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**Project finance,
sustainable
development and
human rights.
Case study 1: the
Baku Tbilisi-Ceyhan
(BTC) pipeline**

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Project finance, sustainable development and human rights

**Case study 1:
the Baku Tbilisi-Ceyhan (BTC) pipeline
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Acronyms and abbreviations

ACG	Azeri Chirag and deepwater Gunashli fields
AGI	Above ground installations
AGT	Azerbaijan-Georgia-Turkey pipeline
AIOC	Azerbaijan International Operating Company
BOTAŞ	BOTAŞ Petroleum Pipeline Corporation
BP	British Petroleum
BPD	Barrels per day
BPU	Business Principles Unit
BTC	Baku Tbilisi-Ceyhan pipeline
CAO	Compliance Advisory Ombudsman
CCIC	Consolidated Contractors International Company
CCP	Contractor Control Plans
CDAP	Caspian Development Advisory Panel
CDM	Clean Development Mechanism
CIP	Community Investment Programmes
CIS	Cumulative impact study
COFACE	Compagnie Francaise pour le Commerce Exterieur
DFID	Department for International Development
EBRD	European Bank for Reconstruction and Development
ECA	Export credit agencies
ECGD	Export Credit Guarantee Department
EIA	Environmental impact assessment
EMMP	Environmental management and monitoring plan
EP	Equator Principles
ESAP	Environmental and social action plan
ESIA	Environmental and social impact assessment
ESRC	Economic and Social Research Council
ESRP	Environmental and Social Review of Projects
FSC	Forest Stewardship Council
GIOC	Georgian International Oil Corporation
GLAC	Guides to land acquisition and compensation
HERMES	Euler Hermes Kreditversicherungs-AG
HGA	Host government agreement
HSE	Health and Safety Executive
ICJ	International Court of Justice
IEC	Independent Environmental Consultants
IFC	International Finance Corporation
IGA	Intergovernmental Agreement
IIED	International Institute for Environment and Development
IPPC	Integrated Pollution Prevention Control
IRM	Independent Recourse Mechanism
JBIC	Japan Bank for International Cooperation
KHRP	Kurdish Human Rights Project
LSTA	Lump Sum Turnkey Agreement
MIGA	Multilateral Investment Guarantee Agency
MSF	Multi-stakeholder forums
NCEIA	Netherlands Commission for Environmental Impact Assessment
NGO	Non-government organisation
OECD	Organisation for Economic Co-operation and Development
OPIC	Overseas Private Investment Corporation
PCDP	Public consultation disclosure plan

RAP	Resettlement action plan
ROW	Right of way
SCP	South Caucasus Pipeline
SEA	Strategic environmental assessment
SLIP	Supplementary lender information pack
SOCAR	State Oil Company of Azerbaijan
SPJV	Spie-Capag Petrofac Joint Venture
VAT	Value added tax

1 Introduction

In recent times, firms operating in the extractive industry sectors are increasingly resorting to project finance in place of more conventional methods for financing their operations, such as equity and conventional commercial corporate borrowing. The obvious advantage of project finance is that the project itself and its assets are used as security for loans advanced to the project. This means that the risks that lenders assume, as well as the liabilities of the project sponsors, are all tied to the project. Thus, lenders cannot, except in highly limited circumstances, have recourse to the assets of project sponsors or shareholders of the firm floating and executing the project in the event of default.

In tandem with the increased recourse to project finance by business enterprises engaged in natural resource extraction, there is also an emerging trend for financial institutions providing such financing to require that borrowers incorporate the protection of fundamental human rights and principles of sustainable development into their implementation plans. For these financial institutions, project lending serves as a leveraging device that is used to obtain commitment by extractive industry firms to comply with norms and principles of fundamental human rights and sustainable development as contained in the laws of the host country and international legal instruments. The International Finance Corporation (IFC), the private sector arm of the World Bank, and banks that subscribe to the Equator Principles² have adopted this practice of requiring borrowing companies to incorporate human rights and sustainable development principles and practices into their operations.

But whilst the linkage between project finance and human rights protection and/or sustainable development may seem straightforward in theory, the empirical evidence may tell an entirely different story. The question is whether, in practice, firms that resort to project financing as a lending mechanism possess better records on human rights and sustainable development than those that do not. What happens after the 'moment of leverage' (e.g. closing of the project finance deal with lenders) has passed? Can regulators, investors and citizens hold the project sponsors (e.g. a multinational mining corporation) accountable for implementing the provisions of the project finance agreement dealing with human rights and sustainable development issues?

² The Equator Principles (EP) are a set of environmental and social benchmarks for managing environmental and social issues in development project finance globally. Once adopted by banks and other financial institutions, the Equator Principles commit the adoptees to refrain from financing projects that fail to follow the processes defined by the principles (Source: en.wikipedia.org, accessed 23.01.09)

The International Institute for Environment and Development (IIED) has been engaged in interdisciplinary research into how financial markets and global investment policies influence sustainable development, poverty reduction and human rights.³ The basic research questions are:

1. What are the links between project finance/foreign direct investment (FDI) and sustainable development and human rights?
2. To what extent does the use of project finance accentuate the positive and negative impacts of FDI on sustainable development and human rights and through which channels?

1.1 The case study: the BTC pipeline

In this document I analyse these two questions for the case of the project to build and operate the Baku Tbilisi-Ceyhan (BTC) pipeline. This 1,768 km long oil pipeline will run through Azerbaijan, Georgia and Turkey to connect the Caspian and Mediterranean seas. The project is headed by British Petroleum (BP). Key reasons for selecting the BTC pipeline as a case study include:

- **Information availability:** access to information on contractual arrangements and the procedures followed by financial institutions involved in the loan was essential. This type of information is usually considered sensitive for both the project sponsors and the financial institutions involved, which means it usually remains confidential. However, in the case of the BTC pipeline, the International Finance Corporation (IFC) was involved in the financial arrangement. IFC requires important information regarding the due diligence process for the project – in particular environmental and social assessments, monitoring plans, etc. – to be disclosed to the public.⁴ In addition, important legal contracts (host government agreements - HGAs) have been agreed between each of the host governments and project sponsors. The BTC's HGAs are considered to be one of the most high profile types of agreements to date, and constitute one of the key points in civil society's opposition to the project. Though this type of agreement usually remains confidential, in the case of the BTC pipeline the IFC asked the project sponsors to put the contractual arrangements into the public domain.
- **Global scrutiny:** the BTC pipeline is one of the largest foreign and private investment projects ever – about US\$ 3.6 to 4 billion. It has therefore received serious global scrutiny and there is a large amount of information produced by different institutions including civil society groups, as well as multilateral financial institutions involved beyond the IFC.
- **Category A project under the Equator Principles (EPs):** The EPs are an industry standard adopted in June 2003 which provide a framework for commercial banks to review, evaluate and mitigate/avoid environmental and

³ With the support of the UK Economic and Social Research Council (ESRC), the University of Essex.

⁴ Due diligence is an important process for risk identification in project financing. It is an interdisciplinary process involving legal, technical, environmental, social and financial specialists, designed to detect events that might result in total or partial project failure (Hoffman 2001).

social impacts and risks associated with project finance activities (see Chapter 4 for more detail). The BTC project was the first project to be classified as Category A under the EPs. This means it could have potentially significant adverse environmental or social impacts.

1.2 Methodology

The research approach involved desk research and some key stakeholder interviews. The desk research involved reviewing the main literature on the BTC project and its financing. In particular, this included official documents and grey literature produced by the financial institutions, project sponsors, civil society groups and newspapers involved. Special attention was given to the contracts between the project sponsors and the host governments' HGA, contracts between the project sponsors and contractors, as well as the numerous documents analysing them. Special attention was also given to information produced by the financial institutions on their own environmental and social due diligence processes, or reviews of these processes conducted by other stakeholders.

2 About the BTC project

2.1 General description

The BTC pipeline transports oil from the port of Baku in Azerbaijan, through Tbilisi in Georgia to the port of Ceyhan in Turkey. The oil originates from the Azeri-Chirag-Guneshi (ACG) offshore oil field complex as well as other Azeri oilfields.⁵ From the Ceyhan terminal and its Yumurtalik port on the Mediterranean coast of Turkey, supertankers ship the Azerbaijani oil to consumer markets. The pipeline is anticipated to have a lifespan of at least 40 years. During the early stages of operation of the oilfields and pipeline, the main consumers will be countries in southern Europe (Socor 2005). At full capacity BTC will be delivering volumes equivalent to 10 per cent of European oil imports (EBRD 2003b).

The BTC pipeline is part of a large-scale attempt to create alternative oil routes and ease dependence on Middle Eastern oil reserves and Russian pipelines, as well as avoiding Iran. As such, the project is a major component of the Azerbaijan-Georgia-Turkey (AGT) pipelines, consisting of four projects, of which BP is the operator and largest shareholder.⁶ The projects are:

- Azeri-Chirag-Gunashli offshore oilfield.
- Baku-Tbilisi-Ceyhan oil pipeline.
- Shah Deniz offshore gasfield.
- South Caucasus gas pipeline.

The construction of the BTC pipeline was also intended to ease the heavy traffic in the Bosphorus straits by carrying some of the Russian and Kazakh oil that is currently transferred by oil tankers entering the Turkish Straits (Taleh 2006). As a result, the pipeline was intended to reduce the risk of environmental catastrophes in the Bosphorus by reducing the volume of ships with hazardous cargo.⁷

The projected annual capacity of the pipeline is 50 million tonnes of oil. First stage capacity is thought to be about 150,000 barrels per day (bpd), which will increase to 1 million bpd by 2009 and thereafter, when production at the Azeri oilfields reaches maximum levels. This assumes that a growing share of the throughput will originate on the eastern Caspian shore, once the output at Azeri-Chirag-Guneshli levels off and begins to decline after 2015 (Socor 2005).

⁵ The Azeri Chirag and deepwater Gunashli (ACG) fields operated by BP Exploration (Caspian Sea) Limited contain an estimated 5.4 billion barrels (bbls) of recoverable crude oil reserves developed in four separate phases, the first of which, the Early Oil project, was financed by IFC and EBRD in 1998. It is producing approximately 140,000 barrels of oil a day. The second stage, called Phase 1, was sanctioned in August 2001 and was financed by IFC and EBRD. The financing of the Phase 1 project will be conducted in parallel with the BTC project. Phase 2 was sanctioned in September 2002, and Phase 3 in September 2004. Following the completion of all of the phases in 2009, the ACG field peak production of crude oil is expected to be over 1 million barrels of oil per day based on proven plus probable reserve estimates.

