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The impact of the Equator Principles on mining and metals finance in emerging markets

Christopher Langdon
White & Case LLP London



Christopher Langdon
Associate

Introduction

The Equator Principles are a set of guidelines, developed by financial institutions for managing environmental and social issues related to project financings, including in respect of mining and metals projects. They were first adopted in June 2003 by 10 leading banks in the project finance arena.

In little more than three years since then, the number of financial institutions committing to the principles has more than quadrupled and is estimated to account for more than 85 percent of global project finance capacity. Equator Principles financial institutions (EPFIs) have attempted to meet criticisms and perceived flaws of the Equator Principles by revision of the principles in July 2006.

But, what impact have the Equator Principles had on mining and metals project finance in emerging markets? This chapter will consider the genesis of the Equator Principles, from their initial implementation in 2003 and revision in 2006, exploring the purpose, scope and mechanics of the principles in their current form. It will reflect on how the principles have had an impact on mining and metals project finance, from the perspective of sponsors in approaching mining projects,

borrowers in terms of their environmental and social contractual obligations, financial institutions in modifying their project funding policies, and, perhaps most importantly, local stakeholders in terms of how Equator Principle-compliant projects affect their lives and environment.

The genesis of the Equator Principles

When the International Finance Corporation (IFC) convened a meeting of commercial banks in London in October 2002 to discuss environmental and social issues in project finance, they did not do so in a vacuum.

Environmental and social issues, along with principles of corporate ethical responsibility, had been gradually moving from a token periphery to become increasingly unavoidable, even in the most hard-nosed commercial circles.

As early as 1992, the United Nations Environmental Programme (UNEP) and a group of commercial banks launched the UNEP Banking Initiative, which in 1997 evolved into the UNEP Financial Institutions Initiative, and the issuance of commitment statements on the environment and sustainable development.

The impact of the Equator Principles on mining and metals finance in emerging markets

Financial institutions in a variety of sectors had been increasingly targeted and criticised by activist environmental non-governmental organisations (NGOs) for their financings of purportedly environmentally questionable projects. In the late 1990s, for example, the NGO Friends of the Earth, campaigned against ABN AMRO’s financing of Freeport-McMoRan Inc’s copper and gold mining operations in Indonesia.

Within the mining and metals industry, mining groups had for a number of years embraced principles of sustainable development and environmental best practices by developing several voluntary codes of conduct (for example, the International Cyanide Management Code, established by the International Cyanide Management Institute in 2002) and developing environmental and sustainable development policies. The International Council on Mining and Metals (ICMM), for example, formed in 2001 and made up of 14 of the largest mining and metal companies and 24 national mining and global commodities associations, required its members to “integrate sustainable development principles into company policies and practices.”

Other influential guidelines in the mining and metals sector included the 2001 Guidelines on Responsible Mining, by the Mineral Policy Center; the 2002 Guidelines on Sustainable Development and Mining, by the Mining, Minerals, and Sustainable Development project; and, a little later, the World Bank’s 2003 Extractive Industries Review, which contained recommendations for the bank’s future lending activities in this sector.

Initial framework

However, the importance of the 2002 IFC meeting was that it galvanised a core group of commercial banks — ABN AMRO, Barclays, Citibank and WestLB — to organise a series of meetings in 2003 to attempt to develop a concrete banking industry framework for addressing environmental and social risks in project financing. This resulted in 10 leading project finance institutions signing the Equator Principles in June of that year, and a further nine institutions signing shortly thereafter. Last December, ANZ became the 45th signatory (see Table 4.1).

Table 4.1: **EPFIs, December 2006**

ABN AMRO Bank	HSBC Group
ANZ	HypoVereinsbank
Banco Bradesco	ING Group
Banco do Brasil	JPMorgan Chase
Banco Itaú	KBC
Banca Intesa	Manulife
Bank of America	Mizuho Corporate
BMO Financial	Bank
BTMU	Millennium bcp
Barclays plc	Nedbank Group
BBVA	Rabobank Group
BES	Royal Bank of Canada
Calyon	Sanpaolo IMI
Caja Navarra	Scotiabank
CIBC	Standard Chartered
Citigroup	SMBC
Credit Suisse Group	Royal Bank of
Dexia Group	Scotland
Dresdner Bank	Unibanco
E+Co	Wachovia
EKF	Wells Fargo
FMO	WestLB AG
Fortis	Westpac
HBOS	

Source: www.equator-principles.com

The motivations of EPFIs in adopting the Equator Principles must have been multi-faceted. EPFIs, through the Equator Principles, ought to be able to better assess, mitigate, document and monitor the credit and reputational risk associated with financing development projects. While some EPFIs saw the Equator Principles as an expression of their continued commitment to responsible banking, others may have been coming to grips with these issues for the first time.

