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Client Alert
Commentary

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Equator Principles Transition: How EP4 Will Impact Projects in High-Income Countries

The transition from EP3 to EP4 has the potential to significantly impact new projects and expansions of existing projects financed by EPFIs in the United States and other high-income Designated Countries

The Equator Principles (EPs) were recently updated and the transition from the June 2013 version (known as EP3) to the November 2019 version (known as EP4) occurred on **October 1, 2020**. On June 19, 2020, the Equator Principles Association (EP Association) extended the previous effective date of July 1, 2020, by three months due to disruptions caused by COVID-19 and released guidance for the implementation of the EPs during the pandemic.

For background on this transition, see Latham's blog posts Equator Principles Association Adopts Equator Principles 4 and Equator Principles Association Issues COVID-19 Guidance for Lenders and Borrowers.

This *Client Alert* updates Latham's June 2020 *Client Alert* on the Equator Principles and focuses on relevant developments as well as the

When do the EPs apply?

The EP Association is the unincorporated association of member EP Financial Institutions (EPFIs). More than 100 financial institutions in 37 countries are members. The full list of EPFIs is available here, and consists primarily of commercial banks, export credit agencies/investment insurance agencies, and development banks. The objective of the EPFIs is to manage, administer, and develop the EPs.

The EPs form a risk management framework for new projects and expansions/upgrades to existing projects financed by the EPFIs that determines, assesses, and manages environmental and social risk in such projects. The EPs are primarily intended to provide a minimum standard for due diligence and monitoring to support responsible risk decision-making. The EPs have global application and **apply to the following five financial products** in all industry sectors:

- Project Finance Advisory Services
- Project Finance
- Project-Related Corporate Loans
- Bridge Loans
- Project-Related Refinance and Project-Related Acquisition Finance

The EPFIs commit to implementing the EPs in environmental and social policies, procedures, and standards, and will not provide funding to projects in which the client is unable to comply with the EPs.

implications of EP4 related to projects sited in Designated Countries — i.e., high-income countries, including the United States.

In September 2020, the EP Association published an Implementation Note providing additional guidance on the types of projects covered by EP4, climate change requirements, the application of the standards in Designated Countries, and reporting requirements. The EP Association also published four subject-matter-specific Guidance Notes addressing biodiversity, climate change, the Free, Prior and Informed Consent (FPIC) of affected Indigenous Peoples, and human rights. The Implementation Note and the Guidance Notes are intended to provide clarity to EPFIs and clients regarding the implementation of EP4.

EP4 Implications for New EPFI-Financed Projects and Expansions in Designated Countries

The implications of EP4 could be significant for new projects and expansions/upgrades of existing projects financed by EPFIs and located in the United States and other Designated Countries, particularly for project sponsors who fail to take EP4 obligations into account until later in the financing process, as many of these requirements involve longer lead-time obligations relating to environmental and social impact assessments and public/stakeholder consultation. EP4 will not otherwise apply retroactively to existing/operating projects.

First, projects located in Designated Countries that comply with host-country environmental and social laws are deemed under EP3 to be in compliance with the most burdensome EP requirements, including, for example, requirements relating to the preparation of broadly scoped environmental and social assessments. **This is no longer the case under EP4**, which eliminates the "deemed in compliance" language, meaning that projects sited in Designated Countries (and otherwise meeting the EP4 applicability threshold) will be required to satisfy all of the EPs. This change should not be overlooked; the EPs are prescriptive, and the undertakings required to satisfy the EPs may not align well with typical due diligence and environmental/social management approaches typically undertaken in connection with Designated Country-based projects. This change is noteworthy for projects categorized as Category A or higher-risk Category B projects, which are considered to have the potential for more significant adverse environmental and social impacts, and are, therefore, subject to heightened environmental and social assessment and documentation requirements (as compared to lower-risk Category B and Category C projects, which are subject to a lighter regime under the EPs). Accordingly, project sponsors are advised to determine how their project(s) will be categorized by the EPFIs early in the financing process to understand the scope of their compliance obligations under EP4.

Second, in addition to the foregoing, projects sited in the United States and other Designated Countries must be evaluated against the International Finance Corporation's Performance Standards on Environmental and Social Sustainability (IFC PS). Under EP4, lenders will evaluate the specific risks of projects located in Designated Countries to determine whether one or more IFC PS should be used to address such risks, in addition to host-country laws.

Third, under EP4, **all** projects located in the United States and other Designated Countries will be benchmarked against the requirements of IFC PS 7 in relation to Indigenous Peoples. This includes a requirement that project sponsors obtain FPIC of affected Indigenous Peoples as a condition to obtaining lender commitments. Compliance with host-country laws, which often only require consultation with Indigenous Peoples, may not be sufficient to meet IFC PS 7's FPIC requirements. This requirement could become a significant gating item in project financings with respect to projects located, for example, near US-based tribal communities.

