Local Content in oil and natural gas exploration and production contracts*

Conteúdo Local nos contratos de exploração e produção de petróleo e gás natural

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ABSTRACT

This article aims to analyze the requirement of contracting minimum percentages from Brazilian suppliers arising from the Local Content clauses in oil and natural gas exploration and production contracts. To this end, the paper examines what constitutes the Local Content obligations, as well as their legal nature. The article then goes on to investigate cases in which Local Content clauses are ineffective and when compliance with the percentages offered when proposals were submitted looks unenforceable, emphasizing that the existence of the obligation imposed by the Local Content clauses is conditional on effective verification. Finally, the work

* Article received on September 3, 2019 and approved on October 3, 2019. DOI: http://dx.doi.org/10.12660/rda.v278.2019.80830.

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focuses on the possibility of applying sanctions to the private contractor in cases of non-compliance.

KEYWORDS

Local Content — oil contracts — administrative law — oil and gas

RESUMO

O presente trabalho tem por objetivo analisar a exigência de contratação em percentuais mínimos de fornecedores brasileiros advinda das cláusulas de Conteúdo Local nos contratos de exploração e produção de petróleo e gás natural. Para tanto, examina-se em que consistem as obrigações de Conteúdo Local, bem como sua natureza jurídica. Em seguida, o artigo investiga os casos em que as cláusulas de Conteúdo Local se mostram ineficazes e o cumprimento dos percentuais ofertados quando da apresentação das respectivas propostas se afigura inexigível, destacando sempre que a existência da obrigação imposta pelas cláusulas de Conteúdo Local é condicionada à verificação concreta do seu suporte fático. Finalmente, o trabalho se debruça sobre a possibilidade de aplicação de sanções ao particular contratante nos casos em que a incidência das cláusulas de Conteúdo Local resta afastada.

PALAVRAS-CHAVE

Conteúdo Local — contratos petrolíferos — direito administrativo — petróleo e gás

I. Introduction

The oil exploration and production business is potentially very profitable, with high demands on services and inputs, and involves non-renewable assets. Accordingly, countries have sought other economic benefits in addition to the traditional tax payment and government shares (royalties etc.).

They are concerned that the oil industry should be more than just extraction, in the sense that its effects on the domestic economy are not simply drilling and selling (mostly exporting) hydrocarbons, with payment of the

sums due to the State; they want the oil industry to also use local labor and domestic services and products as far as possible, adding value, creating jobs and boosting other areas of the economy apart from the oil *stricto sensu*.[1]

This is why, since the fifth bidding round[2] held by the National Oil, Gas and Biofuels Agency (ANP) for the auction of blocks, a minimum percentage of local content has been required, depending on the location, with the oil and gas concessionaires having to use Brazilian suppliers. Since the seventh round, in addition to the demand for minimum overall percentages of local content, offers have been limited to maximum amounts, with the introduction of the so-called Local Content Primer, intended to make the measurement of local content in contracts clearer and more objective.

However the obligation to contract Brazilian suppliers for minimum percentages, as part of the Local Content requirement, has given rise to various arguments, in particular in cases where the domestic market is unable to meet the demand from oil and gas exploration and production, or does not offer favorable, competitive terms compared to foreign suppliers.

This situation — on the one hand, of an obligation to meet minimum percentages under a local content clause, and on the other, the relative immaturity of the domestic market — is the reason why I have undertaken this survey. First of all I shall outline in detail the obligations for local content imposed on contractors, and then list the cases where compliance with these obligation is unenforceable at the time the proposals are submitted.

II. The requirement for Local Content in oil and natural gas exploration and production contracts and its legal nature

Local Content clauses oblige the oil companies to engage domestic suppliers for the E&P contracts allocated to them, so as to not only generate

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1 "Characterized by the immense variety of opportunities, technological advances and competitiveness, the oil and gas industry affects the entire production chain, and has huge potential for creating jobs and income in the country. These aspects encourage many countries to stimulate the industry's participation in local goods and services for surveying and extracting hydrocarbons" (PEDROSO, Daniel Cleverson; SOUZA MOREIRA, José Guilherme de. A evolução da participação da indústria nacional na E&P de petróleo e gás natural após a flexibilização do monopólio no Brasil. *Conjuntura & Informação, Superintendência de Estudos Estratégicos — ANP*, No. 23, pg. 1, Aug./Oct. 2003).

2 Until the fourth bidding round, the local content supply was free for bidders, and a minimum percentage only became obligatory with the publication of the invitation to bid for round five.

wealth from the exploitation of non-renewable mineral resources, but also to encourage local industry, creating a basis for the long-term economic development of the host country.

In commenting on the gradual and long-term nature of local content requirements in public policy, Luiz Cezar P. Quintans calls it "an import-substitution process aimed at transforming an unexploited market into a dynamic one. [...] The aims of local content also include expanding the local supply capacity and therefore the competitiveness of domestic industry, so that it can become part of the international market".[3]

The requirement for local content can take various forms, for instance an obligation not to discriminate against domestic suppliers, an obligation to ensure equal opportunities between local and foreign suppliers, or a preference for domestic suppliers when they offer the same terms as foreign ones.

The specialist literature defines Local Content as

> the added value of domestic components necessary for creating a specific product (asset or service). In Brazil the production cost of an asset is taken to include the cost of its components (materials, inputs, equipment and services) of domestic or foreign origin, and Local Content is defined by a comparison between these costs.[4]

Local Content has only one generic mention, in the latest version of Law No. 9.478/97.[5] Accordingly it is regulated principally by contract, based on the invitations to bid issued and the rules published by the contracting agency, the ANP.[6] Of course Local Content has for a long time been based here on legal and constitutional guidelines, such as good practices in the oil industry and

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3 QUINTANS, Luiz Cezar P. *Conteúdo Local.* A evolução do modelo de contrato e o Conteúdo Local nas atividades de E&P no Brasil. Rio de Janeiro: Freitas Bastos, 2010. pg. 8-9, my emphasis.

4 FERNÁNDEZ Y FERNÁNDEZ, Eloi et al. *Dicionário do petróleo.* Rio de Janeiro: Lexikon, 2009. entry "Conteúdo local".

5 Article 2 The National Council for Energy Policy (CNPE) is created, reporting to the Office of the President of the Republic and chaired by the Minister of State for Mines and Energy, with the duty of proposing to the President a national policy and specific measures intended to: [...] X — produce an increase in the minimum ratios of local content of goods and services to be applied to biddings and concession and production sharing agreements, subject to the provisions of section IX.

6 Basically, ANP Resolutions No. 36 to 39, of November 13, 2007 and No. 19, of June 14, 2013.

national development; but the specific regulations, even with this legislative reference, are mainly to be found in the contracts and sector standards.

The details of the biddings for oil concessions vary widely in the ways they ensure that there will be benefits for the local jobs market and Brazilian industry.

In some invitations to bid and contracts for bidding rounds held by the ANP, the Local Content ratio is one of the criteria for the award of the concession, and must be observed.

On the other hand, the terms of the invitation to bid do not oblige the contractor to meet the ratios at any cost, and they may be ignored if the domestic suppliers' prices, delivery dates or technology are inferior to those of foreign suppliers. In these cases, as we have seen, waiving the Local Content requirement means adapting the entire project, and this cannot be allowed to penalize the contractor with costs for which it is not responsible.

Contracts that provide for the need to use domestic suppliers assume, explicitly or otherwise, that such suppliers exist now or in the future.

These two sides must be reconciled,[7] and there is only one conclusion: the contractor is bound to its proposal as long as there are domestic suppliers that can meet its needs on the same terms as foreign suppliers. This assertion does not represent a violation or mitigation of the principle of adherence to the invitation to bid, since it is implicit in such document and ontologically connected with any local content requirements that can be imagined.

And for the same reason the fact that a condition cannot be met does not require readjustment of the contract terms, since this risk is assumed by the State (which has the constitutional function of encouraging domestic industry) and the obligation is conditional on the assumed existence of domestic suppliers becoming reality. Technically speaking, *before the point is reached where the non-existence of suppliers results in readjustment of the contract terms, the Local Content clause itself loses its efficacy.*

So much so that, even when there are suppliers in Brazil, there is only a duty to prefer them since the concessionaire cannot be obliged to use them if international suppliers are cheaper. So even in cases where a lower ratio of local content is permitted, the contract terms do not need to be adjusted, as if

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[7] "The principle of systematic interpretation is undisputedly valuable, since the intention, which is the spirit of the contract, is indivisible, and cannot be found in one clause isolated from the rest, but rather in the organic whole it makes up" (DIEZ-PICAZO, Luis. *Fundamentos del derecho civil patrimonial.* 5th ed. Madrid: Civitas, 1996. t. I, pg. 400).

an onus had been removed from the contractor, since this is not the basis of a local content clause; the clause is waived if the price is too high.

