LOCAL CONTENT

Mexico – Petroleum
January, 2016
The project\(^1\) - background

Resource-rich countries are increasingly inserting requirements for local content (“local content provisions”) into their legal framework, through legislation, regulations, contracts, and bidding practices. If successful, a policy to increase local content can lead to job creation, boost the domestic private sector, facilitate technology transfer and build a competitive local workforce. However, local content goals are often unfulfilled and the opportunities are not captured. For example, local content provisions typically require investors to meet targets measured as a percentage of investment, hours worked, equipment supplied, or jobs created. If targets are too high, they may either scare away investment or remain unmet as investors accept the fines or find loopholes. If they are too low, the country will not maximize potential linkages. This shows the importance of the framing of local content provisions. Targets, and other local content objectives, need to be carefully quantified, adapted to the local context and collaborative. Because local content provisions can be key to translating resource investments into sustainable benefits for the local population, this project examines the detail of the existing legal frameworks for local content in a number of countries.

CCSI has conducted a survey of the local content frameworks of a number of countries – identifying the key legislation, regulations, contracts and non-binding policies and frameworks dealing with local content issues in the mining and petroleum sectors\(^2\). A profile was created for each country, summarizing the provisions in the legal instruments dealing with local content and highlighting examples of high impact clauses\(^3\) – those containing precise language which might be useful as an example to those looking to draft policies to enhance a country’s local content\(^4\). The profiles examine provisions dealing with local employment, training, procurement, technology transfer, local content plans as well as local ownership, depending on the country’s approach to and definition of local content. In addition, as key to translating provisions into action, the profiles look at implementation, monitoring and enforcement provisions as well as the government’s role in expanding local involvement. Aside from emphasizing the strong clauses, which may be adaptable across countries, the profiles summarize the provisions but do not provide commentary, because local content is so context specific. The profiles are intended as a tool for policy makers, researchers and citizens seeking to understand and compare how local content is dealt with in other countries, and to provide some examples of language that might be adopted in a framework to achieve local content goals. Hyperlinks are provided to the source legislation, regulations, policies and contracts where available.

---

1. The project was managed by Perrine Toledano and Jacky Mandelbaum, with assistance from Sophie Thomashausen. Research was conducted by Antonio Montes de Oca.

2. General legislation with provisions that relate to local content (for example, tax laws with incentives for local procurement or employment in any industry), was not included in the review. The review included dedicated mining or petroleum sector or specific local content legislation, regulations, policies and contracts.

3. Those clauses are framed and singled out by a "thumb up".

4. Our criteria for assessment of the quality of the provisions were language that is less likely to present a loophole, i.e. less likely to be subject to interpretation due to vagueness and more likely to lead to enforcement because of its clarity in terms of rights and obligations of both parties (state and investor), and reasonable in its obligations on the company. In addition, as mentioned above, we looked for clauses that encourage collaboration between the company and the government in defining local content targets and goals, and those where the government has a role, as well as clauses enabling implementation and monitoring of the requirements and those giving the government strong remedies to enforce companies' compliance.
The impact of international law

The World Trade Organization (WTO)'s agreements and investment treaties can present an obstacle to the realization of local content goals by prohibiting some types of local content requirements (a sub-category of “performance requirements”\(^1\)). CCSI therefore surveyed the relevant WTO agreements and investment treaties in each country profiled to identify the provisions that may prevent, counsel against and/or shield local content standards. These provisions are quoted in the profile in order to show the potential barriers to implementation of local content so that they can be kept in mind when countries enter into these international investment treaties\(^2\). Free Trade Agreements other than the WTO agreements, some of which may contain investment chapters, are not included in the scope of the review, but may also be relevant and should be similarly kept in mind.

\(^1\)Performance requirements are measures in law, regulation or contract that require investors to meet specified goals when entering, operating or expanding in, or leaving a host country. Some are strictly mandatory; others are imposed as a condition for receiving some sort of added benefit or advantage.

\(^2\)Countries implementing local content requirements should be aware of the possibility of a challenge to those provisions either through the WTO (state-to-state dispute settlement) or arbitration under the bilateral investment treaties (which is investor-state dispute settlement). While the potential for such actions may be low, they remain a risk depending on the circumstances, and particularly should relations between the state and the investor sour over the course of the investment.
Synopsis

Highlights

• At the core Mexico’s local content requirements in the hydrocarbon sector is a methodology developed by the Ministry of the Economy to measure the achievement of local content targets.

