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## Oil project lending faces new environmental litmus test

A group of major international banks led by ABN Amro Bank NV, Amsterdam; Barclays PLC, London; Citigroup Inc., New York; and WestLB AG, Düsseldorf, has disclosed plans to follow environmental policies of the International Finance Corp., the private-sector arm of the World Bank Group, in their project lending around the world.

Early estimates suggest that this agreement, known as the Equator Principles, may cover more than \$100 billion in global investment over the next decade. The Equator Principles (EP) guidelines will apply to capital projects of \$50 million or more.

Since the announcement of that plan by 10 banks in June, 6 more institutions have joined the EP group, and additional institutions are being recruited.

According to Dealogic ProjectWare, a London-based project-finance database, EP banks last year arranged 70% of worldwide project loans. Clearly, these new guidelines may have a significant impact on oil and gas companies working in so-called "emerging markets."

### Searching for a common framework

The Equator Principles began to take shape 2 years ago when ABN Amro approached IFC for help in creating a "common framework for managing environmental risk." ABN Amro had been impressed with IFC's approach in the Chad-Cameroon oil field development and pipeline project.

Initial conversations led to a meeting of 9 banks in London in October 2002, followed by others last February and April. By the final session in Düsseldorf, attendance had risen to 21. The main objective of these meetings, said one organizer, was to "raise consciousness" among banks about "how much risk is out there" in their portfolios.

According to Suellen Lazarus, senior advisor at the IFC, the first meeting "was like an AA [Alcoholics Anonymous] session." At the outset, she said, most participants simply denied that they faced serious environmental and social issues.

Other participants remember the discussions differently but agree on the outcome. According to Chris Beale, managing director of global project finance at Citigroup, they focused on "the difficulties they experienced" in dealing with significant environmental and social issues. Oil and gas projects—the OCP heavy oil pipeline in Ecuador, the Baku-Tbilisi-Ceyhan pipeline project in Turkey, and the Camisea natural gas megaproject in Peru—headed the list of potential "train wrecks."

At the first London meeting, four "core" banks were delegated to identify a common framework that could be applied throughout the financial industry. They were asked to find standards that would be comprehensive, relatively well-known and accepted, and would minimize political battles—in other words, standards that would "save time and arguments." Until such policies were adopted, one committee member told us, the banks realized that they could be "held accountable for everything."

The four core banks eventually recommended adopting IFC guidelines (World Bank policies that have been modified for use by private companies) because these came closest to "one-stop shopping" across a broad range of industries. Informal consultations were then held with environmental nongovernmental organizations (NGOs), oil and gas companies, mining firms, and other major stakeholders. By June, the Equator Principles were issued.

#### Identifying 'better' best practices

Officially, most major oil companies and large independents are "analyzing the Equator Principles" or "evaluating their position."

Unofficially, they raise a host of doubts and objections:

- Will the banks build in-house expertise so that they can "understand what they've gotten themselves into" and develop workable procedures?
- How will they enforce environmental covenants in their loan agreements?
- Will potential borrowers shop around for bankers who have not signed the Equator Principles or simply turn to other forms of raising capital?
- Is it all just a public relations move to make the banks look good?

Not surprisingly, EP institutions have anticipated most of these questions. They recognize that a voluntary effort such as theirs will take time to implement and that it likely will not change the world overnight. But "as knowledge develops," said Citigroup's Beale, they expect to make a difference. And he pointed out that many banks already assess environmental risk, which they regard as a major source of uncertainty and delay.

How do they respond to the charge—made by a broad coalition of environmental groups including Friends of the Earth, Environmental Defense, and World Wildlife Fund, as well as Germany's Green Party—that IFC standards do not represent "worldwide best practice" and that better standards are available, at least for specific industries? "It's a fair comment," agreed the IFC's Lazarus. "But at this point they are the most comprehensive set of standards that have been time-tested in project finance" for developing countries.

She also noted that World Bank standards undergo periodic review and revision (for example, an "extractive industries review" is just concluding). The World Bank's goal is to raise such standards as Third World governments and private companies learn to improve their environmental performance—what Richard Burrett at ABN Amro called "a general trend toward 'better' best practice." In effect, EP banks have decided to use IFC "safeguard policies" as a worldwide compliance threshold—and the threshold will continue to rise.

It's an ambitious proposition. One important step involves broadening the network of banks that sign onto EP. In large oil and gas projects or other ventures, lenders almost always form loan syndicates to spread risk and raise capital more easily.

In theory, if even one syndicate member subscribes to EP, an entire pipeline or oil field development project should meet EP standards. The result is that EP organizers can effectively "capture the market" for major project loans without enlisting every last bank. In fact, they are on track to add 15 more institutions in key countries by next June.

How will they design and implement uniform procedures? Here again, IFC is expected to play a vital role. At the banks' request, IFC has agreed to provide critical training in environmental management and other essential skills. A former IFC staff member, Glen Armstrong, has been hired to develop appropriate training modules. Many banks also intend to beef up their in-house environmental staffs and to make more use of expert consultants. Their goal is to avoid a deadly "race to the bottom" with institutions that apply lower standards.

Various shades of doubt

In general, oil companies greeted these measures with a large dose of skepticism. Several of them enumerated a long list of reasons why the Equator Principles are destined to fail: the importance of project lending is declining, other financial vehicles are available, smaller banks around the world will be happy to lend their money without regard for EP, etc. But they seem to have missed several important points.

For one thing, private lenders are increasingly asking the IFC itself to join their loan syndicates—not because the IFC brings huge financial resources, but because of its potential influence over developing-country governments. As part of the World Bank Group, it adds a measure of political clout that is unavailable from conventional export credit agencies such as the Overseas Private Investment Corp. or the Export-Import Bank. And the IFC definitely does have the technical resources and know-how to enforce environmental conditions in its loans.

Second, the IFC's mission itself may soon change. Like other World Bank agencies, its activities are being scrutinized as part of the current "extractive industries review" to ensure that they conform to the organization's priorities: poverty alleviation, improved governance, enhanced human-rights protection, and stricter environmental controls.

In effect, the IFC may be asked to accept a broader role as de facto regulator of last resort. Many World Bank experts express enthusiasm for this broader mission. Ultimately, they foresee an emerging framework—of voluntary codes and tighter regulation, of national laws and international agreements, of loan covenants and expanded guidelines—that are geared toward modifying government and corporate behavior. Or as one observer put it, "Oil and gas companies can run, but they can't hide."

Actually, the past 4 months have been a busy time in the evolution of this framework. Major recommendations or resolutions on democratic governance, increased transparency of business agreements and contract terms, human-rights practices, and other critical matters were issued by a range of public and private agencies. Backed by significant NGO coalitions in the US and Europe, these recommendations will almost surely work their way into future standards of one sort or another.

More immediately, NGOs believe that EP enforcement is too weak. In particular, they would like to see the banks agree to public disclosure of their performance under EP. For now, this issue remains unresolved.

So are the Equator Principles just a public relations ploy to put the banks in the winner's circle? Certainly, the bankers don't see it that way. "Environmental risk is business risk," they insist. As for the longer term, one EP organizer added, "In the end, we're only doing what society expects us to do."

One can only imagine what the oil and gas business will be like 10 years from now.

## The authors

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*Oil & Gas Journal* October 13, 2003

volume 101, issue 39

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Article URL:

[http://www.ogj.com/display\\_article/189470/7/ARCHI/none/none/1/Oil-project-lending-faces-new-environmental-litmus-test/](http://www.ogj.com/display_article/189470/7/ARCHI/none/none/1/Oil-project-lending-faces-new-environmental-litmus-test/)

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