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The Equator Principles are having a significant impact on the way environmental and social issues are being addressed in project financing globally

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The Equator Principles – guidelines for responsible project financing

In June 2003, a group of major financial institutions adopted a set of voluntary guidelines known as the 'Equator Principles' with the intention of creating an industry standard for assessing and managing environmental and social issues in the project finance sector. Partner Phillip Cornwell and Lawyer Nicholas Adkins look at the principles and their impact.

Acknowledging a responsibility

The Equator Principles are based on the policies and guidelines of the International Finance Corporation (*IFC*), the private-sector development arm of the World Bank. Their genesis was partially an acknowledgment by financiers of their responsibility to promote responsible social and environmental practices, particularly in emerging markets. It was also a recognition that responsible development makes commercial sense – environmental and social controversies have the potential to affect the profitability of projects, increase political risk and tarnish the reputations of those who promote and finance them.

While environmental groups are calling for greater transparency and accountability as to how banks adopting the principles (*Equator Banks*) are implementing their commitment to the Equator Principles, the move is widely regarded as a positive step towards the goal of responsible and sustainable development. Having now been adopted by lenders who provide the bulk of project finance around the globe, the Equator Principles are close to becoming an industry standard so it is important that borrowers and lenders understand their potential impact on project financing transactions.

What are the Equator Principles?

The Equator Principles are essentially a set of categorisation, assessment and management standards designed to identify and address any potential environmental and social risks that a proposed project may present. Equator Banks have undertaken not to finance any project with a total capital cost of US\$50 million or more, unless the project can comply with those standards or there is a satisfactory reason to deviate.

Screening and categorisation

Proposed projects will be classified into one of the three following categories, depending on the type, location, sensitivity and scale of the project and the nature and magnitude of its potential environmental and social impacts.

- Category A projects are those that are likely to have significant, adverse environmental impacts that are 'sensitive, diverse, or unprecedented'. A potential impact is considered 'sensitive' if it may be irreversible (for example, if it leads to the loss of a major natural habitat) or may affect vulnerable groups or ethnic minorities, involve involuntary displacement or resettlement, or affect significant cultural heritage sites.
- Category B projects are those whose potential adverse environmental impacts on human populations or environmentally important areas are less adverse than those of Category A projects. These impacts are site-specific, few if any of them are irreversible and, in most cases, mitigatory measures can be designed more readily than for Category A projects.
- Category C projects are those that are likely to have minimal or no adverse environmental impacts.

Environmental and social assessment of projects

For all proposed Category A and B projects, the borrower must complete an Environmental Impact Assessment (*EIA*) that satisfactorily addresses key environmental and social issues identified during the categorisation process. Beyond preliminary screening, no further environmental assessment will be required for proposed Category C projects.

In addition to an overall assessment of the environmental and social conditions, the Equator Principles set out a wide range of concerns that the EIA must address in the context of the business of the project, including:

- compliance with applicable host country laws and international treaties;
- impacts on the environment and indigenous communities; and
- consideration of feasible environmental and socially preferable alternatives.

The EIA must also address the project's overall compliance with (or justified deviation from) the minimum standards applicable under the World Bank and IFC pollution prevention and abatement guidelines and, for projects located in low- and middle-income countries, applicable IFC safeguard policies.

Environmental Management Plan

For all Category A projects, and appropriate Category B projects, the borrower must commission an Environmental Management Plan (*EMP*) which draws on the conclusions of the EIA and addresses mitigation, action plans, monitoring, management of risk and schedules.

For lenders, the EMP is likely to form the basis for monitoring compliance throughout the life of the project.

Consultation

For all Category A projects, and appropriate Category B projects, the financier must be satisfied that the borrower, or a third-party expert, has consulted with affected groups, including indigenous peoples and local non-governmental organisations. The EIA, or a summary, must be made available to the public for a reasonable minimum period in local language. The EIA and EMP must take account of those consultations, and for Category A projects, will be subject to independent expert review.

Incorporating the Equator Principles into project finance transactions

The Equator Principles are expected to have the greatest impact on projects in the developing world, where the minimum standards they impose will often be more rigorous than local laws.

In Australia and many other developed countries, local laws already dictate a fairly rigorous environmental impact assessment regime, which a proposed project must satisfy to obtain relevant approvals. While compliance with such a regime is likely to be sufficient to meet the minimum environmental standards stipulated by the Equator Principles, local laws do not always give extensive consideration to social issues, nor do they necessarily mandate the adoption of an



EMP or a decommissioning plan, so the issue cannot be taken for granted.

Project evaluation and terms sheet

The Equator Banks have committed to ensure that all qualifying projects are subject to a preliminary screening process against their internal Equator Principle guidelines. Where this process indicates that an EIA will be necessary, the borrower will be encouraged to commence this process as soon as possible, so that any potential impacts can be assessed and mitigated (if possible) without causing significant delay to the project. The financing terms sheet should indicate that the financing is conditional on the assessment outcome.