So our conclusion is that, far from being an obligation to use local suppliers on whatever terms, as might be understood from a first reading, the Local Content clause in E&P contracts is no more than an obligation to *prefer* domestic industry and services.

The Local Content clause also serves as an obligation to provide potential stakeholders in Brazil with the *means* to access to the information needed to execute a contract. This is the reason, for example, for the obligation to issue communications in Portuguese, to keep up-to-date details of Brazilian suppliers and so on.[8]

The Federal Audit Court (TCU) has defined the requirement for Local Content as "a preference given to domestic goods, products, equipment and services".[9]

Nor could the Local Content requirement be absolutely and immediately effective, since the basis in fact on which it rests would be wholly alien to the contractors' wishes: they have no choice as to the existence of local suppliers. The latter simply exist or do not exist, and the contractors' only duty is to find out whether they do, to notify them of the intention to hire them, and to do so if they submit a competitive proposal.

III. Efficacy and enforceability of the Local Content clause

Under the clauses analyzed in the previous section, therefore, E&P contractors are obliged: firstly, to notify the local market of their contracting needs; and secondly, to engage local suppliers in the ratios which they indicated in their proposal for each item on the list, unless foreign suppliers have more competitive prices, delivery dates or technology, or unless there are other reasons for exemption (e.g. a strike or an accident that prevents local industry from fulfilling the order).

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8 "The concessionaire's responsibility is to keep and file evidence that it has invited Brazilian suppliers (if there are any in the activity in question) to participate in its competitive and internal biddings, in every procedure for acquiring goods, services and labor, so as to prove deference, preference and opportunity for Brazilians" (Luiz Cezar P. Quintans, *Conteúdo Local*, op. cit., pg. 75).

9 Appellate Decision No. 1.157/2007, TCU, Plenary Session, Case No. TC 002.428/2005-3.

I am not by any means saying that the Local Content requirement is not binding, just that it is binding, like any other obligation, only to the extent that its basis exists — that there are domestic suppliers. And similarly, even when a domestic supplier exists, no contractor can be forced to execute a disadvantageous agreement simply to protect Brazilian industry.[10]

To explain this reasoning, let us take the example of a single man who makes a commitment to take his child to live in a particular city: as long as the man remains childless, the obligation does not arise, and there cannot be a failure to fulfill it, nor can such failure be highlighted due to the theory of unpredictability. The existence of suppliers — like the existence of a child in my rhetorical example — is not an unpredictable fact which can prevent the consequences of failure to fulfill an obligation, but, on the contrary, is the fact which gives rise to the obligation As long as this fact does not exist, we cannot talk of legal failure to fulfill the obligation, but simply that the obligation does not exist.

The Local Content requirement, then, has two stages, which we can agree to call the stage of effectiveness and the stage of enforceability. To describe these two stages:

a. *Stage of effectiveness:* for the obligation itself to exist, i.e. for the contractual rule to apply, there must be domestic suppliers — this is the key fact implied in the hypothesis of application. Like every legal regulation that operates on subsumption, as long as the facts generically and abstractly provided for do not exist, it does not apply, it does not cause effects, it is therefore not effective. This state of effectiveness exists through the very mechanism of application of the regulation, irrespective of any contractual provision. If there are domestic suppliers, the obligation arises, but there may still be possibilities for non-compliance. This brings us to the stage of enforceability.

b. *Stage of enforceability:* in principle, if there are domestic suppliers, the contractor must comply with all the local content ratios and be penalized if it fails to do so. The E&P contract, however, to meet any dispute about contractual equity, usually contains a clause to the effect that, even if domestic suppliers exist, and therefore the rule and the obligation also exist, it may be adjusted

[10] "The past of Brazil's naval industry provides many lessons. Some of the reasons why the shipping sector suffered crises and failures were bad management, inefficiency, total dependence on the State, corruption, overstaffing, high labor costs [...], lack of strategic vision by companies and low commitment to quality and technical development, as well as little international exposure" (ZAMITH, Regina. *A indústria parapetroleira nacional.* São Paulo: Annablume, 2001. pg. 93-94).

if the local suppliers offer terms that are comparatively disadvantageous in terms of price, delivery date or technology or for another justifiable reason. In such cases the items on the list for which local suppliers are not competitive must be excluded, and the list redrawn.

Only at this second stage is it possible to meet the local content requirement, and this may, exceptionally, be waived with the prior authorization of the ANP.

The existence of local suppliers is a precondition of the obligation, for otherwise the obligation will not exist even in the legal world, and the contractor, even if it wished, would not be able to engage local suppliers, simply because there are none, even at exorbitant prices and conditions.[11]

What I have called the stage of effectiveness and the stage of enforceability describe phenomena which are governed principally by the general theory of law, and so we can draw some analogies.

Drawing a parallel with a much more common matter, we could compare the stage of effectiveness with the non-requirement of a bidding process (article 25, Law No. 8.666/1993), where a bidding simply cannot be held; and the stage of enforceability with the bid waiver (article 24, Law No. 8.666/1993), where a bidding can be held, but, according to certain criteria and limits, the entity obliged to hold a bidding process (the public administrator) can opt not to do so.

Similarly, using criminal law as a parallel, we can say that there is a similarity in terms of legal dynamics between the stage of effectiveness and the absence of criminal characteristics, on the one hand, and between the stage of enforceability and the causes of exclusion of illegality or disapproval on the other, where the typical fact actually occurs (it is subsumed), but there is some reason for no punishment being imposed, such as self-defense or necessity.

We can also find an analogy with a regulation that obliges the concessionaire of a public service for municipal passenger transport to carry veterans of the Second World War free of charge, when there are no such veterans living in the municipality in question. The rule exists, but as long as there are no veterans it will not be applied, no subjective obligation[12] to carry veterans will arise.

Except for hypothetical cases in which the E&P contract expressly requires the contractor, if no local suppliers exist, to create them or itself to produce the domestic goods and services (which as far as I am aware has never been made into law), thus transforming the contractor into a State development agent,

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[11] I will examine this in more depth in the next section, in the light of general legal theory.

[12] Only the *inferi* obligation provided for in an abstract way in the legal system.

there is no way of avoiding this situation by imposition. As demonstrated (and I shall return to this point in more detail later), the assertion follows from the very dynamic of the mechanism of incidence of the rules of Local Content, making this obligation one of preemption and means.

And in fact, if we analyze the comparative law, we shall see that this is the basis of the Local Content requirement. Implicitly or explicitly, the obligation to use Local Content is an obligation to give preference to local suppliers that are reasonably competitive with foreign ones. But for this it is necessary, obviously, above all, that local suppliers exist. "The issue is that that which does not exist is not fulfilled (and cannot be fulfilled)."[13]

Otherwise we would have an aberrant strict liability of the contractor, due to the omission of undefined third parties for failing to create companies to service it, an indirect expropriation of its assets or a requisition of services by obliging it to "create" domestic suppliers, which would be an even more aberrant rule if we take into account the complexity and range of the key support activities for the oil industry, especially since the oil crisis in the 1970s, which very few companies in the world are capable of undertaking in deep waters.[14]

As Bernard Tavern says, in Russia, for example, "investors have to guarantee Russian companies the priority right to participate in these activities

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[13] Luiz Cezar P. Quintans, *Conteúdo Local,* op. cit., pg. 88.

[14] "Upstream is an activity requiring a thorough knowledge of geophysics, seismology, modeling and data processing, and of the different techniques used for drilling, and major investments in finding reserves and in assessing the viability of new finds. Thus investment decisions in new production areas have to take into account the technical development upstream, the new finds, the forecasts for future oil prices and changes in interest rates. Changes in the industry after the key producing areas were nationalized and the oil shocks led, on the demand side, to substitution of oil by other alternative sources and energy conservation. On the supply side, Opec boosted production. The upstream, with oil being sought in new offshore areas, permitted the introduction of new methods in technology and industrial organization, which led to *significant concentration in the oil industry support sector.* At the same time, there was growing inter-energy competition in the non-captive use of oil industry products. According to Alveal Contreras, "these new technologies led to a rapid increase in non-Opec oil reserves during the 1970s and 80s. In the 1980s, the amount of oil discovered was three times the amount consumed. New production areas with major reserves were developed. The most important new areas were the offshore reserves in the North Sea, the Gulf of Mexico, West Africa and Brazil. With the development of these new areas, Opec's share of world oil production fell from around 40% in 1980 to 30% in 1990" (CAMPOS, Adriana Fioritti. *Indústria do petróleo.* Reestruturação Sul-America anos 90. Rio de Janeiro: Interciência, 2007. pg. 22-23). In other words, it would be a monstrous obligation, practically impossible, to impose on contractors the creation of an oil industry support sector to meet their needs.

as subcontractors, suppliers, transport companies or in another capacity, executing contracts on equal terms".[15]

In Nigeria, although some provisions of contracts are binding, special cases can be submitted to the Nigerian Local Content Division, and, in practice, since the provisions are unrealistic, "it is a case of utopia, because all the time the Master Plans turn into 'special cases' and the percentages are not met".[16]

Now abolished, the local content requirements in Norway were limited to an assurance of "full and fair opportunities for Norwegian goods and services". In other words, a guarantee only of equal opportunities for local industry and services.[17]

In Indonesia, percentages are set for local content, "but if local suppliers do not attain competitive quality standards, imports are allowed".[18]

Mexico applies a local content requirement "when the local market can provide sufficient inputs and meet the best conditions in terms of price, quality, financing, opportunity and other relevant circumstances", in article 53 of the Ley de Petróleos Mexicanos.[19]

Note that this law, as we have seen above, is based on the presumption that local suppliers exist, and only then addresses the equal conditions that these suppliers must offer to be able to be engaged by the contractor.