• The 2014 Hydrocarbon Act sets an overall minimum target of 35% of local content to be achieved over time for shallow water blocks.

• The targets include 5 dimensions:
  • The origin of goods and services contracted;
  • The use of national labor and skilled labor;
  • The training of the national workforce;
  • Investment in local and regional physical infrastructure, and
  • The transfer of technology.

• The Ministry of the Economy, in consultation with the Ministry of Energy is responsible for developing an industrial strategy to ensure the participation of Mexican nationals in the hydrocarbons industry.
Key definitions

- **National (or Local) Content** means: the “percentage that represents the value in Mexican pesos of the goods, services, work force (labor), training, transfer of technology and physical infrastructure on a local and regional basis, from the total value in Mexican pesos of such concepts as defined in this Methodology” (Methodology, Art 2).
Overview

Rights application

- A plan to achieve the local content targets needs to be included in the application material. The exploration and development plans must include compliance programs setting out how the contractor will achieve its local content targets.

Training and Employment

- Preference must be given to the employment and training of Mexican nationals for technical and management level positions.
- A contractor’s performance in terms of the training and employment of Mexican nationals is included in the overall local content target.

Procuring goods and services

- Preference must be given to goods and services of national origin.
- A contractor’s performance in terms of the procurement of local goods and services is included in the Methodology’s overall local content targets.

Technology Transfer

- A contractor’s performance in terms of technology transfer is included in the Methodology’s overall local content targets.

Implementation

- The Ministry of the Economy is responsible for defining an industrial strategy around the hydrocarbons sector, establishing a national registry of domestic suppliers to identify their development needs, and creating an advisory board to help formulate policies to promote the development of domestic suppliers.

Monitoring and Enforcement

- A detailed methodology was developed by the Ministry of Economy to accurately measure local content.
- The 2014 Act penalizes the breach of a number of obligations including in relation to local content.
- Additionally, the model contract includes specific penalties for a failure to comply with local content requirements.
• The contractor’s program to ensure the achievement of the minimum percentage of local content over time needs to be laid out in the bidding documents. The 2014 Act stipulates a minimum percentage of 35% for shallow water blocks and states that the percentage for deep water blocks will be determined by the Ministry of Economy on the advice of the Ministry of Energy (Art. 46, 2014 Act). The 2015 model contract provides more details:

• During the exploration period, a contractor is required to comply with a minimum local content percentage of 13% (as defined in the Methodology in the “Monitoring and Enforcement” slide). In addition, the contractor must propose a compliance program in relation to its local content obligations (Art. 19.3 of the model contract):

The Contractor will have following obligations:

(a) During the Exploration Period: (…)

2) To include in its proposed Exploration Plan a compliance program for the above-referenced minimum percentage of national content, as well as a program for transfer of technology, including the applicable periods and stages for both programs, in order for CNH in consultation with the Ministry of Economy to grant or deny its approval pursuant to Articles 4.1 and 4.3, it being understood that once approved it will form an integral part of this Contract and shall be considered an obligation of the Contractor. The Contractor’s obligations regarding national content will commence upon approval of the Exploration Plan.

• In the first year of the development period, the contractor must comply with a minimum local content percentage of 25% (as defined in the Methodology). This percentage compliance must increase annually at a constant rate until the year 2025 when this minimum percentage becomes 35% (Art. 19.3 of the model contract):

The Contractor will have following obligations:

(b) During the Development Period: (…)

2) To include in its proposed Development Plan a compliance program for the above-referenced minimum percentage of national content, and a technology transfer program including the applicable periods and stages, in order for CNH in consultation with the Ministry of Economy to grant or deny its approval pursuant to Article 6.2, it being understood that once approved it will be part of this Contract and shall be considered an obligation of the Contractor. The obligations relating to national content will commence upon approval of the Development Plan.
• Article 19.4 of the model contract requires the contractor to hire and train Mexican nationals for technical and management level positions.

• Pursuant to the Methodology (in the “Monitoring and Enforcement” section), the local employment and training of Mexican nationals contributes to the contractor’s overall local content performance.
• Article 19.4 of the model contract requires the contractor to procure local goods and services when they are offered on market competitive terms (in terms of price, quality and timeliness of delivery).

• Pursuant to the Methodology (in the “Monitoring and Enforcement” section), the procurement of local goods and services contributes to the contractor’s overall local content performance.
The contractor is required to comply with the technology transfer commitments that the contractor submitted with the exploration and development plans (Art. 19.5 of the model contract).

