Lessons learned as E&S consultants in Project Financing

In collaboration with Raimund Vogelsberger Consulting

In this interview, we identify the critical topics for successful management of environmental and social (E&S) risks in conversation with Professor Cem Avci, founder of ACE Consulting and Professor of Civil Engineering at Boğaziçi University Istanbul Turkey, and Raimund Vogelsberger, an Environmental Engineer with over 35 years of international consulting experience.

We explore lessons learned from their combined 70+ years of international E&S consulting experience involving services on behalf of both the clients/developers and the lenders. The examples span a range of sectors (e.g., transportation, manufacturing, power/renewables) and across geographies in Eastern Europe/Balkans, Turkey, Africa, and Asia.

We address both positive and negative experiences at different stages of the project financing and discuss how certain decisions could have resulted in overall savings of time/effort during the process.

Q1: What are the main E&S standards or benchmarks that apply to projects being funded under project finance arrangements?

Cem:
What can be considered as the “Guiding Light” of all international E&S standards for projects in the private sector are the eight performance standards (PS) and related guidance notes of the International Finance Corporation (IFC), the private-sector arm of the World Bank. The most recent version of the IFC PS is from 2012, and they are currently undergoing an update process. Of course, numerous other multilateral development banks – such as ADB, EBRD, African Development Bank etc - have their own sets of E&S standards… but they are very similar to the IFC PS.

In addition, many private commercial banks have voluntarily committed to align their lending practices with the ten principles of the so-called Equator Principles - EPs (currently in the fourth version as EP4). As of September 2023, there are some 140 of these EP financial institutions (EPFIs) in 39 countries. The EPs require that larger projects with greater E&S risks conform to the IFC PS and a host of other good practice guidelines issued by World Bank/IFC for various industry sectors.

For larger projects with numerous lenders there is usually at least one EPFI in the group, and this means that the EPs/IFC PS will then set the E&S expectations for the whole transaction.

Raimund:
And importantly, the EPs require that in any case, the project must comply with the relevant E&S regulations of the host country where the project is located. So typically, we have the host-country regulation framework constituting the minimum level of E&S management, with the EPs and IFC PS then coming "on top" as they are often more stringent than the local national requirements; together the local requirements plus EP/IFC PS form the benchmark of E&S standards for a new project development. Also, we need to keep in mind that conformance to the EPs/IFC PS is not only about applying certain limits but relates to the whole process of how the E&S risks are managed throughout the entire project implementation from planning to construction, operations, and future decommissioning.

Q2: What would you say are two or three main E&S challenges you have seen arise during the Project Finance cycle?

Cem:
From a top-down perspective, I would first say overall effective E&S Governance structure of the key parties. Are all the involved parties truly "on board" with achieving the high E&S requirements of the lenders? Do the senior managers show sufficient commitment? And by the "key parties" here we can include mainly:

• Project Owners, which is often a government institution, or a private entity such as a single firm or a consortium of several companies set up as a Special Purpose Vehicle (SPV), and usually being the borrower of the Project Finance.
• Project Developer, as the entity that will build and, depending on the contract, then operate the Project for a certain period until handover to a government entity.
• Public Institutions/government agencies, the public institutions that will have a say on permitting and/or implementation of responsibilities that may overlap with Lender's requirements.
• Lenders: typically involves one or more lenders that are signatories of the Equator Principles (EPs).

Secondly, I would say appropriate timing of the required E&S assessments. For example, are the specialist consultants engaged soon enough in the whole process? Did the feasibility studies and technical design aspects of the project consider the Lender's E&S policy requirements?

Raimund:
Plus, I would add that the consultants engaged by the developer need to be sufficiently familiar with the lender E&S requirements and the project finance process – not just subject experts.

Similarly, the scope of the engagement needs to be clear: Are the consultants being hired solely to conduct this or that specific E&S study, or are the developers expecting the consultants to guide and support them as "Project Finance Advisor" through the whole financing process until successful financial closing?

