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**Project finance,
sustainable
development and
human rights.
Case study 2: the
Orion and Celulosas
de M'Bopicua (CMB)
pulp plants in
Uruguay**

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Acronyms and abbreviations

ADP	Air-dried pulp
BAT	Best available technology
BBVA	Banco Bilbao Viscaya Argentaria
BEKP	Bleached eucalyptus kraft pulp
BTO	Back-to-office report
CAO	Compliance Advisory Ombudsman
CARU	Comision Administradora del Rio Uruguay
CARU	River Uruguay Executive Commission
CCIC	Consolidated Contractors International Company
CCIC	Consolidated Contractors International Company
CCP	Contractor Control Plans
CDM	Clean development mechanism
CEDHA	Center for Human Rights and Environment
CESCE	Spanish Export Credit Agency (Compañía Española de Crédito a la Exportación)
CIP	Community Investment Programmes
CIS	Cumulative Impact Study
CMB	Orion and Celulosas de M'Bopicua
COFACE	Compagnie Francaise pour le Commerce Exterieur
DFID	Department for International Development
DINAMA	Dirección Nacional de Medio Ambiente
ECA	Export credit agencies
ECF	Elemental chlorine-free
EIA	Environmental Impact Assessment
EMMP	Environmental Management and Monitoring Plan
ENCE	Grupo Empresarial ENCE S.A. of Spain
EP	Equator Principle
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
FOSA	Compañía Forestal Oriental
FSC	Forest Stewardship Council
GLAC	Guides to Land Acquisition and Compensation
GTAN	High Level Technical Group
ICJ	International Court of Justice
ICO	Instituto de Crédito Oficial
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
MIGA	Multilateral Investment Guarantee Agency
MSF	Multi-stakeholder forums
NCEIA	Netherlands Commission for Environmental Impact Assessment
NGO	Non governmental organisation
OAS	Organisation of American States
OECD	Organisation for Economic Co-operation and Development
OPIC	Overseas Private Investment Corporation
PCDP	Public Consultation Disclosure Plan
SACE	Servizi Assicurativi del Commercio Estero

SEA	Strategic environmental assessment
TCF	Total chlorine free
TLM	Terminal Logistica M' Bopicuá
VAT	Value added tax

1 Introduction

In recent times, firms operating in the natural resource extraction 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?

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?

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)

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

1.1 The case study: the Orion and CMB pulp mills

In this paper I analyse these two sets of issues for the case of the Orion and Celulosas de M'Bopicua (CMB) pulp mills, both located on the Uruguayan and Argentinean border (Figure 2.1). The pulp mills are sponsored by the Finnish company Botnia and the Spanish Group ENCE, respectively (see Section 2.4). The two plants together constitute the largest foreign investment ever in Uruguay. These pulp mills were chosen as a case study for the following reasons:

- **Information availability:** access to information on contractual arrangements and the procedures followed by financial institutions involved in the loan is essential. However, this type of information is considered sensitive both for the project sponsors and the financial institutions involved, which means it is usually confidential. However, for these two pulp mills, the International Finance Corporation (IFC) is involved in the financial arrangement. The IFC has a disclosure policy which means that important information about the due diligence process of the projects – especially environmental and social assessments and monitoring plans – is disclosed to the public.⁴ In addition, the important international dimension of these pulp mills means they have been subject to intense public scrutiny. Thus, there is a large amount of information available on the projects, produced by different stakeholders including civil society groups, national governments and the financial institutions.
- **A new sector for project finance.** To date, the use of project finance in the pulp sector has been very rare. Indeed, between 1990 and January 2005 only US\$ 1 billion was devoted to project finance transactions in the pulp mill sector, which corresponds to only 2.8 per cent of total pulp mill projects (Spek 2006). Considering the current shift on pulp investments to Southern countries and the need to build larger plants, these projects are likely to be a significant test case for expansion of project finance in the sector.

1.2 Methodology and research scope

This case study focuses on the process of negotiating the project finance loans and the application of the IFC guidelines and the Equator Principles (EPs) for conducting environmental and social assessments.

The research was based on interviews with key stakeholders, conducted in the context of a field visit to Uruguay and Argentina in July 2006. This was complemented by a review of the main literature on the Uruguayan pulp mill projects and its financing process. This literature included official documents and grey literature produced by the financial institutions involved, project sponsors, national governments, civil society groups and press documents. Special attention was given to information on the regulatory framework governing the investments in the host country and to information on the environmental and social due diligence processes conducted by the financial institutions involved in the loan.

A key limitation to the research was that negotiations on the project finance loan were still in process while I was conducting the field research and writing this document. The final loan was agreed in March 2007 and this information has been updated and added during 2007.

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).