“The Contractor shall comply with the programs for training and transfer of technology approved by CNH in the Exploration Plan and in the Development Plan. The referenced activities and programs shall include, among others, the adoption, innovation, assimilation, technological research and development, and formation of local human resources in scientific and technological research applied to the Exploration and Extraction of Hydrocarbons in coordination with national institutions of higher education.”
The Ministry of Economy, with the opinion of the Ministry of Energy will define the strategies for the industrial development of local production chains and to promote direct investment in the hydrocarbons industry, with particular attention to small and medium enterprises, as follows:

I. The strategy for industrial development of local production chains must:

a) Identify the industrial sectors and regions that will be the focus of the strategy, those will be aligned with the demand of the hydrocarbons industry; to this end studies could be outsourced to identify the products and services on the market and the suppliers offer them;

b) Integrate, manage and update a register of local suppliers for the hydrocarbons industry in which companies interested in participating in the industry will register and lay out their development needs;

c) Implement programs for the development of national suppliers and contractors, from the detection of business opportunities;

d) Promote the closure of gaps in technical capacity and quality of enterprises through support programs for technical and financial assistance, and

e) Include an advisory council, headed by the Ministry of Economy, representatives of the Ministry of Energy, the National Hydrocarbons Commission, the Energy Regulatory Commission, academics and representatives from the private sector or industry, including at least three representatives from the chambers or business organizations with national presence.

This council will support the definition of policies, criteria and methodologies for the diagnosis of the supply of products, goods and services; the promotion of national industry; the formation of regional and national production chains and talent development of human resources, innovation and technology.” **

** The quotes are the translation of the original text. These translations are author’s own.
II. The strategy for promoting direct investment must:

a) Promote the direct participation of Mexican companies to carry out activities in the hydrocarbons industry by themselves;

b) Promote partnerships between Mexican and foreign companies, to carry out activities in the hydrocarbons industry;

c) Promote domestic and foreign investment in long lasting direct activities linked to the hydrocarbons industry or in the manufacturing of goods or provision of services related to this industry, and

d) Promote the transfer of technology and knowledge.

It is the responsibility of the Ministry of Economy to monitor the progress of the strategies mentioned in this article, and to prepare and publish annually a report on progress in implementing these strategies, which must be presented to Congress no later than 30 June each year.

To help fulfill the provisions of this Article, the Ministry of Economy will support the Public Trust to Promote the Development of National Suppliers and Contractors of the energy industry.

Article 127 provides the creation of a fund to support the development of national suppliers and contractors (2014 Act).

“The Public Trust to Promote the Development of National Suppliers and Contractors of the Energy Industry will be created as an institution of the development bank. Its purpose is to promote the development and competitiveness of local and national suppliers and contractors, through financing schemes and support programs for training, research and certification, in order to close the gaps in technical capacity and quality, with particular attention paid to SMEs.”

** The quotes are the Author’s own translation of the original Spanish text..
• The methodology sets out how to measure local content based on 5 principles (Arts. 1-25) and on the basis of a number of formulae. The below summary from Deloitte provides an explanation of how the methodology is applied:

**Origin of goods and services:**
- **Goods**: The methodology accumulates the value of the transformation made in Mexico within the complete process of a productive chain. It “includes the value of Mexican goods used by the producer, including the proportion of domestic materials incorporated into the goods and excluding the value of imported materials as well as the value of materials produced locally but that do not qualify as Mexican. There is an option to consider the total cost of a material when it is not possible to determine the value.”
- **Services**: The methodology considers the Mexican goods and labor force used in rendering services. It “includes the value of property used, the leasing of property, salaries or fees paid to domestic workers employed by the service provider and subcontracted services.”
- **Workforce**: “Includes the value of wages, salaries, fees and benefits paid in Mexico to national workers according to the number of man hours incurred in the activities.”
- **Training**: The methodology only considers the value of training provided to Mexican workers.
- **Transfer of technology**: “Includes building and operational costs of research and development centers related to the sector in the territory, technology development as well as financing of new techniques in the hydrocarbon sector.”
- **Investment in local physical infrastructure**: “Includes the value of the total expenditure incurred in the territory in order to improve the urban and rural environment (including construction and maintenance of highways, roads, bridges and public transit routes, hospitals, schools, housing, drinkable water supply systems, sanitation and drainage, public and sports parks).”

**Source**: Deloitte: National Content Rules for the Oil & Gas Sector in Mexico (2015)

• At required intervals, the contractor will submit a report to the Ministry of Economy indicating all information related to local content according to the provisions issued by the Ministry.