⁶ For details of this project see:

<http://www.bp.com/managedlistingsection.do?categoryId=9007996&contentId=7014981>.

⁷ Interview of Rizmaya Kazimova to Mithat Rende, a senior Turkish diplomat in charge of energy issues at the Foreign Ministry to Trend.az, July 10th, 2006.

During the first three months of 2007, the Azerbaijan International Operating Company (AIOC) produced a total of 61 million barrels (around 678,000 bpd average) from the Chirag, Central Azeri, West Azeri and East Azeri platforms. The plan to produce an average of 708,000 barrels per day from the four platforms in total for the full year remained on target.

2.2 Construction

Project construction (the Baku portion) officially started in September 2002 in accordance with the development and production schedule at the three oilfields. The pipeline was originally expected to be completed in early 2005. However, engineers only begun final tests to the pipeline in June 2006 and it was formally opened on 13th July 2006, one year behind schedule.⁸ Project delay was explained by 'rigorous testing and commissioning activities designed to ensure the integrity and safety of each section of the pipeline prior to introducing oil, that took longer than expected but were necessary to make sure that the link operates efficiently and safely for the next 40 years or more'. Other factors contributing to the delay claimed to include 'poor winter weather conditions and contractor performance, particularly on the Turkish section of the line'.⁹

In Azerbaijan and Georgia, BP and BTC Co. were directly managing all aspects of pipeline construction (CDAP 2003), hiring two prime contractors: Consolidated Contractors International Company (CCIC), responsible for the pipeline construction and valves, and Spie-Capag Petrofac Joint Venture (SPJV), in charge of the main above ground installations (IRM 2005). In Turkey, BOTAŞ (a Turkish government body) served as managing contractor.

2.3 Costs and sponsors

When the project started, the BTC pipeline was the largest cross-border infrastructure construction project in the world (IFC 2006); it is still the largest foreign investment in any of the three host countries (OPIC 2004). Total construction costs for the BTC pipeline were originally estimated to be US\$ 3.6 billion, including financial costs. However, costs increased during construction, and the final estimate will be to the tune of US\$ 4 billion (*The Oil Daily* 2006). This increase is due to higher than expected costs for contractors and materials, as well as construction delays, especially on the Turkish portion of the pipeline. This figure, however, does not include the additional US\$ 600 million needed for filling the pipeline with oil (Alexander's Gas and Oil Connections 2006).

The BTC oil pipeline was developed by the Baku-Tbilisi-Ceyhan Pipeline Company (BTC Co.). BTC Co. is located on the Cayman Islands and owned by the following oil companies (van Gelder 2003):

- BP United Kingdom (30.1%).
- State Oil Company of Azerbaijan (SOCAR) Azerbaijan (25%).

⁸ IBID

⁹ BP in Azerbaijan: Sustainability Report 2005 at <http://www.bp.com/genericarticle.do?categoryId=9006595&contentId=7020485>

- Unocal United States (8.9%).
- Statoil Norway (8.71%).
- Turkiye Petrolleri Anonim Ortakligi (TPAO) Turkey (6.53%).
- ENI/Agip Italy (5%).
- TotalFinaElf France (5%).
- Itochu Japan (3.4%).
- Inpex Japan (2.5%).
- ConocoPhillips United States (2.5%).
- Amerada Hess United States (2.36%).

As well as being the largest stakeholder in the project, BP is also the project operator.

2.4 Stakeholders' perspectives on the project

Given the size and complexity of the BTC pipeline, it is a controversial project with stakeholders polarised between two views. The stakeholders include project sponsors, host governments, affected communities, third country governments, financial institutions and civil society.

Those supporting the project include the project sponsors, the host governments and the financial institutions involved, i.e. development banks – especially IFC and EDRB – and 15 commercial banks. Their arguments for the project include:

- Economic opportunities for the region. Azerbaijan will benefit from both the BTC pipeline and the ACG Phase 1,¹⁰ through the initial investment, oil revenues, taxes and equity returns to a total of some US\$ 40 billion. Georgia will benefit from an income of US\$ 1 million in investment and US\$ 580 million in transit fees. The latter could reach US\$ 50 million a year, equivalent to 2 per cent of GDP in Georgia (Mansley 2003). Turkey will also benefit (though to a much lesser extent in terms of GDP per capita). The Turkish government will receive an estimated US\$ 1.2 billion to US\$ 1.8 billion in pipeline transit fees, while BOTAS will receive an estimated US\$ 70 million annually in operating fees for its role as operator in Turkey (CDAP 2003).
- Transference of the pipeline to Azerbaijan ownership at no cost, after the investors in BTC Co. achieves a 12.5 per cent rate of return over a 20 year period (BCC 2002).
- Employment creation, in particular during the construction phase (over 10,000 jobs) as well as 850 permanent jobs (BMT 2003).
- Indirect benefits in the form of new infrastructure and technology transfer (ABN AMRO 2003).
- An opportunity for positive co-operation between the three countries involved (ABN AMRO 2003).

¹⁰ ACG = Azeri Chirag and deepwater Gunashli fields.

- Environmental benefits: relieving growing pressure on the environmentally sensitive Bosphorus Straits from increasing tanker traffic (USAID 2004) and through the transfer of higher environmental (and social) standards (CDAP 2003).
- Other environmental and social benefits from the project's community investment programme in all three countries. BTC, together with the South Caucasus pipeline (SCP), will spend some US\$ 30 million (including US\$ 5.5 million already awarded in Azerbaijan) on community and environmental investment in Azerbaijan, Georgia and Turkey (BP 2004).

More broadly, third country governments, and particularly the US, have been among the main promoters of the pipeline since its conception. The US favoured the pipeline on the grounds that it would lessen western dependence on Middle Eastern oil and Russian pipelines, as well as bypassing Iran (*The Guardian* 2005).

Nonetheless, most supporters also recognise that it is a unique project that imposes several challenges, especially in the environmental and social fields. National civil society groups and project-affected communities, together with several international NGOs, have heavily criticised the project. Main criticisms refer to the project's links with undemocratic regimes, exacerbation of tensions in the region and its potential negative environmental and human rights impacts during construction and operation. More specifically these concerns include:

- The HGA between BTC Co. and the host governments, which would exempt BP from all relevant local environmental and social laws, apart from national constitutions. It would also permit the company to block any new laws affecting the pipeline over the course of its life. The HGAs also oblige host governments to maintain the 'economic equilibrium' or profitability of the project, thereby guaranteeing BP's profits and shifting project risks onto the three states (see Section 3.2).
- The BTC pipeline route runs through areas of crucial importance for protected and endangered birds; a national park that is the source of Georgia's largest export product (Borjomi mineral water) and areas of high seismic activity, landslides and avalanches.
- The pipeline runs through areas of the Kurdish community that has suffered decades of human rights abuse from the Turkish government.
- Concerns about pipeline safety: the use of inadequate coating material along some parts of the pipeline carries threats of corrosion, widespread leakage and, potentially, massive explosions.
- Concerns about the potential of militarisation in the region to ensure the security of the pipeline.

These concerns are all discussed later in this paper.

2.5 Project financing

2.5.1 Background

BTC Co. is a very large and complex project whose financing phase took over two and half years, from July 2001 to February 2004. In July 2001 the investment bank Lazard Brothers (UK) was appointed by BP as a financial advisor to set up the most suitable financing structure. The law firm Sullivan & Cromwell (US) was appointed at the same time to advise on the legal side of the financing structure (van Gelder 2003).

Project financing consists of complex transactions involving many participants with diverse interests. The complexity of risk allocation linked to project finance implies that developing countries rarely have an unlimited ability to accept risk allocation and so must reinforce themselves with credible assets or payment promises. Therefore they need to involve multilateral financial institutions such as the IFC and export credit agencies (ECAs) who have been institutionally designed to accept some of the risks in order to make projects 'finance-able' (Hoffman 2001).

Though BTC Co. had planned to make a decision about project financing before the end of 2002, in December of that year BP announced that finding finance for the pipeline would be delayed by six months to the third quarter of 2003 because of the complexity of talks with international lenders. Among the key issues highlighted as delaying the financing were: the IFC and EBRD's need to 'evaluate the project on a number of grounds, including environmental and social, as well as financial and economic'; and the Georgian government's late approval of the pipeline's route because of concerns about its environmental impact (USAID 2004).

The IFC and the EBRD finally approved the financing for the BTC project in November 2003. IFC and EDRB involvement provided the political risk insurance required, and their participation mobilised the additional financing. The final financing package was signed in February 2004 and includes 208 finance documents, with over 17,000 signatures from 78 different parties. It represented a major milestone in the implementation of the financing arrangements for the pipeline (BP 2004).

Approximately 30 per cent of BTC costs are being funded by equity contributions (US\$ 1.01 billion). The remaining 70 per cent are being provided in the form of financing by third parties including multilateral development banks, ECAs and Political Risk Insurers from seven different countries, and a syndicate of 15 commercial banks (Table 2.1).

2.5.2 The loan/debt characteristics

BTC Co was financed through a project finance structure. Project finance is used to refer to a non-recourse or limited recourse structure, in which debt, equity, and credit enhancement are combined for the construction and operation of the refinancing of a particular facility in a capital intensive industry. Lenders base credit appraisals on the projected revenues from the operation of the facility, rather than the general assets or credit of the sponsor of the facility, and rely on the asset of the facility, including

any revenue-producing contracts and other cash flow generated by the facility, as collateral for the debt (Hoffman 2001).

BTC uses “limited recourse” project finance because the lenders have recourse to the sponsors’ assets until the pipeline is completed. Thereafter, the loan would be non-recourse.¹¹ However, as BP is both the operator and also the main stakeholder of the project, liability may nonetheless arise from contractual undertakings, guarantees or other obligations undertaken in the related project agreement (Hoffman 2001).