Another limitation was access to information about the processes conducted by the commercial banks. Commercial banks do not have a disclosure policy and keep information on their due diligence processes away from the public domain on the grounds of client confidentiality. Thus information on this issue was rather poor and has mostly come from civil society groups involved in the projects.

A final limitation relates to the nature of the issues to be analysed. These mostly refer to contractual terms, processes and the stakeholders' motivations to enter into those agreements and conduct the processes involved. These processes and motivations can be explained by many different factors and can also be found in other types of financing structures, and are not unique to the project finance instrument. Moreover, as the research was conducted before the projects started operating, many of the sustainable development links are rather speculative and the actual impacts of the projects remain to be seen.

2 The projects and their financing

2.1 Background

The Orion project is owned by the Uruguayan subsidiary of the Finnish company Botnia SA. It involves constructing a eucalyptus kraft pulp mill on a greenfield site, and building a port.⁵ The pulp mill will have the capacity to produce 1 million metric tonnes a year of air-dried pulp (ADP), the primary raw material for the production of paper and paper-related products. This ADP will be sold on the international market. The Orion project is located in Fray Bentos (Figure 2.1), the capital of the Rio Negro Department of Uruguay, on the border with Argentina (Gualeduaychú). The city is located some 200 miles northwest of Montevideo and has an estimated population of 23,000. Fray Bentos is an important trade conduit as it is located on the Uruguay River and next to an international bridge that connects Uruguay to Argentina.

The CMB project is sponsored by the Spanish group ENCE and the project should be operated by a wholly-owned subsidiary of ENCE. The project originally involved building a greenfield eucalyptus kraft pulp mill with a capacity of 500,000 tonnes a year of ADP, also destined for the international market. The original site of the CMB project was in M'Bopicuá, a district located in the Rio Negro Department, 12 km north of Fray Bentos and roughly 300 km northwest of Montevideo. In 2006 however, ENCE decided, with the consent of the governments of both Argentina and Uruguay, to relocate the pulp mill to Colonia, on the Río de la Plata, half-way between the original location and the capital Montevideo. The new project is planned to have a capacity of 1 million tonnes a year.

The Orion and CMB projects together constituted the largest private investment ever in Uruguay. I chose to analyse both projects because of the controversy surrounding their combined environmental and social impacts.

2.2 Production

The Orion project will have the capacity to produce 1 million metric tonnes a year of ADP. When operating at full capacity, the mill will use 3.5 million cubic metres of raw wood a year. About 70 per cent of this wood will be supplied from the plantations of Botnia's subsidiary Compañía Forestal Oriental (FOSA), most of which are situated near Fray Bentos. FOSA specialises in eucalyptus cultivation, and was founded in Uruguay in 1990. It currently owns 90,000 ha of land, of which around 60 per cent is either already planted or suitable for planting. FOSA's plantations, activities and entire procurement chain have received Forest Stewardship Council (FSC) certification. Another ten per cent of the wood will come from a long-term wood supply contract already signed with the Otegui Group. The remaining 20 per cent will be procured through long-term contracts with private forest owners, funds, foundations or cooperatives within Uruguay and Argentina. The technology to be used by the project is elemental chlorine-free (ECF). The bleached eucalyptus pulp produced by the mill will be sold largely to the paper mills of Botnia's owners in Europe and Asia (see Faroppa and Annala 2004).

⁵ Kraft paper is paper produced by the kraft process from wood pulp. It is strong and relatively coarse. Kraft paper is usually a brown colour but can be bleached to produce white paper. It is used for paper grocery bags, multiwall sacks, envelopes and other packaging (Source: <http://en.wikipedia.org/> accessed 3/2/2009)

CMB will install, own and operate a pulp mill with a capacity of approximately 500,000 tonnes per annum. The pulp mill will produce bleached eucalyptus kraft pulp (BEKP) using an ECF process. The primary raw material will be eucalyptus wood grown within about a 300 km radius of the mill. Almost two-thirds will be sourced from EUFORES, an ENCE-owned affiliate, while the remaining third will come from independently-owned suppliers. The pulp is to be sold on the world market. Eucalyptus pulps are especially well-suited for writing paper and toilet paper/tissues. M'Bopicuá is an uninhabited area on which a dedicated 284 ha industrial park is being constructed, adjacent to Terminal Logística M' Bopicuá (TLM). TLM is a port facility that was constructed in 2003 and owned by ENCE. It has the capacity to load about 11,000 tonnes of bulk materials per day.

