



## **Role of Procurement Strategy in Effective Local Content Management**

Michael Warner, June 2010

### **Summary**

*Through an adaptation of the work of Kraljic, this paper provides a basis for formulating Procurement Strategies that adjust to different capabilities, competitiveness and risk in the local supplier market. Three core components of Procurement Strategy are considered: the packaging of work (contract bundling vs unbundling), level of client control in the supply chain, and choice of compensation mechanism. Illustrations are provided from Brazil and Trinidad.*

### **Local Content and Strategic Procurement**

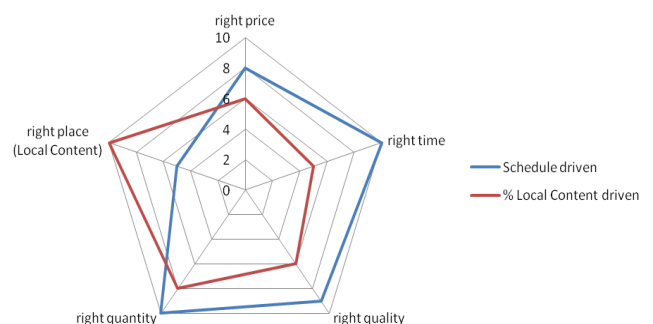
A classic definition of procurement is of a process that seeks to secure equipment, materials and services at the *right price*, at the *right time*, to the *right quality*, in the *right quantity* and from the *right place*<sup>1</sup>. These five Rights are not mutually exclusive, and can result in pressure to make tradeoffs. It is the necessity to minimise trade-offs that means that clients need to be strategic in their procurement planning for a particular investment, project or operation.

For example, if the key business objective of a client for a capital project is the earliest possible commissioning date, and the proposed design has been proven but only in locations outside of the host country, then the client may elect a Procurement Strategy that tenders the bulk of the design, purchase of goods, and construction services on the basis of a fixed-price, turn-key, contract, with a tender list comprising experienced international lead contractors.

Such a strategy makes commercial sense with regard to the all important schedule ('right time'), and is likely to also deliver on the right quantities and quality. If progressed as a contested tender with 'lowest price wins', then the same strategy would also foster the right price. But what of 'place'? Major international contractors frequently have long-term global sourcing arrangements with key equipment and

material suppliers, enabling them to drive down costs and achieve a competitive edge. However, these deals may crowd out domestic suppliers, even if these suppliers are capable and potentially competitive in their own right. Thus, if we equate 'right place' to mean delivering Local Content within a project's total expenditure (for example as measured by the % of total spend on goods and services of domestic origin), then under a Procurement Strategy driven by schedule, we may find that Local Content (place) is traded-off against schedule (time). This trade-off is illustrated in Figure 1.

Fig1 Schematic Comparison of Procurement Strategies: Schedule Driven versus % Local Content Driven



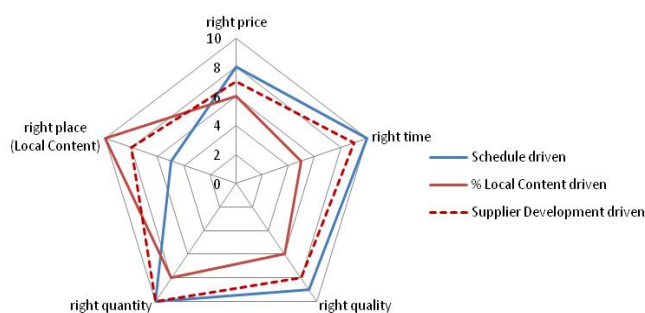
But what happens if delivering Local Content is a legal requirement or strong commercial imperative, for example, in a scenario where the recovery of expenditure costs is compromised if Local Content compliance targets are not met in full. At

the same time, let us factor in the not uncommon practice of regulators setting Local Content % targets at levels higher than the capability of the domestic supplier market to supply goods and services on an internationally competitive basis. A Procurement Strategy that facilitates compliance with these % Local Content targets (ie gives uncompetitive preference to domestic suppliers) will likely impact both project price and schedule, and possibly also quality and quantity.

