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Equator Principles III Enters Into Force This June

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In the last 10 years, the Equator Principles or EPs have emerged as the industry standard for financial institutions to assess social and environmental risk in the project finance market. The EPs – which are based on the International Finance Corporation or IFC’s performance standards on social and environmental sustainability and the World Bank’s environmental, health and safety guidelines – have significantly increased attention on social/community responsibility, including as related to indigenous peoples, labour standards, and consultation with locally affected communities. They have also promoted convergence in the market: at present, 79 financial institutions in 32 countries have officially adopted the EPs, reportedly covering over 70% of international project finance debt in emerging markets.

This month saw the approval of the third version of the EPs, or EP III, completing a consultation process that was launched in July 2011. EP III will be effective from 4 June 2013 and financial institutions that are signatories to the EP, called EPFIs, will need to apply EP III to all new transactions by 1 January 2014.

Many of the EP III changes flow from a major revision of the IFC social/environmental performance standards that became effective 1 January 2012. They incorporate into the EPs some of the key IFC changes as outlined below. As a matter of form, the EP document has been supplemented by more expansive annexes and a glossary of key terms.

The EPs’ overall objective remains the same: for EPFIs not to finance projects in excess of specified values where the borrower does not comply with the EPs’ social and environmental standards. Moreover, the EPs continue to be expressed as broad principles, with details such as emission limit values or plant operational standards being left to either local laws or international standards such as those of the IFC. Nonetheless, the scope of

financings covered has been sufficiently expanded and enough new areas have been emphasised to mark this as a significant development within the EP framework, and one that lenders and sponsors will need to incorporate into the financing process.

The EP III changes will not apply retroactively. However, they will apply to expansions or upgrades of existing projects where changes in scale or scope may create significant environmental and social risks and impacts, or significantly change the nature or degree of an existing impact.

The Basic EP Process Remains the Same

EP III does not change the basics of the EP process. As a first step, EPFIs are still required to conduct a preliminary assessment of the environmental and social risks associated with a covered project and to categorise the project under Category A (significant risks), B (limited risks) or C (minimal or no risks).

A series of required project-related action items, which are set out in nine additional EPs, flow if a project falls under Category A or B, namely:

- Conducting an environmental and social assessment, ranging from a full scale to limited assessment depending on the project.
- Compliance with host country social and environmental laws and permits and, in countries with less rigorous local regimes, the then-applicable IFC and World Bank standards.
- Development of an environmental and social management system, an environmental and social management plan or ESMP to address issues raised in the assessment and, if deemed necessary, an “action plan” to address identified gaps (previously the ESMP and action plan concepts were broadly absorbed in a single action plan concept).
- Consultation with and disclosure to communities affected by the project, now under a broader rubric of stakeholder engagement.
- Creation of a grievance mechanism as part of the environmental and social management system (for Category A and, as appropriate, Category B projects).
- Procuring an independent environmental and social consultant to conduct its own review of the relevant documentation, including the environmental and social management system, the ESMP(s) and/or action plan(s), and the stakeholder engagement process documentation (for Category A and, as appropriate, Category B projects).
- Including covenants in the financing documents to:
 - Comply with all relevant host country social and environmental laws, regulations and permits in all material respects.
 - Comply with the ESMP(s) and, as applicable, action plan(s).
 - Provide periodic reports in a format agreed with the EPFIs that (i) document compliance with the ESMP(s) and, as applicable, action plan(s) and (ii) provide representation of compliance with the relevant local, state and host country laws and permits.
 - Where applicable, decommission the project facilities in accordance with an agreed decommissioning plan.
- Procuring an independent environmental and social consultant or other experienced external expert to conduct ongoing monitoring and reporting of compliance with the EPs over the life of the loan (for Category A and, as appropriate, Category B projects).

In addition, each EPFI commits to report publicly at least annually about its EP implementation processes and experience, taking into account appropriate confidentiality considerations.

Significant Changes Made By EP III

Expanded Scope of Covered Projects

As before, EP III will continue to apply to project finance and project finance advisory services, in each case with total project capital costs of US \$10 million or more.

EP III extends the scope of the EPs additionally to cover the following financial products:

- Project-related corporate loans, including export finance in the form of buyer credit, where all of the following apply:
 - The majority of the loan relates to a single project over which the client has “effective operational control”, which includes both direct control as operator or major shareholder, and indirect control (e.g., where a subsidiary of the client operates the project).
 - The total aggregate loan amount is at least US \$100 million.
 - The EPFI’s individual commitment before syndication or sell down is at least US \$50 million.
 - The loan tenor is at least two years.
- Bridge loans with a tenor of less than two years that are intended to be re-financed by project finance or a project-related corporate loan that is anticipated to meet the relevant criteria above.

Financial arrangements that do not finance an underlying project, such as asset finance, acquisition finance, hedging, leasing, letters of credit, general corporate purposes loans, and general working capital expenditures loans, continue to be excluded from the scope of the EPs.

Application of IFC Performance Standards and World Bank Guidelines in “Non-Designated Countries”

EP III continues as before to draw a distinction between host countries deemed to have robust environmental and social governance, legislation systems and institutional capacity, where the project’s compliance with relevant host country laws and permits would suffice, and other countries, where the project’s environmental and social assessment would be required to evaluate compliance additionally with the then-applicable IFC social/environmental performance standards and World Bank environmental, health and safety guidelines. EP III has changed the terminology, however, replacing the concept of “High-Income OECD” status with host countries that are contained on a list of “Designated Countries”.