2.3 Construction and costs

The total cost of the Orion plant is US\$ 1.2 billion – the largest foreign investment ever in Uruguay and also Finland's biggest private-sector industrial greenfield investment abroad (Varis 2005). While Botnia is in charge of the civil engineering project (construction), the Austrian company Andritz Oy has been hired to supply and assemble all the machinery to be used by the plant.⁶ The agreement involves a fibre line extending from wood handling through to pulp drying, as well as a chemicals recovery system. The value of the order is over € 200 million (about US\$ 260 million). With the exception of the pulp dryers, all the main equipment – representing more than half of the order – will be manufactured in Finland (Botnia 2005b). Botnia has also contracted a Finnish chemicals group – Kemira – to supply the required chemicals. Kemira will build chemical plants on the site involving a total investment of € 60 million (about US\$ 78 million) (Botnia, 2005a). Honeywell and Alstom will supply the entire automation system and the air pollution control systems for the mill, respectively. Botnia has some 17 or 18 contracts with Uruguayan companies involving more than 2,600 workers on the civil engineering project.⁷ By July 2006 the project was 40 per cent complete.⁸ Foundation work for the buildings had finished, construction above ground was in progress and the mill operations were expected to commence by the third quarter of 2007.

The total cost of the CMB project is US\$ 660 million. Construction work was halted in March 2006 due to a diplomatic conflict between Argentina and Uruguay over the pulp mills (see Section 3.2) and it was not expected to recommence until the last quarter of 2006 when international credits were to be finally defined (Diario 20 Minutos 2006). However, in early October 2006 ENCE announced its decision to relocate the plant. The final location chosen is in Punta Pereira, on the Rio de la Plata, 56 km from the Uruguay River delta, and several hundred kilometres from the original mill site (CEDHA 2006a).

2.4 Project sponsors

The Orion project belongs to Botnia SA, a company founded in 2003 in Uruguay. It is entirely owned by entities controlled by the sponsor. However, participation may change as Botnia and the Uruguayan company Otegui Group⁹ have signed a preliminary agreement under which the Otegui Group has the right to become a shareholder in Botnia SA with a stake not

⁶ Ronald Beare, Managing Director of Botnia SA, personal communication July 2006.

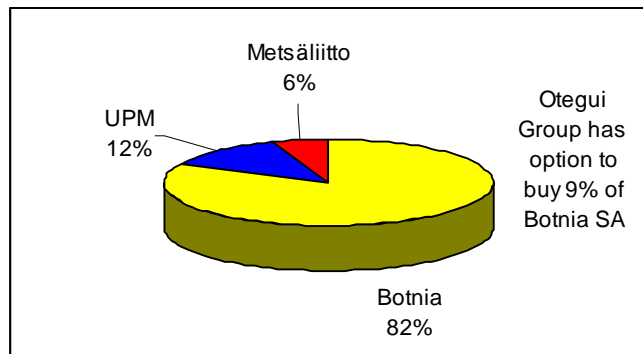
⁷ Ronald Beare, pers. comm.

⁸ Ronald Beare, pers. comm.

⁹ The Otegui Group (Grupo Otegui) has been in the agribusiness sector since the beginning of the last century and employs approximately 600 people. It started its forest products activities at the end of the 1980s and currently owns eucalyptus plantations (FSC-certified since 2001) and sawmills.

exceeding nine per cent (Figure 2.1). This right comes into effect when the pulp mill begins production and will remain in force for seven years.

Figure 2.1 Ownership of Botnia SA



Botnia is the Finnish multinational Metsa-Botnia Ab and was founded in 1973. It is Europe's second largest pulp producer, owning five pulp mills in Finland with a total production capacity of 2.7 million tonnes per annum. Approximately 80 per cent of Botnia's pulp is sold to its shareholders and the rest is sold as market pulp, mainly to Europe. Botnia's audited turnover at the end of 2004 amounted to US\$ 1.5 billion, with a net profit of US\$ 142 million. Botnia is owned by three Finnish companies: M-Real Corporation (39 per cent), UPM-Kymmene (47 per cent) and Metsaliitto Cooperative (14 per cent). M-Real is Europe's third largest paper merchant and a leading supplier of paper, paperboard and packaging. UPM is the world's leading magazine paper, silicon paper and label producer and Europe's leading envelope paper, industrial wrapping products and plywood producer. Metsaliitto Cooperative, the parent company of Metsaliitto Group, is an organisation of Finnish forest owners with approximately 131,000 members.¹⁰

CMB is entirely owned by the Grupo Empresarial ENCE SA of Spain, known as ENCE. ENCE was founded in 1957 and is a partially integrated forestry products company, whose primary assets and activities comprise the ownership and management of forest lands on the Iberian peninsula and in Uruguay (EUFORES), as well as three pulp mills in Spain. ENCE specialises in eucalyptus forestry and pulp production. It manufactured 1.02 million tonnes of pulp in 2004, making it the second largest producer of eucalyptus pulp in the world. At the end of 2004, ENCE managed 87,000 ha of forest reserves in Spain and 63,000 ha in Uruguay, all FSC certified. ENCE is listed on the Madrid exchange, where the 'free float' accounts for a little more than one half of ENCE's shares. The only shareholder with more than a 10 per cent stake in ENCE is Caixa Galicia, the savings bank based in Galicia, Spain, who owns a 17.7 per cent stake.

