Emerging Standards for Sustainable Finance of the Energy Sector

Kirk Herbertson

David Hunter
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by Kirk Herbertson and David Hunter*

INTRODUCTION

The energy sector relies heavily on large-scale projects, advanced technology, and complex infrastructure, and thus relies heavily on project finance and other investments from international financial institutions (“IFIs”). Worldwide, the average annual investment in energy is around U.S. $413 billion.1 This amount is increasing, particularly in the developing world. Developing countries will require an estimated annual investment in electricity of U.S. $165 billion through 2010, which will increase about three percent per year through 2030.2 Because of the magnitude of their investments in the energy sector, IFIs have the potential to profoundly affect future energy paths.

Because of this influence, civil society advocates are pressuring IFIs to develop a variety of environmental and social policies that can influence the types of energy projects they will finance and how those projects must be implemented. Through these efforts, many energy-related projects have been scrutinized (and in some cases rejected) for their contributions to severe environmental degradation, involuntary resettlement of poor and marginalized communities, or the inequitable allocation of project benefits and costs. Controversy around such projects affects the availability and conditionality of international finance for future proposed energy projects. More recently, civil society activists have also begun to focus on the climate change impacts of IFI energy lending, and have begun to push changes they hope will shift IFI lending portfolios away from fossil fuel projects towards renewable energy or energy efficiency investments. These trends can be expected to continue in the future, with increasingly strict standards applying to the energy sector.

This article surveys the environmental and social policies at the IFIs as they relate to the energy sector. After discussing the general impacts of IFIs on the energy sector, the article describes existing and emerging environmental and social policies that impact IFI support for the energy sector. This survey then addresses policies relating to general development impacts, climate change policies, and policies aimed at specific energy sectors (such as dams, renewables, or nuclear energy).

THE EMERGING ENVIRONMENTAL AND SOCIAL STANDARDS FOR IFIs

At least among public IFIs, the World Bank Group is the recognized leader for influencing developing countries’ economic and development paths. The World Bank Group is comprised of four separate, but related, financial institutions: the International Bank for Reconstruction and Development (“IBRD”), the International Development Association (“IDA”), the International Finance Corporation (“IFC”), and the Multilateral Investment Guarantee Agency (“MIGA”).3 IBRD and IDA provide loans to support public-sector projects. Together IBRD and IDA are most frequently referred to as the “World Bank.” The primary difference between the IBRD and IDA is that IDA provides concessional or low-cost loans to the poorest countries (those having per capita annual income below U.S. $1065 in 2005 dollars).4 The IBRD provides loans to other developing countries and countries in economic transition at a near-market rate with longer repayment terms than commercial loans. The IFC and MIGA provide financial support to private sector projects in all developing countries or countries in economic transition. IFC makes loans and equity investments in private sector projects. MIGA provides insurance against political risks faced by private sector investments in developing countries (i.e. risks from civil unrest or war).

The World Bank Group is the largest source for development financing in the world. Each year the Group supports approximately U.S. $20 billion in projects and leverages an additional U.S. $50 billion from other financial institutions. From 1992 to 2004, the World Bank Group financed approximately U.S. $28 billion towards fossil fuel projects.5 But the influence of the World Bank Group extends far beyond the monetary value...
of its investments. The Group is the recognized intellectual leader among development organizations, often setting precedents for other institutions to follow. The Group’s influence is expanded further by coordinating with other donors, mobilizing bilateral and increasingly private-sector financing, conducting policy research, and providing technical assistance to borrowing countries.

Beginning in the 1970s, independent observers began to recognize that the World Bank and other IFIs were providing support for some of the most environmentally damaging projects taking place in developing countries. These projects, including several large energy infrastructure projects, were often associated with allegations of severe environmental destruction, human rights abuses, and long-term harm to the economic well-being of the poor in the project area. Even assuming good intentions, the size and scale of many of the projects simply dwarfed the legal and policy infrastructure of the borrowing country. 6

In response, pressure from environmental and human rights groups pushed IFIs to address the sustainable development impacts of the projects they finance. 7 As part of their response, first the World Bank, and then other IFIs, adopted environmental and social policy frameworks that provide certain protections for local communities affected by the projects. The environmental assessment policy is the cornerstone of the Bank’s safeguard policy system. All World Bank-financed projects are screened into three categories depending on the extent of environmental impacts associated with the project. “Category A” projects, which have “significant adverse impacts that may be sensitive, irreversible and diverse,” must undergo a full environmental assessment, with specific requirements for consultation and disclosure. “Category B” projects have adverse impacts that “are less significant than Category A impacts. Preparation of a mitigatory plan suffices for many Category B projects.” “Category C” projects normally do not require any environmental analysis “because the project is unlikely to have adverse impacts.” 8 In general, about ten percent of World Bank projects are classified as Category A, and significantly more (57 percent in 2005) are classified as Category B. In addition to environmental assessment, the World Bank environmental and social policies include, among other things, specific policies relating to involuntary resettlement, indigenous peoples, and natural habitats.