IV. The existence of local suppliers as a presupposition for the imposition of Local Content: *conditio juris* and temporary impossibility

Every legal rule, whether based on law or contract, needs certain concrete facts to occur to be applicable, i.e. to be effective, producing its specific legal effects, as I explained above. These facts are called legal facts.

We have seen in the preceding section that the rules for Local Content require the existence of local suppliers for the contractor to engage them in accordance with the proposal. Without the precondition being fulfilled, the rule

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15 TAVERN, Bernard. *Petroleum, industry and governments. 2nd* ed. Chicago: Wolters Kluwer, 2008. pg. 279.
16 Luiz Cezar P. Quintans, Conteúdo Local, op. cit., pg. 27.
17 Ibid., pg. 32.
18 Ibid., pg. 36.
19 Article 53, Ley de Petróleos Mexicanos of November 28, 2008.

for Local Contract is ineffective; and if no obligation exists, the concessionaire cannot be exempted from it or penalized for failing to fulfill it.[20]

This is simply the well-known phenomenon of the fact being subsumed to the rule Without the occurrence of this fact, the rules are simply words which cannot create rights or obligations:

> If there is sufficient support in facts, the legal rule applies, and this is what gives it its legal force. The application is, therefore, the effect of the legal regulation of transforming into legal fact. Only after the legal fact has been generated, because of its application, can we speak about legal situations and every other type of legal effect (legal effectiveness). [...] with the result that no legal effect can be attributed either to the law on its own, or to the fact without application. The fact, to the extent it is only a fact, and the law, while its preconditions for application (factual support) do not occur, have no binding effect.[21]

When these tactical supports are inherent in a contract or in one of its clauses, there are differences only in respect of its doctrinaire classification — and not in respect of its legal discipline —, with some authors holding that these are conditions implicit in the business, and others calling them conditions *juris* or improper conditions, as held in article 117 of the Civil Code of 1916,[22] because they do not come from the express will of the parties, but rather from a legal determination or the actual nature of the object of the provision of the contract; and it is interesting how in this particular the theory of *conditio juris* is intimately linked with the paradigms of the impossibility of contractual objects, which have to be possible in order to be executed.

As Carvalho Santos argues, in relation to this latter thinking, "there are contracts or provisions which, depending on their nature or their purpose,

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[20] The situation would be like Mr. Smith undertaking to give Mr. Jones' son a job when he gets a degree in engineering. Until Jones Jr. finishes his engineering course, the contract will not become effective by the very nature of its terms, whether the parties have defined this fact as a suspensive condition or not.

[21] MELLO, Marcos Bernardes de. *Teoria do fato jurídico.* 3rd ed. São Paulo: Saraiva, 1998. pg. 73.

[22] Article 117. A clause is not considered to be a condition if it is not derived exclusively from the will of the parties, but arises of necessity from the nature of the law to which it is subject.

necessarily presuppose the existence or the realization of certain ulterior facts",[23] in our case, the existence of domestic suppliers.

The famous Vicente Ráo, citing Enneccerus, describes as

> *conditio juris* a future, uncertain occurrence on which depends the effectiveness of a transaction according to its nature, or its purpose, or according to a particular legal provision. [...] Conditions on whose verification the effectiveness of an act depends *ex lege* on its special nature, or its purpose, or a particular legal provision, are not true conditions;[24]

This corroborates my argument that there is no mitigation or relativization of the principle of being bound by the invitation to bid because of this verification of the legal nature of the Local Contact clause in the contract: the contractor remains fully bound by the agreed ratio of local content, but the existence of this obligation is conditional on the concrete verification of its factual supposition. If this factual supposition — the existence of local suppliers — is confirmed, the obligation which until then was only *infieri* acquires full efficacy.

Analyzing the question specifically in the light of the theory of efficacy of transactions, Antônio Junqueira de Azevedo reinforces this judgment by showing that there is what is theoretically called simple ineffectiveness:

> An action can, in fact, contain all the conditions of validity but not be effective, because of the lack of an element extrinsic to the action. [...] In fact, many transactions, to produce their effects, require the factors of efficacy, with the word "factors" being understood as something extrinsic to the business, something that does not participate in it, that is not part of it, but which contributes to the attainment of the result desired.[25]

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[23] CARVALHO SANTOS. J. M. *Código civil brasileiro interpretado.* 6th ed. Rio de Janeiro; São Paulo: Freitas Bastos, 1958. v. III, pg. 49. In the same section, the author quotes the thinking of Giorgio, who treats these factual supports as true conditions: "The parties, in the same way as they can tacitly manifest their knowledge in relation to the substantial parties to the contract, can also tacitly manifest their will concerning the accidental modifications to the agreement. Now, if the law, taking into consideration the nature of certain contracts, assumes the will of the parties to submit an uncertain occurrence to its efficacy or its resolution, this presumed will constitutes a condition — a tacit condition, certainly, but a true and proper one".

[24] RÁO, Vicente. *Ato jurídico.* 4th ed. São Paulo: Law Courts Review, 1997. pg. 251.

[25] AZEVEDO, Antônio Junqueira de. *Negócio jurídico.* Existência, validade e eficácia. São Paulo: Saraiva, 1986. p. 63-65.

Now, these characteristics of the said "extrinsic element" depend fully on the extrinsic factor conditioning the efficacy of the Local Content clauses, which is the development of the domestic downstream oil industry to the point that it can meet the ratios indicated by the State in the invitation to bid, based on which the bidders presented their bids.

This factual condition of the Local Content clauses may fail to be realized at the time the contract is signed, and may become effective only in the future; or they may be effective at the start of the contract and subsequently cease to exist. In all these hypotheses, where the factual supposition may be expressed in a succession of suspensive and resolutory conditions,[26] the obligation only exists when its factual support is present, because, if it did not, it would be an impossible obligation.[27]

The specific assertion is quite compatible with the general theory of obligations, as for example Orlando Gomes writes: "Temporary impossibility only delays the fulfillment of an obligation. The transitory nature of the obstacle allows the debtor to satisfy the obligation later".[28] Karl Larenz also explains this from a different perspective: "When something cannot be delivered because of a strike and or a hold-up in transport, or when a painter is ill for a time before finishing a job; in these cases the debtor continues to be obliged to meet a requirement and the creditor has to wait until it is possible".[29]

And there is no point in considering that the existence of local suppliers is something that, in theory, the contractor can arrange, and that therefore the obligation is not impossible, since the impossibility relevant in law is not one that derives from a logical concept, but from a legal concept of impossibility.

> For the former concept, impossibility is conceived in absolute terms. Compliance is only impossible when it cannot be achieved under any circumstances. If the debtor is able to satisfy it, even though at the cost of intolerable sacrifices or overcoming excessive difficulties, logically the impossibility does not exist. True enough. But the acceptance of

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[26] For José Abreu, "the *conditio juris* is essentially suspensive, in the sense that, before its realization, either there will be no contract, or there is one but it is not effective" (ABREU, José. *O negócio jurídico e sua teoria geral.* 2nd ed. São Paulo: Saraiva, 1988. pg. 196).

[27] "Local content is an exercise in futurology, since at the time of bidding the parties have not the slightest idea how much a wellhead will cost, whether such an item will be available in the local market, whether the delivery dates will be acceptable, or how much imported content it will contain, if any" (Luiz Cezar P. Quintans, *Conteúdo Local*, op. cit., pg. 125).

[28] GOMES, Orlando. *Obrigações.* 8th ed. Rio de Janeiro: Forense, 1988. pg. 176.

[29] LARENZ, Karl. *Derecho de las obligaciones.* Madrid: *Derecho de las obligaciones*, 1958. t. I, pg. 301.