Table 2.1 summarises the total debt as of February 2006. The financing comes from a US\$ 1.666 billion debt package. The debt package consists of US\$ 500 million in A and B loans, arranged equally by the IFC and the EBRD. An A loan is financed by the multilateral financial institution’s own sources. A B loan is made by the multilateral financial institution and then syndicated (i.e. participation interests in the loan are sold) to commercial banks but treated in the same way as the A loan (i.e. the multilateral financial institution documents and administers the loan, and collects and distributes payments and collateral pro rata between itself and the B loan lenders). The tranches are priced differently with the weighted average pricing of the deal being L+300bp.

The commercial debt is accompanied by US\$ 923 million in sponsor loans, the conditions of which mirror the commercial debt. The project’s shareholders have invested about US\$ 1 billion in equity. More recent information suggests the shareholders allocated an additional US\$ 333 million for overrunning costs on the Turkish side.¹²

Table 2.1. Summary of the debt

	Characteristics	Margin	Mandate Arrangers	Lead Managers	Guarantor
1	US\$ 125 m 12 Years A Loan		IFC	IFC	
2	US\$ 125 m 10 Years B Loan	LIBOR 200-300bp	IFC + the 15 commercial banks (*)	The 15 commercial banks	
3	US\$ 125 m 12 Years A Loan		EBRD		
4	US\$ 125 m 10 Years B Loan	LIBOR 200-300bp	ERDB + the 15 commercial banks	The 15 commercial banks	
5	US\$ 300 12 Years Term Loan		JBIC	JBIC	
6	US\$ 180 12 Years Term Loan		The 15 commercial banks	The 15 commercial banks	JBIC (Japan)

¹¹ Thomas Dimitroff, British Power, personal interview, 27 May 2006.

¹² AFX News (2006). This amount is outside the 30% cost overrun on the whole project that led to the final estimation of costs at US\$ 3.9 billion.

7	US\$ 120 Years Loan	12 Term	LIBOR 65bp.	The 15 commercial banks	The commercial banks	15	NEXI
8	US\$ 150 Years Loan	12 Term		The 15 commercial banks	The commercial banks	15	US EXIM Bank
9	US\$ 90 Years Loan	12 Term	LIBOR 50bp.	The 15 commercial banks	The commercial banks	15	Hermes AG (Germany)
10	US\$ 90 Years Loan	12 Term	LIBOR 75bp	The 15 commercial banks	The commercial banks	15	COFACE (France)
11	US\$ 30 Years Loan	12 Term	LIBOR 75bp	The 15 commercial banks	The commercial banks	15	SACE SpA (Italy)
12	US\$ 100 Years Loan	12 Term	LIBOR 65bp.	The 15 commercial banks	The commercial banks	15	OPIC
13	US\$ 106 Years Term Loan		LIBOR 25bp.	The 15 commercial banks	The commercial banks	15	ECGD (UK)
14	US\$ 923 Loan	Term		BP Amoco plc; Total SA; Statoil ASA; ConocoPhillips	BP Amoco plc; Total SA; Statoil ASA; ConocoPhillips		

Source: derived from Dealogic projectware database.

(*)-The syndicate of 15 commercial banks includes ABN AMRO, Citibank, Mizuho and Societe Generale as leading institutions with Banca Intesa, BNP Paribas, Credit Agricole Indosuez, Dexia, HypoVereinsbank, ING, KBC, Natexis Banques Populaires, San Paolo IMI, West LB and Royal Bank of Scotland.

3 The legal framework, project finance and sustainable development

Because the ability of the project sponsor to produce revenue from project operation is the foundation of project financing, the contracts form the framework for the project viability and control the allocation of risks. Contracts must not interfere unduly with the expectation for debt repayment from project revenues. They should be designed to anticipate regulatory problems unique to the project and the environment in which the project will exist (Hoffman 2001). However, in their aim to reduce or allocate risk between the partners, these contracts may include stabilisation clauses or financial arrangements that may interfere with the achievement of sustainable development goals in the host country.

The relationship between BTC Co. and each host government is governed by four core documents. The foundation of the structure is an intergovernmental agreement (IGA) entered into by Azerbaijan, Georgia and Turkey. Annexed to the IGA are, amongst other documents, the texts of three separate HGAs between BTC Co. and each host government. The IGA was entered into in November 1999 and each HGA was entered into in October 2000.

These contracts and their sustainable development implications are discussed below.

3.1 The intergovernmental agreement

The IGA is an international treaty through which the host states formally agree to ensure the safety and security of project personnel, facilities, assets, and in-transit petroleum. It therefore creates a binding obligation between each host government, enforceable under public international law. Key terms of the IGA are:

- A commitment from each host government to present the IGA, including the HGAs and other documents included in the annexes, for ratification so as to make it the prevailing legal regime in its state.
- A general commitment from each host government to support the project, including: ensuring freedom of petroleum transit, guaranteeing the performance by state entities of certain project contracts and granting land rights to the project.
- A commitment from each host government to provide security for the pipeline.
- An agreement on the applicable technical, safety and environmental standards for the project. This was an important provision for much of the subsequent debate.
- Confirmation that the only taxes imposed on the project would be those set out in the HGAs and an agreement on how to allocate taxable profits between the project states.¹³

¹³ Article V (1) of IGA. For the summary of the key terms see also Boyd Carpenter and Labadi (2004).

3.2 Host government agreements

HGAs are legal contracts between the state and project sponsor that identify both parties' rights and obligations to ensure the success of the proposed project (USAID 2004). The BTC's HGAs are considered one of the most high profile of these types of agreements to date and constitute one of the major points in civil society opposition to the project.

The three HGAs are drafted in very similar terms. They are long and complex documents of more than 70 pages each with several annexes. Essentially, under the HGA, each host government grants BTC Co. the right to build and operate the pipeline, and agrees to provide various forms of support for the project. BTC Co. commits to a certain set of standards whilst carrying out the project and also commits to paying specified tax or tariff amounts to the host government (Walid and Boyd-Carpenter 2004). Furthermore, each HGA provides for a dispute resolution procedure and stipulates the law applicable to the agreement. Besides that, each HGA specifies certain events which would relieve parties of their duties under the agreement, or rather trigger their liability.¹⁴

3.2.1 Sustainable development concerns

Civil society legal analysis of the HGAs¹⁵ revealed several concerns. A major concern was that the host countries had frozen the laws applicable to the project and given up their right to legislate and impose more stringent standards throughout the 40 to 60 year term of the HGA (Boyd Carpenter and Labadi 2004).

Civil society groups are particularly concerned about the economic equilibrium clause that says the host government has to pay the consortium substantial compensation for any changes in law or other actions that will disturb the economic equilibrium of the project (Amnesty International 2003). This clause gives BTC recourse to contract out the rule of law. This would prevent the government from delaying the project due to environmental and social (e.g. health) concerns except in the case of a national emergency. Moreover, being faced with punitive costs for protecting the human rights of those affected by the pipeline is likely to undermine a government's ability to improve its general human rights record (Amnesty International 2003). NGOs also claim that the stabilisation clause transfers the financial burden from the investor to the government if the government institutes more stringent legislative standards that affect the project (USAID 2004).

A second concern relates to the project's privileged legal status. This status, created when each HGA was enacted as an international treaty, established the agreements as the only applicable regime irrespective of any subsequent legislation, overriding all conflicting domestic law, present and future, bar the Constitution (Boyd Carpenter and Labadi 2004). Concerns were expressed about the HGA taking precedence over existing environmental and social laws even if local laws conflict with the standards

¹⁴ The three HGAs can be accessed at:
<http://www.bp.com/genericarticle.do?categoryId=9006628&contentId=7013492>.

¹⁵ See Amnesty International (2003).

in the HGA (WWF 2003). For instance, in Georgia the HGA was invoked to override the national Water Act in order to develop the pipeline right-of-way (USAID 2004).

A third area of concern is the lack of scope for individual citizens to enforce the obligations assumed by BTC Co.; while host governments might be able to enforce a rigorous environmental and social regime upon the project, a local citizen could not (Amnesty International 2003; Boyd Carpenter and Labadi 2004).

On account of the controversy surrounding these issues, and because the standards to which the project were subject were not explicitly set out in the HGAs, project sponsors subsequently issued several clarifying legal documents including:

- *The Joint Statement* (BTC 2003) set up in May 2003, which responds to NGO concerns about the potential impact of the project's legal framework on the autonomy and policy-making discretion of the host states. It clarifies and restates the parties' interpretation of the HGAs, focusing on the standards to which the project is subject, and highlighting the primacy of national law (Boyd Carpenter and Labadi 2004).
- *The Protocol Relating to the Provision of Security for the East-West Energy Corridor (Security Protocol)*, executed on July 2003, which formally commits the host governments to a cooperative security scheme. It deals with the manner in which the host governments propose to meet their security commitments under the HGAs (Boyd Carpenter and Labadi 2004).
- *The BTC Human Rights Undertaking* (BTC 2003), which is a legally binding unilateral deed under English law executed by BTC Co. in September 2003. It clarifies aspects of BTC's legal framework and among other issues, seeks to annul the compensation claims in the HGA in the event of new laws being introduced for human rights or environmental reasons (WWF 2003).

However, there are mixed views about the impacts that these additional instruments may have. On the one hand, NGOs state that the documents have been drafted from a blinkered perspective and do not appear to resolve the deficiencies in the HGAs. Concerns also prevail over whether the *Human Rights Undertaking* will be able to bind BTC when SOCAR increases its proportional ownership of BTC (Amnesty International 2003, WWF 2003, USAID 2004, CDAD 2003). Moreover, even though the Caspian Development Advisory Panel recognises BP's efforts, these documents are only seen as a first step towards supporting human rights in the area.

On the other hand, analysis conducted by EBRD states that when the HGAs are read from the perspective of commitments set down in the Joint Statement, the commitment in the key areas of concern is to standards that should be acceptable throughout the life of the project (Boyd Carpenter and Labadi 2004).

3.3 Construction agreements

Other key documents for project finance initiatives are the construction agreements. According to Hoffman (2001), the construction contract in project financing must provide the project company with a finished facility that satisfies certain agreed-upon

performance criteria for a fixed or reasonably predictable price on a defined date. The tension between the project company and the contractor in project financing is based on the turnkey nature of the construction contract, i.e. the contract must deliver the project at a fixed or predictable price, on a certain date, with the warrantee to perform at agreed levels.