¹⁰ See IFC website: Summary of Project Information:
<http://www.ifc.org/ifcext/lac.nsf/Content/SelectedProject?OpenDocument&UNID=59329B838E724DCB85256FE900536C02>.

2.5 Stakeholders' perceptions of the projects

Stakeholders can be divided into two main groups: those supporting the projects and those opposing them.

2.5.1 Support for the projects

Stakeholders supporting the projects include the government of Uruguay, the projects' sponsors (Botnia and ENCE) and the people of Fray Bentos. Key reasons for supporting the projects are their contribution to the national economy and employment:

- The Orion project is the largest foreign direct investment (FDI) ever in the country, equivalent to some 2 per cent of GDP (based on 2005 figures) and more than 8 per cent of the country's exports annually for an estimated period of 30 years of full production.¹¹
- According to Botnia (HCG Environment 2004), the pulp mill alone will create 8,000 direct and indirect jobs during the construction phase (of which 300 are long-term jobs).
- For the Uruguayan government, the projects are an additional step in the development of the forestry sector. The sector had begun to develop by the late 1980s when the government introduced several economic instruments such as subsidies and soft loans.¹² The cellulose plants are the next step in this development process. Indeed, in addition to the Orion and CMB projects, the Swedish-Finnish company Stora Enso has started to purchase land in Uruguay with the intention of establishing fast-growing plantations to supply a future Stora Enso pulp mill to be located in the same district of Rio Negro.

The IFC, the private sector arm of the World Bank, has been supporting the projects since their conception. According to the IFC, it is supporting the projects due to the benefits they give to the national economy. The projects also fit in with the World Bank Group's long-term strategy for the development of Uruguay, which recommends investments in forestry and in the diversification of the country's export base to increase its competitiveness. But according to the IFC guidelines, the institution should also aim to increase the projects' local contributions.¹³ To this end, the IFC has requested further studies by and requirements of the projects' sponsors in the context of the projects' due diligence processes (see Section 3.1.3).

2.5.2 Opposition to the projects

Those opposing the pulpmills include the people from Gualaguaychú (in Argentina), and Uruguayan and Argentinean civil society groups, supported by international NGOs and the government of Argentina. The main reasons for opposition are the projects' negative sustainable development impacts and the shortcomings in the due diligence processes conducted by the financial institutions:

- The positive economic impacts of the projects have been overestimated. In the case of Botnia, for example, only a small proportion of the whole investment (less than 20 per cent) would actually be spent in Uruguay (Roque 2006). The bulk of job creation is during the construction phase and would have very little impact on longer term job prospects. Also, the free zone status granted to the companies means that there will be almost no revenue paid to the government of Uruguay.

¹¹ See IFC website: http://www.ifc.org/ifcext/lac.nsf/Content/Uruguay_PulpMills_FAQ.

¹² Through the *Ley de Promoción Forestal* in 1988.

¹³ See IFC website: http://www.ifc.org/ifcext/lac.nsf/Content/Uruguay_PulpMills_FAQ.

- There are significant concerns about the potential negative environmental impacts of the projects, such as the effect on water quality due to the use of ECF instead of total chlorine free (TCF) processing. Concerns also relate to the negative impacts on the local population and on other economic sectors such as tourism and agriculture.
- The Argentinian government opposes the project due to potential negative effects on the Argentinean population of Gualaguaychú. It also accuses Uruguay of violating the Uruguay River Statute International Treaty (see Section 3.2).
- Several civil society groups also highlight inadequacies in the environmental and social due diligence proceedings conducted by the IFC.

2.6 Project financing

Both projects have approached multilateral financing institutions and commercial banks for financial support using the project finance mode.

2.6.1 Orion project

Total costs of the Orion project come to US\$ 1,200 million; about 60 per cent of which will come from capital invested by Botnia SA, and the remaining 40 per cent will be arranged through external loans. Of these external loans, one part has been applied for from the IFC and the rest from commercial banks.

The proposed IFC investment consists of an 'A' loan (up to US\$ 170 million) for IFC's own account and a syndicated 'B' loan of up to US\$ 100 million for participants' accounts.¹⁴ The Multilateral Investment Guarantee Agency (MIGA)¹⁵ of the World Bank has also been approached by the project sponsor, who requested US\$ 350 million to cover potential political risks. Finnvera, the official state-owned export credit agency of Finland, has also underwritten political risk.¹⁶

ING Bank was initially appointed as the global coordinator of the syndicated loan, together with Nordea as the co-advisor (Botnia 2005). However, ING decided to pull out in late March 2006 after being targeted by several NGOs opposing the project who claimed that it did not comply with the EPs.

