PART I

The framework

1

An introduction to the issues

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To someone interested in the social and environmental impact of foreign direct investment (FDI), a focus on project finance (PF) might seem to be a small corner of concern, not worth straying into for too long. That would be a mistake. The closer one looks at the relationships between corporate decision making, lenders' disciplines and the social and environmental impacts of projects, the more the techniques of PF emerge as important forces at work when human rights and environmental values are at stake.

PF provides a set of refined tools for the spreading and mitigating of risks between corporations, host states, lenders and those contractors involved in building and operating a project. At the same time, civil society is producing its own increasingly refined tools for measuring the potential gains and losses to the populations affected by this investment strategy. PF has arguably become one of the most closely watched modes of international finance, as various bodies assess the risk to social and environmental standards by projects to which this form of lending is extended. There are positive and negative elements in the picture. Positively, the finance provided in this way has sometimes provided a bridge to very large social gains, generating revenues that give host governments the space to fund major work in housing, health care and education. Negatively, praise is sometimes brought up short by those whose lives are overturned by a project because of its pollution; accidents during its construction or operation; seizure of lands; and many other impacts. In short, PF provides a prism through which pass many of the fundamental tensions

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characterizing the relation between basic rights, sustainable development and foreign direct investment.

As civil society, both national and international, raises the pressure for meaningful social accountability of business, PF is often in its sights – either intentionally or without realizing it. Demands made for protection of local populations sometimes place particular requirements on this financing technique that it may not be well equipped to handle. Because of certain structural features of PF, a company borrowing under a PF scheme may not easily cede to civil society's demands because of its perception that there is little room for manoeuvre left by the conditions set by lenders. Of concern here are some of the largest projects in the world, many playing a central part in the politics and societies of those countries receiving the investment. A measure of this concern is to be seen in a special meeting which focused on the impact of PF called by the UN's Special Representative on Human Rights and Transnational Corporations, Prof. John Ruggie.[2] It has also been the subject of a report by International Alert, an organization interested in the links between PF and social conflict.[3] The investment community has been taking its own initiatives towards meeting the demand for accountability. Lenders have been developing social and environmental standards that are the most elaborate criteria yet to have been deployed by the international financial community aimed at controlling the impact of what they do. Two leading examples of these standards are, in the public sector, the International Finance Corporation's (IFC) performance standards, meant to control eight different types of potential damage.[4] In the private sector, major lending banks concerted with PF have banded together to formulate the Equator Principles (EP).[5]

[2] See report of the United Nations High Commissioner on Human Rights on the sectoral consultation entitled 'Human rights and the financial sector', 16 February 2007 A/HRC/4/99, 6 March 2007, available at: http://198.170.85.29/UNHCHR-finance-sector-consultation-report-6-Mar-2007.pdf.

[3] The report focused on the relationship between PF and social conflict. See International Alert, 'Conflict and project finance: exploring options for better management of conflict risk' by Corene Crossin and Jessie Banfield, January 2006.

[4] Latest version, April 2011, with draft amendments at www.ifc.org/policyreview. Note that human rights are not specifically included. For critique, see 'Joint Civil Society Statement' (at http://accountabilityproject.org).

[5] At: www.equator-principles.com. These, sometimes referred to collectively as IFC/EP standards, themselves draw both on international norms, such as International Labour Organization (ILO) conventions, as well as domestically formulated criteria, and will be considered in later chapters.

Can the norms for a better environment, human rights and related concerns be adequately satisfied by an investment community aiming to hold onto the full commercial benefits offered by PF? The jury is still out. The aim of this book is to look at the different dimensions of the issue, setting a framework for tackling that question. It draws on, but looks beyond, the views of academics, basing itself on interviews with a variety of actors involved practically in the process.

It is important, first of all, to describe briefly the elements of project finance and to sketch, in an introductory way, the main points of contact with social and environmental issues with which we will be concerned.

The elements

Project finance

Project financing is a method of funding in which the lenders 'base credit appraisals on the projected revenues from the operation of the facility, rather than the general assets or the credit of the sponsor of the facility, and rely on the assets of the facility . . . as collateral for the debt'.[6] It is to be distinguished from those modes of finance in which the general assets of a sponsoring company, often owning several projects, are wholly or in part the subject of claims by the lender in the event of a failure to repay the loan.[7]

This relatively sparse definition needs to be placed within the corporate structure tailored for it. We can use here a classic model: a parent company or a group of companies in a consortium (project sponsors) are typically set up as a project company, or special purpose vehicle (SPV), the latter usually owning the land, machinery, operating funds and other assets directly connected to its owning and operating the pipeline, dam, hydroelectric plant, etc. which is the target of the investment. The controlling equity in the SPV will be held by the project sponsor(s), sometimes accompanied by equity participation from the host state. A loan is then made to the SPV by private banks or public lenders, without – or with limited – recourse to the parent in the event of default on the loan. Instead,