In Fig 1. the implications of this type of % Local Content driven Procurement Strategy on the five Rights is contrasted with a schedule-driven strategy.

Fig 2. takes the illustration a step further. Here we introduce a scenario where the client is not compelled to meet Local Content % targets. Instead, for reasons of corporate reputation and long-term cost efficiencies, a Procurement Strategy is adopted that encourages international contractors to partner with, or sub-contract to, domestic suppliers in ways that develop their skill, technical capability and competitiveness (ie their ability to meet schedules, avoid cost escalation, deliver on quality and quantity, and be more competitive in the future).

Fig2 Schematic Comparison of Procurement Strategies: % Local Content Driven versus Local Supplier Development Driven, against base of Schedule Driven



Overall, the negative impact of this supplier development driven Procurement Strategy on the other four Rights is less pronounced than with the % Local Content driven strategy. Note, however, that 'price' is still assumed to include a small premium to support technology transfer from international to domestic firms, offset price distortions (such as the higher logistic costs

of importing components for domestic assembly), or cover the increased liabilities and risk faced by the international contractor. We assume that this premium is less than the cost implication of complying with excessive Local Content % targets. Further, under this strategy the overall proportion of Local Content within expenditure will be less than in the target-driven strategy, since international contractors are taking more of the procurement budget.

Of course, formulating a procurement strategy is more complex than in this scenario. In practice there are multiple business objectives to consider, and a variety of commercial and non-commercial risks. Procurement Strategies for large projects (referred to as Contracting Strategies) have to consider whether to integrate the procurement of different categories of expenditure (design, project management, equipment and materials, construction services, production and operations management, distribution etc.), as well whether to contract together or keep separate the procurement of different project components (eg production units, utilities, civil works, transportation). Such complexity requires a patch-work of interlocking procurement sub-strategies.

Effective consideration of Local Content within the formulation of Procurement Strategies is essentially a three step process. First, it is about understanding what level of priority the business should give to Local Content when compared to the other four Rights of price, time, quality and schedule, and what value creation or protection might be anticipated from formulating a strategy that enhances Local Content

Secondly, it is about understanding what the client's forward demand for goods and services is, and the capabilities, capacity and competitiveness of local and national suppliers to meet this demand, taking into consideration the demand of other companies competing in the same supplier markets. Thirdly, it is about selecting the right mix of procurement-driven solutions: the packaging of work, extent of client control, contractor selection process and contract terms. The remainder of this paper describes each of these in turn.

## Prioritising Local Content within Procurement Strategy

Forthcoming briefings in this series will provide guidance on formulating Local Content Strategy. It is these longer-term strategies that identify the value drivers for a client company in managing or developing Local Content. To illustrate, key drivers for Local Content management in oil and gas development projects are given in Table 1.

Table 1 Value Drivers for Local Content Management in the Formulation of Procurement Strategy - *Upstream Oil and Gas Development*

Category	Value Driver
Commercial Risk	Manage risk that regulatory requirements or political pressure to utilise domestic suppliers will lead to higher award costs, cost escalation or schedule delays that then undermine investment returns
Compliance	Avoid fines and protect company reputation by meeting regulatory requirements for Local Content
Reputation	Build reputation and market differentiation with host Government through innovation and economic impact in employment and training of nationals, local sourcing and domestic supplier development.
Cost Efficiency	Reduce costs by preferencing domestic suppliers or developing their capability. Cost savings may include: import duties, labour costs, logistics costs, total life costs of equipment due to localised repair and maintenance
Supply bottlenecks	Promote domestic supplier development as a strategy to address scarcity in global supplier chains
Cost Recovery	Assure the recovery of investment costs in cases where (because of regulatory requirements, joint operating agreements or political pressures) recovery of these costs is tied to preferencing certain suppliers, meeting local content targets or developing supplier capability
Budget and Permitting Approvals	Use procurement to delivery Local Content closely aligned with Government industrial priorities, thus preventing delays to budget approvals, permits, and contract awards
Social license to operate	Use local supply chain expenditure to provide economic opportunities for project-affected local communities and community-based suppliers, as part of compensation for disturbance, eg facilities maintenance contracts, agricultural supply agreements
Concession negotiations	Align project options and high level Procurement Strategy with Government industrial development priorities as a means to gain competitive advantage when bidding or negotiating new concession agreements

