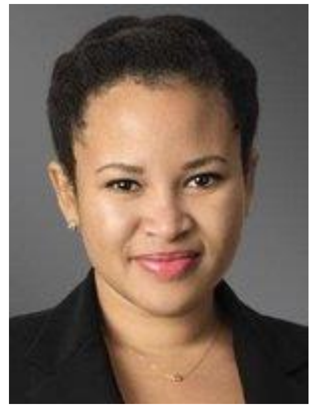
Equator Principles Update: What Energy Cos. Should Know

By **Jillian Kirn**



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Environmental, social and governance, or ESG, factors are the three central factors in measuring sustainability and societal impact of an investment in a company or business. An update of one of the main ESG frameworks, the Equator Principles, is scheduled to take effect on Oct. 1.

This latest iteration of the Equator Principles, known as EP4, includes significant changes from its predecessor, EPIII, with implications for financial institutions and their clients seeking to finance projects. The EPs have been broadly applied to large-scale infrastructure projects as well as to projects in energy industries.

Given the Oct. 1 effective date, companies in the energy industry should take a close look at EP4 and consider its implications, particularly for projects located in developing economies. Importantly, EP4 also extends certain obligations to designated countries such as the U.S., potentially requiring assurance of steps beyond compliance with those countries' legal requirements.

What are the Equator Principles?

Formally launched in June 2003, the Equator Principles were created based on the environmental and social policy frameworks established by the International Finance Corporation. The principles are a risk management framework for assessing and managing environmental and social risks associated with project financing.

The Equator Principles provide a minimum due diligence standard and monitoring protocol designed to encourage responsible risk assessment and decision-making. The principles apply globally, to all industry sectors, and are focused on risk management for projects financed by the institutions that have adopted them.

Currently, the Equator Principles have been adopted by 110 financial institutions across 38 countries. Financial institutions that are members of the Equator Principles Association commit to making informed investment decisions, and withholding or withdrawing financing on projects or assets that do not conform to "good international industry practice."

In November 2019, the Equator Principles Association released EP4, the latest iteration of the Equator Principles. On June 19, the association issued guidance on the implementation of the principles during the COVID-19 pandemic. EP4 was scheduled to take effect on July 1, but in light of COVID-19, the association approved a three-month extension until Oct. 1.

Who is affected?

The Equator Principles apply to all Equator Principles Association member financial institutions, and cover a variety of financial services and products across all industry sectors. Since their initial adoption, the principles have been applied to a broader cross-section of projects, including those arising in the energy and extractive industries, as well as to large-scale projects with significant potential to impact the environment or local communities in developing economies.

More transactions and projects are covered under EP4 than previous iterations, including certain loans to local, regional or national governments, and project-related refinancing and project-related acquisition financing that meet certain conditions. Additionally, EP4 is the first time the Equator Principles have included a statement recognizing a broader responsibility for managing adverse environmental and social risks and impacts, even for financial products that fall outside the principles' current scope.

What are the implications for the energy industry?

Applicability

Under EP4, project-related refinancing and acquisition financing is now in scope, and EP4 will apply to project-related corporate loans over $50 million (the previous threshold level was $100 million). As a result, smaller energy projects that do not require as much financing could now be subject to EP4 review.

Biodiversity

Some higher-risk projects will be encouraged to share biodiversity data with the Global Biodiversity Information Facility and relevant national or global data repositories.

Under the Equator Principles, projects are classified as Category A, for projects with potentially significant adverse environmental and social risks and/or impacts that are diverse, irreversible or unprecedented; Category B, for projects with limited potential adverse environmental and social risks and/or impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures; or Category C, for projects posing minimal or no risk.

Wind, solar and other alternative energy projects are frequently classified as Category B, with oil and gas projects often categorized as Category A. Therefore, under EP4, financial institutions may encourage more Endangered Species Act analysis and biodiversity reporting from oil and gas projects.

Climate Change

Equator Principles financial institutions will be required to support the objectives of the Paris Agreement. As with previous iterations of the Equator Principles, EP4 requires a lower-emission alternative analysis for projects above a specified greenhouse gas threshold, and reporting of GHG emissions projects.

However, EP4 also includes requirements that any environmental and social impact assessment, or ESIA, must include a climate change risk assessment identifying physical risk — e.g., direct damage to infrastructure, indirect impacts to supply chains — and transition risks — e.g., policy and legacy risks from national policy changes, and reputational risk.

For the energy industry, this means that even if a project has obtained its environmental impact statement and any analogous state assessments, diligence and permitting will require additional consideration of physical and transition risks that are not currently included in the deal process.

Human Rights and Social Risks

EPIII only included a general statement on respect for human rights, whereas EP4 requires financial institutions to meet the United Nations Guiding Principles on Business and Human Rights. ESIAs must include a human rights impacts assessment, and a human rights impact evaluation will be required, even if the level of risk does not warrant a full ESIA.

Indigenous Peoples

EP4 will require financial institutions to retain an independent consultant to evaluate the consultation process with indigenous peoples. The independent consultation is a new requirement, as is the requirement that projects not only obtain free, prior and informed consent and follow host-country laws, but also comply with the International Finance Corporation performance standards.

All projects affecting indigenous peoples are subject to this process — even projects in designated countries such as the U.S. While energy projects do engage in tribal consultation pursuant to statutes like the National Environmental Policy Act, the human rights and indigenous peoples requirements of EP4 will likely increased the time and documentation required for this process, and could make it difficult for certain controversial projects to attract debt.

What are the implications for U.S. energy projects?

EP4 applies globally, but designated countries like the U.S. may feel the changes of EP4 particularly acutely.

In previous iterations of the Equator Principles, projects located in designated countries were deemed to satisfy principles 2, 4, 5 and 6 if they met host-country laws. Under EP4, all projects will be reviewed for compliance with the principles, and projects located in designated countries will be separately evaluated for specific project-related risk to determine if International Finance Corporation performance standards should be applied.

In the U.S., the application of new standards that are distinct from host-country laws could play out in a variety of ways. For instance, a liquefied natural gas project might be under the jurisdiction of the Federal Energy Regulatory Commission. Even if an environmental impact statement has been prepared and a consultation with affected tribes has been completed, that consultation might be insufficient to meet the standards of EP4.

In the pipeline context, an intrastate gas pipeline in the U.S. might have no obligations to prepare an environmental impact statement under the National Environmental Policy Act. However, under EP4, the project might require an ESIA, an environmental and social management plan and an Equator Principles action plan.

In the U.S., interstate pipeline development is already quite fraught, but the tribal consultation requirements of EP4 could make it significantly harder to acquire funding for a project that has difficulties obtaining free, prior and informed consent.

Conclusion

EP4 includes material changes from EPIII, with potentially significant impacts on energy clients seeking to finance projects.

Some nongovernmental organizations have been critical of the Equator Principles for their perceived failure to impose adequate mitigation standards, compliance or policing mechanisms. Still, impacted industries have become increasingly concerned about the potential for legal challenges to arise from shortfalls between a project's commitments under the principles or other similar ESG protocols, and the project's actual implementation. In some instances, those ESG commitments could be legally binding, making the upcoming EP4 update even more important to review.

As EP4 comes into effect and environmental and ESG requirements continue to develop, preparation is key. So planning ahead for project delays, distilling key facts and challenges on issues such as climate or human rights rather than bundling them under a corporate ESG or sustainability policy, and reviewing corporate environmental and social management systems may help facilitate a smoother transaction.

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