A recent survey of the Economist Intelligence Unit, The Evolving Role of the CRO (May 2005) reports that protecting a company’s reputation is both the most important and most challenging task facing management today. Undoubtedly, some EPFIs’ motives must have been related to mitigation of reputational risk, though it would be unfair to go so far as to suggest, as some NGOs maintain, that

The impact of the Equator Principles on mining and metals finance in emerging markets

the Equator Principles have merely been a form of 'greenwashing'. In fairness, the Equator Principles, especially as now revised, have probably exceeded most objective expectations in elevating the importance of environmental and social factors in the context of project financings.

The purpose of the Equator Principles

The Equator Principles were devised to promote environmental stewardship and responsible development in the context of project financings, including in respect of mining and metals projects. They constitute recognition that lenders are able to influence the environmental and social aspects of a project, and are intended to serve as a common framework and create an industry standard for the

implementation by each EPFI of its own internal social and environmental policies, procedures and standards related to its project financing activities.

The core commitment of the Equator Principles is that EPFIs will not provide loans to projects where the borrower will not, or is unable to, comply with each EPFI's environmental and social policies and processes.

The scope of the Equator Principles

With their revision in July 2006, the Equator Principles now apply to all new project financings with total project capital costs of US\$10m or more — across all industry sectors.

Case study: Kainantu gold project, Papua New Guinea

This project was subject to NGO and stakeholder criticism for its potential adverse social and environmental impacts, but fell below the 2003 Equator Principles' threshold of US\$50m. Highland Pacific Limited's estimated project costs were US\$40m, and ABN AMRO arranged limited recourse facilities of US\$31m. While the project, an underground facility, had a small footprint, disputes arose with landowner groups in connection with the relocation of local inhabitants. NGOs, including BankTrack, an international network of advocacy NGOs made up of organisations such as Friends of the Earth and the Rainforest Action Network, cite this project as failing to comply with the Equator Principles. However, given that Highland Pacific included certain environmental measures in its project plan and engaged with the local community, it is not clear whether this project, had it qualified for Equator Principles review, would have necessarily failed to satisfy the principles. Nevertheless, it is probably fairly cited as an example of a project that highlights the unsuitability of a US\$50m threshold for application of the Equator Principles and may have contributed to the lowering of this threshold to US\$10m in 2006. Today, ABN AMRO explicitly states in its own environmental policy that it no longer applies any threshold — even the new US\$10m threshold — in applying the Equator Principles.

The Equator Principles still only apply to project financings and not to corporate financings. While some have criticised this narrow application, since project finance is a type of finance where borrowers covenant with lenders in respect of specific elements of the financed activity, and therefore lenders can exert a strong influence over borrowers' conduct, extension of the principles beyond project finance may risk their dilution.

Nonetheless, EPFIs point to the fact that the Equator Principles, even after their revision in 2006, should

be viewed as a starting point, and that other forms of financing may ultimately be made subject to the same or similar principles. There is evidence of this occurring already with some EPFIs; ABN AMRO, for example, revised its Mining Policy in 2004 to cover all engagements (even beyond project financings).

The Equator Principles apply to all project financings covering expansion or upgrades of an existing facility, where changes in scale or scope may create significant environmental and/or social impacts, or significantly change the nature or degree of an

The impact of the Equator Principles on mining and metals finance in emerging markets

existing impact. However, the Equator Principles are not intended to be applied retrospectively.

In addition, the Equator Principles now also apply to project finance advisory activities. In this way, EPFIs commit to making their clients aware of the content, application and benefits of applying the Equator Principles to the anticipated project. This is significant, since it means that the Equator Principle standards become part of the project finance at a much earlier stage in the process of project planning.