In formulating Procurement Strategy, key is to know how important Local Content considerations are in relation to other factors that might influence the same value drivers. For example, with regard to reputation and alignment with host Government economic priorities, how important is it to formulate a Procurement

Strategy that delivers high levels of Local Content, compared to one that meets the Government's anticipated schedule for production volumes or revenue raising. Or, with regard to managing commercial risks, what level of risk to overall project cost and schedule is posed by sourcing materials from higher unit priced, less experienced, local suppliers, compared to the higher freight and insurance costs and longer delivery times of importing the same materials from international suppliers.

## Understanding Local Supplier Markets

Too many Procurement Strategies are prepared with insufficient information about the capability of the domestic supplier market. Critical is accurate information about where local suppliers benchmark on price, schedule and quality against both competition from within the domestic market and against international suppliers.

It is not sufficient to know whether a local trade association purports that there is 'some' capability in the country. Further information is needed about the *range* of products or services available, labour productivity, production *capacity* (eg the size of the fabrication yard, or throughput volumes of a particular product or service), the supplier's *experience* in providing similar products or services (including that of its senior managers), and its ability to *deliver* on time, at internationally competitive prices, with the right after sales service and *maintenance*, to the right standards of *quality*, and with acceptable levels of *health, safety and environmental* performance.

To some extent, if the client keeps records, the past performance of suppliers will answer some of these questions. But for green field developments, or for new entrants in the local supplier market, or for periodic projects with significant time-lags in between, such information will need to be sought proactively, in advance of formulating the Procurement Strategy.

In such cases, preliminary pre-qualification processes or selective local market benchmarking and market surveys will need to be targeted at the expenditure

categories most relevant to the core value drivers for Local Content (refer to Table 1).

A key consideration in this type of market analysis will be how to classify different categories of expenditure against the capabilities of the domestic supplier market. Drawing on the work of Kraljic<sup>2</sup> on purchasing strategy, one approach is to assess the level of risk arising from different suppliers. On this basis, suggested classifications are as follows:

- categories of expenditure that if sourced locally would carry the **highest risks** to project or operational objectives, ie the cost, schedule or quality of a Project would be materially compromised;
- categories of negligible or **low risk**, ie domestic suppliers can provide the goods and services on a routine and internationally competitive basis;
- categories where domestic suppliers carry **some risks**, but for which there is an imperative to procure locally, and thus ways must be found to overcome these risks. Circumstances might include:
  - where the client is being **compelled to source locally** due to either regulatory requirements (eg Local Content targets directed at certain spend categories), or political pressure to use certain nominated or state-owned companies,
  - **equipment and technology** categories of priority to the host Government's industrial development, manufacturing or export policies,
  - **sub-contractor services** where local employment and hiring opportunities are most likely to arise,
  - categories that may encounter potential **local bottlenecks**, eg certain skilled labour.

A second consideration is to map the local supplier market onto the different approaches to managing Local Content. There are broadly two types of approach:

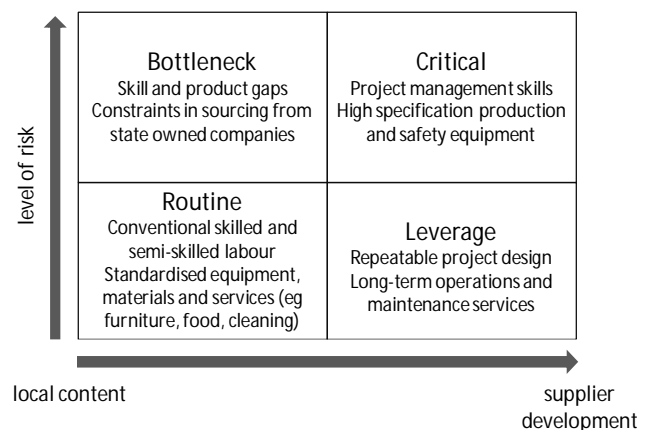
- **Type I - maximise the proportion of Local Content within expenditure** (national workers or suppliers). This is applicable to