> this logical concept would lead to major difficulties in practice. The duty of delivering cannot be demanded beyond a reasonable limit, as Hendemann argues. Hence the preference for the legal concept of impossibility. Its supporters also argue that delivery should be classed as impossible if it demands extraordinary and unjustifiable efforts of the debtor [...], relating to the duty of delivering as defined by the principle of good faith.[30]

And the specific principles of oil rights in respect of the development of domestic support industries holds that they "depend on many other variable which the contractor cannot control — such as technological development, tax issues and so on".[31]

German jurists describe the circumstance as "excessive difficulty in respect of the obligation, in other words, a difficulty so large in realizing the delivery that the debtor can only achieve it with sacrifices or costs which good faith does not demand".[32]

Certainly it would be an "intolerable sacrifice" or an "excessive difficulty" to demand that the contractor, to fulfill a contract whose main purpose is E&P, should structure an entire domestic oil industry support sector, figuratively creating its own "Halliburton".

Similarly, if the domestic oil industry support sector is developed, but does not meet the ratios indicated in the contract, we shall be faced with a partial impossibility, and then the contractor in good faith must partially comply with the obligation, which will be enough to satisfy the granting power.

Once again, Orlando Gomes explains: "Total impossibility occurs when the debtor is entirely prevented from satisfying an obligation. At times it happens that the obstacle only affects part of the delivery. If the impossibility is partial, the entire obligation may be extinguished, or only part of it. To find out how much, it is necessary to consider the interests of the creditor".[33]

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[30] Orlando Gomes, *Obligaciones,* op. cit., pg. 173-174.

[31] REPSOLD JR., Hugo; FREITAS, Jucelino L. de; SOUZA, Renata Barrouin C. *Conteúdo Local no contrato de concessão:* influências e perspectivas. Rio de Janeiro: Rio Oil & Gás, 2004. "To determine that a promise of development and purchase of goods and services will be fulfilled, in five, six or eight years' time, in a country where the laws change, the courts suspend the bidding process, inflation corrodes and technologies and prices vary, is a risk, and is very hard to understand, because it is not an objective, certain commitment" (Luiz Cezar P. Quintans, *Conteúdo Local,* op. cit., pg. 5-6).

[32] Karl Larenz, *Derecho de las obligaciones,* op. cit., pg. 310-311.

[33] Orlando Gomes, *Obligaciones*, op. cit., pg. 176.

If the Local Content requirement is impossible, this does not mean that it is null and void, but that it is ineffective, with plans being totally different from the outcome.[34] So in this case we have a valid clause, but one that is temporarily ineffective, since the contract may apply "to things not currently in existence at the time of signature, but which may come into existence at a later or future time. [...] The contract will only be executed if the expected thing really comes into existence".[35]

V. Inapplicability of sanctions

Without the factual supposition of the existence of local suppliers, the Local Content regulations will not apply. In consequence, and logically, there is no possibility of the contractor failing to comply with a obligation which has not arisen, and, more logically still, it cannot be punished for such failure.

But, in addition to this theoretical and logical conclusion, it would also be unconstitutional, because it would violate the constitutional principles of penal and sanctioning law for a private citizen to be punished without being guilty — having strict liability— for the omission of others; being held liable either for the fault of the public administration, for not having sufficiently developed the oil industry support sector, or for having been overly optimistic when drafting the invitation to bid; or for the general fault of Brazilian private initiative for not having invested in oil support activities.

This is a case of the Principle of Personal Nature of Sanction, according to which, says Fábio Medina Osório, "responsibility for others' faults and strict liability are fundamentally incompatible".[36]

Similarly, Celso Antônio Bandeira de Mello observes that

> the provision for sanctions (administrative, tax-related or criminal) applicable to transgressors of the regulations exists precisely to discourage them from transgression and to encourage them to adjust their conduct to the standard required by the rule of law. [...] Whence

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[34] "A business transaction, viewed in terms of existence, needs certain elements to exist; for validity, it needs requirements to be valid; and for efficacy, it needs factors of efficacy to be effective" (Antônio Junqueira de Azevedo, *Negócio jurídico,* op. cit., pg. 39).

[35] Luis Diez-Picazo, *Fundamentos del derecho civil patrimonial*, op. cit., pg. 203-204.

[36] OSÓRIO, Fábio Medina. *Direito administrativo sancionador.* São Paulo: Revista dos Tribunais, 2000. pg. 339.

> it is absolutely clear that no one can be regarded as a transgressor, and subject to the corresponding sanctions, when there is no possibility of their having known in advance and chosen, in a specific case, a behavior which would free them from the application of the infraction and, thus, from the imposition of sanctions.[37]

I have already shown — and it is also the conclusion of common sense and general knowledge — that a contractor cannot reasonably develop an entire oil industry support sector to meet a supposed obligation that is not even the principal purpose of a contract. To oblige it to do so would be also to violate the principle of reality, which is closely related to the principle of reasonableness, and is so addressed by Mateus Eduardo Siqueira Nunes Bertoncini, referring to the teaching of Diogo de Figueiredo Moreira Neto: "The law governs the reality of social life; it is not a set of precepts unrelated to what in fact has happened, is happening or may happen, but is clearly applicable to those of discretion, reasonableness and motivation, in the specific field of Administrative Law".[38]

If this were not so, the application of a penalty in cases where there are simply no domestic suppliers in the market would also violate the principle of proportionality, since it would not be an appropriate means of prevention or of obliging contractors to achieve that local content, since, however many fines they had to pay, they would still be unable to meet the ratio indicated in the contract.

With specific reference to this point, jurists hold that "taking a criterion that can be substituted by money, i.e. a fine, is the same as to say that the 'Local Content' criterion is a postponement of the signing bonus (in the form of a fine)".[39]

By the same argument, in cases where removal of compliance with one of the items on the list must be followed by adapting the rest of the list accordingly, this must not be at the expense of the contractor, who cannot be prejudiced by something for which it has no responsibility and which the contract itself recognizes as excluding the obligation originally assumed.

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[37] BANDEIRA DE MELLO, Celso Antônio. Ilícitos tributários: notas frias. Revista de Direito Tributário — *RDT*, v. 62, pg. 25, Oct./Dec. 1993.

[38] MATEUS, Eduardo Siqueira Nunes Bertoncini. *Princípios de direito administrativo brasileiro.* São Paulo: Malheiros, 2002. pg. 234.

[39] Luiz Cezar P. Quintans, *Conteúdo Local*, op. cit., pg. 6.

VI. Inapplicability of prior consent of the ANP

In cases where domestic suppliers exist, but are not able to supply the items on competitive terms, the E&P contracts usually provide for prior authorization by the ANP — a waiver — allowing the contractor not to meet the ratio for the items of local content in question, and adjusting the list.

On the other hand, in cases where local suppliers do not even exist, the Local Content clause, as I have said, is inapplicable for lack of a factual supposition, thus becoming ineffective.

In this case, since the clause is ineffective, the obligation has not even come into being, and it cannot be waived by anybody, nor can there follow the adaptation or updating of the list in the contract.

It is impossible to waive an obligation that has never existed in the world of law, just as it is impossible to extend a contract that has been cancelled or has not yet come into force.

Additionally, administrative authorizations in the broad sense have to be formulated expressly, and in the model concession agreements drafted as from the fifth bidding round for blocks, this has not been the case, since the contractual or regulatory provisions in general are exclusively intended for cases where domestic suppliers exist but where, for some reason, it is not economically viable for the E&P company to engage them.

In fact, E&P contract clauses provide, as a rule, that local contracting will not be obligatory if there is another reasonable justification, because they assume that a local supplier exists. So in the case where no local supplier exists, we are faced with a hypotheses not provided for in the draft agreements, in respect of the requirement for prior administrative consent, and the overall rule *in favor libertate* will apply.[40]

From the point of view of the general theory of obligations, these assertions are detailed technically by Luis Diez-Picazo because the *conditio juris* of the Local Content clause is automatically ineffective, not enforceable. Let us see.

Except for the exceptions where contractual clauses are subordinated to a decision by one of the parties, where we have what is called enforced

[40] Moreover, the restrictions (always exceptional) on fundamental rights must be interpreted restrictively, since, beyond the area where they operate, the general law *pro libertate* inherent in fundamental rights is in force, *in casu,* the guarantee of private initiative (FERRAZ JÚNIOR, Tércio Sampaio. *Introdução ao estudo do direito.* 2nd ed. São Paulo: Atlas, 1994. pg. 296).

ineffectiveness (such as a contract which remains in force until one of the parties decides to terminate it unilaterally), the ineffectiveness of acts subject to all the other modalities of conditions are automatic,

> being produced by the legal framework and without the need for any additional requirement. Legal tradition calls this type of production of a legal effect *ipso jure,* that is, caused by the law itself. The same idea is expressed by the phrase "by right". [...] "By right" means that there is no need for anyone to apply to the court (or, *a fortiori,* the administrative authorities), or (and this is the same thing) to declare in advance that some provision can be waived, and, consequently, that there is ineffectiveness as from the exact moment when the ineffective contract comes into being. [...] When ineffectiveness is automatic, the contract is from the start unable to be fulfilled and nobody, not even an employee of the courts, can make it effective (or, naturally, any one of its clauses, if only one of them is subordinated to the condition) or the pretensions which are built on it,[41]

which, in this case, would be any pretensions by the ANP to penalize the contractor or submit it, in this aspect, to its prior authorization.