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Other IFIs, including multilateral development banks (“MDBs”) such as the Asian Development Bank and the Inter-American Development Bank, commercial banks such as Citibank and ABN Amro, and export credit and insurance agencies (“ECAs”) such as the U.S. Export-Import Bank and the UK’s Export Credits Guarantee Department, have all followed the World Bank Group’s lead in developing environmental and social standards. Even though many of these IFIs do not share the World Bank’s development mandate, they increasingly understand that setting environmental and social requirements for projects lowers project risk and the institution’s own reputational risk. 9 Thus, for example, ECAs, which are bilateral agencies that provide project finance, guarantees, or insurance to promote a country’s exports and investments abroad, adopted the Organization for Economic Co-operation and Development (“OECD”) Recommendations on Common Approaches on Environment and Officially Supported Export Credits. 10 While the OECD Common Approaches bind the ECAs to relatively few commitments, they explicitly require ECAs to benchmark their projects against other environmental and social standards, including those of the World Bank Group’s safeguard policies. 11 Many individual ECAs have also adopted more specific environmental and social policies that have significant implications for their support of the energy sector. 12

Perhaps even more importantly, in 2003, a group of leading commercial banks committed to adhere to the “Equator Principles,” which essentially incorporate the IFC’s environmental and social standards. 13 The Equator Principles have now been adopted by commercial banks that collectively arrange more than 80 percent of all international project finance in developing countries. 14 In addition, many of these commercial banks have issued separate environmental and social policies that go well beyond the requirements of the Equator Principles (or those of the IFC). 15

Policies Implicating the Energy Sector

For the most part, IFI environmental and social policies have not specifically targeted the energy sector. Although the World Bank, for example, has developed lending strategies for the energy sector, no policy establishes environmental and social conditions specifically for energy-sector lending. Nonetheless, concern over the development impacts, and more recently the climate impacts, of the energy sector have led to policies that directly bear on the future of IFI financial support.

Development Impacts

Many of the most controversial projects supported by IFIs in recent years have been energy projects. These projects have engendered stiff international opposition from civil society networks, primarily motivated by a belief that these projects do not provide sufficient development benefits for, and impose unaccept-
ably high costs on, local affected communities. In some instances, these campaigns led to stronger environmental and social conditions being placed on the projects, including for example the Baku-Tbilisi-Ceyhan pipeline (environmental and human rights conditions),\(^1\) the Chad-Cameroon pipeline (environmental and revenue management requirements),\(^2\) and the Sakhalin II Oil and Gas project off of Russia (expanded protections of whales and salmon habitat).\(^3\) Some projects were precluded from receiving financial support from specific institutions, including the Camisea pipeline in Peru (financing rejected by the U.S. Export-Import Bank due to environmental and social concerns),\(^4\) and China’s massive Three Gorges dam (both the World Bank and the U.S. Export-Import Bank refused financial support).\(^5\) Still others have been cancelled (or at least delayed) due to these campaigns, including the Ilisu hydroelectric dam in Turkey\(^6\) and Uganda’s Bujagali dam.\(^7\)

These projects were delayed, modified, or cancelled because of their failure to meet the environmental and social conditions that IFIs placed on them, in order to improve the development impacts. Although the environmental and social policies applicable to each project depend both on the proposed lending institutions and the project’s specific impacts, in general the policies fall into five categories: (1) policies relating to environmental and social assessment; (2) policies relating to information disclosure\(^8\) and community consultation;\(^9\) (3) policies intended to ensure full compensation to people involuntarily resettled;\(^10\) (4) policies meant to protect the rights and interests of indigenous peoples;\(^11\) and (5) policies meant to protect critical natural habitats. Most of the IFIs mentioned above have adopted their own policies or follow the World Bank Group’s policies on these issues.

In addition to the normative framework found in the environmental and social policies, at least nine financial institutions have also adopted some form of accountability mechanism that enables affected people to raise concerns regarding compliance with the IFIs’ environmental and social policies. Beginning with the creation of the World Bank Inspection Panel in 1993, five multilateral financial institutions\(^12\) and three bilateral financial institutions\(^13\) currently provide locally-affected people access to accountability mechanisms. Although the effectiveness and independence of these mechanisms vary, they collectively provide significant new opportunities for challenges to future energy projects.