categories of expenditure which, if sourced locally, either (i) carry low levels of risk, eg suppliers of *routine* materials and services, or (ii) carry some constraints or risk of *bottlenecks* (such as gaps in certain skilled labour or plant capacity), but which if overcome would contribute significantly to the % of Local Content achieved across the operation or project.

- **Type II - develop local skills and supplier competitiveness as part of contract execution.** Applicable to expenditure that (i) offers the client *leverage* to build the broad competencies of national employees and/or strengthen the capabilities, capacity and future competitiveness of local suppliers (into this group would fall expenditure involving long-term contracts or a series of shorter-term contracts with replicable engineering or product specifications), or (ii) is critical to the operation or project and thus ways must be found to manage the commercial risks of sourcing these goods or services locally, eg lack of experienced project management, safety equipment, high specification OEM goods, eg compressors, turbines, heat exchangers.

Fig 3 below is a version of the Kraljic expenditure classification matrix frequently used to formulate Procurement Strategy. The matrix has been adapted to identify four different categories of expenditure matched to the levels of risk posed by local suppliers and the type of Local Content management opportunity presented.

Fig 3 Expenditure Classification for Local Sourcing, adapted from Kraljic





Linking local supplier market analysis to the formulation of Procurement Strategy in this way has similarities to recent events in Brazil, in the context of developing the off-shore oil fields of the Santos Basin (see Box 1).

#### Box 1

#### Local Supplier Analysis and Procurement Strategy – Santos Basin Developments, Brazil<sup>3</sup>

PROMINP is a joint initiative of the national Brazilian oil company Petrobras and Ministry of Mines and Energy. The organisation has identified aggregate demand for oil and gas development in the Santos Basin over the next 20 years and compared this to current and projected local supplier capability and capacity. This has enabled PROMINP to understand where Brazilian suppliers (i) are already capable, (ii) where they could be capable if supported by international contractors and manufacturers through alliances, and (iii) where there is no current competitive local capability, and thus a need to attract direct foreign investment. The table below give an overview of the different levels of capability in the Brazilian oil industry supply sector.

#### General Capability of Brazilian Suppliers in Oil Sector

Technical Base	Sectors	Sector Challenges						
		Infrastructure (pipelines, cables, etc.)	Logistics (ports, roads)	Low Local Content	Low Skill Levels	Process Technology	Basic Industrial Technology	Human Resources (Engineering, Professional Qualification)
Manufacturing Technology	Steel Mills							
	Pipelines							
	Flanges and Connections							
Mechanical Technology	Boiler Works							
	Reels and Bucket Rod Pumps							
	Ballasts							
Instrumentation Technology	Pumps							
	Compressors							
	Six / Street Engines							
Ship Parts	Turbines							
	Cranes and Hoists							
	Valves and City Gates							
Electrical Technology	Generators and Electric Engines							
	Substations and Transformers							
	Automation and Instrumentation							
Services	Engineering							
	Commission and Assembly							

The analysis has fed through into the Contracting Strategies of Petrobras. For category (ii) above, these Strategies intended to incentivise foreign contractors to partner with Brazilian firms to strengthen local capacity, for example in marine vessel fabrication, cranes and valve manufacture and engineering services. For category (iii), the Strategies intended to encourage international firms to establish subsidiaries in Brazil, eg to manufacture centrifugal compressors, diesel engines and instrumentation equipment.

Further, for category (iii) the Contracting Strategies provide incentives to foreign contractors by bundling together work packages and using repeatable designs, for example in the construction of floating production, storage and offloading (FPSO) vessels and manufacture of certain materials and equipment. It is anticipated that such Strategies will increase the returns and reduce the commercial risks for foreign contractors and manufacturers willing to investment in Brazil.