One point to note is that, in the case of Designated Countries, EP III deems compliance with host country laws to satisfy the requirements of only a portion of the EPs, namely: environmental and social assessments (EP 2), environmental and social management systems and plans (EP 4), stakeholder engagement (EP 5) and grievance mechanisms (EP 6). The other EPs still need to be satisfied – something of which lenders and sponsors of projects in more developed countries are not always mindful. So, for example, Category A projects will still require initial independent consultant review (EP 7) and ongoing independent monitoring during the term of the loan (EP 9). Further, the specific EP covenants would need to appear in the financing documents of such projects (EP 8).

In addition, EP III now states that these applicable standards represent the minimum to be adopted by EPFIs and EPFIs, in their sole discretion, may apply additional requirements. Thus, for example, EPFIs may elect to apply IFC performance standards even to a Designated Country project. Lenders and borrowers will need to monitor whether compliance with heightened, international standards will emerge as the requirement in any particular market where they would not otherwise be anticipated.

Enhanced Public Disclosure by Both Borrowers and EPFIs

All Category A and, as appropriate, Category B projects will require borrowers to disclose, at a minimum, a summary of the environmental and social impact assessment online (unless they do not have internet access). This website disclosure requirement is new relative to EP II but is scaled back from the August 2012 draft of EP III changes, which required full

website disclosure of the impact assessment as well as the ESMP. This disclosure is in addition to the existing requirement to make environmental and social assessment documentation readily (and usually locally) available to affected communities and stakeholders as part of the stakeholder engagement process.

In addition, for all Category A and B projects that, in each case, emit more than 100,000 tonnes of carbon dioxide equivalent annually, borrowers will be required to report publicly combined “Scope 1 and Scope 2” greenhouse gas emission levels on an annual basis during the operational phase of the project. Scope 1 emissions are direct greenhouse gas emissions from facilities within the physical project boundary, while “Scope 2” emissions are indirect emissions from the offsite production of energy used by the project. Borrowers are encouraged to report publicly emissions over 25,000 tonnes annually. This requirement can be satisfied by regulatory requirements or voluntary reporting mechanisms such as the Carbon Disclosure Project.

As for EPFIs, EP III now explicitly requires website posting of the annual report on the EP implementation process and experience. It also provides an annex with considerably more detail and organisation for the required components of the EPFI report. The components include details of the EP reviewers’ mandate, responsibilities and staffing and details of internal preparation and training for EP review.

Covenants

Whereas EP II only specified covenants in financing documents for Category A and B projects, EP III requires financing documentation for all projects, regardless of category, at least to contain a borrower covenant that it will comply with all relevant host country environmental and social laws, regulations and permits in all material respects.

Greenhouse Gas Alternatives Analysis

Under EP III, borrowers of projects that emit more than 100,000 tonnes of carbon dioxide equivalent annually, wherever the projects may be located, will be required to conduct an “alternatives analysis” to evaluate less greenhouse gas-intensive alternatives. This may coincide with any alternatives analysis required by a regulatory permitting process. An alternatives analysis is already required by the IFC performance standards.

The analysis requires evaluation of technically and financially feasible and cost-effective options to reduce emissions during the design, construction and operation of the project. For high carbon intensity industries such as thermal power, cement and lime manufacturing, integrated steel mills, base metal smelting and refining, and foundries, it should include comparisons to other viable technologies used in the same industry and in the same country or region.

The borrower must provide documentary evidence of technically and financially feasible and cost-effective options, presumably to the EPFI although this is not specified.

Specific Human Rights Due Diligence

For the first time, the EPs now state that in limited high risk circumstances, it may be appropriate for a borrower to complement its environmental and social assessment documentation with specific human rights due diligence. EP III refers to the UN “Protect, Respect and Remedy Framework for Business and Human Rights” and associated “Guiding Principles on Business and Human Rights” but does not prescribe a framework. The IFC itself already has performance standards on land acquisition and involuntary resettlement, indigenous peoples and cultural heritage. It will be incumbent on EPFIs and borrowers to explore what this will entail beyond the existing stakeholder engagement requirements and what standards they will use for this due diligence.

Heightened Stakeholder Engagement

Whereas EP II spoke of the need for effective project consultation with and disclosure to project affected communities, EP III expressly acknowledges that effective stakeholder engagement would additionally include, where relevant, stakeholders other than local communities within the project’s direct area of influence who may have an interest in the project, such as national and local authorities, neighbouring projects and NGOs.

Consistent with changes made to the 2012 IFC performance standards, EP III states that projects with adverse impacts on indigenous peoples will require their “Free, Prior and Informed Consent” or FPIC. This is a step up from the text of the pre-existing EP5, which required that consultation with affected communities be “free, prior and informed”. As defined by IFC, FPIC builds on and expands the process of informed consultation and participation. It is established through good faith negotiation between the borrower and the affected communities of indigenous peoples. The borrower must document: (i) the mutually accepted process between it and these communities, and (ii) evidence of agreement between the parties as the outcome of the negotiations. FPIC does not necessarily require unanimity and may be achieved even when individuals or groups within the community explicitly disagree.

The transition into EP III from June until the end of 2013 signals an appropriate time for lenders and project borrowers to revisit their internal EP compliance policies and procedures. This is especially true in the case of developers and financiers of projects in developing countries where the EPs would mandate application of the relatively new set of IFC performance standards as well.
