Briefing Note 4

Meeting the Social and Local Economic Performance Standards of International Project Finance Institutions

Guidance for the Extractive Industries Sector

Why Companies Seek International Project Finance

For the most part, multi-national and national oil, gas or mining companies are able to finance their share of mineral development costs from internal financial resources, ie. from the Balance Sheet. However, when working with partners in low and low-middle income countries, characterised by high political and social risks, there are a number of reasons why companies might seek to secure international project finance. These include:

- to spread the elevated project risks beyond the internal resources of the company or joint venture;
- to retain influence over certain joint venture partners, such as national companies and junior partners, who might have less experience in controlling project risks;
- as a 'comfort factor' for commercial banks to provide finance;
- as a form of implicit risk guarantee (principally associated with approaching development finance institutions whose shareholders — ie. governments — may have national interests related to the investment);
- to provide credibility and transparency for a potentially controversial project through association with internationally recognised environmental and social standards.

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Box 1. Social Risks Affecting Extractive Industries

- Operational and reputational risks arising from the effects of construction and operations on local and indigenous communities (eg. from on- and off-site accidents, loss of natural resources, proximity of worker camps to communities, degradation of local water supplies and other local infrastructure);
- Compliance and reputational risks linked to specific issues such as involuntary resettlement, workers' rights, child labour in local supply chains, corruption etc.;
- Operational risks related to association with community grievances;
- Local economic grievances arising from 'boomtown effects', failure of government to re-distribute tax revenues, and unfulfilled local and national employment and supplier expectations.

Social Risks

For international finance institutions (IFIs), sound social risk management and social performance are becoming key components of due diligence studies and project finance agreements for investments in developing countries. Social risks affecting extractive industry developments are listedin *Box 1*.

If left unmanaged, such risks and impacts can lead to commercial consequences for the business in both the short-term (eg. in relation to construction schedules and costs, production output and timely facilities maintenance) and the long-term (eg. reduced access to in-country growth opportunities and damage to global reputation).

Importance of Social Performance within Finance Institutions

Securing international project finance — be that in the form of equity, loans (debt), export credit or other risk guarantees or insurance — requires a project to meet increasingly stringent health, safety, environmental, economic and social performance standards. Of these, **social standards are the least evolved**. The social requirements of international finance institutions often rely on either an interpretation of environmental standards and procedures, such as the Environmental Policy of the European Bank for Reconstruction and Development, or on good practice guidelines that lie outside an institution's minimum requirements, such as the good practice guidance note on social impact assessment recently published by the International Finance Corporation. Furthermore, the social performance standards of many IFIs are designed to avoid or mitigate the negative social and socio-economic consequences of a project. They are less clear on how to enhance social or local economic benefits.

As demonstrated by the current review of environmental and social standards within the World Bank Group, the evolution of social performance standards within international finance institutions is piece-meal at best. By implication, the social performance practices of companies invariably overlap with not only the stated minimum social standards of the finance institutions, but also with aspects of their environmental standards, and with the broader economic and international development aims that inform investment decisions and define aspects of project performance. At least four types of standards and guidance are thus relevant to oil, gas and mining companies as they seek to meet the social performance requirements of international project finance institutions:

- **social policy standards** — policy statements, core principles and implementing rules for managing issues such as resettlement, cultural property, indigenous peoples, child labour and worker camps;
- **economic standards and guidance** — institutional policy statements, qualitative benchmarks and assessment procedures that assist institutions and project sponsors to ensure that the investment delivers a positive economic and 'development' impact;
- **procedural social standards and guidance** — minimum required procedures and good practices for preparing environmental and social impact assessment studies and for social performance reporting; and
- **numerical social and environmental standards** — quantifiable social performance requirements such as rates of staff succession and compensation levels (as well as environmental performance requirements with a social aspect, eg. effluent discharges to surface water bodies).

Influence of the World Bank Group

The World Bank Group is significant to the way in which IFIs around the world manage social performance within their project portfolio. The Group is influential not only with other multi-lateral and bi-lateral financial institutions (Asian Development Bank, UK Commonwealth Development Corporation, US and UK export credit agencies etc.), but also within commercial banks. Twenty seven major banks are now signatories to the 'Equator Principles'. These principles are essentially the World Bank Group's environmental and social 'safeguard policies'. This is important since commercial banks, and not development finance institutions, are generally the first port of call for companies seeking international project finance.

A Road Map for Compliance

Box 2 provides a Road Map for companies to meet the social performance standards of IFIs. Full details are given in the main report from which this Briefing Note is distilled (see Key References).

Key References

- **ODI (2005) Meeting the Social Performance Standards of International Project Finance Institutions, London**
  www.odi.org.uk/PPPG/activities/country_level/odpci/msp/sector1.html
- World Bank/IFC social and environmental review procedures (safe guard policies, SIA/EIA procedures; guidance notes etc.)
  http://ifcln1.ifc.org/ifcext/enviro.nsf/Content/ESRP#policies
- Equator Principles (social and environmental standards for commercial lenders) www.equator-principles.com
- International Finance Corporation (2003) Addressing the Social Dimensions of Business: A Good Practice Note
  http://ifcln1.ifc.org/ifcext/enviro.nsf/AttachmentsByTitle/p_socialGPN/$FILE/SocialGPN.pdf

Box 2.

'Road Map' for Companies to Meet the Social Performance Requirements of International Finance Institutions

First and foremost, all negotiators need to understand that meeting the social (and environmental) performance requirements of IFIs is an incremental, iterative, process. Steps include:

1. Identify the dominant IFIs for social standards within the consortium of project finance institutions.
2. Bring social specialists into project finance negotiations early.
3. Document a common understanding of the relevance to the project of the IFI's different social performance standards.
4. Assess the need for alignment of the financing institution's social performance standards with those agreed during other project negotiations, eg. with joint venture partners, host country governments or environmental regulators.
5. Undertake a Gap Analysis of the company's (or joint venture's) internal social performance standards and guidance, against those of the lead project financing institutions.
6. Agree actions to manage unforeseen social issues that fall outside of the covenants of financing agreements.
7. Build the capacity of local staff and consultants to ensure social performance requirements are met and sustained over time.

For further information contact:
Programme on Business and Development Performance
Overseas Development Institute
111 Westminster Bridge Road, London SE1 7JD
web: www.odi.org.uk/pppg/activities/country_level/odpci email: m.warner@odi.org.uk
tel: +44 (0)20 7922 0386

The Social Performance Management Unit of Shell International in London and the programme on Business and Development Performance of the Overseas Development Institute, have collaborated in the preparation of a number of social performance guidance notes. This Briefing Note draws substantially on a longer Shell Guidance Note: 'Meeting International Social Performance Requirements for Project Financing' (2005).

This series of briefing notes provides information to oil, gas and mining companies operating in developing countries. The notes aim to assist operators to enhance their social performance, be that: to deliver effective management of the negative local socio-economic impacts of project activities; or extend employment, training, infrastructure and business support benefits to communities and suppliers.