Unless the contract price is extremely attractive, the three main objectives of the contractor in contract negotiation are to limit the risk of any change in the cost of the project, to ensure there is sufficient contractual excuse for late delivery, and to provide sufficient time to satisfy performance guarantees. If the contract involves a fixed price without a premium and/or financial penalties, the contractor has the incentive to cut corners on environmental, social, and technical standards in order to remain on schedule and/or under budget (Hoffman 2001, CDAP 2003).

In **Azerbaijan** and **Georgia**, BP and BTC are directly managing all aspects of pipeline construction, i.e. hiring and supervising contractors handling the construction (CDAP 2003). Two main contractors were hired: Consolidated Contractors International Company (CCIC), who was responsible for the pipeline construction and valves; and Spie-Capag Petrofac Joint Venture (SPJV), who were responsible for the main AGIs (IRM 2005). In **Turkey**, BOTAŞ (a state company) serves as managing contractor. The relationship between BOTAŞ and BTC Co. is set out in a lump sum turnkey agreement (LSTA) included in an annex to the HGA. Appendix 2 of the LSTA provides the details of the turnkey agreement between the project sponsors and BOTAŞ.

Under the LSTA, BOTAŞ agrees to design, engineer, procure, construct, start-up, demonstrate, test and put into operation the BTC facilities in Turkey for a fixed price of US\$ 1.3 billion. The LSTA also provides the option of renegotiating both the amount of the fixed price and the completion dates. The agreement gives BOTAŞ responsibility for land acquisition and compensation, for which a lump sum of US\$ 99 million was set. In addition, according to the approved environmental impact assessment (EIA) (October 2002) for Turkey, BOTAŞ is obliged to implement and administer a Health, Safety and Environment (HSE) Programme. This includes developing the HSE manual to establish the turnkey contractor's and subcontractors' HSE guidelines and requirements.

Within the lump sum fixed price of US\$ 1.3 billion, BOTAŞ is also responsible for producing an EIA report (BP 2002), and must undertake all environmental planning, mitigation and monitoring in Turkey, particularly by implementing the Environmental Management and Monitoring Plan (EMMP) and the Social Management and Monitoring Plan (SMMP) and supporting plans. Contractors will be responsible for implementing and adhering to all the mitigation measures outlined in the EIA, the EMMP and the SMMP. BTC Co. must ensure that the management plans are implemented.¹⁶

¹⁶ In a separate letter, the Turkish government guaranteed performance of all BOTAŞ' duties under the Turnkey Agreement, including payments of amounts due by the company under the agreement. According to CDAP (2003), the guarantee is for up to US\$ 300 million to assist BOTAŞ if it is not able to complete its tasks within the US\$ 1.3 billion budget. If costs go beyond this US\$ 300 million buffer, the amounts will be withheld from transit fees and other amounts owing to BOTAŞ (subject to a cap of

It should be noted that there is some analysis suggesting that the fixed price agreed by BOTAŞ might be too low (BCC 2002). Claros Consulting (2003) suggest that the contract is under priced by some US\$ 600 million.¹⁷ It compares BTC with pipelines in the UK and Alaska, where the cost is respectively twice and ten times more than their original estimates (Mansley 2003). Moreover, the price of the agreement fixed in the Turnkey Agreement was negotiated nearly two years before the EIA was approved by the Turkish government; hence any findings of the EIA that would result in significant additional project costs were not included in this initial budget. More recent information supports the claim that the Turkish portion was indeed under priced, as BOTAŞ has filed compensation claims for US\$ 400 million against BTC Co. due to increased construction costs (Prime-news online 2006). Lawyers and financial experts for both parties negotiated the allocation of an additional US\$ 330 million as compensation to BOTAŞ.

Additional costs have arisen in all three countries. Increased costs are partly attributed to construction delays due to environmental and social concerns raised by civil society, but also due to a global increase in demand for labour and electric power, and higher fuel costs (Caspian Energy 2005).

3.3.1 Sustainable development and human rights concerns

Several concerns have been raised over the terms of the LSTA. These partly relate to the earlier secrecy surrounding the Turnkey Agreement, which was not in the public domain until later in the construction phase. In addition, the low price, the financial penalties involved, and the Turkish government's guarantee for BOTAŞ's performance, could also pave the way for several sustainable development issues to be partially or wholly disregarded.

The initial lack of transparency over the Turnkey Agreement prevented stakeholders from assessing whether the project promoters were complying with their legal obligations (WWF 2003, Amis de la Terre et al. 2003).

Moreover, intervening in the project on environmental and social grounds was further complicated because the contract was probably underpriced, raising the likelihood of financial penalties to either the host government or the contractor if project completion/product delivery dates were not met. The threat of financial penalties is a disincentive for project parties to mitigate adverse environmental or social impacts (Hoffman 2001).

All these issues raise concerns about the capacity and incentives for BOTAŞ - and the Turkish government in general - to comply with adequate environmental and social standards. In addition to civil society groups, these concerns have been voiced by the Caspian Development Advisory Panel (CDAP) – a BP-established

30 per cent of the overall LSTA budget). BOTAŞ will separately be liable for monetary damages if the project is not completed on time (CDAP 2003).

¹⁷ More recent information (June 2006) suggests that BOTAS asked for an additional US\$ 400 million to complete the project and a final amount of US\$ 333 million was agreed. This was stated by the official of the Foreign Investment Department of SOCAR, but BP declined to confirm or reject this.

independent external advisory panel studying the BTC project. The CDAP notes that BOTAŞ's central role in the HGA and the LSTA has presented BP with perhaps the most significant challenge in Turkey. The financial challenges raised by the LSTA, coupled with a weak but evolving environmental and social compliance culture among BOTAŞ and its contractors, raises questions over whether the environmental, social, health and safety commitments would be met. In particular, CDAP is concerned that BOTAŞ and its contractors may feel pressure to cut environmental, social and technical corners in order to remain on schedule and/or under budget. Moreover, they argue that BP and BTC personnel lack the authority to stop work, or to exercise other severe contract remedies, to ensure that BOTAŞ and its contractors meet BTC's EIA commitments (CDAP 2003). These fears were reinforced by meetings between CDAP and key senior Turkish government officials, who demonstrated little appreciation of the need for such standards and instead voiced complaints about BP's insistence on maintaining its environmental, health, and safety standards. They suggested that relaxing these standards would enable BOTAŞ to complete construction on time and under budget (CDAP 2003).

These factors could also be linked to the way BOTAŞ conducted the land acquisition and compensation process. Under the HGA, BOTAŞ is also responsible for the resettlement plan, to which US\$ 99 million was allocated. In Turkey, land may be held by private owners in two ways: (i) registered ownership or (ii) customary ownership. Compensation should be provided for both categories of owners. BOTAŞ identified 2,748 parcels subject to customary ownership and 6,358 registered parcels of private land, all of which needed to be acquired along the right-of-way. Ownership determination of registered land is complicated by factors such as multiple ownership, out-of-date deeds and conflicting customary and registered ownership claims. Additionally, villages typically have use rights on common lands (particularly on pasture lands) although the legal owner of the land is a state agency such as the treasury. On average, each of the 6,358 privately owned registered parcels of land along the pipeline right-of-way has six owners (CDAP 2003).

Given that the terms of BOTAŞ's contract were negotiated well before the identification of all these complexities, and that BOTAŞ needed to conduct the land acquisition plan on time and within budget, it decided to make use of Article 27¹⁸ of the reformed code for its land acquisition along the pipeline rather than Article 10.¹⁹ This raised several human rights concerns amongst civil society (CDAP 2003). In response to these concerns, BTC and BOTAŞ modified the Article 27 process to provide, among other safeguards, more time for identification and notification of landowners and valuation of private parcels based on market surveys.

Another issue is that BOTAŞ has been accused of offering far less compensation to landowners than promised and NGOs cite cases of landowners being threatened for refusing to accept offers of compensation (*The Guardian* 2005).

¹⁸ Article 27 speeds up the land expropriation process; courts are required to make property valuation decisions within seven days, and the expropriation is effective immediately upon deposit of the appraised amount in a trust for the owner or owners, even if the valuation is appealed.

¹⁹ Article 10 is the ordinary process for land expropriation processes, which provides enough time for owners to be identified, negotiations to occur, and appeals of expropriation decisions to be lodged.

Finally, it seems the pressure to keep activities on schedule and within budget has sustainable development implications that go beyond the Turkish portion of the pipeline (Box 3.1).

Box 3.1. The Georgian ESIA approval process

In Georgia, given the volume and complexity of the material to be reviewed for the Environmental and Social Impact Assessment (ESIA), the Minister of Environment requested technical assistance from the Dutch Commission. By November 2002, BP wrote to the president of Georgia demanding it approve the ESIA for the project so as not to upset the consortium's commercial timetable, despite major outstanding issues on the pipeline. As the letter states, 'Without . . . timely approval we cannot move forward with the construction phase and we will halt work in Azerbaijan and the Lump Sum Turnkey Contract in Turkey. This will have an immediate knock on effect on the upstream investment and the Shah Deniz project and destroy the benefits detailed in the Declaration of Intent signed between BTC and GIOC (Georgian International Oil Corporation) on October 30th in your presence' (cited in BCC et al. 2002). The Georgian ESIA was finally approved on 30th November 2002.

In 2004, USAID maintained that the Georgian Minister of Environment signed the environmental permit for construction to proceed but attached a number of conditions in order to remedy deficiencies in the ESIA. These conditions included additional analyses of a series of potential landslide zones along the route, and providing another route alternative. Later in 2004, the Government of Georgia imposed a two week suspension on the construction of the BTC pipeline in the Borjomi region, which is a sensitive site for both environmental and security reasons. The government wanted independent experts to conduct safety tests. The Minister of Environment expressed continued concerns about the environmental impact stating that some of the conditions of the environmental permit had not been met. However it is not clear how effectively the government's concerns were addressed due to the contractual deadline and its financial responsibility for any substantial delays in project completion (USAID 2004).