#### Procurement-Driven Solutions

Assuming that 'place' – interpreted as the level of Local Content or a focus on local supplier development - is a material consideration in a client's overall approach to procurement, then what are the possible

strategies. Core are (i) the way in which contracts are packaged, (ii) the extent of client control over the supply chain, and (iii) the choice of compensation arrangement.

#### Packaging of Contracts

Whether a client elects to procure goods and services as a series of small contracts, or to package work together into higher value, more encompassing contracts, will impact on the amount of Local Content or supplier development that can be achieved. The strategic choice is essentially between contract *bundling* and *unbundling*.

**Unbundling** of expenditure into smaller work packages may be preferable for expenditure categories where market surveys or testing has indicated that domestic suppliers can satisfy client demand at the right price, schedule, quality and quantity, ie the Routine quadrant of the adapted Kraljic matrix.

Beyond increasing the proportion of Local Content, there are other reasons why a client might unbundle contracts, and thus strengthen the case for such a Procurement Strategy. Most obvious is where the client wishes to have clear visibility of potential interface risks and bottlenecks in its supply chain, and thus have direct control over the delivery and quality performance of these suppliers. Since such risks may arise from pressure to use domestic suppliers, unbundling can also be viewed as a strategy to manage expenditure that falls within the Bottleneck quadrant of the adapted Kraljic matrix.

If the client is heavily dependent on lead contractors to undertake procurement on its behalf, then (if within the bounds of applicable competition rules<sup>4</sup>), the Procurement Strategy for these categories may include a commitment to include flow-down provision on unbundling within the contract terms for the lead contractors.

Although unbundling as a Procurement Strategy is likely to increase the proportion of total expenditure awarded to domestic suppliers, it is not always effective in developing labour skills, building supplier capability and long-term competitiveness or managing the commercial risks posed by

inexperienced local suppliers. This may be better served by bundling. **Bundling** of contracts takes two main forms:

- *vertical bundling*, where the same contractor is selected to implement a common activity (be that engineering design or construction or commissioning) across multiple components of a project or operation (production unit, utilities infrastructure, civil works, pipelines etc.);
- *horizontal bundling*, where the same contractor takes a single component of the project or operations and implements some or all of the relevant activities: design, procurement, construction, commissioning. EPC and EPIC contractors fall into this category.

Fig 4 shows a hypothetical Procurement Strategy for an FPSO (Floating Production, Storage and Offloading) vessel and associated SURF infrastructure (Subsea Umbilicals Risers Flowlines).

In this scenario the FPSO is destined for an off-shore field in an emerging economy. The country is not yet a member of the World Trade Organisation and is thus able to place contractual requirements on the client company to meet Local Content targets. The country has some existing capability in shipbuilding (relevant skills and shipyards), and its Government has ambitious plans to leverage off the energy exploration and development sector to develop the local ship-building industry so that it can eventually compete in regional markets.

The resulting Procurement Strategy is formulated to raise the volume of local

Fig 4 Hypothetical Procurement Strategy Illustrating Bundling and Unbundling of Work Packages - FPSO Construction in an Emerging Economy<sup>5</sup>

PROCUREMENT STRATEGY	FPSO		SURF
	HULL	TOPSIDES	
Project Management	Client		
Detailed Engineering	Domestic EPC with Int consulting engineer	International EPCm	International EPIC Tendering and compensation incentives for inward investment
Procurement			
Fabrication			
Transportation of Hull	Domestic Sub-contractor		
Integration			
Installation			
Commissioning			
Start Up	Client		

content in the project (proportion of spend with domestic suppliers), whilst concurrently managing the cost, schedule and quality risks of so doing, and aligning with Government ambitions for developing a competitive ship-building industry.