Nevertheless, if the contract is silent, nothing prevents the public administration from being consulted on the point — indeed this is desirable, since it will avoid future disputes and the threat, however improper this may be in our view, of the application of penalties.

VII. Good practices and risk allocation in the oil industry

For any issue about oil concessions where no specific rules exists, or where there is a rule but a particular case is open to more than one plausible interpretation, the best practices of the oil industry should serve as the main guide to a solution,[42] since it is thus that ANP should implement the model

[41] Luis Diez-Picazo, *Fundamentos del derecho civil patrimonial*, op. cit., pg. 459, my digressions.
[42] ARAGÃO, Alexandre Santos de. As boas práticas da indústria do petróleo como o eixo da regulação do setor. *Revista de Direito Administrativo — RDA,* v. 238, 2004.

detailed in Constitutional Amendment 09/1995, which provides for more flexibility in the oil monopoly, and the Petroleum Law which regulated it.[43]

E&P contracts usually define the "best practices of the oil industry" as

> the practices and procedures generally used in the industry worldwide by prudent and diligent operators, on conditions and in circumstances similar to those experienced in respect of material aspects of the operations, aimed primarily at ensuring: (a) conservation of oil and gas resources, which implies using methods and processes to maximize the recovery of hydrocarbons in a technically and economically sustainable manner, with the corresponding control of the decline in reserves, and the minimization of losses on the surface; (b) operational safety, which means using safe methods and processes and preventing accidents; and (c) environmental protection, by means of methods and procedures to minimize the impact of the operations on the environment.[44]

This definition can be broken down into the following elements: international practices must be followed, and operators must be cautious and rational in preserving resources, safety-conscious and respectful of the environment.

The reference to international practices does not mean that they must be absolutely the same in every region where oil exploration and production takes place, because there are many peculiarities and differences between them.

As I have said elsewhere,[45] these days we are aware that the more knowledge we have of the field to be regulated, the more chance there is of efficient and effective regulation. If this is true in general terms, it must be more so in terms of regulating the economy.

The economy has always been dynamic, relatively unpredictable and with independent tendencies, but in recent years, with globalization and the

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[43] "It [the Petroleum Law] is an important milestone: it shows that, in Brazil, the oil industry has come of age and is being opened up to make new investments possible and to allow a balanced interaction between the State and private initiative" (Explanatory Memorandum 25/96, of the Ministry of Mines and Energy, submitting the draft law in question to the Office of the President of the Republic).

[44] Draft of the Tenth Round concession agreement, section 12.2.24, available at: <www.brasil-rounds.gov.br>.

[45] ARAGÃO, Alexandre Santos de. Ensaio de uma visão autopoiética do direito administrativo. *Revista de Direito Público da Economia — RDPE*, v. 4, 2003.

internationalization of phases of the production chain, it has increasingly required the intervention of the law to regulate its activities.

Adopting "best international practices of the oil industry" in the ANP's E&P contracts, with a view to "rationalizing production" (article 44, VI, Petroleum Law), is the best way to attain the objectives outlined in article 1: protection of the national interest, of development, of the environment, of consumers, supply of oil derivatives, attraction of investments, expanding the country's competitiveness in the international market, encouraging competition etc.

In relation to the law, such as article 44, VI, of the Petroleum Law, which refers to practices common to the agents of a particular economic sector, Marc Tarrés Vives[46] writes that

> the insufficiency of traditional administrative instruments must be compensated by self-regulating formulas which serve individual or collective interests and enable public objectives to be fulfilled. [...] There is a desire to be guided by the commitments, methods and skills that these agents possess in order to achieve public purposes. In other words, self-regulation becomes part of regulation. [...] To a large extent, regulation has ceased to contain complex technical prescriptions — which took up pages of the Federal Gazette — and now only consists of general conditions, which are put into effect in accordance with their references, [...] and this is nothing new.

Further on he says that

> the use of expressions of this sort (such as "best practices of the oil industry") in laws indicates that the legislator has ceased to detail technical regulations which, in fact, can quickly become obsolete, and it should also be recognized that the use of indefinite legal concepts for this purpose is a legislative technique widely adopted in very different areas, such as those of industrial products, information technology, the environment, the economy, etc.[47]

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[46] VIVES, Marc Tarrés. *Normas técnicas y ordenamiento jurídico.* Valencia: Tirant lo Blanch, 2003. pg. 172 and 253.

[47] Ibid., pg. 274-275. But, in fact, "the use of what today we call business usage to interpret contracts and conditions originated long ago. Formerly it was common for the doctrine to

Applying these concepts to the issue of Local Content, we saw earlier that international practice is to consider it an obligation to prefer domestic suppliers, not an absolute obligation, at whatever cost and whether or not domestic suppliers exist, to engage them, because this would be a legal impossibility: to apply a rule without the necessary facts being in place; to generate legal effects without subsuming a fact to the hypothesis of normative incidence.

What is more, best practices of the international oil industry are intended, among other things, to reduce uncertainty, which is already subject to geological, political and other risks, and the adoption of an imperative posture such as that imagined earlier would make an E&P contract even more risky and random and, therefore, less interesting to private initiative, thus reducing the price paid to the State for the grant — every risk has a price.

While on this subject, another important issue is the allocation of risk in E&P contracts. It is a basic principle of economics that each risk should be allocated to the party managing it or that can best act to prevent it.

According to Mauricio Portugal Ribeiro and Lucas Navarro Prado, writing about public-private partnership agreements, but applicable to all public administration contracts, especially long-term ones:

> when a risk relates to an event that does not affect the contractor's conduct (including awareness of the risk itself) and which the contractor cannot adequately manage — by arranging insurance cover, for example — it is advisable to transfer it to the public sector, since in this way the price will be borne by the public administration alone [...] if and when an accident happens. In short, when the private partner is unable to manage a given risk, it is advisable to assign it to the public administration.[48]

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quote different texts of the Digest" (Luis Diez-Picazo, *Fundamentos del derecho civil patrimonial*, op. cit., pg. 407).

48 RIBEIRO, Maurício Portugal; PRADO, Lucas Navarro. *Comentários à Lei de PPP: Parceria Público-privada:* fundamentos econômico-jurídicos. São Paulo: Malheiros, 2007. pg. 119-120. The authors illustrate their argument using the example of a subway works project, as follows: "Frequently, when drilling a tunnel, they come across underground ducts or cables of which they were previously unaware. It is impossible to know if such things are going to be found beneath an old urban area. In view of this, there are two options when drafting a contract for building a subway: the first is for the public administration to bear the risk. If unforeseen difficulties arise, the administration will have to compensate the contractor. The second option is to transfer the risk to the contractor. In this case, the contractor will include in its commercial proposal the value of this risk (risk pricing). As there is no way the contractor can find out

If the public administration cannot handle it, it will be violating the constitutional principles of efficiency and economy (articles 37, main section and 70, Constitution of the Federative Republic of Brazil), since the contractor will now have to include this risk in the proposal, and the public administration and the public in general will bear the cost, whether or not the unforeseen events actually happen.

The risk to which this article relates is whether or not local suppliers exist.

Now it is clear that concessionaire companies have few if any instruments to make other individuals opt for that business, invest in it and become their suppliers, while the State in the widest sense has all the tax, development and regulatory instruments for the purpose.

Confirmation of this is the fact that the ANP itself has carried out studies and assumed as possible certain local content ratios, and has even included them in the invitations to bid issued for some bidding rounds held. Any excess optimism on the part of government cannot, naturally, be allowed to prejudice individuals, who have no responsibility for the State's expectations for the sector or for the failure to realize them.

It would be as absurd to attribute to contractors the risk of growth in one sector of the economy (the oil industry supply sector) as to attribute to the State the geological risks for discovering or not discovering oil, since the contractors are much more able to deal with geological risk than the State.

In addition, it is not the contractors' job to encourage or plan the activity of other businesses or entire sectors of the economy, such as the oil industry support sector. For its part, the State is the entity with constitutional duties for inductively planning the activities of private initiative (article, 174, Constitution of the Federative Republic of Brazil).