3.4 Legal action against BTC and other stakeholders

As a result of the various concerns outlined above, civil society has pursued several legal actions against BTC Co.:

- In 2004 the Cemender Korkmaz, Corner House and the Kurdish Human Rights Project (KHRP) applied to take the European Commission to the Court of First Instance. The case centred on the HGAs – the legal contracts for the BTC pipeline between BP and the three host nations, Azerbaijan, Georgia and Turkey. The plaintiffs argue that the project's legal agreements undermined Turkey's ability to legislate so that it was in breach of its pre-accession agreements with the European Union. These agreements centre on respect and protection of human rights (Official Journal of the European Union 2004). The Court of First Instance declared the application inadmissible, thus preventing the judgement on the substance (Official Journal of the European Union 2006).
- The KHRP also filed cases with the European Court of Human Rights on behalf of 38 affected villagers along the route, alleging multiple violations of the European Convention on Human Rights (Lustgarten 2005).

- The Georgian environmental group Green Alternative alleged that the pipeline consortium and Shevardnadze government had violated Georgian environmental law by sending the pipeline through the Borjomi-Kharagauli National Park. The Georgian District Court granted Green Alternative the right to commence legal action in connection with the pipeline (CBB 2003). Houston-based ConocoPhillips was named among the defendants in the lawsuit, as well as other members of the BP PLC-led pipeline consortium, including Statoil ASA, Unocal, Inpex and Delta Hess (HBJ 2003). The group is appealing an unfavourable ruling on this case (BankTrack, 2004).
- In April 2003 a consortium of NGOs including Friends of the Earth, Milieudefensie (Friends of the Earth Netherlands) and The Corner House filed a complaint against BP stating that the HGAs would be breaching the *OECD Guidelines for Multinational Enterprises* (FoE et al. 2003). Following the submission of the complaint to the national contact point in the UK, the host governments and BTC signed the Joint Statement on the Interpretation of the HGA in June 2003 (EBRD 2003b). In October 2003, a complaint accusing three French companies involved in the BTC Pipeline construction of not observing the guidelines for environment, contracts and human rights was submitted to the French national contact point (OECD 2006). A similar complaint against Italian companies involved in BTC was submitted to the Italian national contact point (OECD 2006).

The banks themselves have also been under direct attack for alleged failed due diligence on the BTC pipeline (see Section 4.2).

4 Lenders' approach to risk and sustainable development

Financial institutions approach sustainable development through their due diligence process. Due diligence is an important process for risk identification in project financing. It is an interdisciplinary process involving legal, technical, environmental, social and financial specialists, designed to detect events that might result in total or partial project failure. Participants involved in this process, besides project sponsors, are lawyers, engineering firms, fuels consultants, market consultants, insurance consultants, financial advisors and environmental consultants. The level of due diligence undertaken depends on the time available, cost and project type (Hoffman 2001).

The environmental and social due diligence applied to project finance depends on the requirements of the financial institutions involved, the nature of the project and also the size of the loan. For example, multilateral development institutions such as the IFC require due diligence processes for all the projects they fund. The level of due diligence will depend on the categorisation of the project according to potential adverse impacts (A, B or C, see below).²⁰ Since July 2003 the large majority of commercial banks have committed to the Equator Principles (EPs), which provide a framework for banks to review, evaluate and mitigate or avoid environmental and social impacts and risks of projects financed through project finance. The EPs are based on the IFC's environmental and social safeguard policies and apply to project finance transactions over US\$ 50 million (IFC 2006b).²¹

Thus, financial institutions may affect the sustainable development impacts of a project by only awarding the loan on the condition of compliance with a set of environmental/social standards.

The due diligence processes conducted by the main financial institutions involved in the BTC pipeline are described below.

4.1 IFC and EBRD's environmental and social due diligence processes

The IFC expects clients to manage the social and environmental risks and impacts of their projects. This includes assessing the risks and impacts and implementing measures to meet IFC standards. The IFC's role is to:

- Review the client's assessments.
- Help the client develop measures to avoid, minimise, mitigate or compensate for social and environmental impacts consistent with IFC standards.
- Categorise the project in order to specify the IFC's institutional requirements to disclose project-specific information to the public.
- Help identify opportunities to improve social and environmental outcomes.
- Monitor the client's social and environmental performance throughout the life of the IFC's investment.

²⁰ In February 2006 IFC released a new set of standards for conducting environmental and social reviews of the projects.

²¹ A revised version of the EP (The EP II) was released in July 2006. The EP II sets US\$ 10 million as the new threshold for EP to apply.

According to the 1998 *IFC Environmental and Social Review Procedure*, the BTC pipeline is a Category A project. In other words it has potentially significant adverse environmental or social impacts that could be diverse, irreversible or unprecedented.²² The framework under which the IFC's due diligence for Category A projects is guided by:

- The IFC's procedure for Environmental and Social Review of Projects (ESRPs) (1998).
- The IFC's OP 4.01 Policy on Environmental Assessment (EA) (1998).
- The IFC's Policy on Disclosure of Information
- The sector-specific guidelines within the *Pollution Prevention and Abatement Handbook* (World Bank and IFC 1999).

In addition, the IFC has relevant safeguard policies addressing specific issues such as international waterways (OP 7.50), involuntary resettlement, natural habitats, indigenous peoples and cultural property.

The EBRD also applied World Bank and IFC environmental and social safeguard policies and guidelines as the project is jointly financed by these institutions. In addition, the EBRD *1996 Environmental Policy and Environmental Procedures*²³ and the *2000 Disclosure of Information Policy* have been applied to this project, requiring the application of pertinent EU environmental standards.

IFC financing to the BTC pipeline includes the operations in Azerbaijan, Georgia and Turkey, while EBRD only covers those in Azerbaijan and Georgia as it does not operate in Turkey.

4.1.1 The due diligence process

IFC and EBRD's due diligence process for the BTC project officially began with the signing of the joint mandate letter in December 2001 (IFC 2003). However, both multilateral development institutions comment that they had engaged with the project prior to this, providing inputs into the scoping document for the draft ESIA (IFC 2003, EBRD 2003a).

In accordance with the IFC guidelines for Category A projects, the banks required project sponsors to prepare separate ESIA's for Azerbaijan and Georgia and an EIA for Turkey to comply with each country's requirements. Preparation of the ESIA's/EIA started in 2001 with initial scoping meetings with affected communities, and interaction continued in the form of a number of environmental and socio-economic baseline surveys. The draft ESIA's and the EIA were released in May and June 2002 respectively, as part of the host country disclosure process (IFC, 2003).

²² Projects are classified according to three categories: Category A Projects: projects with potential significant adverse environmental or social impacts that are diverse, irreversible or unprecedented; Category B Projects: projects with potential limited adverse environmental or social impacts that are few in number, site-specific, largely reversible, and readily addressed through mitigation measures; or Category C Projects: projects with minimal or no adverse environmental or social impacts.

²³ Both of these policies are now obsolete, but were in effect during the period of BTC due diligence.

The main impacts identified by the ESIA's include:

- Temporary economic disruption (mainly cropping and grazing) and limited permanent use of land (no physical resettlement).
- Displacement of fishermen near the Ceyhan terminal and of other informal users of common property resources for whom compensation will be required.
- Potential impacts on various vulnerable groups (e.g. the elderly and ethnic minorities); need for alternative analysis of pipeline corridors and pipeline alignment within the preferred corridor; impacts on biodiversity.
- Need for oil spill prevention and response planning.
- Need to ensure worker and public health and safety.

The ESIA's/EIA release was followed by a 60-day consultation period with national governments, affected villages, NGOs and civil society along the pipeline route. This process generated numerous comments that were incorporated into the final ESIA's/EIA (IFC 2003).

In addition to the public consultations held by BTC, the IFC and EBRD decided to formally meet with project stakeholders so that they could validate the sponsors' consultation efforts and also ensure the respective board would be well informed of public responses. In August/September 2003 a series of six multi-stakeholder forums (MSF) run by independent facilitators were held along the pipeline route (two in each country) and were attended by over 800 people. There have also been over 80 NGO meetings between the IFC and NGOs between 2001 and 2003, making this project one of the most community/NGO interactive projects completed to date (IFC 2003).

In response to specific questions raised by the lenders following the review of the ESIA's and the HGAs, BTC Co. was also asked to prepare supplementary documentation to demonstrate that the project adhered to IFC safeguard policies and guidelines. This included the Supplementary Lender Information Pack (SLIP), which contains detailed information on environmental and social matters including:

- A discussion of the environmental standards that apply to the project such as air emission standards, water discharge and noise emissions.
- An analysis of the power generation option.
- An approach to groundwater protection.
- A summary of project benefits.
- The project environmental and community investment plans.
- An analysis of compliance with IFC policy OP 4.04 on natural habitat and OPN 11.03 on cultural property.
- Detailed information on issues specific to each country.²⁴

On the basis of the findings of the ESIA's and EIA, an Environmental and Social Action Plan (ESAP) was prepared for the project detailing how impacts would be avoided, mitigated or compensated for, including numerous Contractor Control Plans

²⁴ SLIP documents are available at:
<http://www.bp.com/genericarticle.do?categoryId=9006631&contentId=7013945>

(CCP) and BTC Co. management plans. The CCPs set out the potential risks posed by the project, the mitigation measures to be implemented, and the monitoring plan for ensuring that mitigation measures are adequately implemented. The IFC and EBRD established a process for monitoring the implementation of these mitigation measures (EBRD 2003a).

The framework and procedures for land acquisition, compensation and measures for livelihood restoration for affected populations are outlined in the Guides to Land Acquisition and Compensation (GLACs) and the Resettlement Action Plan (RAP). Copies of the GLACs (which are user-friendly summaries of the full RAP) were distributed to affected communities in September 2002. The full RAPs were released in December 2002. By September 2003, 99, 69 and 77 per cent of land needed had been acquired in Azerbaijan, Georgia and Turkey respectively (IFC, 2003).

IFC also required an updated Public Consultation Disclosure Plan (PCDP), a Georgia-specific route study, a regional review and various other supplementary studies. It also requested the sponsors to make public the agreements between BTC Co. and the host governments (IFC, 2003).

Given the exceptional nature of the BTC project, the sponsors agreed to a programme of close pre-financial construction monitoring to enable the IFC and EBRD to ensure compliance during the early stages of construction. This consisted of visits by the IFC and EBRD, supported by independent advisors (EBRD 2003a). Post-financial monitoring began in early 2004, conducted by the companies D'Appolonia S.p.A and WorleyParsons, who were appointed as the post-financial close independent environmental consultants (IEC) to the lender group.