The product is a 'mixed' Procurement Strategy, combining elements of both vertical and horizontal contract bundling as well as unbundling. The engineering design, procurement, fabrication, integration installation and commissioning of SURF infrastructure is under a single EPIC contract, tendered to experienced international contractors. Bundling the work in this way incentivises the winning contractor to use its influence over its suppliers of SURF equipment to encourage them to set up product finishing, maintenance and repair facilities in the host country (a strategy that fits the Critical quadrant of the adapted Kraljic matrix).

To achieve this outcome, the Procurement Strategy establishes the principle of giving additional weight in the EPIC tender evaluation to bidders able to leverage this type of investment. Highest weighting is given to inward investment in those categories of equipment manufacture and repair services most closely aligned with the host Government's ambitions for technology transfer and industrial development.

In contrast, the proposed procurement Strategy for FPSO construction is to partially unbundle. The FPSO topsides engineering, procurement and construction management services are separated from the sub-contracted fabrication work under an EPCm (engineering, procurement, construction-management) Lump Sum contract. The total work package is tendered to experienced international contractors, but with the pricing of the sub-contract for fabrication, integration and commissioning work negotiated with the preferred bidder as an open-book build up to Lump Sum. This approach provides the client with evidence that the necessary level of risk mitigation is priced in (either directly within the Lump Sum or as an Option or Contingency), such as additional in-the-yard management supervision and quality control. The Procurement Strategy further requires that tendering for the EPCm

contract should stipulate that the Tender must choose between a limited number of pre-market-tested, nominated, local fabrication sub-contractors. In addition, overall project management for the fabrication and integration work is retained by the client to further manage the schedule and quality risks involved in using less experienced local fabricators.

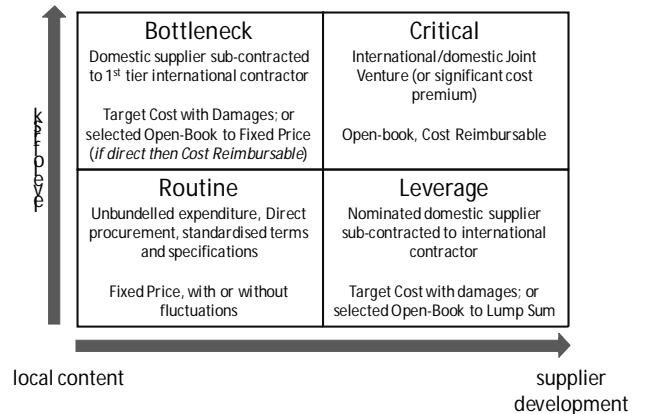
With regard to the FPSO hull, design, procurement and fabrication is isolated from the topsides work, enabling experienced shipbuilders in the country to bid directly for the work. To manage the inherent risks the Procurement Strategy requires that an experienced engineering consultant firm be part of the bidding consortium. This firm will contribute the design drawings and provide contract performance oversight. As with the EPCm contract, the client also retains an overarching project management role.

A survey of the local fabrication and ship building yards suggested the need for prior capital investment in earth works, heavy equipment and experienced project managers. To incentivise these investments, the Procurement Strategy includes a stated presumption to place additional orders for FPSO construction in the same local yards, if contract performance targets on the first FPSO are met. This presumption is to be communicated to the tenderers along with the key performance indicators that will trigger the follow-on work: schedule delivery, labour productivity rates, quality of project management, HSSE performance and welding defects performance.

In summary then, with reference to Fig 3, unbundling seems likely to work best where there is existing domestic supplier capability, and/or measures can readily be put in place to overcome gaps or potential bottlenecks (the Routine and Bottleneck quadrants). Bundling is likely to be preferable in cases where more substantive building of the capability of domestic suppliers is needed, either because of concern over serious risks to schedule or quality (the Critical quadrant), or where the risks are low but there is some reputational or long-term cost advantage to strengthening the competitiveness of local suppliers (the Leverage quadrant).

Box 2 illustrates this type of leveraged, Procurement Strategy, in the context of oil field platform fabrication in Trinidad and Tobago.