How the Equator Principles work

Review and categorisation

An EPFI will categorise a project, based on the magnitude of the potential social or environmental impacts and risks of that project, in accordance with IFC classification criteria. These categories are:

- Category A — Projects with potential significant adverse social or environmental impacts that are diverse, irreversible or unprecedented;
- Category B — Projects with 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.

Mining projects, by their extractive nature, tend to fall into Categories A or B, being high or medium risk. Certain EPFIs as a matter of policy — Barclays, for example — treat every mining project as Category A.

Social and environmental assessment, applicable standards

For Category A and B projects, the borrower (or its consultants) must conduct a social and environmental assessment (the Assessment) to determine the social and environmental impacts and risks of the

project, and to propose relevant and appropriate mitigation and management measures in respect of the project.

For projects located in emerging markets (non-OECD countries and OECD countries not designated as 'high-income' by reference to the World Bank's development indicators database), the Assessment must refer to IFC Performance Standards and industry-specific Environment, Health and Safety (EHS) Guidelines. It is noteworthy that the IFC Performance Standards were revised in early 2006, and part of the impetus of the 2006 revision to the Equator Principles was to accommodate these new standards and place a greater emphasis on the social risks and impacts associated with a project.

EHS Guidelines that specifically relate to the mining and metals industry include:

- Aluminium manufacturing;
- Base metal and iron ore mining;
- Coal mining and production;
- Copper smelting;
- Iron and steel manufacturing;
- Lead and zinc smelting;
- Mini steel mills;
- Nickel smelting and refining.

The World Bank's Pollution Prevention and Abatement Handbook will also apply generally to many projects. Furthermore, the 'Mining and Milling — Underground', and 'Mining and Milling — Open pit' policies comprising part of the EHS Guidelines will be applicable to many mining projects.

The Assessment must establish, to an EPFI's satisfaction, the project's overall compliance with, or justified deviation from, the applicable standards and guidelines.

Action plan and management system

The borrower must prepare an action plan which addresses the relevant findings and draws on the conclusions of the Assessment in respect of all Category A and B projects located in emerging markets. The action plan must describe and prioritise the actions needed to implement mitigation measures, corrective actions and monitoring measures necessary to manage the impacts and risks identified in the Assessment. Furthermore, the borrower must maintain and establish a social and environmental management system that addresses the management of the action plan.

Consultation and disclosure

Likewise, for all Category A and B projects located in emerging markets, project-affected communities must be consulted in a structured and culturally appropriate manner to ensure their free, prior and informed consultation and facilitate their informed participation as a means to establish, to the satisfaction of the EPFI, whether a project has adequately incorporated the concerns of affected communities. To accomplish this, the Assessment documentation and action plan must be made available by the borrower to the public for a reasonable minimum period, in the relevant local language. The borrower must also take account of and document the process and the results of the consultation.

To ensure consultation continues throughout construction and operation of the project, the borrower must establish a grievance mechanism as part of its management system.

Borrower's covenants

For Category A and B projects, the borrower must covenant to:

- Comply with all relevant host country social and environmental laws, regulations and permits in all *material* respects;
- Comply with the action plan (where applicable) during the construction and operation of the project in all *material* respects;
- Provide periodic reports (the timing and format of which are to be agreed with the EPFI) — first, that document compliance with the action plan (where applicable), and second, that provide representation of compliance with relevant local, state and host country social and environmental laws etc;
- Decommission the facilities, where applicable, in accordance with an agreed decommissioning plan.

Case study: Borrower covenant of compliance with the Equator Principles

In a number of mining project finance transactions, confusion has been evident between EPFIs and borrowers, regarding negotiation of a covenant of the borrower to “comply with the Equator Principles”. Clearly, on a technical level, the Equator Principles are drafted as a set of conditions to an EPFI lending and not for a borrower to directly comply with. Nevertheless, a borrower must recognise that, as a condition precedent to funding, an EPFI must be satisfied that all requisite elements of the Equator Principles are met. Hence, while a broadly drafted covenant of this nature is not appropriate, a combination of covenants and conditions precedent should be carefully drafted in loan documentation to specify precisely what the borrower must do or deliver as a result of the Equator Principles which EPFIs have committed themselves to comply with.