**Climate Change**

The impact of IFIs on climate change is clear and significant. The World Resources Institute (“WRI”) reports that “[t]he lending profile of MDBs demonstrates significant concentrations of finance in sectors with substantial greenhouse gas (“GHG”) emission footprints, including transport, oil and gas, electric power, and mining.”\(^14\) The report calculates that 27 percent of the World Bank’s lending in 2004 went toward these projects, with an investment of U.S. $7.6 billion. Since the signing of the UN Framework Convention on Climate Change (“UNFCCC”) in 1992, the World Bank Group has financed over U.S. $28.4 billion in fossil fuel projects, resulting in 43.3 billion tons of lifetime carbon emissions.\(^15\) Other MDBs are similarly committed to projects that contribute substantially to GHG emissions. In 2004, the Inter-American Development Bank invested U.S. $730 million (twelve percent of its total lending), and in 2003 the European Bank for Reconstruction and Development invested U.S. $3.3 billion (27 percent of its total lending), in projects with potentially substantial impacts on the climate.\(^16\)

Closer review of the World Bank shows the influence of the banks, and their connection to climate change. In addition to its direct financing, the World Bank is also an implementing agency of the Global Environment Facility (“GEF”), which among other roles, acts as the financial mechanism for the UNFCCC.\(^17\) Through its Carbon Finance Unit,\(^18\) the Bank launched the Prototype Carbon Fund in 2000 and continues to champion the global carbon market, by financing the purchase of emission credits under the Kyoto Protocol’s Clean Development Mechanism. The Bank’s influence is expanded further by coordinating other donors, mobilizing bilateral private-sector financing, conducting policy research, and providing technical assistance to borrowing countries.

In recent years, the IFIs have begun to recognize that the climate change policy landscape has changed and that this may lead to new financing conditionalities and a need to change their energy portfolios. Almost every country in the world has signed the 1992 UNFCCC and the 1997 Kyoto Protocol. Under Kyoto, all industrialized countries, except the United States and Australia, have committed to mandatory timetables and targets for reducing emissions. As a result, many regional, national, and sub-national governments throughout the world have created policies to regulate GHG emissions, and many have established carbon trading systems.\(^19\)

Even though emissions reductions under the Kyoto Protocol do not apply to developing countries, climate change is now recognized as a major development issue, requiring more direct attention from development institutions. For example, climate change impacts must now be included in the environmental assessments required by the World Bank and most other IFIs.\(^20\) In addition, IFC’s new Performance Standards require projects with annual GHG emissions greater than 100,000 tons to estimate and report their emissions annually.\(^21\)
Other IFIs are also beginning to respond to climate change with new policies that may restrict or change their lending practices. Private commercial banks, which are increasingly exposed to climate risks, are beginning to account for these risks in the costs of their loans and other services. Many commercial banks have started to reduce their own internal carbon footprint, with HSBC having achieved carbon neutrality in 2005. At least four private commercial banks—Bank of America, Citibank, JPMorganChase, and HSBC—have specific policies addressing the climate impacts of their lending portfolios. JPMorganChase has committed to work with its largest GHG-emitting clients to develop carbon mitigation plans, which include measuring and disclosing GHG emissions and developing strategies to reduce or offset them. Starting in 2006, the bank began reporting annually on GHG emissions from its power portfolio and working with clients to develop new financial products that facilitate emission reductions. Bank of America’s policy is noteworthy because it includes a reduction target that commits the bank to reduce emissions from its energy and utility portfolios by seven percent by 2008. Neither Citigroup nor HSBC have specific commitments relating to emissions reductions or carbon mitigation plans, although Citigroup has committed to reporting on emissions resulting from its energy sector lending. Export credit agencies can also be expected to shift their climate policies, as part of their home country’s national climate or environmental policies.

To be sure, the IFIs’ current climate-related policies make only modest commitments and their implementation appears to be insufficient. According to WRI, for example, “[o]ver 80 percent of World Bank’s publicly disclosed lending in the energy sector from 2000 to 2004 did not consider climate change issues in project appraisals and documentation.” Nonetheless, clear trends are emerging that IFIs will increasingly have to commit at least to: (1) assessing and reporting on climate emissions and impacts; (2) reducing GHG emissions at the transactional and portfolio levels; and (3) shifting towards clean energy technologies. Indeed, recently civil society is beginning to push for the complete withdrawal of international financial assistance to the fossil fuel industry. As climate impacts become more urgent, such pressure will build and we can expect more stringent policy responses from the IFIs.