The constitutional principle of efficiency (article 37, main section, Constitution of the Federative Republic of Brazil) added to best practices of the international oil industry, as provided for in the Petroleum Law, should illuminate the application of laws and contracts for oil, so that they are not inefficient or less efficient in meeting the primary legal objectives of the sector. The rules "meet the criteria of validity not only because of the health of their

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whether there are interferences in the path of the subway tunnels, and no way of avoiding them if there are, we have a situation where nobody will bid, since no private partner will wish to enter into a contract with the administration, unless they include in their proposal the cost of dealing with every possible interference, whether or not existing. Since the risk of occurrence of interferences is included in the contract price, the administration will have to pay whether or not they exist" (pg. 119).

creative procedure, but of their ability to meet the objectives of public policy, in addition to being able to resolve the ills that this policy aims at combating".[49]

Nor should the principle of proportionality, in its elements "adequacy" and "necessity", impose the adoption (normally an interpretation) of an inadequate or unnecessary means of attaining the legal purposes.[50] If the contractor was attributed the risk of the existence of domestic suppliers, this would not be an adequate means to encourage the domestic oil industry support sector, since it would penalize the contractor without its being able to do anything individually to create such suppliers.

However many fines imposed, it would still be unable to make the big international companies in the sector open local subsidiaries, or, an even more impossible task, arrange for the creation at least in the medium terms of new genuinely domestic companies to provide the same services on the same terms as those international giants are capable of doing. We must not forget that, in the majority of cases, these suppliers are of a similar size or larger in economic terms than the E&P concessionaires themselves.

We must also keep in mind that the oil E&P contract is not primarily intended to oblige the private company to foster the national economy, but to produce oil, and the contractual interpretation

> cannot be separated from the practical and empirical results proposed by the parties as the purpose of the agreement. Therefore, in addition to the socioeconomic function that the law assigns, the concrete purpose of the agreement for the parties (in this case, the exercise of E&P activities) must be taken into account. This means that all the terms of the agreement are aimed at achieving this empirical result and must be interpreted, as far as possible, in this light.[51]

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[49] MORAND, Charles-Albert. *Le droit néo-moderne des politiques publiques.* Paris: LGDJ, 1999. pg. 95.

[50] "Depending on the objective (the purpose, the desire of the Legislator) to be attained (also with the participation of the private sector: also essential to help identify the interests involved), the Administration must reach concrete, operative decisions, which will preserve as far as possible the personal assets that are not incompatible with the asset-right of public importance, and satisfying the greatest possible number of interests, thus fulfilling the greatest number of fundamental rights" (IANNOTTA, Lucio. *Princípio di legalità e amministrazione di risultato.* Amministrazione e legalità — fonti normativi e ordinamenti (Atti dei Convegno, Macerata, 21 e 22 Maggio 1999). Milan: Giuffrè, 2000. pg. 45).

[51] Luis Diez-Picazo, *Fundamentos del derecho civil patrimonial*, op. cit., pg. 404, my digression.

This solution would also, as we have seen, violate the principle of good faith which "as well as a starting point should be also the arrival point. The contract must be interpreted in such a way that the meaning attributed to it is the most appropriate to reach a development of the contractual relations and attain the contractual consequences".[52]

One of the corollaries of the application of the principle of good faith to the case in point will be the subject of the next section.

VIII. Interpretation *contra proferentem*

Since an E&P contract, like all contracts subject to government bids, is an adhesion contract, the State determines its rules in advance. Some of them are included in the invitation to bid itself/contractual instrument attached to it, or the draft agreement attached to it, others are contained in applicable regulations. In the case of Local Content requirements, they can be found both in the ANP regulations and, in more detail, in the agreement itself, thus being "mixed in nature between regulation and contractual obligation".[53]

Since it is an adhesion contract,[54] it must be interpreted even more closely in line with general good faith clauses, and to the benefit of a contractor who has accepted the contract without fully exercising contractual freedom.

In relation to these contacts, also referred to as "predefined contracts", Atilio Anibal Alterini remarks that they must be interpreted "favorably towards the party which had no input into the wording".[55]

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[52] Ibid, pg. 308.

[53] Luiz Cezar P. Quintans, *Conteúdo Local*, op. cit., p. 190-191.

[54] "Bearing in mind that, in adhering to a contract, the participant merely indicates acceptance of a standard document drafted by the other party (the party that drafts the contract in advance and not just an offer), and there is a duty to draft the conditions clearly, precisely and in simple terms. If, in spite of this, an obscure, complex condition in included, that raises doubts in the interpreter's mind, it must be interpreted in the manner most favorable to the participant. Since the latter has no power to discuss the terms or demand less onerous conditions, it cannot be jeopardized by the wording given by the other party" (PEREIRA, Caio Mário da Silva. *Instituições de direito civil.* Rio de Janeiro: Forense, 2006. v. III, pg. 76). "The stronger party can in this way expand and achieve its aims. The legislator and, even more so, the judge, must set limits to this imposition of terms, taking into account the fact that the participant is the weaker party. So we must conclude that these days total freedom in drafting contracts is indefensible, because society will no longer permit it. Paradoxically, total contractual freedom, nowadays, would lead to the actual negation of such freedom [...]" (VENOSA, Silvio de Salvo. *Direito civil:* teoria geral das obrigações e teoria geral dos contratos. 6th ed. São Paulo: Atlas, 2006. pg. 382.)

[55] ALTERINI, Atílio Aníbal. Bases para armar la teoria general del contrato en el derecho moderno. Revista de Direito do Consumidor, No. 19, pg. 17, Jul./Sep. 1996.

The Civil Code of 2002, reflecting this concern, determines that the interpretation of ambiguous or contradictory conditions must be to the benefit of the adhering party (article 423).[56]

The Regional Federal Court of the Fourth Region has also ruled that: "if there is concrete doubt as to the interpretation of the terms of an obligation of acceptance (adhesion) containing clauses not applicable to the type, confessed circumstance, its reading to the detriment of the one who simply accepted the conditions in question is totally unreasonable".[57]

We must also consider the general principles of interpretation of contracts favorable to the weaker party. In fact, in the event of obscurity in a contract, the principle is to decide against the stronger party, in this case the government, one reason being that the latter is not only the principal but also the regulatory authority and the granting power.[58]

The same principle, with a different focus, is known as the "rule of interpretation *contra proferentem*"[59] and, as provided for in article 423 of the Civil Code, means that doubts in interpreting contracts are resolved against the drafter, in this case the ANP, which defines all the conditions of the E&P contracts to be entered into with the specific sellers of the bidding rounds.

According to Filippo Viglione, "ambiguous expressions must be interpreted in the sense least favorable to the party that drafted the text of the contract".[60] This is because, "the person drafting a contract has a sort of burden to be clear, so that one can believe that this canon of interpretation also fulfills an important educational function for those entering the market, guiding the formulation of the clauses regulating the contract clearly and comprehensively".[61]

So, on this basis also, the best interpretation is to the effect that the contractor cannot be obliged, or penalized, for the fact that the oil industry support sector of our economy cannot yet fully meet the ratios indicated in

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56 Article 423. When the adhesion agreement contains ambiguous or contradictory conditions, they must be interpreted in the manner most favorable to the participant.

57 AC — Civil Appeal; Case: 95.04.53154-7 State: SC.

58 VIGO, Rodolfo Luis. *Interpretación jurídica.* Buenos Aires: Rubinzal-Culzoni, 1999. pg. 160.

59 DIEZ-PICAZO, Luis. *Fundamentos del derecho civil patrimonial.* 5th ed. Madrid: Civitas, 1996. t. II — Las relaciones obligatorias, pg. 413 et seq.

60 VIGLIONE, Filippo. *L'interpretazione del contrato nem common law inglese.* Problemi e prospettive. Supplemento Annuale di studi e ricerche, 2008. Casa Editrice Dott. Antonio Milani. Free translation. pg. 153 "le expressioni ambigue debbono essere intese nel senso meno favorevole alia parte che ha predisposto il testo contrattratuale."

61 Ibid., pg. 154. Free translation.

the proposal, within the parameters set by the government itself which held the bidding process.

IX. The position of the E&P company and fostering domestic industry as an obligation of the State

Signing an agreement for the concession of a state activity is not enough to make an oil contractor part of the State organization and subject to the imposition of any other State function. Its list of duties is limited to the purpose of the agreement: oil exploration and production. This is why the public administration could not use an agreement with a specific purpose, and drafted in accordance with both the Petroleum Law and article 177 of the Federal Constitution, to oblige the contractor, for example, to foster sectors of local industry, a task which, as we have seen, is not within its powers, however hard it may try.[62]

Jordana de Pozas defines fostering as

> a half-way measure between the inhibition and the interventionism of the State, intended to reconcile freedom with the common good by directly influencing the will of the individual to want what is necessary to satisfy the public need in question. We could define it as the action of the Administration intended to protect or promote those activities, establishment or riches owed to private individuals, which satisfy public needs or are considered to be of general utility, without using coercion or creating public services.[63]

In Brazilian doctrine, Célia Cunha Mello argues that

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[62] "The attractiveness of the oil sector is significantly influenced by the competitiveness of local suppliers. In the case of Brazil, industrial competitiveness is affected by the excessive tax burden, the high cost of borrowing, unfavorable exchange rates and gaps in technological modernization" (PEDROSA, Oswaldo; GUIMARÃES, Paulo Buarque; FERNÁNDEZ Y FERNÁNDEZ, Eloi. Perspectivas do fornecimento de bens e serviços em regiões de E&P terrestre. In: FERREIRA, Doneivan Fernandes (Org.). *Produção de petróleo e gás em campos marginais:* um nascente mercado no Brasil. Campinas: Komedi, 2009. pg. 446).