After ING withdrew, Calyon and the Norea Group became involved as the main loan arrangers. Nordea is the leading financial services group in the Nordic and Baltic Sea region. Calyon is the corporate and investment banking arm of the French Crédit Agricole Group. IFC financial support for the project was delayed until an additional cumulative impact study (CIS) on the environmental and social impact of the Orion and CMB projects was conducted (Varis 2006). The final results were published in September 2006 and both the IFC loan and the MIGA guarantee were approved by the respective boards of directors on the 21st November 2007. Commercial banks were also awaiting the results of the CIS to decide whether to support the project but as of January 2007 had not yet officially approved the loans.

¹⁴ 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).

¹⁵ MIGA provides political risk insurance (guarantees) against losses arising from currency transfer restrictions; breach of contract; expropriation; and war and civil disturbance, for private foreign investments into developing countries. Unlike IFC, MIGA does not finance projects (see: http://www.ifc.org/ifcext/lac.nsf/Content/Uruguay_PulpMills_FAQ).

¹⁶ See IFC website: http://www.ifc.org/ifcext/lac.nsf/Content/Uruguay_PulpMills_FAQ.

2.6.2 CMB project

The total cost of the CMB project is US\$ 660 million, with a possible US\$ 200 million investment from the IFC, through both type A and B loans. The proposed IFC investment consists of an A loan for the IFC's own account of about US\$ 50 million and a syndicated B loan for the account of participant financial institutions of about US\$ 150 million.¹⁷ Banco Bilbao Viscaya Argentaria (BBVA) is the commercial institution leading the syndicated loan. Due to delays in the IFC proceedings regarding the financing, CMB approached the Spanish state-owned corporate entity attached to the Spanish Ministry of Economy and Finance, ICO (Instituto de Crédito Oficial), for financial support. The ICO is analysing the provision of a US\$ 350 million loan plus interest (7 per cent) to the company, and is also asking the Spanish export credit agency CESCE (Compañía Española de Crédito a la Exportación) to consider providing risk insurance for ENCE.

In early October 2006 ENCE announced its decision to relocate the CMB plant. As a consequence, the IFC decided to put CMB on hold and stated it would consider financing the ENCE plant only once the corporation had been able to assess the project in its new location.

¹⁷See IFC website:
<http://www.ifc.org/ifcext/lac.nsf/Content/SelectedProject?OpenDocument&UNID=4208C72853E61DF785257045006F993F>.

3 The projects' legal and political context

3.1 The legal framework

The projects' legal framework is crucial as it shapes the projects' viability, and controls the allocation of risks between the parties (Hoffman 2001). Contracts must not interfere unduly with the expectation for debt repayment from project revenue. They should be designed to anticipate regulatory problems unique to the project and the environment in which the projects will exist. 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. Two main legal frameworks govern the relationship between the government of Uruguay and the projects' sponsors: (1) investment agreements between the government of Uruguay and the governments of the sponsors' countries of origin; and (2) Law NR 15.921 regulating the free zone status of the projects.

3.1.1 Investment agreements

The investment agreement between Uruguay and Finland was signed in March 2002 and was ratified by the Uruguayan Congress in April 2004. The agreement covers different aspects of inflow investment including: the promotion of investment between the two countries, non-discrimination, expropriation, compensation, revenue repatriation and controversy resolution (Gobiernos de Finlandia y Uruguay undated).

The agreement has been strongly criticised by different civil society groups. Main criticisms are that it has been 'tailored to Botnia's needs',¹⁸ and that the company only guaranteed the investment on the condition that this agreement was signed (Cabrera 2005).

Criticisms also refer to the potential implications of Articles 6 and 9 of the agreement. Article 6 deals with establishing compensation for economic losses deriving from a number of causes, including 'demonstrations' (*manifestaciones* in Spanish) that might affect the company (Gentili 2006, Guayubira undated). Several stakeholders have interpreted this article to mean that if public demonstrations were to affect the company, the Uruguayan government would have to compensate the company for any resulting losses. Article 9 deals with the resolution of controversy and establishes that in case of controversy between the company and the government of Uruguay, the former would have the right to decide whether the case be ruled in a domestic or international court.

The investment agreement between Uruguay and Spain (Gobiernos de España y Uruguay undated) was signed in April 1992, prior to ENCE's arrival in Uruguay through EUFOREs in 1990, and well before the development of the CMB pulp mill project. The agreement covers areas related to the promotion and protection of foreign investment, issues of non-discrimination, compensation, repatriation of the revenues and capital, nationalisation and expropriation, and dispute settlement, among others.