The impact of the Equator Principles on mining and metals finance in emerging markets

The Equator Principles encourage EPFIs to work with borrowers to remedy any breaches of social or environmental covenants within agreed grace periods.

Independent review and monitoring

For all Category A and, as appropriate, B projects, an independent social or environmental expert not directly associated with the borrower must review the Assessment, the action plan and consultation process documentation in order to assist EPFIs' due diligence and assess Equator Principle compliance. To ensure ongoing monitoring and reporting over the life of the project loan, such expert must be appointed to verify monitoring information provided to EPFIs.

EPFI reporting

Finally, each EPFI commits to report publicly at least annually on its Equator Principles implementation process and experience.

This requirement, added to the 2006 Equator Principles, seeks to address a common criticism of the 2003 Equator Principles regarding lack of transparency and accountability of EPFIs in applying the principles. BankTrack, for example, in their 'Unproven Principles: The Equator Principles at Year Two' publication, criticised EPFIs for their failure to provide full disclosure of application of the Equator Principles to particular projects and whether such projects were approved as-is, with conditions, or declined, along with project details.

Admittedly, to date there has been uneven reporting by EPFIs regarding application of the Equator Principles. However, disclosure of project details must inevitably be subject to banking confidentiality requirements, and ultimately, as some EPFIs have noted, project sponsors are in a better position to provide more detailed disclosure regarding their projects than EPFIs are. Furthermore, it must also be kept in mind that, notwithstanding EPFIs' commitment to the Equator Principles, EPFIs cannot function as proxy environmental regulators. Nevertheless, EPFIs should recognise that transparency and accountability of application of the Equator Principles is a legitimate concern of NGOs and other stakeholders that should, to the extent EPFIs are able, be addressed by regular and meaningful reporting.

Impact of the Equator Principles on loan documentation

EPFIs need to ensure that loan documentation satisfies the requirements imposed by the Equator Principles. The following examples are not exhaustive, but may be considered as broadly representative of some of the key Equator Principles' requirements in mining project loan documentation. The Equator Principles acknowledge materiality thresholds in respect of some of the following provisions — and this will inevitably be subject to negotiation between the borrower and lenders.

The impact of the Equator Principles on mining and metals finance in emerging markets

Conditions precedent to funding should include:

- All required environmental consents have been obtained;
- There is no outstanding environmental liability;
- An appropriate environmental and social impact assessment has been carried out and the resulting report delivered to the lenders;
- An action plan has been agreed and a copy delivered to the lenders;
- A decommissioning plan has been agreed and a copy delivered to the lenders.

The borrower should represent and warrant to the lenders (with appropriate repetition of such representations and warranties to be negotiated):

- Compliance with applicable social and environmental laws and regulations;
- That all required environmental consents have been obtained and that all of the terms and conditions of such consents are being complied with;
- That the environmental impact assessment has been prepared, among other things, in accordance with best practice in the mining industry and discloses all material matters etc;
- That there is no outstanding environmental liability.

The borrower should covenant with the lenders:

- To remedy any environmental damage that occurs;
- To comply with the action plan in the construction and operation of the project, and to provide the lender with regular reports on compliance with the action plan;
- To comply with applicable social and environmental laws and regulations;
- To provide the lenders with regular compliance reports;
- To implement an environmental monitoring and management scheme;
- To inform the lenders of any events which may result in environmental liability;
- To provide the lenders with an environmental report in specified circumstances (for example, if the bank suspects that a significant environmental liability has arisen);
- To prepare and agree a closure or decommissioning plan when appropriate and to carry out decommissioning in accordance with that plan.

The borrower should expect events of default, leading to acceleration of, and enforcement under, its project loan facility, to include:

- Material breach of environmental laws;
- The occurrence of events which give rise to material environmental liability;
- Failure to comply with environmental covenants.

Have the Equator Principles made a difference?

Sponsors and borrowers in the mining and metals sector generally appear to welcome the Equator Principles, since they provide a higher degree of consistency in the application of environmental requirements by financial institutions and higher standards in mining projects.

With the Equator Principles now being applied in the advisory stage of projects, there is less concern that the Equator Principles will be applied to a project too late in the planning process and impose additional costs that were not anticipated early enough to accommodate in a financing plan.

