SULLIVAN & CROMWELL LLP
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MEMORANDUM

Re: Equator Principles – New Environmental and Social Guidelines for Project Finance Transactions

SUMMARY

On June 4, 2003, ten banks active in the project finance market announced their adoption of the "Equator Principles," a set of voluntary guidelines developed for managing social and environmental issues related to projects, particularly in emerging markets. The Equator Principles are based on and expressly incorporate a number of the policies and guidelines of the International Finance Corporation (IFC), the private sector lending arm of the World Bank Group. By adopting the principles, a bank undertakes to develop individual internal practices and policies consistent with the framework established by the Equator Principles. These individual practices and policies would be expected to permit the bank to provide direct loans only to projects whose sponsors demonstrate an ability and willingness to comply with a process, and meet substantive standards, similar to those that apply in the case of loans from IFC.[1]

The adopting banks and IFC intend for the guidelines to become an industry standard in the bank project finance market. Banks adopting the Equator Principles will either require projects to meet these standards or to justify deviations from the standards.

1 We believe the emphasis on "direct" lending is intended to make clear that the principles do not apply to general purpose corporate loans to project sponsors.

Deviations must be justified by the sponsor to the satisfaction of the lending bank. The IFC has no direct role in appraising projects or approving deviations from the principles.

The initial group of banks that have adopted the Equator Principles include ABN AMRO Bank, N.V., Barclays Bank plc, Citigroup, Inc., Crédit Lyonnais, Credit Suisse Group, HVB Group, Rabobank, The Royal Bank of Scotland, WestLB AG, and Westpac Banking Corporation.

The practical effect of the principles will depend on the individual internal practices and policies adopted by each bank. We would expect these policies to give the banks considerable discretion, as is the case today, to accept appropriate deviations from the IFC practices and guidelines, and to craft credit agreement provisions appropriately tailored to each project.

The Equator Principles represent an incremental step toward the adoption of the IFC's environmental and social policies and procedures as a market standard for emerging market project finance, even where financing is expected to come primarily from private sources of capital. Sponsors should continue to plan larger projects, especially in low- and middle-income countries, with a view towards these policies and procedures.

THE EQUATOR PRINCIPLES

The Equator Principles apply to projects with a total capital cost of at least $50 million and establish criteria that a project should satisfy as a condition to obtaining financing. The criteria include various environmental and social screening procedures that will need to be followed by a project borrower in order to obtain loans, as well as ongoing covenants. These are summarized below:

- **Categorization of each project depending on likely environmental and social impact.** Each bank, in adopting the principles, agrees to screen any proposed project and classify it into one of three categories to determine the extent and type of Environmental Assessment (EA) necessary. These categories are based on the existing categories used by the IFC. Category A projects are likely to have "significant adverse environmental impacts that are sensitive, diverse or unprecedented" and may affect an area broader than the actual project site. The impact of a project would be considered "sensitive" if the impact were irreversible, affected vulnerable groups, ethnic minorities or significant cultural heritage sites or involved involuntary displacement or resettlement. Category B projects, in contrast, are site-specific in their potentially adverse environmental impact. The impact of Category B projects is not considered irreversible and mitigation measures are more readily available than for Category A projects. Category C projects are likely to have minimal or no adverse environmental impact. Beyond the initial screening, no EA is required for Category C projects.

- **An Environmental Assessment report requirement for all Category A and Category B projects.** For all Category A and Category B projects, the borrower must complete an EA report. The scope of the report should cover the likely environmental impacts that were used by the bank to classify the project as Category A or B. The report should address, to the bank's satisfaction, the key environmental and social issues that were identified during the categorization process along with compliance with applicable host country law, regulations and permits. The EA report should also refer to the minimum standards applicable under the World Bank and IFC Pollution Prevention and Abatement Guidelines and, for projects in low- and middle-income countries (as defined by the World Bank Development Indicators Database), the EA report should consider applicable IFC Safeguard Policies.[2]
- **Environmental Management Plan Requirements.** For all Category A projects and, as determined to be appropriate by the lending banks for Category B projects, the borrower must prepare an Environmental Management Plan (EMP). The EMP is based on the conclusions set out in the EA report and should address mitigation, action plans, monitoring, risk management and schedules.
- **Required consultation.** For all Category A projects and, as determined to be appropriate by the lending banks for Category B projects, the borrower should consult to the bank's satisfaction in a "structured and culturally appropriate way with project affected groups, including indigenous peoples and local NGOs", following which the EA report and EMP must be updated to reflect the comments received. In addition to consultation, the borrower will be required to disclose publicly the EA report, in the local language, for a "reasonable minimum period".[3] For Category A projects, the EA report and EMP will also be subject to independent expert review.
- **Ongoing covenants and monitoring.** The financing documentation must include a covenant from the borrower to "(a) comply with the EMP in the construction