¹⁸ Teresa Perez, Grupo Guayubira, personal communication June 2006.

3.1.2 *Free zone status*

Both pulp mills were granted free zone status in October 2004 for a period of 30 years. 'Users of the free zones shall be exempted from all national tax, created or to be created, including those requiring by law a specific exemption, as regards any activity carried out therein'.¹⁹ This means the companies will be completely exempt from profit tax, capital tax, VAT and import and export taxes. In return, the companies have to pay an annual fee of US\$ 30,000 to the Uruguayan government, an amount that will be complemented by other charges that vary according to the level of activity, productivity and occupation of the free zone (Orellana 2004).

The granting of free zone status has received significant criticism by those opposing the projects. They argue that it means there will be very little economic benefit to the country, while the potential environmental and social damage will be significant.²⁰ Moreover, they argue that the projects' profits will be taxed in Finland and Spain, leading to a net transfer of revenue from Uruguay to these countries. In the case of Botnia, opponents also argue that the company only decided to proceed with the investment on the condition that the free zone status was granted by the government of Uruguay. On the other hand, Botnia argues that the free zone status is needed to ensure the stability of Botnia's customs and tax treatment in the long term (Botnia 2004).

3.2 **The political context**

At the international level the construction of the two pulp mills is causing a dispute between the governments of Argentina and Uruguay, a controversy that, at the moment of writing this report, was being resolved at the International Court of Justice (ICJ) in The Hague.²¹ Argentina decided to take the Uruguay government before the ICJ in January 2006, after the High Level Technical Group (GTAN) completed its work without reaching an agreement. The GTAN, a group of authorities from Argentina and Uruguay, was set up in May 1995 by the presidents of the two countries to exchange information and analyse the impacts of the projects (Box 3.1).

Box 3.1. The High Level Technical Group (GTAN)

The creation of the GTAN was the result of several political and diplomatic actions taken by the governments of the two countries following Argentinean opposition to the construction of the mills (Sabsay et al. 2006). These actions commenced in October 2003 when Botnia officially announced the Orion project to the Uruguayan authorities, and the Uruguayan Environmental Authority, DINAMA, released the environmental permit to ENCE.

After these developments the Argentinean delegation to the River Uruguay Executive Commission (CARU) complained that Uruguay was not in compliance with the Uruguay River Statute (Sabsay et al. 2006). Under this 1975 treaty, all the issues concerning the Uruguay River must be agreed by both countries.

¹⁹ According to Article 19, Law NR 15.921 'LEY DE ZONAS FRANCAS N°. 15921 del 17 de diciembre de 1987' available at: <http://www.zonafrancacolonia.com/ley.htm>.

²⁰ See Guayubira undated, and Red Uruguay de ONGs Ambientalistas 2006;

²¹ The ICJ is the UN court which deals with conflicts between states.

Argentina's concern is that the projects will jeopardise the environment of the River Uruguay and its area of influence and affect more than 300,000 residents of the town of Gualeguaychú. Residents are concerned about the significant risk of pollution of the river, deterioration of diversity, harmful effects on health and damage to fisheries.

The group had 180 days, between August 1995 and January 2006, to carry out the study and produce a first report. However, during the process the Argentinean delegation complained that Uruguay had not handed over all the relevant available information. It finally concluded in its report in January 2006 that due to the technology being used by the projects, the geographical location, the proximity to populated areas and the fragility of the aquatic ecosystem, the environment could not be preserved at the highest international level.²²

Following the failure of the GTAN, Argentina began preparations for a plea to the ICJ. However, on 11th March 2006 the Uruguayan and Argentinean presidents reached a 90-day agreement to halt the projects to allow further social, economic and environmental impact studies to be carried out. This was also agreed by the companies, meaning that ENCE and Botnia would have to stop construction during the stipulated period. The presidents also asked civil society organisations and citizens to support the agreement by suspending their blockade of the three bridges linking Argentina and Uruguay.²³

However, Botnia only halted the plant construction for ten days. According to the company, construction works continued due to the lack of any official statement from the government of Uruguay on the issue (Helsingin Sanomat 2006). Those opposing the projects hold the view that Botnia's decision was based on fear of damaging the company's stock prices on the Helsinki and New York stock exchanges (CEDHA 2006c). On the other hand, Botnia's decision to continue with construction activities, despite the governments' request to halt them, might be attributed to the financial pressure resulting from the need to repay the financial loans. However, as the project financing is still unresolved and therefore the company is financing construction activities with shareholders' money, it is not easy to establish such a link.