The environmental and social assessment package produced for the IFC and EBRD due diligence process was released on 11th June 2003 for a 120-day comment period. The package includes 46 volumes involving more than 11,000 pages. According to the IFC this is 'the largest environmental and social document ever released' (IFC 2003).

The IFC and EBRD Boards approved the financing for the BTC project in November 2003.

4.1.2 Environmental and social concerns

Both the IFC and EBRD received several critical comments from civil society, including national and international NGOs, local communities and other institutions such as the Netherlands Commission for Environmental Impact Assessment (NCEIA) (Box 4.2). These included the inadequacy of the due diligence processes for assessing several of the project's environmental and social impacts, and their breach of several key institutional policies. In terms of project implementation, these groups felt that BTC was not fulfilling the obligations outlined in the ESIA or the RAP. They also emphasised that the financial institutions' due diligence processes were overly reliant on information provided by the project sponsor, and instead should have undertaken independent investigations of their own.

Box 4.2. Key criticisms of IFC/EBRD's due diligence processes

Violation of IFC Policy OP 4.01 on environmental assessment, and of EDRB environmental policy and environmental procedures, due to:

- Inadequate assessment of route alternatives for the pipeline.
- Failure to take into account the impacts of the pipeline route in Georgia, in particular near Lake Tsalka and Borjomi National Park. The latter is the source of Borjomi mineral water, one of Georgia's main exports.
- Poor planning and inadequate assessment of the cumulative impacts, failure to conduct a strategic environmental assessment (SEA) for the BTC pipeline and ACG Phase 1 projects.
- Starting construction of the BTC pipeline before any EIA was approved.
- Inadequate assessment of impacts on flora and fauna.
- Failure to complete an adequate baseline study.
- Inadequate treatment of seismic risks.
- Failure to reduce or remedy risk of oil spills at Ceyhan and of decommissioning.
- Insufficient analysis of species.
- Failure to present original data.
- Methodological gaps not indicated in the EIA.
- Inadequate consultation with affected villagers.
- Uncertainties around independence of EIA experts.
- Failure to address transboundary impacts of tanker traffic.
- Failure to address indirect impacts on climate change.

Violation of IFC Policy OP 4.04 on natural habitats due to:

- Delayed consultation process, while pipeline construction began too early to permit project sponsors to tap into the knowledge of local communities on natural habitats.
- Failure of project sponsors to provide adequate information to affected people on the protection of natural habitats, and on their rights; under-reporting by project sponsors of likely negative impacts of project.
- Failure to sufficiently take into account views of local communities or NGOs on the impact of project on natural habitats.
- Failure of project sponsors to conduct sufficient research into local ecosystems to understand or accommodate local communities' roles in relation to natural habitats.
- Failure to give local communities a significant role in planning, designing, implementing or monitoring project in relation to natural habitats.

Violation of World Bank Policy OD 4.30 on involuntary resettlement due to:

- Displacement occurring before compensation was completed.
- Insufficient level of compensation.
- Inadequate consultation with affected communities on land expropriation and compensation.
- Failure to inform affected communities of their rights with respect to land expropriation.
- Failure to consult on resettlement alternatives.
- Inadequate consideration of the specific impacts of land expropriation on vulnerable groups and ethnic minorities.
- Failure to treat customary land users equally or fairly.
- Premature approval of RAP by IFC staff as 'fit for purpose' – for example, before the resettlement plan for fishing communities had been finalised.

Violation of the World Bank Policy OPN 11.03 on cultural property due to:

- Failure to acknowledge links between local people and cultural heritage.
- Failure to obtain comprehensive inventory of cultural heritage resources before construction.
- Failure to predict or adequately prevent likely impacts of construction on cultural resources.
- Failure to consult local people over cultural heritage and route planning.
- Failure to engage local people as stakeholders in the preservation of cultural resources.
- Inadequate mitigation measures.
- Cursory and superficial survey methods.
- Ongoing destruction of cultural resources.

Violation of the World Bank OD 4.20 policy on indigenous peoples:

- Decision by IFC not to apply this policy to the affected Kurdish population in Turkey.

Violation of IFC Policy on public disclosure/EBRD policy on public disclosure:

- Inability of vulnerable groups (especially Kurds) to express their views freely in the socio-political context of Turkey, and specifically when representatives of the central government authority were present during consultations.
- Inappropriate language used for consultations (rare use of Kurdish-language media particularly for women).
- Non representative groups identified and selected for consultation (some potentially relevant consultees seem to have been omitted).
- Inappropriate choice of consultation or mechanisms for certain groups.
- In general the consultation procedures took place too late in the process.

Regarding the legal regime:

- Several NGOs hold the view that although BTC has resolved some of the problems raised by the HGAs (see Section 3.2), there are still some problems in protecting the rights of affected people; these issues need to be dealt with.
- Conflicts between the HGA and Turkey's accession agreements.
- In Turkey, there are accusations of massive use of emergency powers normally reserved for national disasters to acquire land without compensation being agreed.

Source: Baku-Ceyhan Campaign (undated).

In some cases, CSOs and communities complained formally to the banks' ombudsman bodies – the Compliance Advisory Ombudsman (CAO) in the case of the IFC and the Independent Recourse Mechanism (IRM) in the case of EBRD – that BTC was not fulfilling its obligations under the ESIA and RAP.²⁵

²⁵ For a summary of complaints lodged with the IFC CAO during the years 2003-2006 please see http://www.cao-ombudsman.org/documents/CurrentBTCComplaintTracker_updatedJan07.pdf. For updated information on the Georgia-BTC-Krtsanisi and Georgia-BTC-Tbilisi complaints, please visit <http://www.cao-ombudsman.org/html-english/complaintKrtanisi.htm> and <http://www.cao-ombudsman.org/html-english/complaintTbilisi.htm>, respectively. For a list of complaints filed with the EBRD IRM about the BTC project please visit <http://www.ebrd.com/about/integrity/irm/register.htm>.

Both the IFC and EBRD responded to the civil society comments received during their due diligence process. In general they dismissed the criticisms and argued that after careful review of all comments they determined that the environmental and social documentation complied with all their institutional safeguard policies, procedures and guidelines (IFC 2003, EBRD 2003a). According to the banks, the sponsors had conducted 'world class' ESIA's and mitigation measures (including resettlement/compensation) and public consultation processes (IFC 2003). In many cases they argued that the project sponsors had gone beyond the multilateral banks' policies, such as:

- Conducting a 120-day consultation period instead of 60-day.
- Using NGOs to assist in land acquisition and compensation.
- Initiating national Community Investment Programmes (CIPs) for communities affected by the pipeline.
- Preparing RAPs and GLACs, despite this not being a requirement of any of the three governments involved. GLACs are not even an IFC requirement, so their preparation is another example of an 'above and beyond' measure taken to ensure landowners were well informed and had user-friendly information at their disposal (IFC 2003).

However, the multilateral banks did recognise that there were numerous implementation challenges as the project progressed that would require monitoring, supervision and adjustments/improvement (IFC 2003). One example is the involuntary resettlement proceedings from the complex land acquisition process involving over 17,700 parcels of land. Regarding the legal framework of the project and the HGAs, the IFC argued that while they did not participate in the HGA negotiations, and they required project sponsors to disclose the HGAs to the public, they believed the HGAs were embedded in the laws of the countries concerned, and have been reviewed and passed by their parliaments. Such arrangements in projects of this nature are needed in order to provide a reasonable framework for their implementation where none had existed before.²⁶

On the other hand, external reviews of the due diligence process conducted by IFC/EDRB do highlight some shortcomings. For instance, the UK Department for International Development (DFID) commissioned a compliance review of the EAs with IFC and EBRD policies (BMT 2003). It concluded that consultation processes for the draft and final ESIA reports and for the ESAP, did not take place in time for the EA policies. It further states that construction activities commenced without full completion and acceptance of the environmental and social management documents, systems and procedures by all governments and members of the lenders group. Though this situation was not contrary to any IFC/EBRD policies, procedures or guidelines, it was certainly not consistent with good international ESIA practice.

²⁶ Jasmin Tayyab Civil Society Coordinator of IFC in a letter to Platform and CEE Bankwatch available at: <http://www.carbonweb.org/documents/ifc.pdf>.

The report points to two main problems with the public consultation disclosure plan (PCPD) policies:

1. A periodic lack of PCPDs following soon after completion of the scoping stage – e.g. the Azerbaijan PCDP was issued as a draft in April 2003 at the end of the ESIA process, and at the same time as construction works were initiated.
2. The PCDPs did not demonstrate the use of suitable consultation techniques for the socio-political situation in parts of the pipeline route where vulnerable groups are exposed to differences in access to power and knowledge (BMT 2003).

Regarding Policy OD 4.20 on indigenous people (Box 4.2), the report argues that the IFC made a conscious decision not to apply this policy to the Kurdish population, and that it is within the IFC's rights to decide which policies apply to a project. The IFC considers that the Kurds are not sufficiently dependent on subsistence agriculture or alienated from wider socio-political processes to be classed as indigenous even though they meet the other key criteria set out in OD 4.20. However many NGOs take the opposite view. The report concludes that, based on this analysis, a case can be made for and against the application of OD 4.20 and therefore it is not a clear-cut issue.

A USAID review of the IFC/EBRD environmental and social due diligence process in October 2003, under the framework of its own due diligence process, also questions some elements (Box 4.3).²⁷

Box 4.3. USAID review of the ESIA process for the BTC Pipeline

The USAID review of the Georgian ESIA for the BTC project revealed that the analysis of alternatives and key baseline data associated with the project were insufficient, and did not meet USAID internal standards (22 CFR 216). The review revealed key elements that were missing in project documents including the ESIA, addendum, and CCPs:

- **The analysis of route alternatives was not conducted according to standard EIA practices.** At regional level the final ESIA discussed five strategic route options and concluded that:

The Baku-Tbilisi-Ceyhan route represented the lowest environmental risk option. However, the assessment lacks transparency since documents supporting this conclusion were not available for the public to review. Therefore, it is unclear how environmental and social impacts were factored into the risk assessment and decision-making process for selecting the final strategic route. For the strategic and national levels of corridor selection the analysis needed to provide a thorough description of alternatives that facilitated their side-by-side comparison in terms of their technical, social, environmental, economic and security risks and benefits. The same information was also needed for segments of the preferred 500m right-of-way (ROW).