• Article 85 of the 2014 Act states that the sanctions will be imposed taking into account the seriousness of the infraction of Section II of the 2014 Act (which includes local content). It also authorizes the National Hydrocarbons Commission to levy fines of between 15 000 to 450 000 times the value of the minimum wage. [The daily minimum wage in Mexico is currently approximately 70 Mexican pesos (around 4.5 dollars per day)].
Monitoring and Enforcement

- Art. 19.3 of the model contract has detailed sanctions to be applied in case of lack of performance related to local content:

  c) (…) If the Contractor fails to satisfy the minimum percentage of national content stated in the referenced compliance programs, the Contractor shall pay as liquidated damages to the Nation, through the Fund, a percentage of the value of the items outlined in the methodology established by the Ministry of Economy for the measurement of national content that were acquired in violation of the required minimum percentages of national content, as verified by the Ministry of Economy, pursuant to the following:

  - (1) The equivalent to fifteen percent (15%) for the Exploration Period;
  - (2) The equivalent to twenty percent (20%) for the first year of the Development Period;
  - The equivalent to forty percent (40%) for the second year of the Development Period;
  - (4) The equivalent to sixty percent (60%) for the third year of the Development Plan;
  - (5) The equivalent to eighty percent (80%) for the fourth year of the Development Period, and
  - (6) The equivalent to one hundred percent (100%) as of the fifth year of the Development Period.

  Failure to comply with other national content provisions stated in this Article 19.3 and under the Applicable Laws will obligate the Contractor to pay as liquidated damages to the Nation, through the Fund, the maximum sanction set in article 85, Section II, subparagraph o) of the Hydrocarbons Law.

- Art. 19.3 of the model contract also explains that the engagement of sub-contractors does not change the contractor liability in terms of local content.

  d) Notwithstanding any engagement of subcontractors by the Contractor, it shall remain liable for all of the Contractor’s obligations regarding national content arising under this Contract.
Agreement on Trade-Related Investment Measures (TRIMs)\(^1\)

- Mexico has been member of the WTO since January 1, 1995.

- All World Trade Organization (WTO) Members must adopt and abide by the obligations of TRIMs. This can impact a country’s ability to impose certain local content requirements (referred to as “investment measures”), to the extent they affect trade in goods.

- Angola, as a Least Developed Country, is only required to implement TRIMs to the extent consistent with its individual development, financial and trade needs and administrative and institutional capabilities, subject to notification to the General Council.

- The following types of local content requirements are covered by TRIMS\(^2\):
  - requiring a company to purchase or use products of domestic origin – TRIMs prohibits discrimination between goods of domestic and imported origin;
  - limiting the amount of imported products that an enterprise may purchase or use depending on the volume or value of local products that the enterprise exports;
  - restricting foreign exchange necessary to import (e.g., restricting the importation by an enterprise of products used in local production by restricting its access to foreign exchange); and
  - restricting exports.

---

\(^1\) The TRIMs Agreement clarifies existing rules contained in Articles III (National Treatment Obligation (NTO)) and XI (Prohibition on Quantitative Restrictions) of the General Agreement on Tariffs and Trade (GATT), 1994.

\(^2\) It is important to be aware of the types of measures prohibited under the TRIMs Agreement, in order to avoid the potential for dispute settlement under the WTO - a state can bring an action against another state for an alleged violation of the TRIMs Agreement (i.e. “state-to-state action”).
General Agreement on Trade in Services (GATS)

- A separate WTO agreement, the General Agreement on Trade in Services (“GATS”), covers investment measures related to services (in Article XVI), including the following which are relevant to local content:
  - Requirements to use domestic service suppliers
  - Limits on the number of service suppliers
  - Limits on the total value of service transactions or assets
  - Limits on the total number of service operations or quantity of service output
  - Limits on the total number of natural persons permitted
  - Restrictions on or requirements for certain types of legal entities (e.g., joint venture requirements)
  - Imposition of domestic equity

- GATS only applies to those service sectors that the country chooses to include in its Schedule of Commitments. Mexico’s commitments related to Construction and Engineering services can be contradictory with its local content requirements.
International law – bilateral investment treaties

• Mexico has entered into 32 bilateral investment treaties (BITs). All but 3 are in force.¹

• Investment treaties are international agreements between two or more countries which establish the terms and conditions of foreign investment within each country and provide rights directly to the investors of each country which is party to the treaty. The treaties can contain restrictions on local content requirements.²