Figure 3 Procurement Strategy Choices for Packaging of Works, Client Control and Compensation Arrangements



#### Box 2

#### Procurement Strategy to Manage Supplier Risks and Build Competitiveness: Illustration from Trinidad<sup>6</sup>

From 2003, BG Trinidad and Tobago executed a Contracting Strategy formulated in part to ensure that fabrication of its off-shore platforms (deck and jacket) could be performed by a Trinidadian fabricator. Key elements of the Strategy were:

- a replicable, *cookie-cutter*, design for the platform jacket and deck, such that the local fabricator could move up the learning curve on progressive platforms;
- a price premium, paid in part to cover the additional shipping costs of importing construction materials to enable fabrication in Trinidad, additional insurance costs and competency development of the fabricator's employees;
- a decision-gate within the series of platform constructions to ensure adequate performance by the fabricator before award of subsequent platforms.

The local fabricator - TOFCO Ltd - successfully completed the Cannonball platform in 2005 and was subsequently awarded contracts to construct a sequence of additional platforms on a rolling basis.

In 2006, the operations of BG Group in Trinidad formulated its Contracting Strategy to construct and install a new platform on the Poinsettia off-shore field. To align with the industrial policy objectives of the Government and to protect the commercial interests of BG Group, the Strategy a core objectives to maximise local content through alliances between the winning international EPCm contractor and a Trinidadian deck fabricator. The Strategy lead to:

- Local Content being an important and communicated evaluation criteria in the EPCm tender process;
- the Letter of Award to the EPCm contractor specifically nominated TOFCO as the fabricator of the platform deck

- an *open-book* approach to agree a lump sum contract with the EPC contractor, needed to provide comfort that the risks posed by TOFCO were fully mitigated and priced in
- prior to contract execution, capital investment by TOFCO in site development, equipment and marine vessel capability.

BG was thus able to procure the topsides of the Poinsettia platform from TOFCO. At 4,200 tonnes, this deck was three times the weight of the previous BP decks. The sub-contract achieved 91% local content (measured as economic value added to the Trinidadian economy) and significantly developed the capability and competitiveness of the fabricator, especially in HSSE performance and project controls.

*The front page image shows the BG Poinsettia deck being fabricated alongside a BP deck and jacket.*

### Control Over the Supply Chain

The level of commercial risk consequent of sourcing from domestic suppliers in different expenditure categories will inform the extent to which the client wishes to stay in management control of its local procurement.

For example, with reference to the adapted Kraljic matrix (Fig 3), for local suppliers proven by market testing to be capable and competitive on the other four Rights, the client may elect a Procurement Strategy that procures from these local suppliers using standardised contract terms and which states the scope of work or goods for purchase as standardised performance requirements. In such cases no additional client supervision is needed, nor the introduction of some higher tier contractor or consulting engineer to provide additional supervision. Procurement Strategies need to be well informed of exactly where within the expenditure plans such opportunities arise, since procuring from these suppliers will likely constitute a high proportion of the total contributions to Local Content.

The case is different for goods and services for which local suppliers present either a significant but manageable risk (the Bottleneck quadrant), or that offer opportunity to develop local supplier capability (the Leverage quadrant). It is rationale for clients who are compelled to procure from inefficient or inexperienced state-owned or local private suppliers to insert between themselves and the domestic supplier a lead contractor or consultant engineer. Procurement

Strategies need to identify which spend categories might be relevant to this approach, what the level of risk or opportunity is, and describe the core principles for contract award to manage the risks or realise the opportunities, be that contested tender, negotiated contract, or single sourced. Crucially, the strategy needs to articulate what the purpose of the higher tier contractor is with respect to supporting local suppliers, be that to:

- **safeguard contract performance** (eg through additional quality controls, management supervision, third party inspections), or
- **develop supplier potential** (eg enabling suppliers to achieve international quality standards, investing in joint ventures, facilitating long-term technology transfer or providing access to regional or global markets), or
- **some combination**, as with long-term or repeat contracts that facilitate a learning curve relevant to both immediate contract performance and future marketability.