The government of Argentina strongly criticised the Uruguay government for failing to order Botnia to halt construction activities. The government of Uruguay responded that it did not have the legal authority to halt construction of the two plants (Valente 2006). However, other stakeholders (Gentili 2006, Valente 2006, Guayubira undated) argue that the Uruguay government's refusal to give orders to Botnia to halt the construction is due to the potential conflicts that might arise regarding the commitment made by the government in the investment agreement (see above).

After the failure of the bilateral negotiations, the two governments filed a series of complaints before different international organisations. In May 2006, Argentina filed a claim against Uruguay at the ICJ, maintaining that it wanted the construction of the two mills halted because Uruguay had violated the 1975 Uruguay River Statute by improperly and unilaterally authorising the construction of the plants without prior consultation. Uruguay, on the other hand, argued that the mills will generate jobs and will be under strict environmental control. On the 13th July 2006, the ICJ issued its provisional ruling; the judges voted 14-1 in

²² For a summary of the key developments between the two governments see Sabsay et al. 2006.

²³ Opponents of the mills have held numerous demonstrations in which they have blocked a number of bridges linking the two countries, the road between Gualeguaychú and Fray Bentos and the road between Colón and Paysandú.

Uruguay's favour. They ruled that the construction of the mills posed no serious threat to the environment and could continue, with the judges evaluating the potential risks of the pulp plants once they began operation. The final ruling of the court was expected by the end of 2007.

In turn, due to the continued blockade by Argentinean citizens of the international bridge, Uruguay filed complaints against Argentina to the Secretary General of the Organisation of American States (OAS), the South American trading block MERCOSUR and the ICJ to induce the Argentinean government to intervene.

4 Lenders' approaches to environmental and social due diligences

4.1 IFC and due diligence

According to the IFC's environmental and social guidelines,²⁴ the Orion and CMB pulp mill projects were both classified as Environmental and Social Review Category A projects. In other words it has potentially significant adverse environmental or social impacts that could be diverse, irreversible or unprecedented.²⁵ The framework within which the IFC determines 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 this case for pulp and paper mills.

The IFC also has safeguard policies addressing specific issues such as international waterways, involuntary resettlement, natural habitats, indigenous peoples, cultural property, and forestry.

A description of the IFC's due diligence process for each project is provided below.

4.1.1 Orion's environmental impact assessment

At the time the IFC became involved in the project (early 2005), the processes for review and disclosure of the environmental impact assessment (EIA) by the competent authority in Uruguay, DINAMA (Dirección Nacional de Medio Ambiente)²⁶ were largely completed. Therefore, when the IFC started the due diligence process, Botnia had already received the Environmental Permit from DINAMA (See Box 4.1 for details). As a result, the IFC conducted the social and environmental due diligence process from the EIA documentation produced by the sponsor to DINAMA and the back-to-office report (BTO) from MIGA's appraisal visit to the project in January 2005.

Based on the information provided in these documents, the IFC stated the need to assess the cumulative impacts of the Orion and CMB projects. Botnia responded that this issue had been addressed in an additional analysis provided to DINAMA between September 2004 and January 2005. IFC also raised concerns about air and water quality. The sponsor replied that air quality indices would not be affected by the project and the proposed treatment of Fray Bento's wastewater by Orion would improve the water quality (CAO 2006). A site visit by the IFC's environmental team in late March/early April 2005 was also conducted.

²⁴ See <http://www.ifc.org/ifcext/sustainability.nsf/Content/EnvironmentalGuidelines>

²⁵ 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.

²⁶ The EIA was submitted to DINAMA on March 31, 2004 and after several requests for supplementary information and analysis covering a range of topics, on December 6, 2004, DINAMA instructed Botnia to commence the process of public participation. The Orion Environmental Permit was released by DINAMA on February 15 allowing the specified construction works to start within 24 months following notification of the order and for operations to start within 48 months of the start of construction.

The EIA did not include the Ontur Terminal at Nueva Palmira as the port was finally considered a non-associated facility to the Orion project. Moreover, the IFC did not require a public consultation and disclosure plan as it considered the consultations undertaken by the sponsor under DINAMA's requirements to be adequate.

Finally, on April 2005 the IFC posted the Category A Disclosure Sheet on the Infoshop. This confirmed that it considered the EIA complete in all respects, and also obtained permission for the release of a set of 20 documents from the sponsor (CAO 2006).

Box 4.1. DINAMA and the Orion EIA process

The Orion project's submitted its EIA to DINAMA on 31st March 2004. DINAMA reviewed this and made six requests for supplementary information and analysis covering a range of topics, including assessment of the cumulative impacts of the Botnia and CMB projects in relation to water, air and odour. A seventh request was made on 20th December 2004, and the response to this was dated 17th January 2005.