RENEWABLE ENERGY PORTFOLIOS

Closely related to the push for a response to climate change have been policies aimed at promoting renewable energy. Thus far, IFIs have been slow to shift their energy sector portfolios in the direction of renewable energy. The IBRD has committed to increasing its lending for renewables by twenty percent per year, but this is a modest increase given that renewable lending starts from such a low baseline. In fiscal year 2005, for instance, the IBRD’s financing for renewable energy projects comprised less than five percent of its overall lending to the energy sector. In its September 2006 Investment Framework for Clean Energy and Development, the IBRD does not make further commitments to sustainable energy practices, and continues to rely on fossil fuel projects to meet the energy needs of the poor.

Other IFIs have made only limited commitments to increasing their renewable energy portfolios. In May 2005, OECD countries participating in the Arrangement on Officially Supported Export Credits, established special financial terms to favor renewable energy projects. For a trial period from 1 July 2005 to 1 July 2007, participating ECAs agreed to give borrowers for renewable energy projects extended repayment terms of fifteen years (an improvement over the twelve year terms generally offered to power plants). This fell short of the calls by civil society groups pushing for ECA reforms, which called for: (1) developing a sustainable energy portfolio, requiring a phase-out of support to fossil fuel and other unsustainable energy technologies within two years; (2) committing twenty percent of the total energy portfolio within two years to supporting sustainable energy; (3) introducing institutional reforms and capacity building measures to abolish preferences for fossil fuels and nuclear technology; (4) providing the lowest interest rates and maximum repayment terms available under existing guidelines to support renewable energy, energy efficiency, and conservation projects; and (5) establishing a Renewable Energy Advisory Committee composed of representatives of the renewable energy sector, civil society, and government officials to make a series of recommendations. These or similar requests are likely to form the civil society platforms for future IFI reforms.

DAMS

Large hydro-electric dams have long been a lightning rod for civil society campaigns around IFI financing. Financing for projects such as China’s Three Gorges dam, India’s Narmada dam, Turkey’s Ilisu dam and Uganda’s Bujagali dam, have all sparked considerable controversy, and in the cases of the Ilisu and Bujagali dams, international financing (from the World Bank group) was rejected. Nonetheless, in part as a response to climate change, many IFIs are now calling for greater use of hydropower. The World Bank Group, for example, considers large scale dams to be a key component of its renewable energy portfolios. Of the U.S. $748 million that the Bank financed in fiscal year 2005 for “renewable energy and energy efficiency,” approximately 60 percent went towards hydropower with capacity of over ten megawatts.

Many civil society organizations have argued that large scale hydropower cannot be considered a viable renewable energy alternative. Large dam projects have displaced between 40 and 80 million people worldwide, in addition to the millions displaced by canals, powerhouses, and other infrastructure associated with dams. In many cases, IFIs, governments, and project proponents have not provided displaced communities with viable resettlement plans or adequate compensation, shattering the livelihoods of these persons. At the same time, dams have caused irreversible impacts to local habitats and water basins. Because of their methane emissions, GHG emissions from large dams have often exceeded the emissions of conventional fossil fuel power plants generating equivalent amounts of energy. Furthermore, dams often do not run efficiently or meet their power generation targets, and often suffer lengthy construction delays and large cost overruns.
Because of these and related concerns, the World Bank constituted a World Commission on Dams ("WCD") in 1997 to provide an independent assessment of the future of large dams. The highly acclaimed WCD report provided several recommendations in 2000, including that IFIs should: (1) use comprehensive options assessments as a risk mitigation tool; (2) incorporate the WCD principles, criteria, and guidelines into their environmental and social policies, and use the guidelines as minimum screens for evaluating support for, and investment in, individual projects; (3) develop legally binding environmental and social provisions in their insurance coverage, and debt and equity arrangements; and (4) develop criteria for bond-rating systems for use in financing all options, including large dams, in the water resources and electric power sectors.56 Despite its initial support, however, the World Bank rejected the WCD’s recommendations and the Banks’ environmental and social policies do not currently meet the WCD standards with respect to issues such as human rights, indigenous peoples, social assessments, and transboundary impacts.57 The IFC’s Policy and Performance Standards follow many, but not all, of the main recommendations of the WCD. Most importantly, the IFC does not emphasize the human rights of affected peoples to the same degree as the WCD. The only IFIs to explicitly incorporate the WCD recommendations are the commercial banks HSBC and ABN Amro.58 Because most IFIs do not have proper safeguards in place for dam projects, their reliance on hydropower as a renewable alternative to oil and coal will likely continue to engender substantial controversy and opposition among civil society organizations.