[2] IFC Safeguard Policies include policies covering environmental assessment, natural habitats, pest management, forestry, safety of dams, indigenous peoples, involuntary resettlement, cultural property, child and forced labor and international waterways.

[3] The IFC's Good Practice Manual on Effective Public Consultation and Disclosure may provide general guidance on the scope of the public consultation and disclosure requirements. The Good Practice Manual is available at http://www.ifc.org/enviro/Publications/Practice/practice.htm.

and operation of the project, (b) provide regular reports, prepared by in-house staff or third-party experts, on compliance with the EMP, and (c) where applicable, decommission the facilities in accordance with an agreed Decommissioning Plan". The bank may also appoint an independent environmental expert to provide additional monitoring and reporting services. If the borrower fails to comply with these covenants, the principles require the bank to engage the borrower in its efforts to remedy such non-compliance.

POTENTIAL ISSUES FOR PROJECT SPONSORS

The adoption of the Equator Principles reflects the increasing scrutiny that project sponsors and lenders face in dealing with environmental and social issues surrounding projects in emerging markets and can be seen as a direct response by the adopting banks to criticism from NGOs and others relating to their past lending practices. In many cases, the principles will simply formalize criteria for addressing the environmental and social impact of projects with which banks and sponsors have been complying for some time. The principles also address concerns that the IFC has raised about banks asking project borrowers, in loan documentation, to agree to comply with World Bank guidelines without being clear as to how these guidelines would be applied.

In deciding whether to seek financing from the project finance market to fund projects in emerging markets, project sponsors should consider the following:

- When preparing the technical and economic feasibility studies for a project, project sponsors will need to give greater consideration early in the process to the likely environmental and social impact assessment requirements of potential sources of financing. The EA process and preparation of the EA reports often take place as part of the project design process, well before the financing market is approached, and will need to anticipate eventual lender requirements. Project planning and operations should take into account the social requirements included in the relevant IFC policies, in particular those relating to land acquisition and resettlement. Otherwise, sponsors risk delays and additional costs associated with revising the EA and EA report to satisfy lender requirements at the later stages of the financing process. Sponsors may wish to consider appointing an independent environmental expert to review the EA and EA report before the lenders are engaged, on the basis that the expert will act on behalf of the eventual lending group when it is mandated. If possible, this expert should be "pre-approved" by potential members of the lending group.
- Project sponsors should review carefully all of the environmental and social requirements of potential financing sources. Where in the past export credit and

multilateral agencies relied upon references to World Bank requirements, a number of these agencies are now developing independent standards and guidelines. For example, the Export-Import Bank of the United States has developed its own set of environmental guidelines in determining whether to participate in a project, and other export credit agencies have adopted more stringent environmental and social policies indicating their intention to increase scrutiny of environmental and social matters arising from projects they fund. As a result, while the guidelines and criteria can be expected to be similar to the World Bank/IFC guidelines to which the Equator Principles refer, sponsors financing projects with the participation of multilateral agencies, export credit agencies and commercial banks may face three (or more) different sets of environmental and social management guidelines.

- Project sponsors in extractive industries, such as oil and gas and mining, should expect to face even greater scrutiny of the environmental issues related to their proposed projects. The World Bank Group has launched an Extractive Industries Review (EIR), under which an in-depth review of the role of the World Bank in oil and gas and mining projects is being undertaken and which will produce a set of recommendations that will guide the World Bank Group's future participation in these sectors. These recommendations are expected to be published in December 2003.

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If you have any questions regarding the Equator Principles or related matters, please feel free to contact any of our lawyers listed on the following page, or any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on project finance matters. Additional information is available on the Equator Principles website at http://www.equator-principles.com and copies of the Equator Principles are also available on the IFC's website at http://equatorprinciples.ifc.org. You may also obtain copies by contacting Melissa Caprio (212-558-3864; capriom@sullcrom.com) in our New York office.

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