Fourth, EP4 requires a Climate Change Risk Assessment (CCRA) aligned with the Recommendations of the Task Force on Climate-related Financial Disclosures' (TCFD) Climate Physical Risk and Climate Transition Risk categories for many projects. The Guidance Note recommends that the CCRA be completed *prior to* financial close along with the rest of the environmental and social due diligence. In order to evaluate these risks in line with the TCFD recommendations, project sponsors and lenders should discuss the scope of risks early on in the financing process. Because climate risks occur over a long time horizon (often longer than financing), borrowers and lenders should anticipate risks over the lifetime of the financing in addition to adaption and mitigation strategies to make the project as resilient as possible.

Finally, EP4 focuses on biodiversity protection, calling for project sponsors to identify sensitive habitat areas and notify lenders as early as possible. Projects that affect certain habitats may not be acceptable for financing.

As noted above, the EP Association has prepared guidance documents, issued in September 2020, to clarify how requirements should be implemented in Designated Countries.

EP4 Implications: Real-World Examples

So what does this mean in practice? Below are a couple of hypothetical examples of how EP4 could affect new projects financed by EPFIs in the United States (these examples are based on actual projects that were subject to EP3):

Intrastate Gas Pipeline Project: Here, assume no obligation to prepare an Environmental Impact Statement (EIS) under the National Environmental Policy Act or any equivalent document evaluating project impacts to the environment or affected communities — which is a good assumption for an intrastate pipeline project in most US states, for example. Under EP4, if the project sponsor is not aware of the EP4-related conditions precedent to financing lenders will require (including delivery of an Environmental and Social Impact Assessment), the project sponsor will likely not have considered the need to prepare such an assessment, let alone one that meets EP4 requirements. (Similarly, the project sponsor likely has not contemplated undertaking any of the other tasks required to satisfy EP4, including preparation of an Environmental and Social Management Plan and related Equator Principles Action Plan). Under this scenario, the project sponsor could find itself in a scramble to "backfill" the record to satisfy lender requirements under EP4 — including preparation of a fully scoped environmental and social assessment — all of which can consume time at significant additional cost. Issues turning up in any such eleventh-hour assessment may also put project financing at risk (e.g., the proximity of tribal interests that create friction on the extent to which FPIC must be obtained). Had the project sponsor been aware that lenders would mandate borrower compliance with EP4, it could have tailored its development plan to meet lender requirements in addition to applicable federal/state/local permitting requirements.

Gulf Coast LNG Project: Here, assume the US Federal Energy Regulatory Commission (FERC) has jurisdiction over the project and has prepared an EIS. If there are one or more tribal communities located near the project site, both FERC and the project sponsor would have participated in an extensive outreach and consultation process with federally recognized tribes to evaluate whether the project may impact historic and cultural resources of significance to the tribes. The outreach would have been performed to comply with Section 106 of the National Historic Preservation Act, which requires that a federal agency, in this case FERC, engage in a consultation process with affected parties to account for the effects of agency undertakings on historic and cultural resources. FERC and the project would typically maintain copies of letters sent to the tribes to solicit any concerns or questions they may have regarding the project. Under EP4, the project sponsor may learn that the foregoing consultation efforts may not satisfy the new standards. Lenders may insist on substantially more consultation with the tribal communities from the project sponsors, including evidence sufficient to demonstrate that the project has obtained FPIC from one or more tribes and/or that sponsors have exhausted all reasonable efforts to obtain FPIC. Waiting until the eleventh hour to address this issue could unnecessarily create a potentially significant project financing risk.

These examples highlight the fact that project financings in the United States and other Designated Countries are now subject to many of the same lender requirements applicable to projects sited in developing countries. Notably, export credit agency-backed project financings in the United States and other high-income countries have been subject to the IFC PS and EPs, but now projects supported solely by commercial lenders are also subject to the EP4 and, to a lesser or greater extent, the IFC PS. Accordingly, for clients developing projects in the United States and other high-income countries, it will be critical to evaluate early in the development process the scope of potential lender requirements under EP4, and then undertake steps necessary to adequately document the project's satisfaction of such obligations (including, for example, preparation of an Environmental and Social Impact Assessment, even if not otherwise required under federal or state law).

Next Steps

Any project sponsor looking to finance a project should immediately contact outside counsel — and/or reach out to the potential lenders — to evaluate the implications of the new EP4 standards on the project. This recommendation applies equally to any projects that have not yet achieved closing and for which the lenders have not expressly agreed to apply EP3 (instead of EP4).

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