Nuclear Policies

Except for one loan to Italy in 1959, the World Bank Group does not support nuclear power, primarily out of concerns that it is non-economic and never a least-cost solution.59 Indeed, the only multilateral development bank that directly supports nuclear power is the European Bank for Reconstruction and Development, which has supported the construction and modernization of nuclear power plants in the former Soviet bloc. Nonetheless, the World Bank and other IFIs increasingly consider nuclear power projects as a non-fossil fuel option for reducing emissions, acid rain, and air pollution,60 and the multilateral reluctance to support nuclear power has not carried over to the ECAs, which play a significant role in promoting nuclear power technology around the world. According to one study, fourteen of the 25 nuclear reactors under construction in 2001 were supported by ECA financing.61

The renewed interest in nuclear power concerns many civil society organizations because it is essentially “replacing one evil with another.” Nuclear power plants contribute fewer emissions than coal or oil, but are not emissions free. In order for nuclear power to contribute to a twenty percent decline in carbon emissions across the world, there would have to be three to four times more reactors. This would cost trillions of dollars, draining resources that could be spent on developing emissions free technologies.62 Because nuclear power is also a “base-load technology” whose energy output runs continuously, nuclear energy cannot be adjusted to specific consumer and industrial demands, and thus does not create incentives for energy consumers to shift to more efficient, sustainable energy use.63 Furthermore, there are enormous environmental and public health risks associated with nuclear power. As WWF describes, “The entire commercial chain of the processing of nuclear raw materials from nuclear mining; operating nuclear power stations; handling nuclear waste and finally re-processing, is full of leaks and contamination and produces a highly toxic legacy for thousands of years to come.”64 Nuclear power is also a “power-grid based technology,” which means that these projects would be much more unlikely to extend energy access to the world’s poorest, remote communities.65 For these reasons, the European ECA Reform Campaign recommended that a responsible ECA sustainable energy policy (which is applicable to all IFIs) should include the following elements: (1) the IFI will not fund new nuclear projects or the expansion of old or delayed projects; and (2) the IFI “may offer support to help decommission nuclear installations or improve the safety of a running nuclear power plant, but only if this safety improvement does not prolong the life of the plant.”66

Future Trends

IFIs are in a key position to provide leadership in the shift from fossil fuels to renewable energy that must be part of a global response to climate change. Moreover, the development mandates of many of the IFIs should force them to consider the potential positive and negative development impacts of such a shift, and will likely lead them to continue to expand their environmental and social conditionality on energy lending. This trend will be fueled by civil society’s continued calls for stronger policies, to address both climate and development impacts.

Clear trends in the IFI environmental and social policies are evident. These policies have become increasingly salient to energy lending over time and have formed the basis for successful civil society campaigns to delay, prevent or improve environmentally and socially harmful projects.67 But although progress has been made, the IFIs’ policies have failed to keep pace with advances in clean energy technology and knowledge about climate change. Additionally, civil society organizations continue to criticize the weaknesses of existing safeguard policies, for example: (1) many policies fall far short
of current international law and norms; (2) policies do not comprehensively address the full range of environmental and social impacts of IFIs’ activities; (3) policies are often limited only to project finance; (4) many policies allow only for limited and inconsistent stakeholder involvement; (5) the language of many policies is crafted so that IFIs do not actually commit to any particular action; and (6) many policies have not been well implemented. In some cases, as with climate change policies, a few commercial banks have surpassed the safeguards of the World Bank and other public institutions. Furthermore, there continues to be lack of full implementation of safeguard policies.

Endnotes: Emerging Standards for Sustainable Finance

3 The World Bank Group also includes the International Center for the Settlement of Investment Disputes, the leading international dispute resolution body for transnational investment disputes. This general discussion of the World Bank is borrowed generally from D. Hunter, J. Salzman & D. Zaelke, International Environmental Law and Policy 1560-61 (3d ed. 2006).
4 1999, at para. 14 (“For all Category A and B projects proposed for IBRD or IDA financing, during the EA process, the borrower consults project-affected groups and local nongovernmental organizations about the project’s
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CONCLUSION

As concern over climate change continues, we can expect more pressure to build on IFIs to restrict their fossil-fuel energy portfolios and to expand their lending to other sectors. Existing policies and approaches with respect to renewables, energy efficiency, dams, and nuclear power will likely be revisited and serve as flashpoints for future policy dialogue. Expansion of relatively new energy sources, most notably biofuels, will likely also launch substantial debates (and future policies) on the development impacts. New IFI policies that emerge from these debates will likely continue to shape the path of energy development in the future.


