

# FOCUS

## PROJECT FINANCE



August 2006

## UPDATE ON THE EQUATOR PRINCIPLES – 2006 REVISION

In our *Focus: Project Finance* – August 2005, we looked at the ‘Equator Principles’ and their impact on the project finance sector. The Equator Principles have since been revised to broaden their application and strengthen the social and environmental standards they impose. Partner Steve Pemberton and Lawyer David Donnelly of our Singapore office look at the recent revisions.

An overview of the latest revision of the ‘Equator Principles’ and their impact on the project finance sector

### ADOPTION AND REVISION

In June 2003, a group of major financial institutions adopted the Equator Principles, a set of voluntary guidelines for the categorisation, assessment and management of social and environmental risks in the project finance sector. The impact of the original principles was discussed in *Focus: Project Finance* – August 2005. The principles were revised in July this year, a little over three years after they were first adopted.

The revised principles (the **2006 Principles**) are the product of three years’ collective learning. They reflect the collective experience of the financial institutions that have adopted the principles to date (the **Equator financial institutions**), and address many of the concerns raised by NGOs and environmental groups since the principles were first adopted. Thirty-nine institutions have now adopted the 2006 Principles.

### KEY CHANGES

The revised principles implement four key changes.

1. The 2006 Principles have broader application than the original principles. They apply to all new project financings with a total capital cost of US\$10 million or more. While this change represents a significant reduction from the former US\$50 million threshold, it is not surprising. Both commentators and financial institutions have recognised that a project’s capital cost, and its social and environmental impact, are not necessarily correlative. The change also follows the practise of some Equator financial institutions that had independently lowered or abandoned the US\$50 million threshold.



The 2006 Principles will apply to project financings covering expansions or upgrades of existing facilities where changes to the scale or scope of the facility may create significant environmental or social impacts, or significantly change the nature or degree of an existing impact. They will also extend to project finance advisory activities.

In short, the 2006 Principles will apply to a wider range of projects.

2. The baseline requirements imposed by the 2006 Principles will differ depending on where a project is located. The 2006 Principles draw a distinction between high-income OECD countries (as defined in the World Bank's development indicators database) and 'other countries'. As local law requirements in high-income OECD countries generally meet or exceed the International Finance Corporation's (*IFC*) performance standards, and environmental, health and safety (*EHS*) guidelines, the 2006 Principles do not seek to supplement local law requirements with these standards for projects located in high-income OECD countries. It is hoped that the change will streamline the application of the 2006 Principles, without compromising the social and environmental standards they seek to impose.
3. The 2006 Principles adopt stronger social and environmental standards. They place a greater emphasis on the social risks and impacts associated with a project. These changes are reflected in both the language (eg the shift to 'social and environmental assessment') and substance (eg the clear separation of social and environmental impacts in the revised project categories) of the 2006 Principles.

4. The 2006 Principles include a commitment to periodic reporting. This change seeks to address a common criticism of the original principles: a lack of transparency. However, the 2006 Principles also expressly recognise that confidentiality must be taken into account in reporting.

At a minimum, the Equator financial institutions commit to report annually on the number of transactions screened and the categorisation accorded to them, and on their experience in implementing the 2006 Principles. It is expected that reporting will exceed this benchmark.

To the extent that the Equator financial institutions are able to balance periodic reporting on the kinds of items described in BankTrack's working document, *Transparency and the Equator Principles*, with their confidentiality obligations, the 2006 Principles may avoid some of the criticism levelled at the original principles.