With specific regard to the level of client control over expenditure in the Critical quadrant; here the commercial risks are likely to be so great that the Procurement Strategy needs to establish the general principles of contract award, be that to:

- accept a **cost premium** to mitigate the additional risks or provide insurance (eg a back-up contract with an alternative supplier, or financial insurance);
- require specified **liquidated damages** as a condition of contract;
- accept a **delay to supply** delivery or project schedule to enable the capability of domestic suppliers to be enhanced to more competitive acceptable levels of performance;
- limit tender lists only to where an internationally experienced contractor enters into a **joint venture** with a relevant domestic supplier (and in such a way that the international contractor carries the main contractual risks and liabilities).



## Compensation Arrangements

The Procurement Strategy will also need to consider how best to use compensation payments to limit the risks of local sourcing, and/or how to incentivise contractors to meet Local Content targets or achieve successful supplier development.

In reference to the adapted Kraljic matrix (Fig 3), direct expenditure with a domestic supplier in the moderately risky Bottlenecks quadrant, is more likely to benefit from a Cost Reimbursable compensation structure, payable against a schedule of rates or more detailed bill of quantities.

Where an experienced international contractor is providing higher tier management of domestic suppliers, then for expenditure falling within both the Bottleneck and Leverage quadrants, there are likely two main compensation options applicable to the lead contractor:

- for less risky local suppliers – **Target Cost** (eg 50/50 pain gain), with **liquidated damages** against schedule slippage;
- for more risky local suppliers – selective **open-book** build-up of cost, allowing scrutiny over the riskiest supplier and sub-contractor contracts.

The assumptions in both cases are that the international contractor will wish to retain some element of cost control and 'up-side' over the type and quality of support it gives to domestic suppliers, and that the client has sufficient confidence to allow the contractor to take on such risks.

For expenditure in the Critical quadrant, the Procurement Strategy is likely to favour an **open-book, Cost Reimbursable**, mechanism, to minimise the risks involved.

## Conclusion

Purchasing goods and services from the right 'place' is becoming an increasingly important consideration in the formulation of Procurement Strategies. Give insufficient weight to regulatory and political

expectations for the local sourcing of goods and services and supplier development and compliance targets may be missed, eligibility to recover expenditure costs foregone, and opportunities for enhanced reputation lost. Give too much, and serious commercial value can be eroded due to the higher costs of goods and services, longer delivery times and inferior quality.

Knowing what should comprise an effective Procurement Strategy to meet expectations around Local Content requires some key considerations:

- an understanding of the **level of risk** posed by local suppliers in different expenditure categories;
- the right choices on packaging expenditure through contract **bundling and unbundling**;
- placing experienced contractors between the client and riskier local suppliers,
- establishing principles of **contractor selection** and using the leverage afforded by **scale** and repeat work to incentivise lead contractors to play a pivotal role in local supply chain oversight and supplier development; and
- adopting a **compensation** structure suited to the level of risk of local suppliers and the client's objectives for local sourcing and supplier development.

## End Notes

<sup>1</sup> adapted from: Emmett, S. and Croker, B. (2008) Excellence in Procurement: How to Optimise Costs and Add Value, Cambridge Academic

<sup>2</sup> Kraljic, P. (1983) Purchasing Must Become Supply Management, Harvard Business Review

<sup>3</sup> PROMINP: O&G Brazilian Industry Mobilisation Programme, London 15<sup>th</sup> September 2009: [http://www.ukenergyexcellence.com/marketing-your-business/tools/link\\_past-events/2009/brasil-energy1-html/](http://www.ukenergyexcellence.com/marketing-your-business/tools/link_past-events/2009/brasil-energy1-html/)

<sup>4</sup> In some countries competition rules would preclude against such a flow down clause, since the client may be prohibited from directing sub-contracting terms to its lead contractors.

<sup>5</sup> Adapted from: Stewart, G. (2008) *The Great Plutonio FPSO: Mixed Contracting Strategies to Optimise Delivery*, paper presented at OTC, May 2008

<sup>6</sup> Grateful thanks to BG Group.