²⁷ Transmittal letter from USAID to the Department of Treasury on 29th October 2003, available in USAID (2004).

- **Lack of critical baseline information and impact analysis for determining to what extent impacts could be mitigated, and lack of mitigation measures.** For example:
 - *Hydrogeology in the Borjomi region:* Additional research was needed to bridge the information gap highlighted by Georgian and other scientists. Particularly, a proper assessment was needed on the risks of pollution of groundwater springs and mineral water aquifers to determine if the pipeline route presented an acceptable risk and, if so, to develop mitigation measures using the most precise and accurate information possible.
 - *New and/or improved access roads:* Prior to additional road construction/improvements, complete analysis was needed of the entire road development in conjunction with the pipeline ROW development to determine the extent of impacts (direct, indirect and cumulative) and to identify proper avoidance and mitigation measures.
 - *Outstanding biodiversity data issues:* Prior to additional construction, key deficiencies in data collection for endangered species along the pipeline ROW needed to be addressed. These data should have included estimates of population size and habitat use, i.e. feeding and nesting sites. A clear methodology and decision-making process was needed for determining when pre-clearance surveys were needed to assess biodiversity impact. Adequate time should also have been allotted to conduct surveys and develop mitigation measures and monitoring plans. A biodiversity monitoring plan is needed for the entire project. Examples of missing data included for the Georgian ESIA, for instance: identification of all sections of the pipeline where species are protected by Georgian law; and a quantitative evaluation of endangered species to help determine impacts, mitigation measures and monitoring programmes. Specific examples include the treatment of the endemic Caucasus black grouse and grey partridge, as well as aquatic species. In the case of Turkey, inadequate attention was given to critical wetlands, bird assessments and endangered species. The latter is something the BTC's document acknowledges when it states 'Turkey is relatively under-surveyed', but it appears to have made no effort to improve data gaps.
 - *Blind faults:* The presence of blind faults should have been assessed through seismic surveys. This would provide the missing information required to thoroughly review the various routes and improve pipeline alignment along environmentally sensitive areas of the route.

In addition to these concerns about the ESIA, USAID's review identified the following substantive environmental and social issues under Title XIII of the International Financial Institutions Act :

- Lack of government capacity to oversee and monitor construction and operation phases of project, including interaction between affected communities and project sponsor.
- Lack of definition of mechanisms for transparent revenue management from oil production/transit proceeds.
- Potential cumulative negative impacts of non-ACG oil (which may not be produced following relevant MDB and/or international environmental and social standards) transported via BTC pipeline.
- Absence of a decommissioning plan and of designated resources for pipeline decommissioning.

Source: USAID 2004

Another issue, the choice of pipeline coating, called the adequacy of the multilateral banks' due diligence processes into question. However, the issue only appeared in the public domain after IFC and EBRD approved the loan. The problem was that the material chosen for the anti-corrosion coating of the pipeline was inadequate, raising significant concerns over the safety of the pipeline. This issue was raised by the UK Parliament during an inquiry into the adequacy of the due diligence processes (Box 4.4) conducted by the UK Export Credit Guarantee Department (ECGD) – a junior partner in the lenders group of banks in the BTC project.²⁸

The House of Commons Trade and Industry Select Committee asked ECGD to report on the coating issue after revelations in the *Sunday Times* newspaper on the 15th February 2004. The newspaper stated that BP, the operator of the project, decided to ignore internal warnings that their coating would fail to seal the pipeline's welds from corrosion, and also that BP failed to disclose this information to the lenders so as not to jeopardise lending. The article maintains that the information was available in a critical internal BP report dated November 2002. Although at the beginning of the enquiry ECGD maintained the 'pipeline was safe', after further allegations and enquiries by Members of Parliament, ECGD finally admitted that there were problems with the coating material chosen and that the pipeline was likely to fail some time during its 40-year operational life (Hansard 2005a and b). However, we can find no major reaction to the issue from the other multilateral financial institutions involved in the loan. The IFC's response was that they and some other lenders were now satisfied with 'corrective actions' on the BP pipeline (Monahan 2005).

Box 4.4. ECGD's due diligence process

In accordance with its public disclosure procedures, the UK Export Credit Guarantee Department (ECGD) published a brief account of the project on its website from 19th May through to 10th November 2003. To determine the acceptability of the project's impacts, ECGD considered the relevant directives, policies and guidelines of the World Bank Group including the safeguard policies, the *Pollution Prevention and Abatement Handbook* and the IFC's equivalent environmental guidelines. On the basis of this documentation the Departmental Business Principles Unit (BPU) produced a report that constituted a major element of the information considered by the Department's Underwriting Committee in its decision whether to authorise support for the project. On the 17th December 2003 the department published a *Note of Decision* on its website describing the factors that were taken into account in ECGD's decision to support the BTC project. The note states the ECGD cover for the project is subject to: ECGD's prior approval of the Project's Environmental and Social Action Plan, the General Oil Spill Response Plan and the General Hydrostatic Testing Plan; and the establishment of final project documentation to the satisfaction of ECGD (ECGD 2003).

Main criticisms

Key critics included civil society groups and UK parliamentarians, who questioned whether ECGD's business principles complied with the government's objectives for sustainable development, environmental protection, the protection of human rights and the prevention of corruption. The main criticisms refer to ECGD's reluctance to put the BPU report into the public domain.

²⁸ The original enquiry focused on whether breaches of the World Bank Policy OD 4.30 on involuntary resettlement represented a breach of the ECGD loan agreement for the BTC project.

Making it public would have provided an essential insight into ECGD's decision-making process and enhanced transparency. Critics also point out that the *Note of Decision* was too general in describing the factors influencing ECGD's decision to support the BTC project, and therefore fell a long way short of the assessment of the project produced by the BPU. Moreover, it was also noted that ECGD's reluctance to make public its own assessment of the project runs counter to the department's professed commitment to transparency in its business.

Other criticisms include ECGD relying too heavily on information provided by the project sponsor during the evaluation of the project and in the decision-making process, and that they were too ready to accept companies' assurances that the required environmental and social standards were being observed, rather than undertake independent investigations to verify those assurances (Hansard 2005b).

Another set of criticisms called into question ECGD's ability to effectively monitor the implementation of the project, and suggested that quality control failures during the pipeline construction were partly due to inadequate supervision by ECGD.

ECGD's response

ECGD responded that it assessed the financial, social, technical and environmental risks of the project before deciding to support the project. In arriving at its decision, ECGD was advised by a number of independent experts and was not, as was alleged, over-reliant on information provided by the project sponsors. The department explained that, in line with normal practice for projects of this size, ECGD had, together with the other lenders, carried out a wide-ranging consultation about BTC with NGOs from the three host countries and other stakeholders. Where NGOs raised specific issues ECGD investigated them properly, taking advice from the independent consultants appointed by the lenders group to assess the project application and monitor the implementation of the project. The ECGD's Business Principles Adviser conducted field visits in order to clarify specific issues and to verify the findings of the department's consultants. The BPU's report to ECGD's Underwriting Committee reviewed the concerns expressed by the NGOs during the consultation process. Where they found those concerns to be justified, they recommended that ECGD's support for the project should be conditional upon action being taken by the applicant to remedy the problem. The department accepted these recommendations and gave support to the project subject to a number of conditions. Compliance was then monitored by the BPU and by ECGD's consultants. Regarding project monitoring, ECGD argued the construction phase of the project was subject to regular inspection and monitoring by the Lenders Group's independent consultants, WorleyParsons, supplemented by less frequent site inspections by the BPU. ECGD was satisfied that the regime of inspection and auditing would ensure best practice during the construction of the pipeline. ECGD's Business Principles Adviser, David Allwood, was satisfied that the construction defects identified (the pipeline coating) had been remedied by the company, who had discovered the problem with defective welding during its own quality assurance procedures and had rectified the fault before the engineering consultants visited the site (Hansard 2005b).

4.2 Commercial banks' due diligence

Over recent years a growing number of commercial banks have been adopting policies to conduct environmental and social risk assessment of the projects in which they are involved. Notably, in June 2003, ten of the major commercial banks endorsed the Equator Principles, which provide a framework for banks to review,

evaluate, mitigate or avoid environmental and social impacts and risks associated with projects they finance. As of February 2006, the number of banks signing up to the EPs had grown to 40, which collectively represent some 80 per cent of global project finance. The EPs are therefore considered the industry standard for conducting environmental and social due diligence on project finance transactions.

Ten of the 15 commercial banks involved in the BTC loan were committed to the EPs when the loan was approved (February 2004). The exceptions were Société Générale, BNP Paribas, Bank Intesa, Natexis Banques Populaire and Sao Paolo INI. The BTC project was the first Category A project under the EPs and was thus considered a major test for them (EP 2004).

However, commercial banks, especially EPs signatories, have been criticised by civil society groups for their failure to comply with the EPs. Alleged violations include, for example, some clauses of the EIA report, such as the clause on consultation; several violations of IFC standards (OP 4.01 environmental assessment; OP 4.04 natural habitats; OD 4.20 indigenous peoples; OP 4.30 involuntary resettlement and OPN 11.03 cultural property), with which the EPs require compliance (Platform 2003). Moreover, they argue that the banks did not require improvements from BP to ensure compliance.

Commercial banks responded to the criticisms by providing general information about their due diligence processes and their decision-making on the project. Among the key issues highlighted by the banks as influencing their decision making on the project were: the due diligence process conducted by the IFC and EBRD, since each of them have extensive environmental and social policies and staff experienced in environmental and social evaluation; and the appointment of independent environmental consultant (IEC) Mott MacDonald to carry out the due diligence process and assess compliance with the EPs.

