. ➔ <i>outward linkages</i> — where the lead contractor builds on a particular employment or supplier sub-contract to develop skills or supplier competencies for utility outside the immediate contract, ie either on another aspect of the same project, or more likely in other markets, be they related or unrelated to the project, public or private, national or international. An example might be a community-based catering start-up enterprise with a sub-contract with a lead contractor, supported in the last six months of its contract to market its growing competency in quality control to the local tourism sector. From the contractor's perspective, the aim of outward strategies is to both develop off-project markets so as to assist the client reduce local supplier dependency on the project as the single customer, and to build up the lead contractor's own in-country supplier-base. ➔ <i>infrastructure linkages</i> — aligning operational infrastructure (or temporary construction works) with the infrastructure development plans of government authorities and project-affected communities priorities (eg power, water, telecoms, transport, waste management, etc). It is unlikely that a lead contractor would undertake this work without collaboration with the client or local authorities in some form of public-private partnership (PPP). The design, construction and maintenance of this local infrastructure is also an opportunity for enhanced local employment, training and local enterprise development.
Off-Project	Strategies that utilise the competencies of the lead contractor to enhance local skills, employment and community enterprise opportunities outside the needs of the project. This might be undertaken within the context of a community investment programme of the lead contractor, or, more likely, as a costed service of the lead contractor for the client, eg contractual obligations on the client to implement measures to mitigate aspects of the adverse effects of the project on local livelihoods.

⁶ Illustrations only. For comprehensive inventory of social and local economic project impacts see: Addressing the Social Dimensions of Private Sector Projects (2002) IFC, source: [http://ifcln1.ifc.org/ifcext/enviro.nsf/AttachmentsByTitle/p_socialGPN/\\$FILE/SocialGPN.pdf](http://ifcln1.ifc.org/ifcext/enviro.nsf/AttachmentsByTitle/p_socialGPN/$FILE/SocialGPN.pdf)

Table 2. Incentivising Engineering Services Contractors to Innovate in Social and Economic Performance: Options through Contract Tendering



Incentives in Contract Tendering

Service contractors invariably work to tight profit margins. Single figure returns on a project are not uncommon. In light of this, commercial incentives are needed to encourage innovation by contractors to enhance a project's social and local economic performance. In the area of conventional environmental and social impact management, contractors are familiar with delivering on a pre-specified scope of work, derived either from the client's (or joint venture) environmental and social performance standards, from the quality standards and requirements of country regulators, or from management plans generated by project-specific environmental and social impact assessment studies.

The question is how to encourage contractors to innovate and go beyond these minimum performance requirements. To do this, changes are needed to the process of contract tendering and procurement.

Table 2 identifies the generic steps in procuring the services of engineering companies, whether this be for design and feasibility work, procurement, fabrication, construction management, procurement, operations management or asset and integrity maintenance. The main tender and contract documents are identified (in green). A number of options for their modification are suggested. These are summarised in Box 2, with details in Table 2. Each option is designed to introduce incentives into the tendering process, encouraging contractors to innovate in social and local economic performance. Some options are related (in pink), since more than one document in the process needs to be modified for the option to be realised.

The options have been discussed with the Shell Group social performance unit (London) and Shell Group and E&P Contracting and Procurement units (The Hague). Further work is needed to develop and test the options with clients, contractors, government ministers and economic ministries, international development assistance agencies and project finance institutions.

Risks

Upstream and integrated extractive industry companies place an increasingly high value on being able to deliver to governments on the 'promise' of enhanced local content and local economic development. Using procurement to incentivise lead contractors to innovate in local economic performance is therefore not without risks. Of particular concern to clients is that contractors will not be able to 'walk the talk' - that their bids will include all

the right language on local economic enhancement, but that in practice they will not be able to deliver and thus undermine their clients reputation. Furthermore, if the emphasis in the process of procurement is on 'innovation' rather than 'instruction', then there is the further risk that the lead contractor's efforts in enhancing local economic development will duplicate or interfere with those of its client, sending a confused message to the government.

Box 2

Options for Modifying the Tendering Process to Incentivise Lead Contractors to Innovate in Local Economic Development (see details in Table 2)

Client's Procurement Policy

- business principles
- inventory of allowable expenditure
- inventory of dis-allowable expenditure

Pre-Qualification

- pre-qualification appraisal criteria
- pre-qualification questionnaire

Tender Documents

- social and economic pre-bid thresholds
- ring-fenced social and economic innovation budget
- HSE and social standards

Preferred Bidder

- joint risk and Opportunities analysis
- joint skills and supplier survey
- social 'value engineering'
- partnering opportunities with external organisations

Conditions of Contract

- financial incentives
- special conditions of contract (various)
- risk analysis reporting
- participating in client-stakeholder engagement.

Risk Management and the Enabling Environment

Many of the proposed changes to the procurement process will require modifications further up the 'transaction chain'. Host government agreements signed between joint venture partners, national oil companies and/or governments are an obvious target. *Table 2* offers some proposals for modifying the terms of these agreements so that they in turn incentivise oil, gas and mining operators to take the risks involved in changing to their own tendering procedures.