[6] S. L. Hoffman, *The Law and Business of International Project Finance* (2nd edn, Boston: Kluwer, 2001), pp. 4–5.
[7] *Ibid.*, pp. 6–7.

as the definition indicates, the lender's recourse will be to the assets of the SPV.[8]

This arrangement has several noteworthy characteristics:

- The project sponsor is protected from threats to its assets that would otherwise be posed by a venture's failure. The sponsor stands to lose the money it has already invested in the SPV, but its explicit understanding with the lender is that the latter will not have recourse against its other assets. This autonomy is buttressed by the fact that the SPV is a separate legal entity and its sponsors, as shareholders, enjoy limited liability.
- Emphasis is placed by the lender on predictable revenue flow. This concern, while also present in lending against general assets of a sponsor, is here heightened. Were the loan to have been made to the project sponsor, the latter would normally be obligated to pay the loan back from its general revenues, coming from all of the projects in which it is involved. In PF, however, the loan is repaid from one source only: a single project. This typically leads to a heightened emphasis on meeting target dates for construction accompanied by penalties for failure to do so, paving the way for the start of operation and generation of revenue. This is accompanied by a focus on the need to keep project costs as closely as possible to their initial predicted amounts.

These two factors lead to certain intensified concerns on the part of both lenders and borrowers that can have social and environmental impacts. These concerns are also present in other modes of financing, but can be stronger here:

- *Regulatory stability*: Lenders as well as other parties to the project have a strong interest in discouraging the host state from introducing changes in law or regulation that will have a negative impact on project costs, and hence can put pressure on the ability of the project to meet its loan repayment targets.
- *Allocation of risk*: While such allocations are a concern in all projects, those financed by PF place particular emphasis on a spread of risks that will induce the relevant parties to help meet project deadlines and keep expenses within the expected limits.

[8] This non-recourse element functions primarily during the operational phase of the project. The earlier construction phase is often accompanied by some form of recourse the lender will have to the sponsor directly. There are many variants and qualifications to this picture, but it is a good starting point.

- *Presumption in favour of meeting of costs from within project revenues*: Given the insulation of the project from its sponsor's own liabilities, there is a concern to avoid calling on further funds from sponsors to meet unexpected problems with the project.

These concerns can generate both positive and negative effects on societies hosting a project:

- *Positive*: The needs for predictability of return on project investment may encourage a particularly careful calculation of environmental/social risks, given the impact these can have on steady cash flow. As will be seen in later chapters, where the lender has recourse against the project sponsor's assets, there can be less inducement to pay close attention to such factors. The assessment of these risks is called for by the performance standards set by several major public and private lenders, most notably by the IFC and Equator banks.
- *Negative*: On the other side, there is the possibility that risks of certain types of damage to local populations might be heightened by some of the pressures on project timing and performance, as well as techniques of risk management, in PF. Our investigations indicate that this may be so, for example, when unrealistic completion deadlines for construction are set; stringent stabilization requirements freezing regulatory change are placed on host governments; or the possibility exists for project sponsors to abandon a project that is underperforming, with potential loss to third parties. The concern for stability might sometimes be intense enough to pull against an investor's endorsement of democracy in the host country, in favour of the more predictable environment that a strong non-democratic form of government can provide.[9]
- *Issues shared with other modes of finance*: Finally, there is a set of concerns that involve problems of projects financed by PF which would also be shared to the same extent by other modes of finance: e.g. complicity with human rights violations; shortcomings in the due diligence processes conducted by the financial institutions – as will be discussed in several of the chapters in Parts II and III.

[9] This is one possible explanation for the correlations between forms of government and the price of loans discussed in Chapter 8.

The standards for evaluating social impacts of PF

'Basic' and 'human' rights and duties

The fundamental rights of concern throughout this work fall into two overlapping categories, as will be seen in more detail in Chapter 3. First, there are internationally recognized human rights that come from recognized sources. For these purposes such sources include the International Covenant on Civil and Political Rights (ICCPR) and the International Covenant on Economic, Social and Cultural Rights (ICESCR) as well as more narrowly focused human rights conventions. Second, at some points a wider category, 'basic' rights, is used. They are the fundamental entitlements that are formulated in instruments such as the 1972 Stockholm Declaration of the United Nations Conference on the Human Environment, and the 1992 Rio Declaration on Environment and Development. Finally, within the class of basic rights and duties will be those entitlements and obligations imposed on borrowers by the requirements of the IFC as well as Equator Principles banks (hereafter IFC/EP standards), several of which coincide with the international norms mentioned.

How should one deploy basic rights as a critical tool for evaluating the impacts of private investment? How, in turn, should these critical standards be used in evaluating PF projects? There are several elements in an answer, each of which will be more fully developed in Parts I and II.