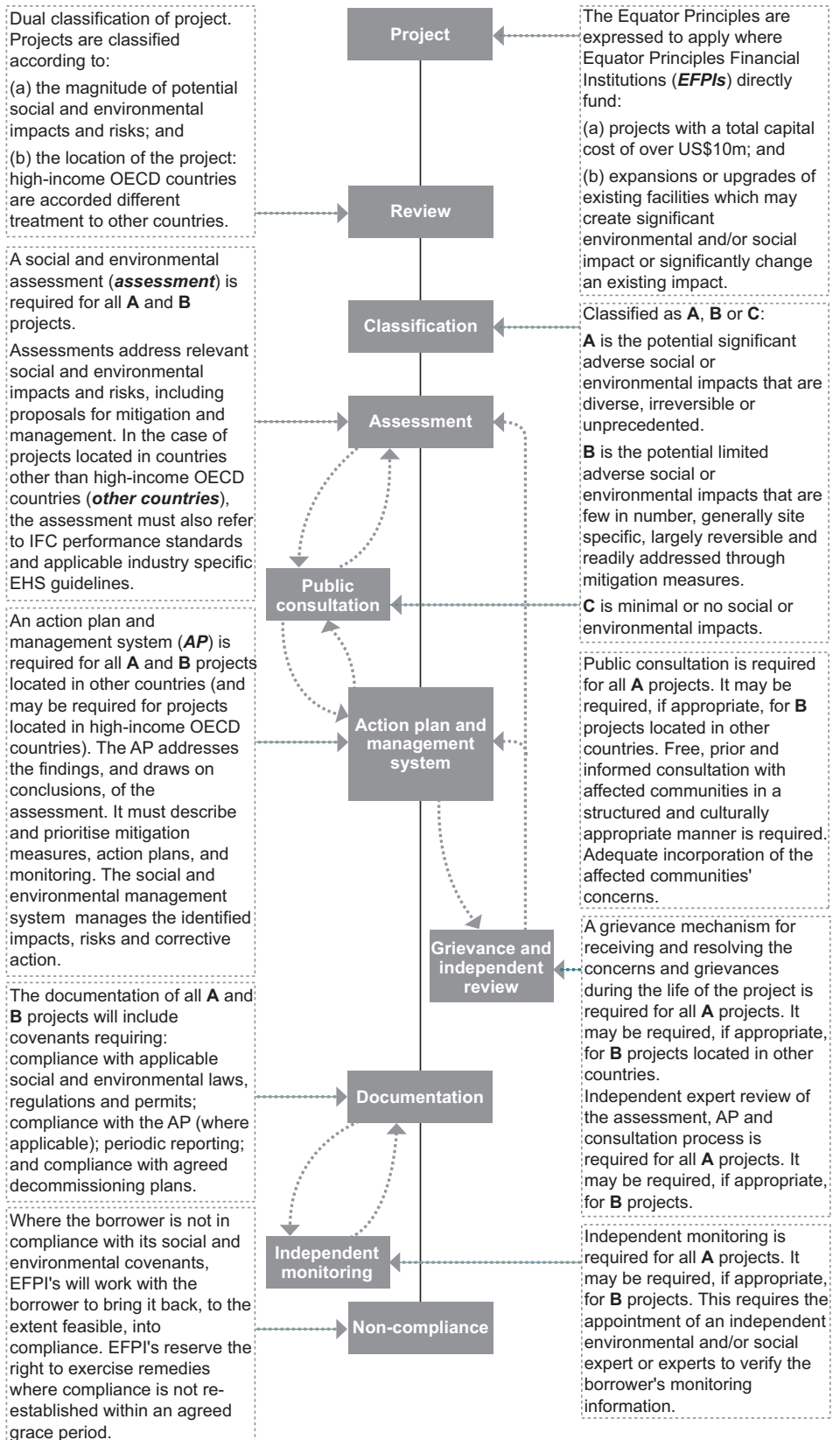
# STRUCTURE

The revised principles retain the same implementation structure as the original principles. An overview of the implementation steps is set out in the diagram below.

Broadly speaking, the implementation structure involves the following stages:

- screening and categorisation;
- social and environmental assessment;
- risk management planning; and
- monitoring.

Each of these stages has been revised to some extent.