Box 3

Precedent for Allowable 'Cost Recovery' against Social Performance Innovation in Production Sharing Contracts: An Example

Agreement on the Exploration, Development and Production Sharing for the Shakh Deniz Prospective Area in the Azerbaijan Sector of the Caspian Sea

Article 6.1 Training — "Contractor [operating company] shall provide training for citizens of the Azerbaijan Republic with respect to the Petroleum Operations. Expenditure by Contractor... shall be included as Petroleum Cost; however [if] the aforesaid expenditures [are] less than two hundred thousand (200,000) Dollars in any year [this] shall not be Cost Recoverable. Expenditures in excess of two hundred thousand (200,000) Dollars in any year shall be included as Petroleum Costs and shall be Cost Recoverable."

Source: www.caspiandevlopmentandexport.com

Key is to extend existing clauses to include a wider range of social and local economic performance expenditure than is current practice. The choice of this expenditure should be framed by national and international social and economic development goals, in particular poverty reduction strategies and policies for encouraging private sector investment and supplier development. The version of 'allowable expenditure' promoted by the World Bank Group is given in *Box 4*. Clearly existing host government agreements cannot be readily changed. However, in the future these agreements may provide the 'top line' incentive necessary for operators to feel more confident in leveraging the underused competencies of their lead contractors through procurement.

Other incentives from government might include revising environmental clearance regulations or planning approval procedures to promote local economic 'additionality', or

introducing voluntary industry codes such as The Charter and 'scorecard' used by the South African Ministry of Mining and Energy.⁷ Public endorsement by government of companies who are proactive in using procurement to enhance local economic development is another option (see *Box 1*).

Also beneficial would be achieving alignment across the wide range of different local economic enhancement programmes operative in a single province or region. Although lead contractors can enact their own programmes, greater reach and sustainability (and less duplication) is likely if these are integrated with the on-going business linkage and training programmes of government (eg investment promotion boards, DTI), business associations, client-driven supplier and worker programmes, and the SME support services of international development assistance agencies. Common elements of SME and business linkage support programmes are given in *Box 5*. Finally, tax incentives for clients and lead contractors are further options for promoting procurement as vehicle for employment, training and supplier support.

Conclusion

Box 4

Example of Procurement Policy for Allowable Expenditure on Social and Local Economic Performance

World Bank Procurement Guidelines, article 3.17 — Community Participation in Procurement:

"Where, in the interest of project sustainability, or to achieve certain specific social objectives of the project, it is desirable in selected project components to:

- ➔ call for the participation of local communities and/or nongovernmental organizations (NGOs) in the delivery of services, or
- ➔ increase the utilization of local know-how and materials, or
- ➔ employ labour-intensive and other appropriate technologies, the procurement procedures, specifications, and contract packaging shall be suitably adapted to reflect these considerations,

provided these are efficient and are acceptable to the Bank".

⁷ South African Mining Charter (2004), source: www.dme.gov.za/minerals/mining_charter.htm

Box 5

Elements of SME and Business and Linkage Programmes

Financial

- Financial products — loans (of different sizes and terms); leasing; venture capital; credit guarantee funds; export credit insurance; bond release; micro loans
- Equity and joint venture schemes — where a long-term commitment is shown by the client or lead contractor to local firms through the purchase of equity

Management

- Business management support — business management, business plans, tendering advice, regulatory navigation advice, marketing
- Technical support — on quality standards, reliability etc
- Human resource development — business management and technical skills

Matching, Mergers and Acquisitions

- Local 'meet the buyers' expos
- 'Matching pools' that bring investors and local companies together
- Dedicated searches for value adding joint venture partners
- Advice on mergers and acquisitions between and among domestic firms

Institutional Strengthening

- Support and training to regional SME support agencies in offering above services
- Support to local banks to: (i) provide a wider range of financial products tailored to SMEs; (ii) be able to properly rate and manage 'risk'; (iii) look beyond current collateral requirements, eg to cash-flow expectations
- Development (or establishment) of local credit risk rating agencies
- Development of national quality standards, eg project relevant university diplomas, establishment of institutes specialising in environmental safety, cost effectiveness etc
- Design of revenue structures for SME support agencies, taking into consideration government grants, SME contributions, percentage of new finance secured etc.

In conclusion, lead contractors are currently an underused resource for enhancing the economic multiplier effect of extractive industry projects. The procurement process offers a mechanism for incentivising contractors to release these competencies, but there are risks, and managing these risks means also looking higher up the 'transaction chain'.

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programme on

**Business and
Development Performance**

This series of briefing notes provides information to engineering service companies operating in developing countries. The notes aim to assist contractors to enhance their social performance, be that: to deliver effective management of the negative socio-economic impacts of project activities; or extend employment, training, infrastructure and business support benefits to communities and suppliers.