The Equator Principles: Evolving to EP4

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E3 Consulting provides technical advisory and due diligence services on projects in various stages of development. In most cases, our work supports financial transactions, such as an acquisition, refinance, or divestiture. If a transaction meets certain criteria (see side-bar), the project may need to meet the Equator Principles (EPs). As of June 2021, 118 Equator Principles Financial Institutions (EPFIs) in 37 countries have adopted the EPs, which apply globally and to all industry sectors.

The EPs are a risk management framework for determining, assessing and managing environmental and social risk when financing projects (www.equator-principles.com). The first Principle involves categorizing the project as A, B or C, reflecting its potential environmental and social risks and impacts, where Category A has the most significant impacts and Category C has minimal to none. Because they have limited site-specific effects that are largely reversible or that can be mitigated through conditions of environmental permits, most of the projects that E3 reviews are Category B.

In July 2020, the fourth version of the EPs, EP4, was published. Due to the pandemic, the implementation date was delayed until October 2020. The key changes from the 2013 EP3 focus on three topics: human rights, climate change and biodiversity.

The Equator Principles applies globally, to all industry sectors and to five financial products:

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

The relevant thresholds and criteria that define when the EP is applicable to each product type are described in detail in the Scope section of the EP. Along with new construction, the EPs apply to the expansion or upgrade of an existing project where changes in scale or scope may create or significantly change environmental and social risks and impacts. The EPs are not intended to be applied retroactively.

Regarding Human Rights:

- Each client (borrower) is expected to conduct Human Rights due diligence in line with the United Nations Guiding Principles and to document that process in its Assessment Documentation.

Regarding Climate Change Risks:

- New for EP4, for all Category A and, as appropriate, Category B projects, a Climate Change Risk Assessment (CCRA) will include consideration of relevant physical risks from climate change.
- In addition, for projects in all categories when combined Scope 1 and Scope 2 emissions are expected to be more than 100,000 metric tons of CO_2e per year, the CCRA must consider transition risks. The EP3 requirement for an alternatives analysis to evaluate less greenhouse gas intensive alternatives has been retained. CCRA details are summarized below.

The borrower will likely have already conducted reviews for other permitting requirements, such as an Environmental Assessment under the National Environmental Policy Act. A consultant can certainly reference these efforts to validate EP4 compliance, while gaps in information may necessitate a specialized study. For example, in the US, current air permitting requirements will not cover the full scope of a CCRA.

Regarding Biodiversity:

- The EPFI will encourage the client to share non-sensitive project-specific biodiversity data with the Global Biodiversity Information Facility and relevant national and global data repositories.

In addition, the documentation requirements became more comprehensive. EP4 compliance is to be supported by "Assessment Documentation," defined as an adequate, accurate and objective evaluation and presentation of the environmental and social risks and impacts, whether prepared by the client, consultants or external experts. Principle 7 addresses whether an independent review of the assessment process is required:

- For all Category A and, as appropriate, Category B projects, an independent environmental and social consultant will carry out an independent review of the Assessment process in order to assist the EPFI's due diligence and determination of EP compliance.

EP4 allows the EPFIs, at their discretion, to determine the appropriate level of Assessment Documentation required for a Category B project. While the flexibility is good, this level of discretion can be challenging when an EPFI is asking a consultant to opine on the EP compliance of a Project. The EPFI needs to be very familiar with both the EPs and the potential project impacts in order to justify limiting the scope of a consultant's assessment.

Navigating the Climate Change Risk Assessment.

EP4 references the new CCRA in Principle 1 (Review and Categorization) and Principle 2 (Environmental and Social Assessment). In working on our first project that required EP4, a CCRA was needed. Civil & Environmental Consultants (CEC), an engineering and environmental consulting firm with 27 offices nationwide provided the CCRA. Below, CEC's Kris Macoskey explains the key terminology and concepts behind preparing a CCRA under EP4.

In the context of a CCRA, it is helpful to distinguish impacts from risks. Climate impacts are the environmental consequences of climate change such as increased air temperatures and an increased frequency of extreme storms. Risks are the resultant effects that those impacts may have on the ability of a project to achieve its designed performance objectives (see side-bar). For those who are not familiar with these terms from Task Force on Climate-Related Financial Disclosures (TCFD)[1] guidance or other sources, the new Guidance Note provides a helpful summary with examples. The temporal aspects of how these risks are evaluated is left to the discretion of the preparer to determine, considering the lifespan of the project. The Alternatives Analysis as previously specified in EP3 has been retained in EP4 but clarification on what that analysis should contain is included in the new Guidance Note.

Examples of physical risks from climate change include severity and frequency of drought, storms, floods, heat waves and wildfires, as well as long-term risks such as sea level rise and temperature increase. Transition risks include policy, legal, technology, reputation and market changes resulting from transitioning to a lower-carbon economy.

The updated version of Principle 1 clarifies that Category B projects can reflect a range of environmental and social risks and impacts. As such, while Category A projects are expected to receive CCRA evaluations, some discretion is left to the EPFI regarding the appropriate level of analysis for Category B projects. The expectation is that high-risk Category B projects will be reviewed for physical risks, while low-risk Category B projects may not require that level of analysis at all. Our recommendation is that Category B projects be evaluated with a CCRA at least at a high level. Because both physical and transition impacts can pose significant risks to projects, it's not appropriate to exclude a project from a CCRA based on negligible physical risks alone. For example, a power project located in a mid-Atlantic state may be subject to minimal physical risks compared to a Gulf Coast project, however, transition risks may be equal or greater.

The main EP4 additions related to CCRAs are contained in Principle 2, an expanded Annex A, and a new Guidance Note on Climate Change Risk Assessment. Whereas the EP3 version of Principle 2 simply stated that "one or more specialized studies may also need to be undertaken," EP4 states that a CCRA is "required" for all Category A projects, and some in Category B.

The EP4 guidance also states that plans, processes, policies, or systems that the project developer has instituted to manage identified risks should be discussed in the CCRA. In some cases, pre-existing materials that have been assembled for other purposes, such as voluntary Carbon Disclosure Project questionnaires or Sustainability Accounting Standards Board reporting initiatives, may provide useful responses. In cases where project developers have not yet instituted efforts to assess or manage these risks, industry-specific guidance documents may provide relevant templates with which to develop appropriate responses.

The final part of a CCRA is to assess the compatibility of the proposed project with the host country's national climate commitments. Here again, the new Guidance Note provides helpful information for how to address this new requirement. Whereas the prior elements of the CCRA focus on the risks of climate change impacts on project performance, this element of the CCRA assesses the alignment of the project with goals of the host country. In the U.S., how a project aligns with the re-commitment to the Paris Accord and related emission reduction goals over the life of the project would need to be briefly summarized.

The EP4 guidance materials provide helpful roadmaps for the preparation of the newly-required CCRA. If your organization needs assistance with any aspects of this process, CEC is happy to discuss how we can help.

[1]Recommendations of the Task Force on Climate-Related Financial Disclosures, June 2017.

CONCLUSION

To learn more about our services or to discuss your situation with E3, contact **Carol Ho** at **(720) 833.6345** or email at **carol.ho@e3co.com.** To discuss with CEC, contact **Kris Macoskey** at **(412) 249.3147** or **kmacoskey@cecinc.com.**