Often, clients who are new to the project finance process may feel that all they need to do is submit a decent E&S report

to the lenders and the E&S topic is then completed. They are then quite surprised to learn that this is merely the start of the process: the lender's independent E&S advisors will typically come back with a long list of further E&S actions needed, and the related discussions and negotiations about additional studies and E&S commitments – and which of these items are conditions precedent to signing - can drag on for many months. As a Project Owner/Developer, you will thus usually benefit by having an E&S consultant at your side from the beginning who not only brings the necessary E&S expertise to the table but can also support you during the contractual negotiations.

Q3: How is the overall E&S governance important at the project level?

Cem:
The most critical component of a successful E&S assessment – and achieving project finance - will be developing and implementing an effective E&S Governance structure across the key parties. The responsibilities among the various parties need to be understood at the forefront through an E&S Governance management system that includes supervision of construction and operations, reporting, stakeholder structure, and quality management to which all parties need to adhere. In other words, all parties need to be fully aware of the goals and challenges posed by the stringent E&S requirements of the lenders – typically the host country regulations plus the EPs/IFC PS, as previously mentioned. For large projects, the conformance to all these requirements is not a trivial matter. Such an important governance structure also needs adequate time to be established – it is not something that can be cobbled together over a weekend.

Q4: Can you give some examples where such governance-awareness was lacking in a project?

Cem:
We have often seen a disconnect in effective governance where the project owners/borrowers are government entities, e.g. the Ministry of Finance, while the project itself (e.g. a railway or motorway) is undertaken by a private contractor in a PPP or FBOT arrangement. In such cases we have seen, for example, a lack of inter-governmental coordination and support between the ministry responsible for the project itself and other involved ministries, such as those responsible for land acquisition process; this often results in project delays as the policies differ between the lenders and country-specific regulations. In many cases, land acquisition funding is to be conducted by both the government and the Project Developer in a hybrid approach.

Often when governments are involved as the owners/borrowers, they lack the internal capacity to properly conduct the supervision of the construction contractors and provide routine reporting to lenders, as is obligatory per the loan agreement. Often governments are prevented from adding staff due to public hiring freezes and they lack the finances to engage external experts.

Or also other cases where the project is being developed by a joint-venture of two or three firms and there is internal disagreement about the strategy on addressing E&S topics, for example, to be proactive in achieving lender requirements or to rather "push back" wherever possible. Such internal discord of course poses a challenge in the efficient management of E&S topics.

Raimund:
Similarly, along with the aspect of "awareness" is the matter of the key parties allocating sufficient resources to deal with the E&S topics. In cases where an SPV is setup to develop the Project, the staffing in the early stages of the Project is of course very lean. But soon enough, a larger infrastructure or energy project will require a dedicated senior manager (and often then a small team) to handle the E&S topics.

In some projects, we have seen the SPV drag out the E&S hiring for too long, which resulted in huge bottlenecks at the SPV in making E&S decisions in a timely manner and caused delays in the whole process.

Such understaffing can also occur when large corporates are involved. I recall a huge infrastructure investment in Africa where the Developer had assigned only one person to manage the many significant E&S aspects of the project, instead of the three or four people really needed. After a few months, during which urgent requests for more support were not granted, this lone E&S person suffered a serious burn-out, and numerous work-streams were delayed until replacement and more E&S staff could be found. Had the company beefed up its E&S team sooner, lots of time and money could have been saved and personal suffering avoided.

Q5: Can you think of some positive examples of good governance upfront?

Raimund:
Sure, we've seen many cases where the project parties – and, importantly, the specific individuals involved - are experienced in such project finance deals and have often worked with each other, e.g. a large international lender, a private windfarm developer, consultant teams, etc. Everybody knows each other and understands the challenges to expect. From a consultant perspective, such projects are a pleasure to work on – even if there is a lot of work in short-term and the usual pressures of getting the project financed by the target date.

Cem:
A good practice I have experienced is when the project developer sets up a combined meeting early in the process to introduce the different team members to each other face-to-face and jointly discuss the key project challenges, across all main topics, including ESG. In the early project stage, the lenders might not yet be on board, but an experienced E&S consultant can usually anticipate what the key E&S risks of the project will entail. A strong team spirit can be created and everybody pulling in the same direction makes for more efficient project execution.

Q6: This mention of the early stage of the project seems to lead into your second point about the appropriate timing of the E&S assessments.