Clearly, junior and mid-cap mining companies do not have access to unlimited financial resources and are more sensitive to additional costs applied to any project. As sponsors, these entities are perhaps the most concerned about the time, effort and financial cost required to comply with the Equator Principles. However, most major mining companies have been actively engaged in complying with similar requirements for a significant period of time and are well used to imposing their own

stringent environmental and social assessments. Many such companies are looking beyond social and environmental responsibilities, to broader goals of governance and structural change — for example, in the enhancing of revenue transparency in extractive industries, pursuant to the landmark Extractive Industries Transparency Initiative — and welcome the Equator Principles as a component of their overall risk management strategies to mitigate against political and operational risk in respect of their mining projects in emerging markets.

Future prospects

Many will judge the Equator Principles by whether they actually improve the environmental and social outcomes for project-related communities. But it is too early to determine this with any certainty. Anecdotal evidence suggests that lenders have seen an overall increase in the importance given to social and environmental considerations, and that projects are being modified or rejected when they are unable to comply with the Equator Principle standards. However, inevitably, NGOs and other observers will base their assessment of the impact of the Equator Principles on what project-affected communities have to say.

Case study: Rapu-Rapu mine, the Philippines

When it first opened in 2005, the Rapu-Rapu gold, silver, copper and zinc mine, operated by Lafayette Philippines Inc., was the Philippine's first foreign-run mine in nearly 40 years. However, within months the mine was ordered to close by authorities, after twice spilling cyanide into local waterways. In a jurisdiction with a history of pollution disasters caused by careless miners, these spills provoked a public outcry. While the project was later permitted by environmental authorities to reopen, on the basis of the contamination not having been material, BankTrack and other NGOs have nonetheless levelled substantial criticism of EPFI financing of this project.

While many NGOs concede that the Equator Principles are consistent with the vision elaborated in the 2003 Collevocchio Declaration, a set of social and environmental principles applicable to financial institutions endorsed by over 100 NGOs, they believe that the Equator Principles do not go far enough to protect local communities. For example, the mitigation emphasis underlying the principle of Assessment under the Equator Principles has

been criticised by various NGOs for failing to delineate no-go zones or categorical prohibitions of certain activities, and falls short of the categorical 'Do no harm' Principle enunciated in the Collevocchio Declaration.

However, despite these perceived failings of the Equator Principles, they appear to have had impact on EPFIs themselves. EPFIs have invested substantially

in recruitment and staff training and in raising general levels of awareness of the Equator Principles and their application. There is also evidence that a number of EPFIs — BBVA and Citigroup, for example — have taken credible steps to integrate environmental risk management and corporate social responsibility principles into their core businesses, beyond only project finance.

EPFIs will have to maintain their high road and remain uninfluenced by non-EPFIs marketing themselves as ‘flexible friends’ of project sponsors, and not be swayed by ‘race to the bottom’ fears prompted by less environmentally concerned hedge funds and emerging market financiers. Concerns have focused on Chinese lending and the gaps between China’s current practices and emerging international norms and standards in the mining sector, including application of the Equator Principles. However, this fear may be short-sighted, with recent indications of change in China including increased government funding for improving mine safety, new legislation calling for greater public participation in domestic environmental impact assessments, and an official White Paper on environmental protection. And, notably, many non-EPFIs have begun to include Equator Principle compliance in their syndicated loan documentation.

The impact of the Equator Principles will inevitably be measured not only by their capacity over time to bring into the fold more financial institutions, but also by their contribution to an evolving set of international norms to balance the world’s need for metal with responsible, socially and environmentally sustainable values. In spite of the criticisms, no doubt the Equator Principles are already making a difference.

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Christopher Langdon is a London based, English law-qualified senior associate with particular emphasis on project financing in the mining and natural resources sector. He has substantial experience advising lenders and sponsors on project finance transactions across the world. Chris’s practice is focussed principally on project finance and development, along with extensive experience in mergers, acquisitions, earn-ins, joint ventures, off takes and concessions, whilst acting for corporates, commercial banks, and international financial institutions. Chris has sectoral expertise in mining and metals, along with upstream oil and gas, in emerging markets in various jurisdictions around the world.

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