Three banks released public notes addressing the criticisms:

- ABN AMRO, the lead arranger of the syndicated loan. Their note outlined the bank's due diligence process: an assessment of all relevant BTC project documentation; reports by multilateral development banks; reports by independent advisors and other related institutions; and reports by NGOs. They also conducted several meetings with NGOs about the project. According to the bank's own assessment, the BTC pipeline project complies with the EPs. Moreover, the bank included an analysis of its application of the EPs to the BTC project (ABN AMRO 2003).
- The Royal Bank Group: this group highlighted the fact they work closely with the IFC to ensure that a project meets the social and environmental criteria enshrined in the EPs. They will not participate in a transaction unless satisfied that the social and environmental criteria set by the EPs will be met (RBS 2003).
- Credit Agricole Group: this group highlighted that they started their social and environmental due diligence process from the outset of their involvement and they relied heavily on the work undertaken by the sponsors, IFC/EBRD and the independent environmental consultant (IEC). They also noted that they were confident the project was compliant with the EPs (Credit Agricole (2004).

Moreover, lenders noted that BTC is a complex project and there might be diverging views on whether the project complies with the EPs. They argued that because the safeguard policies referenced in the EPs are processes, they require significant judgement on the part of the banks. This means that, in spite of intensive work and good faith by all parties, people can differ in their conclusions. All in all, while NGOs have a different view, the private sector banks, the multilateral and bilateral agencies, the sponsors and the host governments all believed that the project incorporated significant measures to respect the environment and social concerns (Monahan 2005).

It seems the vast majority of the banks did not take further measures following disclosure of the pipeline coating problem and its concealment. Indeed, all the commercial banks, including both EPs signatories and non-signatories, refused to comment on the issue at all, citing commercial confidentiality (Muttit 2004). Later, the IFC commented that they and some other lenders were satisfied with the 'corrective actions' taken by BP on the pipeline. However, there is no information on whether lenders placed additional requirements or conditions on the loan, or whether any other type of action was taken. Only one bank, Banca Intesa, decided to pull out of the loan agreement due to concerns about safety flaws and risks to reputation (Gillard 2004).

Commercial banks have been under direct attack for their alleged lack of due diligence on the BTC pipeline. NGOs have warned them that they risk being sued for their part in the environmental and social damage if the pipeline leaks and it can be proved they knew about the coating defect. This warning came in a letter to the banks' boards and legal departments from British, Georgian and Azeri campaign groups who have been monitoring the pipeline's impacts. The banks, including the Royal Bank of Scotland and ABN AMRO, would be liable to Turkish, Georgian and Azeri claimants if they had prior knowledge of a potential cause of pipeline failure yet failed to act to remove the risk of pollution. In this same vein, a Belgian NGO, Proyecto Gato, lodged a formal complaint against three Belgian banks (Dexia, KBC and ING – all three of which are EP signatories) through the OECD's *Guidelines on Multinational Enterprises*. This complaint also centres on the pipeline coating issue and on the undue constraint that the project's legal documents exercise over host governments' regulating powers (Muttit 2004).

5 The links between project finance, sustainable development and human rights: a critical analysis

The BTC case study shows that there can be both positive and negative impacts associated with the use of project finance. This chapter describes these main links.

5.1 Project finance and sustainable development

The involvement of IFC and other multilateral financial institutions in a project finance arrangement can have some positive effects:

- **IFC environmental and social procedures encourage positive sustainable development impacts.** The IFC has a comprehensive set of procedures for conducting environmental and social assessments, which it applies – though not without shortcomings – to all the projects it funds. This allows the project's key environmental and social risks to be internalised from the beginning, thus reducing the project's risk. IFC also has the mandate to increase the development contribution of the projects it funds.
- **IFC involvement sends a strong signal to other financial institutions** about the environmental and social 'health' of a project.
- **IFC involvement ensures an EIA process that is more open to public scrutiny.** The IFC has a disclosure policy, which means its due diligence processes are more open to public scrutiny than, for example, when only commercial banks are involved. The IFC Disclosure Policy provides an opportunity for other stakeholders to have an influence on the process. In the case of the BTC pipeline, for example, the IFC required the project sponsors to disclose the HGAs. This enabled civil society groups to comment on the contracts and to highlight areas that conflicted with sustainable development and human rights goals, which finally led to clarification about interpretation of the HGAs from the project sponsor.

Other links between project finance and sustainable development include:

- **Project finance can be a trigger for long-term sustainable development.** The BTC, EBRD and BP agreed to establish a programme of sustainable socio-economic development activities following the completion of the BTC construction phase in 2005. This initiative aims to stimulate long-term sustainable development in the non-oil sector in the region through provision of financing and grants. BP is ready to commit some US\$ 25 million to the programme, with EBRD having agreed to match BP's commitment. EBRD and BP hope to be able to attract further commitments to this facility, raising a total amount of up to US\$ 100 million to be invested over the first ten years of operations, beginning in 2005 (EBRD 2003).
- **Commercial banks' commitments to the EPs provide opportunities for a project to promote sustainable development.** The EPs have brought opportunities for reducing a project's risk and improving the sustainable development impacts of projects funded through project finance. The BTC project was the first Category A project under the EPs and therefore considered a major test for them.

- **EPs provide a window of opportunity through which to scrutinise commercial banks' practices.** Since EPs are a public commitment made by the banks and as they are linked to familiar procedures such as the IFC guidelines, they enable civil society to intervene in the process and to promote/advocate better practice where non-compliance is suspected.
- **Sensitivity to public opinion.** One of the key motivations of banks to engage with better environmental and social practice is to have some assurance that their financing actions will not become subject to negative publicity (Spek 2006). Indeed, the decision of Banca Intesa to sell its part of the loan due to concerns about safety flaws and risks to its reputation may illustrate this point.

5.2 Improving the sustainable development and human rights performance of project finance

However, we have also identified some important sustainable development problems and challenges that can be linked to the use of project finance. Project finance creates incentives to engage in contractual arrangements that may interfere with the achievement of sustainable development goals. For example, the contracts may include stabilisation clauses (e.g. the HGAs between BTC Co. and each host government) or financial arrangements (e.g. the LSTA between BTC Co. and the government of Turkey) that can interfere with the achievement of sustainable development and human rights goals in the host country. There are also several issues arising from the financing process of the BTC pipeline case study that need to be addressed to improve the project's sustainable development impacts.

The following recommendations attempt to address some of these shortcomings:

- **Financial institutions should undertake their own independent processes, rather than relying on the IFC's due diligence process.** Multilateral financial institutions, such as EDRB and ECGD, as well as commercial banks, have relied heavily on the IFC's due diligence process rather than undertaking their own independent processes. This provides less opportunity to identify additional project problems. For example, the IFC process failed to detect the problem with the pipeline coating. The issue was not detected by any of the other institutions either, because they relied on the information provided by the IFC, the project sponsors and the IEC jointly appointed by the Lender Group. This issue also leads to the next point.
- **All lending institutions need to independently verify the information provided by the project sponsor.** This applies to both multilateral financial institutions such as the IFC and EBRD, commercial banks and the IEC. In general, there is a marked trend for the financial institutions involved in the loan to rely on the information provided by the project sponsor and not to conduct an independent verification of the information. In the case of BTC, though lenders did hire an IEC to conduct the environmental and social due diligence and monitoring processes, the evidence also shows that at least in the case of the coating issue, the IEC only conducted a desk review which mostly relied on the information provided by the project sponsor (Girard 2004).

- **There is a need for more standardisation in reporting how implementation and compliance with environmental and social procedures are measured.** As noted by the commercial banks themselves, policies referenced in the EPs are processes and questions that need to be applied and they require significant judgement on the part of the banks. This means that different institutions can vary in their conclusions about the same project. This problem could be improved through the integration of an independent compliance mechanism similar to the CAO or the IRM in the case of the IFC and EBRD, respectively.
- **There is a need for information disclosure by commercial banks.** Commercial banks often use the need for ‘client confidentiality’ to avoid disclosing their involvement in the project finance transactions; they are not obliged to disclose how they are conducting their social and environmental due diligence processes or their decision-making processes. Just as IFC’s disclosure policy provides some opportunities to improve the sustainable development impacts of the BTC pipeline, improved transparency of commercial banks would also improve levels of trust and relationships with civil society.
- **Financial institutions should place important conditions/penalties on the project sponsors beforehand so as to avoid/minimise the likelihood of serious negligence.** The integrity of most financial institutions is called into question by their apparent lack of reaction to evident shortcomings such as the pipeline coating and its cover up by the project sponsor. Banks must improve how they conduct their due diligence process (i.e. extensive and independent verification as highlighted in the point above). This would increase the possibilities of detecting problems early in the process and minimise the likelihood of such problems appearing after the loan is agreed. Financial institutions have a responsibility towards the projects they fund and, according to the IFC guidelines and the EPs, they are committed to monitoring the project to verify compliance. However, it seems they have no strategy for dealing with serious negligence by the project sponsors. Financial institutions need to react seriously when there is strong evidence of negligence.
- **IFC policy should be aligned with good ESIA international practice by starting construction only once the due diligence activities have finished.** Timing is important in order to have the opportunity to influence the sustainable development impacts of a project. In the case of the BTC pipeline, the sponsor started construction before the financial institution had finished its due diligence processes and even before the release of the final EIA for public comment. Such poor timing makes it extremely difficult to change the dynamics of the project to avoid, eliminate or mitigate any potential adverse impacts, especially when this involves modifications in the design, construction and operations phases. Though this is consistent with IFC policy, it goes against good international ESIA practice.

- **Financial institutions should be responsible for the entire life of the projects they fund and not only until the loan has been repaid.** With the BTC pipeline, financial institutions provided for pre-financial close construction monitoring and also for post-financial monitoring during the construction phase. However, although impacts might occur during pipeline operation or even during the pipeline closure, at present there is no evidence of monitoring or any leverage point on the part of financial institutions after the loan is repaid. These measures are important to give the lender the incentive to comply with the environmental and social commitments contained in the ESIA and the ESAP. Indeed, USAID (2004) notes the lack of a detailed decommissioning plan for any of the three countries. The handover of facilities to state-owned SOCAR (Azerbaijan's state-owned oil and gas company) and GIOC (Georgian International Oil Corporation) will occur after 20 years when the oil field productivity is below profitable rates unless supplemented with oil from other sources. Therefore, the financial resources that would be ultimately required for decommissioning are uncertain. This is particularly worrying considering that SOCAR does not have a sound environmental performance record with other oil fields under its management regime.

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