Raimund:
Correct, in our experience, the sooner that at least preliminary studies can be started, such as an E&S scoping exercise or an early internal "red-flag assessment", the better in the long term. This may mean that the project is still in the design/feasibility stage, with construction contracts not yet awarded and lenders not yet confirmed. But that is fine, as the whole intent of the international E&S standards (eg EPs, IFC) is that the E&S studies and design finalisation should proceed in parallel in an iterative process, with the E&S findings providing input to the design optimization, contractor specifications, etc.

Early-stage engagement will also circumvent issues related to lack of engagement by the government authority within its institutions to support the Project, as there is a preconception that the Project Developer will take care of the Lender's E&S requirements without understanding and engaging the various government institutions.

Cem:
Unfortunately, what we often encounter is that the Project E&S assessment is requested only after all the project details have been established regarding land, corridor, feasibility studies, predesign, and, in some cases, detailed design establishment and project construction contracts award. And if also the Lenders are only confirmed at such a late stage, it will be very challenging to still provide efficient solutions to E&S issues, e.g. it is tough to convince construction contractors to undertake any additional mitigation actions that are not already defined in their contract. For example, for several recent large motorway and bridge construction projects in Türkiye we encountered:

• Challenges in assessing alternative design options for the Project, which may have had overall E&S benefits (as the design was essentially already “carved in stone”).
• Less ability to affect design aspects and alternative options as the Project had been awarded to the contractor per the “final design” before any E&S assessments were undertaken.
• Timing pressure to complete the required E&S evaluations in an unrealistic time frame and additional costs for the comprehensive, fast-tracked assessments.

Raimund:
That is why we advise developers to not wait too long in assigning the E&S assessments – best to get an early jump on these topics. You may think you are saving some money upfront by delaying studies until later, but long-term it is far more costly later when financial closing dates are delayed because this or that (predictable) E&S assessment still needs to be completed.

Cem:
Another reason for delays is that often the project developer has obtained all of the necessary local E&S permits and approvals and then underestimates the substantial scope and effort (and cost) on top of all this to conform with EP/IFC requirements of the international lenders. This is often the point where we as international consultants are engaged in a project, to essentially "bridge the gap” between the local permits and the international requirements. Developers are then sometimes shocked to learn that a LOT of studies are still needed, and the process will still take many months to complete. At this stage it is essential to setup discussions with the lenders and their advisors to get mutual agreement on exactly what further E&S studies the lenders are expecting and by when.

Q7: And this brings us to the third point about consultant expertise?

Cem:
Yes, and not only expertise of the consultants, but of all parties… In many Project instances I have experienced, the key parties were unfamiliar with the international E&S Policy Requirements and their impact on timing, design, construction, and operation requirements. Lack of familiarity then led to a "culture clash" in how the projects moved forward. The E&S Policy Requirements add layers and layers of assessment and mitigation measures that Project developers and local consultants may be unfamiliar with since the country-specific regulations are (usually) not as stringent as or as wide in scope as the Lender's policies.

For example, there are differences between the impact assessment methodology, baseline collection development and level of detail, and the extent of mitigation measures. Many socially-oriented topics that are relevant for the lenders, such as gender equality or human rights, are often not considered at all in the local studies. The local EHS consultants are often very reputable "subject matter experts" (e.g., local biologists or air pollution modeling experts), but they frequently lack the understanding and experience with the broader context of project finance. Hence, the developer/client is too often faced with detailed academic reports, but it is unclear how all this information fits the Lender's expectations. Also, the local experts are often unfamiliar with the E&S management and governance systems to implement them effectively during project construction and operation. This leads to much noncompliance with lenders' requirements and frustration all around, because numerous essential studies will still need to be done (or re-done) to close the information gaps. And of course, this results in extra costs for the developers and timing delays, with potential delay of financial close – which also translates to additional costs.

Raimund:
We discussed earlier about the benchmark E&S standards, mainly being the EPs/IFC and relevant guidance. Well, these E&S standards – and expectations of lenders - are becoming ever more comprehensive in scope and detail, with updated "best practice" guidance documents being issued for numerous specific topics and industry sectors. This means that the E&S consultants need to cover an increasingly wide range of topic expertise, and to understand how all this fits into the context of the transaction. This marks the key difference between purely a subject expert, versus somebody who can translate the E&S information constructively into the "project finance" mechanisms. These include a set of clear, agreed commitments for actions to manage E&S risks, with certain actions defined as conditions precedent to be completed before financial close, and others able to be shifted to post-closing, with regular monitoring to track and confirm completion progress.