[63] DE POZAS, Jordana. Ensayo de uma teoria de fomento em el derecho administrativo. Revista de Estudios Políticos, *No.* 48, pg. 46,1949. Apud ORTIZ, Gaspar Ariño. *Princípios de derecho público económico.* Bogotá: Universidad Externado de Colombia, 2003. pg. 338.

> the protection and promotion of the object fostered correspond to the function of inducing, by stimuli and incentives, the agents fostered to adopt certain behavior, thus dispensing with imperative, cogent investments. [...] The legal-administrative relationship of public development is based on the consent of the agent fostered, who manifests the will to adopt the behavior desired by the State.[64]

The activity of fostering and of inductive planning of private initiative is a function of the State pursuant to article 174 of the Constitution of the Federative Republic of Brazil. So much so that the Brazilian government has effectively, with varying amounts of success, assumed responsibility for providing suppliers with high Local Content for its E&P contractors, who show that these ratios are gradual objectives to be aimed at by the State and, once attained, are binding on contractors.[65] The oil contractors, after signing an E&P agreement, continue to be fully qualified as private agents, even when carrying out the public activity delegated to them.[66]

An ANP article written by those responsible for biddings indicates that the concessionaires have no direct role in generating local suppliers, if they do not exist in the market, and are only obliged to deal with those that do exist. To quote: "The increase in the percentage of local purchases starting with the Fifth Bidding Round sustains and reinforces the commitment of the ANP to

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[64] MELLO, Célia Cunha. *O fomento da administração pública.* Belo Horizonte: Del Rey, 2003. pg. 29.

[65] "The ANP has done a huge amount of work, in the areas for which it is responsible, to boost the share of local suppliers in E&P activities. These initiatives include the creation of worker training programs and technological development, and agreements for cooperation with Finep ("Project Trends") and BNDES. Another decisive action of the ANP has been its support for the creation of agents to catalyze the development of the sector: registering companies, issuing regulations and publishing local industry capacity. An example of this was the establishment of the National Petroleum Industry Organization (Onip), in 1999, which has taken a leading role in organizing the development of Brazilian suppliers. Project Trends is intended to identify sector prospects in terms of technology and new industry needs, orienting the technological programs supported by the ANP, and other efforts to maintain the development of local suppliers. The aim of the agreements with BNDES and Onip is to set up mechanisms for checking and supplying the local content required by the concessionaires. CTPetro, managed by MCT/Finep, and the ANP human resources program (PRH-ANP) are aimed at training staff and carrying out R&D activities in Brazilian institutions, and this can assist the technological training of the local suppliers" (Daniel Cleverson Pedroso and José Guilherme de Souza Moreira, A evolução da participação da indústria nacional na E&P de petróleo e gás natural após a flexibilização do monopólio no Brasil, op. cit., pg. 6)

[66] They have no constitutional rights of their own or powers to carry on the activities belonging to the state, but after delegation the contractual position comes under their private ownership and, thus, they can exercise their rights of economic initiative.

develop local industry, *naturally and competitively, preserving the free initiative of the bidders"*.[67]

If E&P agreements were interpreted as obliging individuals to engage national suppliers at any cost and, if none existed, to arrange for them to exist, we would have much more than an accessory obligation instrumental to the agreement; we would have its total distortion, with an E&P agreement coming to oblige the individual to foster a certain sector of the economy, receiving in exchange the possibility of exploring for and producing oil, if it found any.

This posture would contradict the legal and constitutional characteristics of the oil concessions, for example, with a contractual element to which the Petroleum Law does not even refer becoming the principal element in the E&P agreement. On top of this, such an obligation would be impractical to fulfill, as we have seen, particularly because of the great economic concentration existing in the global oil service industry, principally in that it combines high levels of capital with complex technology for deep-water drilling, limited to just a few transnational companies.

This would be in effect an indirect expropriation or requisition of services of a private contractor, which would see its main business purpose changing, becoming more a development agent that an oil company. "Even though the Public Administration may place limits on private ownership in favor of the public interest, they have a logical limitation: the measure imposed cannot exceed what, from the technical and legal point of view, is specifically a 'restriction'; if the conceptual limits are exceeded, the measure will be void."[68]

Pierre Devolvé remarks that "if corporate freedom is a public freedom the exercise of which can be regulated by the Legislator, with support from the Constitution, the existence of corporate freedom in itself takes precedence over it: the member of the Constitutional Conventional wanted to allow the Legislator to adjust corporate freedom; but it did not allow for corporate freedom to be stamped out altogether".[69]

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[67] Daniel Cleverson Pedroso and José Guilherme de Souza Moreira, A evolução da participação da indústria nacional na E&P de petróleo e gás natural após a flexibilização do monopólio no Brasil, op. cit., pg. 6, my emphasis.

[68] MARIENHOFF, Miguel S. *Tratado de derecho administrativo*. 6th ed. Buenos Aires: Abeledo-Perrot, 1975. t. VI, pg. 47.

[69] DEVOLVÉ, Pierre. *Droit public de l'économie.* Paris: Dalloz, 1998. pg. 110-111. The explicit or implicit permission in the Constitution for limits on the exercise of constitutional rights can also be considered from the point of view of the structure of the constitutional safeguards for the freedom of economic initiative, especially article 170, sole paragraph, Constitution of the Federative Republic of Brazil, which has full efficacy *ab ovo*, but may have its effectiveness

The essential nucleus of the right of free initiative must not, therefore, be sacrificed by limitations prior to or during the activity, irrespective of the public interest invoked, however important it may be. Not that the law leaves these public interests to their own devices, but this way is not appropriate to realize them, since the legal framework contains instruments for the purpose, such as development through official banks and other development programs, including those devised by the ANP, as mentioned.

X. Fact of the administration

The doctrine defines fact of the administration as follows: "The Administrative Risk of the Fact of the Administration is the action or omission of the contracting Administration which concretely and directly [it is not general] affects the concession".[70]

In the context, Bartolome A. Fiorini[71] defines fact of the administration as the "prejudicial actions that arise from the state power, especially from the public administration, which make fulfilling the contract more onerous".

The author explains that the fact of the administration produces legal effects even if there is no prior intention for this to occur. In other words, it is a practical factor that produces legal effects with the necessary presence of the intentional will to produce a legal effect. He gives as examples of legal facts negligence and carelessness without subjective intention.[72]

In the case of oil concessions and, specifically, the local content clause, the fact of the administration to be borne in mind would consist in the excessively

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reduced by subsequent legislation: "Its efficacy and applicability are limited by the balance required by the State" (SILVA, José Afonso da. *Aplicabilidade das normas constitucionais*. 3rd ed. São Paulo: Malheiros, 1998. pg. 115). It is logical that the constitutional permission granted to the legislator to limit the efficacy of constitutional safeguards does not allow their full practical effectiveness to be taken away, but can only align them with other constitutional values. Otherwise we would have an improbable delegation of constitution-making power to the legislator, who could in fact abrogate and cancel constitutional rights without following the procedures defined for constitutional reform, and this, *ipso facto,* would make our Constitution a flexible one. If a right is assured by the constitution, the legislator (and more strictly the public administration) may regulate it, but not extinguish it.

70 ARAGÃO, Alexandre Santos de. *O direito dos serviços públicos*. 2nd ed. Rio de Janeiro: Forense, 2008. XII.14.

71 FIORINI, Bartolome A. *Manual de derecho administrativo:* primeira parte. Buenos Aires: La Ley, 1968. pg. 459.

72 Ibid., pg. 273-274.

optimistic estimate of the ANP of the ratios according to which the national oil industry support sector can supply the contractors.[73]

From the principle of presumption of legitimacy of administrative acts and their interpretation under the law and the Constitution, we cannot suppose that this is wrong, and must always seek to adopt a plausible hermeneutic posture that can provide a content free from errors.

The proposal of the bidders in this criterion of judgment (more Local Content) is not that they will meet the local content ratio exactly, but that, to the extent that the domestic oil industry support sector can provide, they will meet the ratios to the greatest extent possible until they attain the ratio indicated in their proposal.