• Investment treaties can contain the following types of provisions, each of which affects a country’s ability to impose local content requirements:
  • non-discrimination provisions (“national treatment” and “most-favored nation” obligations), which are relevant in the context of local content when:
    1. host countries require some foreign investors to source from certain goods and service providers but don’t impose similar requirements on other investors; and
    2. host countries give an advantage to some domestic or foreign goods and services providers, but not to a foreign provider whose state has a relevant treaty with the host country. (Note that this is relevant only where the foreign provider of goods or services has or, intends to have³, a presence in the host country);
  • restrictions on capital transfers;
  • “pre-establishment” protections, which prevent a state from imposing conditions on foreign investors that are not imposed on domestic investors, such as requirements to transfer technology to local firms, to establish the firm through a joint venture, or to reinvest a certain amount of capital in the host country;
  • incorporation of the TRIMs agreement; and
  • explicit prohibition of performance requirements that go beyond what is restricted by the TRIMs Agreement.

¹ According to UNCTAD’s country specific list of bilateral investment treaties
² It is important to be aware of the BITs a country has signed and the types of requirements prohibited under it, in order to avoid the potential for arbitration against the country - the majority of investment treaties allow investors to bring arbitration claims directly against the country in which they have invested (“investor-state arbitration).
³ I.e., the conditions under which an investor may enter into the territory of a party, not only the conditions once the investment is made.
International law – bilateral investment treaties

- All the BITs signed by Mexico were reviewed (and are available on UNCTAD’s database).
- Aside from the inclusion of National Treatment Obligations and Most Favored Nation clauses, which are included in most BITs, performance requirements are not more specifically prohibited.
- However Mexico is party to the North American Free Trade Agreement and its investment chapter clearly limits the imposition of local content requirements:

**Article1106: Performance Requirements**

1. No Party may impose or enforce any of the following requirements, or enforce any commitment or undertaking, in connection with the establishment, acquisition, expansion, management, conduct or operation of an investment of an investor of a Party or of a non-Party in its territory:
   (a) to export a given level or percentage of goods or services;
   (b) to achieve a given level or percentage of domestic content;
   (c) to purchase, use or accord a preference to goods produced or services provided in its territory, or to purchase goods or services from persons in its territory;
   (d) to relate in any way the volume or value of imports to the volume or value of exports or to the amount of foreign exchange inflows associated with such investment;
   (e) to restrict sales of goods or services in its territory that such investment produces or provides by relating such sales in any way to the volume or value of its exports or foreign exchange earnings;
   (f) to transfer technology, a production process or other proprietary knowledge to a person in its territory, except when the requirement is imposed or the commitment or undertaking is enforced by a court, administrative tribunal or competition authority to remedy an alleged violation of competition laws or to act in a manner not inconsistent with other provisions of this Agreement; or
   (g) to act as the exclusive supplier of the goods it produces or services it provides to a specific region or world market.

2. A measure that requires an investment to use a technology to meet generally applicable health, safety or environmental requirements shall not be construed to be inconsistent with paragraph 1(f). For greater certainty, Articles 1102 and 1103 apply to the measure.

3. No Party may condition the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non-Party, on compliance with any of the following requirements:
   (a) to achieve a given level or percentage of domestic content;
   (b) to purchase, use or accord a preference to goods produced in its territory, or to purchase goods from producers in its territory;
   (c) to relate in any way the volume or value of imports to the volume or value of exports or to the amount of foreign exchange inflows associated with such investment; or
   (d) to restrict sales of goods or services in its territory that such investment produces or provides by relating such sales in any way to the volume or value of its exports or foreign exchange earnings.

4. Nothing in paragraph 3 shall be construed to prevent a Party from conditioning the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non-Party, on compliance with a requirement to locate production, provide a service, train or employ workers, construct or expand particular facilities, or carry out research and development, in its territory.

5. Paragraphs 1 and 3 do not apply to any requirement other than the requirements set out in those paragraphs.

6. Provided that such measures are not applied in an arbitrary or unjustifiable manner, or do not constitute a disguised restriction on international trade or investment, nothing in paragraph 1(b) or (c) or 3(a) or (b) shall be construed to prevent any Party from adopting or maintaining measures, including environmental measures:
   (a) necessary to secure compliance with laws and regulations that are not inconsistent with the provisions of this Agreement;
   (b) necessary to protect human, animal or plant life or health; or
   (c) necessary for the conservation of living or non-living exhaustible natural resources.