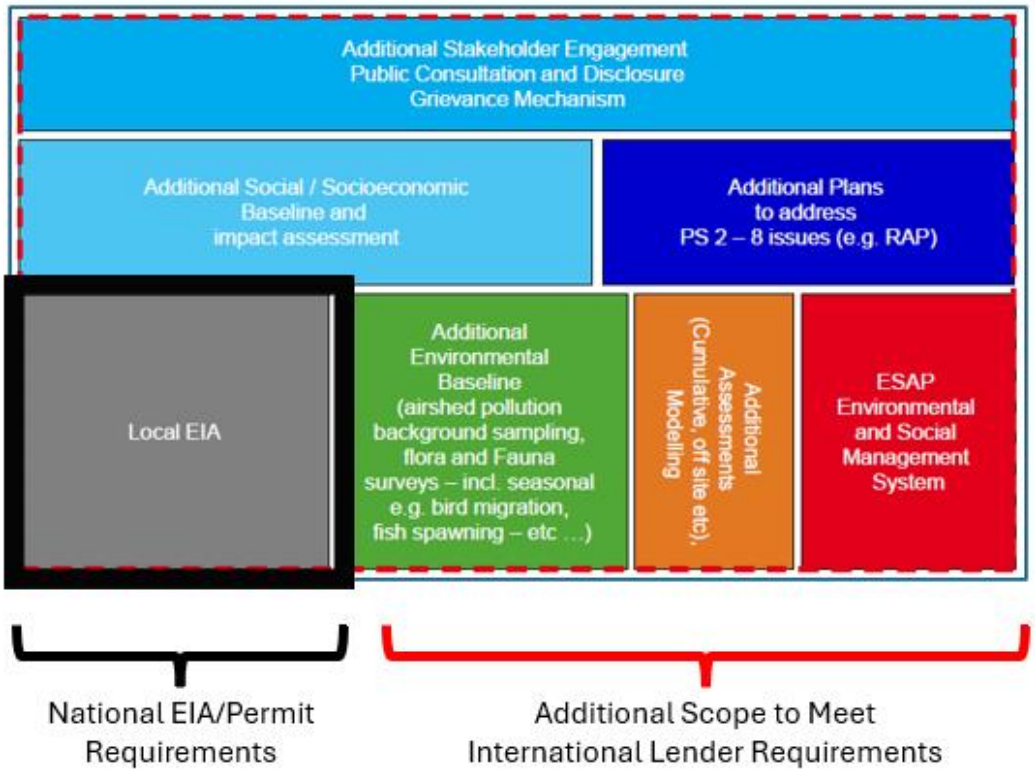
Cem:
A typical worst-case we see is when developers have hired subject experts who then compile long and detailed reports spelling out a myriad of potential project risks and impacts – without offering constructive suggestions for avoidance or mitigation to "resolve" the risks. A useful approach then in selecting E&S consultants is a combination of local expertise – and persons familiar with the local/national permitting requirements - and international experts who specifically have experience in dealing with the project finance mechanisms related to E&S risk management. That is then a win-win setup.

From Local EIA to International ESIA

The diagram below highlights some of the typical examples of supplemental studies needed to "bridge the gap" between the local permits and Environmental Impact Assessment (EIA) and a full Environmental and Social Impact Assessment (ESIA) package to satisfy international lender requirements (IFC/EPs). Besides further in-depth evaluation of ecological/biodiversity issues and a number of other topics, the IFC/EPs place a large emphasis on stakeholder engagement and a wide range of potential social impacts.

These assessments may require substantial additional time and effort, especially in cases where local persons may be subject to physical or economic displacement, thus triggering the need for a comprehensive resettlement action plan (RAP) and/or livelihood restoration plans.

Overall, our experience shows that for Project Financing of infrastructure projects, the resolution of the social topics is often more challenging and time-consuming than for the environmental topics.



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