## SCREENING AND CATEGORISATION

The 2006 Principles retain the three-tier ('A', 'B', 'C') categorisation system. However, the category descriptions have been amended to refer directly to social impacts. The categories are now described as follows.

- Category A – Projects with potential significant adverse social or environmental impacts that are diverse, irreversible or unprecedented.
- Category B – Projects with potential limited adverse social or environmental impacts that are few in number, generally site-specific, largely reversible, and readily addressed through mitigation measures.
- Category C – Projects with minimal or no social or environmental impacts.

As noted above, the revised category descriptions clearly separate social and environmental impacts. The new language calls for a direct assessment of whether a project gives rise to a potential adverse social impact as opposed to requiring an assessment of whether any potential environmental impacts may result in a social impact (eg displacement or resettlement). To the extent that Equator financial institutions are already asking the direct question, the change provides an affirming codification of the approach.

## SOCIAL AND ENVIRONMENTAL ASSESSMENT AND RISK MANAGEMENT

The 2006 Principles replace the 'environmental assessment' with a 'social and environmental assessment'. Again, the change in language emphasises the need to independently consider the social risks and impacts.

The 2006 Principles introduce three other important changes at this point.

1. They require mitigation and management measures to be addressed in the social and environmental assessment.
2. For all category 'A' projects and, as appropriate, category 'B' projects, they require an independent social or environmental expert to review the social and environmental assessment.
3. For all category 'A' projects and, as appropriate, category 'B' projects located in 'other countries', they require a grievance mechanism to be set up to allow project-affected communities to raise concerns and grievances throughout the construction and operation of the project.

The grievance mechanism represents a significant extension of the consultation and disclosure process, which is also retained in the 2006 Principles. In addition to increasing the potential for input from project-affected groups, the grievance procedure may also assist in the ongoing monitoring of the project.

The revised principles introduce equivalent changes at the risk management stage, where the 'environmental management plan' is renamed the 'action plan and management system'.

It is during the social and environmental assessment and the risk management stages that projects located in high-income OECD countries are afforded differential treatment.

## MONITORING

For all category 'A' projects and, as appropriate, category 'B' projects, the revised principles require Equator financial institutions, or borrowers, to retain independent environmental and/or social experts to verify for the benefit of the Equator financial institution, the monitoring information supplied by the borrower.

This requirement is stronger than the equivalent provision in the original principles, which only called for the appointment of independent experts where necessary for additional monitoring and reporting. In combination with the feedback loop established by the grievance mechanism, this requirement should help to ensure ongoing compliance during the life of the project.

## COSTS

The streamlined treatment accorded to projects located in high-income OECD countries is likely to reduce compliance costs. However, several changes introduced by the 2006 Principles, most obviously the compulsory involvement of experts during the social and environmental assessment, risk management and monitoring stages, and the new grievance mechanism, are likely to increase compliance costs.

These additional compliance costs are part of the overall cost of ensuring that the true economic cost of the project, including negative externalities, is borne by project sponsors. The additional costs are intended to result in better outcomes for project-affected groups and corresponding benefits for the reputations of Equator financial institutions and project sponsors.

The 2006 Principles place a greater emphasis on the social impacts of projects, and provide for increased mechanisms for consultation and dialogue with project-affected groups.

In summary, they are a stronger set of baseline requirements than the original principles.

While some have criticised the 2006 Principles for not going far enough, they are widely regarded as another positive step towards responsible and sustainable development. However, as with the original principles, the success of the 2006 Principles will be measured by the social and environmental benefits they secure for project-affected communities. It is hoped the information the Equator financial institutions provide as part of their new commitment to periodic reporting will make these benefits, and the success of the Equator Principles easier to gauge.

## CONCLUSION

The 2006 Principles have a wider application than the original principles. The social and environmental standards they impose have been strengthened, while their application to projects in countries with existing high standards for social and environmental issues has been streamlined.



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