Comparing rights-based development and rights-based investment

Host states have obligations to respect, protect and fulfil certain basic rights of their populations, and these in turn have been woven into the guidelines for rights-based development: guidelines developed by the UN High Commissioner for Human Rights.[10] Investors can come under an overlapping, but also diverging, set of obligations

[10] For the UN's approach to rights-based development, see UN High Commissioner on Human Rights, 'Rights-based Approaches', available at www.unhchr.ch/development/approaches-04.html, last reviewed on 5 January 2008. For a discussion of the conceptual framework of a rights-based approach to development, see Jakob Kirkemann Hansen and Hans-Otto Sano, 'The Implications and Value-added of a Rights-based Approach', in B. A. Andreassen and S. P. Marks (eds.), *Development as a Human Right: Legal, Political, and Economic Dimensions* (Cambridge, MA: Harvard School of Public Health, 2007), at 42. See also L. VeneKlasen *et al.*, 'Rights-based Approaches and Beyond: Challenges of Linking Rights and Participation', Institute of Development Studies, Working Paper 235, Brighton, 2004.

corresponding to the same rights. The difference between the two sets of duties is one of scope. This can be seen if we consider the example of the right of access to water – an example to be treated in more detail in Chapter 3.[11] Consider an investment in a pipeline project that uses water to such an extent that the supply to the local population falls below minimal standards set by international instruments. The host state could legitimately impose, in fulfilment of its obligation to protect this basic right, regulations requiring the pipeline not to block this access. At that point the obligations of the investor and those of the host state converge: both aim at a portion of the guarantees involved in rights-based development. Not only that, but were the host state to fail to enforce protection of this right in its own domestic rules, there would nevertheless be independent grounds on which the investor could be held responsible for the damage done to the water supply. It could, for example, be held to have broken a basic condition of its loan from an Equator Principles bank. The same would be true were the project company to violate fundamental labour rights as defined in certain ILO conventions. These are conventions which bind the host states, but also form part of the lending conditions set by the Equator banks and the IFC.[12]

An investor's human rights obligations do not completely mirror the host state's responsibilities for rights-based development. Yet over a significant terrain those responsibilities coincide. It is in this domain and others like it that tensions can appear which are of central concern to this book. Even though the private investor might acknowledge, at a general level, that it has to respect these rights, it may aim to determine their content and weight in a way that weakens their protective potential. This can happen as the web of contracts framing an investment are drawn up and given effect. One of the tasks of these chapters is to see how the disciplines of PF might stand behind these problematic features of the legal framework, and then to see what changes to PF arrangements might be made in order to avoid the problem.

[11] See 'What Price for the Priceless? Implementing the Justiciability of the Right to Water', 120 (2007) *Harv. L. Rev.*, 1067.

[12] For example, ILO Conventions No. 182 on Worst Forms of Child Labour, No. 176 on Health and Safety in Mines, No. 167 on Health and Safety in Construction or No. 154 on Collective Bargaining, available at: www.ilo.org/ilolex/english/convdisp1.htm, last reviewed 3 March 2008.

Rights on both sides of the fence

It is tempting to place the concern for basic rights on the side of a population that can be damaged by a project, and the concern for other goals, such as commercial objectives, on the side of the investor. Such a division does not work. There are situations in which the choice of PF as a technique can clearly help a host state discharge its own human rights responsibilities. Water supplied by private sources might reach the neediest parts of the population; and schools or hospitals financed from tax revenues generated by a petroleum pipeline might do the same. Yet, at the same time, as pipelines or water facilities are built, they may themselves do damage: to people, to environments and to property. The real issue at that point might be better cast as a matter of choosing between two courses of action, each with its own distinct impact on human rights. Is it, for example, better to take a step towards fulfilling a basic right to adequate medical care on a national level via tax revenues from a project, but at the expense of allowing construction to move at a pace that destroys the health of some of a local population, or should the adjustment between the two sets of rights move in the opposite direction? Where does the drive for commercial profit legitimately fit into this picture? This clash of fundamental entitlements stands in the background, and sometimes in the foreground, of the enquiries in the following chapters.

Property rights of the investor

In this book it will be important to include in the mix of relevant basic rights those of the investor. We shall work with a model in which the investor enjoys a right to protection of its property via internationally recognized human rights norms. It is tempting, as some do, to construct policy around the denial of this fundamental status to property rights, and in particular to the rights of the investor. Our approach will be to admit the right to property fully into the picture, but will then turn to the question of the appropriate adjustment between this entitlement and competing fundamental rights of those who are affected by any given investment project. It is here that the appropriate constraints on the operation of PF can be constructed. They will not be built on the assumption that the property rights of the investor must automatically take second place, but also that those property rights are not automatically dominant. They must enter into a balance. Understanding the terms of this balance will be a major underlying theme in the analyses at various points in the book. They provide a dynamic way of assessing the qualities of project financing in various settings.