Where a lender is relying on due diligence conducted by the sponsor, it will be important to examine its adequacy (including as to scope, methodology and findings) carefully to ensure that all relevant environmental and social issues have been considered and that sufficient time and resources have been dedicated to the due diligence process. It may be appropriate for the bank (or syndicate) to appoint its own independent expert to assist in that evaluation.

Loan documentation and compliance

It is not appropriate for Equator Banks to oblige borrowers to comply with the Equator Principles, because they are a set of guidelines that apply to the banks themselves. Instead, banks will need to review their loan documents to incorporate the assessment, monitoring and enforcement obligations for Equator Principles compliance.

Loan documents should now include conditions precedent concerning provision of an EIA and EMP in satisfactory form, together with any environmental experts' reports and, if applicable, a decommissioning plan.

The borrower should make specific representations as to the disclosure of available environmental and social information and reports, as well as compliance with relevant local laws and policies and guidelines incorporated into the Equator Principles (such as those of the IFC and the World Bank). Those representations would be repeated as conditions precedent to each drawdown.

In addition to the usual general undertakings to comply with all environmental laws, the borrower should specifically undertake to:

- comply with the EMP in the construction and operation of the project, and update it in response to changes in circumstances;
- provide regular reports on compliance with the EMP; and
- where applicable, decommission the facilities in accordance with an agreed decommissioning plan.

Ideally the borrower would covenant to comply with the IFC safeguard policies in force from time to time. However that may be controversial and is more likely to be finessed by incorporating that requirement within the EMP itself. Breaches of these warranties and undertakings would give rise to default after the lapse of an appropriate grace period.

Syndications and refinancings

While the Equator Principles do not expressly address loan syndications, arranging banks should carefully consider the demand for non-compliant, syndication market loans. Given that the bulk of project finance lending is provided by banks that have adopted the principles, successful syndication of a project finance deal is likely to mean that there is an expectation of compliance.

Similar considerations apply to the refinancing of an existing project, although perhaps greater flexibility will be extended to the refinancing of projects that were funded before the introduction of the Equator Principles. Nonetheless, it would seem reasonable that the project be required to adopt and comply with an EMP and related obligations, in keeping with the spirit of the Equator Principles.

Adoption, status and implementation of the Equator Principles

Banks that adopt the Equator Principles are able to implement the principles as they see fit, and the principles themselves allow for considerable discretion. The principles only have the status of internal policies of the banks and the IFC does not play any direct role in supervising or reviewing compliance. Unlike, say, the Banking Code of Conduct, there is no undertaking given to the world at large; indeed, there is an express disclaimer of any liability.

The first step in implementing the principles will be for the adopting bank to evaluate what activities and staff are affected and what policies, systems and procedures should be put in place to enable it to incorporate the Equator Principles into its operations



most effectively. Internal audit procedures should also be modified to monitor compliance with these new policies.

Westpac, for example, has enhanced its internal procedures to assist with project categorisation and to ensure that its credit assessment process complies with the Equator Principles. Staff have also been trained on environmental risk management and specific compliance with the Equator Principles. Michael Cleary, Head of Westpac Project and Structured Debt (the team given overall responsibility for implementation and monitoring of the principles at Westpac) noted that 'using a common framework and approach which transparently sets out the social and environmental considerations within all Project Finance, has helped to standardise and simplify the consideration of often complex issues.'

The IFC, whose policies are incorporated in the Equator Principles, has taken a leading role in the training and development of staff at Equator Banks.

Scrutiny of the Equator Principles by environmental groups

In the relatively short period of time since they were first adopted, the Equator Principles have been subjected to intense scrutiny and assessment, particularly from BankTrack (an international network of major, environmental non-government organisations including World Wide Fund for Nature and Friends of the Earth), which has released a report on each anniversary of the adoption of the principles.

While it has been generally supportive, BankTrack has called for greater transparency and accountability in the implementation of, and compliance with, the

principles. It has also expressed concern that the Equator Banks might be mobilised as a lobby group against the tightening in World Bank environmental and social standards (some of which the Equator Principles incorporate), a concern that is particularly acute in light of the review of the IFC safeguard policies that is currently underway.

Conclusion

The Equator Principles present financial institutions across the globe with a landmark opportunity to adopt a meaningful industry standard for the evaluation and management of environmental and social risks within project developments.

Worthwhile as this is, many will judge the Equator Principles by whether they actually improve the environmental and social outcomes for project-affected communities. It is still too early to tell whether this will be achieved, but anecdotal evidence is positive. Lenders have reported an overall increase in the importance given to environmental and social considerations and, perhaps most significantly, that projects are being heavily modified or rejected where they are unable to comply with the new standards.

Not surprisingly, environmental groups have laid out the way ahead for the Equator Principles. While still calling for greater consistency and accountability in the way they are implemented, they are asking banks to apply the Equator Principles to corporate loans (some already do) and to use them as a springboard to develop similar standards in other areas of their operations.

The full text of the Equator Principles, a list of Equator Banks and other related resources can be found at the website: www.equator-principles.com.

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