Nevertheless, only to try to explore every aspect of the question, let us imagine, for argument's sake, that this is not the case, and that the ratios indicated in the proposal, within the parameters defined in the invitation to bid, are immediately the contractor's responsibility, irrespective of the reality of the national oil industry support sector.

Now, if this was the case, in any case the agreement would have to be adjusted for the fact of administration to allow the contractor not to comply with these ratios without the imposition of a sanction, whether by the canons of administrative contracts or, if this type of contract is taken not to belong to oil concessions, by the general theory of contracts (articles 479 and 480, Civil Code).

In fact, according to the principles of good faith, legitimate confidence and the presumption of veracity of administrative action, the bidders would have to trust in the plausibility of the parameters established by the State as a floor and a ceiling of the local content, simply because it has, much more than any private company, access to all the data and information about the domestic economy that can serve as a basis to assess the capacity of the domestic oil industry support sector.

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[73] If a mistake occurs, it can possibly be explained by a failure in assessment, for instance in the article published in the ANP newsletter by its Bidding superintendent and a technical analyst from the same department which, when dividing groups of countries according to the capacity of their oil support industries, put Brazil with the United States, England and Norway (Daniel Cleverson Pedroso and José Guilherme de Souza Moreira, A evolução da participação da indústria nacional na E&P de petróleo e gás natural após a flexibilização do monopólio no Brasil, op. cit., pg. 3). Now, our industry may indeed be more developed than that of Bolivia or Nigeria, but it is very far behind those other countries in terms of capital mobilization and technology; and whereas most of the world's major oil support companies are based there, Brazil so far has none of them.

One could not presume that the State would be willing, by its own express decision, to accept unenforceable proposals, since it was precisely "with the aim of avoiding proposals incompatible with the supply capacity of domestic industry that the ANP introduced a further amendment in the Seventh Round, fixing a maximum percentage for Local Content".[74]

The individual could and should, therefore, be confident that, if it proposed the maximum local content percentage allowed by the State, the domestic economy would be able to provide it. Otherwise, the mistake would not be the bidder's, because it has submitted a proposal within the stipulations of the invitation to bid, but rather of the public power which determined and forecast this capacity of the national oil industry support sector wrongly.

If, for argument's sake, and differently from what I have argued previously, it is considered that the Local Content clause is immediately effective, irrespective of the existence of local suppliers, and once the contract has started it is found that these ratios are unrealistic, the contract must be adjusted.

One of the ways of adjusting it would be to reduce the ratio included by the administration in error, and this would only prejudice the public interest and the aims of the regulatory framework of the sector, since if, in the future, the national oil industry support sector developed more, its contracting would be subject to this limit, and this, once again, shows the error of the hypothesis which we are considering only for the sake of argument.

Fernando Vernalha Guimarães says that the right to economic and financial balance ensures that a relationship of economic equity is maintained from the start of an agreement, and that, in addition, "it becomes part of the realization, viability and continuity of the public interest pursued; otherwise, contractual efficacy is threatened".[75]

Although economic and financial adjustment is normally seen as arising from facts subsequent to the signing of the contract, since this is the rule, Carlos Ari Sundfeld explains that

> there is nothing, during the period between the submission of the proposal and the actual signing of the agreement — before its execution,

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[74] ROSADO, Marilda, in the preface to the work by Luiz Cezar P. Quintans, *Conteúdo Local,* op. cit.

[75] GUIMARÃES, Fernando Vernalha. *Alteração unilateral do contrato administrativo.* São Paulo: Malheiros, 2003. pg. 261.

> therefore — to prevent events occurring that make it necessary to adapt the original terms of the invitation to bid or even of the winning bid. [...] The rule of strict and absolute conformity of the contract with the terms of the invitation to bid and the winning bid is not the best solution.[76]

What this shows is that the possibility of economic "rebalancing" of the proposal itself, in the event that, even before a contract is signed, factors arise over which the bidder has no control and which make the proposal economically unviable, or which affect the expectations of remuneration documented in the proposal which, as we have seen, has to be based on the data and parameters included by the public administration in the invitation to bid.

Along these lines, Toshio Mukai[77] asserts that

> we can also talk about economic and financial rebalancing (adjustment or revision) of the proposal itself; not just after a contract has been exercised. If a balance has to be maintained between the costs and the remuneration of the proposal, and in a particular case the costs are increased before the contract is signed [...], I believe that, without a shadow of a doubt, it is possible to rebalance the "costs-remuneration" equation of the proposal itself, and therefore the contract should be executed on the basis of this adjusted proposal.

So, if this line was taken, we should classify the occurrence in question (the inclusion in the invitation to bid of local content ratios beyond the actual capacity of local industry) as a fact of the administration originating the bidding, i.e. an act or omission of the contracting public administration that concretely and directly affects the administrative contract, causing imbalance in the equation and thus creating a right for the private contractor to amend it.

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[76] SUNDFELD, Carlos Ari. A vinculação ao edital da licitação e o problema da alteração das condições contratuais (parecer). *Interesse Público, No.* 23, pg. 79-80, 2004.

[77] MUKAI, Toshio. Do reequilíbrio econômico-financeiro da proposta. *Interesse Público,* No. 36, pg. 145-146, 2006.

XI. Conclusion

We can conclude, in view of the above, that the contractor is bound to the proposal for local content to the extent that there are domestic suppliers to meet it. This is an obligation *ab ovo* conditional on the realization of the presupposition that domestic suppliers exist. The contractor remains fully bound by the percentage of Local Content defined, but the existence of the obligation is conditional on the concrete verification of its factual support. If the factual support exists, the obligation becomes fully effective, having till then existed only *infieri.*

The fulfillment of the Local Content percentages included in E&P contracts consists of an obligation to prefer domestic industry and services, rather than an obligation to meet them at any cost; and of an obligation to provide potential stakeholders in Brazil with the *means* to access the information necessary to execute an agreement. Nor could the Local Content requirement be absolutely and immediately effective, since the factual basis on which it rests (the domestic oil support market) would be wholly alien to the contractors' wishes. This means that an obligation to meet local content percentages is binding within the factual limit of possible action by the contractor (the existence of local suppliers).

So, the obligation to keep to an overall ratio of local content only applies when the obligation comes into existence — the adaptation of the obligation logically assumes that the obligation itself has arisen.

The clauses dealing with maintaining an overall ratio of local content and the requirement for prior authorization from the ANP will not be obligatory if there is any reasonable justification, since they exist precisely because of the supposition that there is a local supplier. If there is no local supplier, the local content requirement will not arise and there is no question of applying these clauses, even for the purpose of prior ANP authorization.

The proposal of the bidders in this criterion of judgment (more Local Content) is not that they will meet the local content ratio exactly, but that, to the extent that the domestic oil industry support sector can provide, they will meet the ratios to the greatest extent possible until they attain the ratio indicated in their proposal.

If the national oil industry support sector develops, but does not reach the ratios indicated in the contract, we shall be facing a partial impossibility, and then the contractor, acting in good faith, must meet the obligation partially. If

the Local Content requirement is partially impossible, this does not mean that it is null and void, but that it is partially ineffective, with plans being totally different from the outcome.

The E&P contract, however, to meet any dispute about contractual equity, usually contains a clause to the effect that, even if domestic suppliers exist, and therefore the rule and the obligation also exist, it may be adjusted if the local suppliers offer terms that are comparatively disadvantageous in terms of price, delivery date or technology or for another justifiable reason. In these cases, the local content clause will be effective, but compliance cannot be demanded, as provided for in E&P contracts: the items on the list for which local suppliers are not competitive must be excluded, and the list redrawn.

In consequence, there is no possibility of the contractor failing to comply with an obligation which has not arisen and, logically, it cannot be punished for such failure. These would involve unconstitutionality, because the duty to foster local industry lies with the State, not the contractor. It is a basic principle of economics that each risk should be allocated to the party managing it or that can best act to prevent it.

This is why the public administration could not use an agreement with a specific purpose, and drafted in accordance with both the Petroleum Law and article 177 of the Constitution of the Federative Republic of Brazil, to oblige the contractor, for example, to develop sectors of domestic industry. A different posture would violate the elements of necessity and adherence to the principle of proportionality, by imposing an obligation and sanctions which would do nothing to develop the national oil industry support sector, since the individual has no instruments for the purpose, and because there are less onerous ways of achieving the objective, such as official development programs.

Ad argumentadum, the individual should, therefore, be confident that, if it proposed the maximum local content percentage allowed by the State, the domestic economy would be able to provide it. If this is impossible, the administration's error in assessing local logistics cannot be attributed to the individual bidder that submitted a proposal in accordance with the invitation to bid, but is the fault of government that determined and forecast this capacity of the domestic oil industry support sector, and this should result in an adjustment to the proposal.

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