On 6th December 2004, DINAMA instructed Botnia to announce the beginning of the public disclosure period with a public hearing to be held in Fray Bentos on 21st December 2004. Botnia printed and distributed 3,000 copies of the EA summary and opened a public consultation office in Fray Bentos for the week of 13th December 2004. Botnia announced the consultation in local newspapers and on radio and TV stations in the Fray Bentos area, including adjacent towns and across the river in the city of Gualeguaychu, Argentina.

The permit was released for public disclosure on 14th February 2005. During the 14-day notification period, one appeal was lodged by the NGO group Guayubira, which reserved its right to specify the appeal at a later date.

The Orion Environmental Permit was granted on 15th February 2005. It sets out the EIA submission and review process, listing the main issues raised at the public hearing on the EIA. It notes that the issues raised during the public notices and the hearing in connection with the permit were properly taken into account in DINAMA's examination of the application, and sets out 34 conditions attached to the permit. These conditions include information and access to be provided to DINAMA, additional plans and studies to be completed at various stages, project-specific emission limits, monitoring and monitoring plan requirements, participation of Botnia in an environmental performance committee to include local government and community representatives, proposals for a revised location of the on-site landfill, acquisition and management of a conservation area, and construction of a cycle way.

4.1.1.1 Process concerns

The IFC's due diligence process for the Orion project has received much criticism. Several NGOs in Uruguay and Argentina, the local people of Gualeiguaychú, the Government of Argentina and other international institutions have challenged the adequacy of the EIA study on several technical grounds (Box 4.2), as well as the IFC's public participation and disclosure processes.

Considerable concern was expressed about the adequacy of the assessment on issues such as the choice of site, area of influence, socio-economic impacts, technology of choice and impacts on other sectors.

Concern about the impacts of the Orion project was further exacerbated by the fact that, at the time the IFC's due diligence process was taking place for Orion, the IFC was also considering the CMB project. Therefore, stakeholders opposing the projects expressed their worries about the cumulative environmental and social impacts of both projects. They wanted a separate study on the cumulative impacts of the Orion and CMB projects to be conducted.²⁷

Box 4.2 Examples of shortcomings in Botnia's EIA

Botnia's EIA report, while apparently comprehensive, lacks clarity on a number of critical issues and falls far short of what a proper assessment of the mill should consider (Spek 2006). Spek highlights some examples of how the EIA report is insufficient:

Forestry and land use: the pulp mill will have a production capacity of 1 million tonnes per annum and will obtain its wood supply from sustainably managed plantations. But the report does not show clearly where this fibre will be sourced from, or how extra plantation land will need to be planted to meet this demand. The EIA report states that some of this eucalyptus wood will come from FOSA, of which Botnia is part-owner, while the balance will be sourced externally. According to the report, the mill will have an annual fibre demand of 3.5 million cubic metres, which Spek assumes refers to debarked volume. FOSA's plantations totalled 31,754 ha in 2004. In the same year, there were a further two certified plantations containing 13,059 ha and 5,040 ha, respectively. While the EIA report gives no information on their productivity, Spek argues that these plantations are insufficient to meet future wood demand. The EIA report does concede that there is a fibre deficit: "As of the present wood volume, by the turn of the first decade, the apparent shortage of wood resources will be covered with the wood coming from plantations established from 2003 onwards" and makes the following recommendation: "Foster investments if present harvesting technologies are limiting considering the available wood." Spek found this recommendation too vague to even be of use. There is no discussion about the impact if these investments in plantations are not made, or what would happen if any other potential mills begin operation. The fibre deficit is not even mentioned in the summary and the conclusions do not make any mention of the concerns of the local people.²⁸ Spek argues that if the mill is to obtain its fibre from sustainably managed plantations, more of these will have to be established. While this is conceded by the EIA report, it does not provide a meaningful analysis of how the establishment of these plantations would affect land used by the population for current economic activities, such as agriculture, cattle farming, etc.

Infrastructure: Although the EIA report discusses the mill's impact on traffic loads and infrastructure, Spek argues that it paints an overly optimistic picture. The EIA analysis for the Rio Negro municipality shows an increased road maintenance cost of US\$ 1 million a year, but this is balanced against US\$ 1.4 million in income. However, the cost of road maintenance is not mentioned for the other two departments through which wood will be transported. These departments will derive few taxes from the mill. The Botnia report states that the traffic volume generated by the wood transport will be 20 per cent of the magnitude of long-distance trucking traffic to and from Montevideo. But because this traffic will not be going to Montevideo, there will be no overburden.

²⁷ Whilst the EIA approved by DINAMA contained an annex with an assessment of the cumulative impacts of the Orion and CMB projects, it was based on obsolete technical data.

²⁸ According to Botnia the raw material had been secured from the beginning of the project.

The daily transport of 10,000 tonnes of wood needs 324 trucks to make 1.5 round trips a day. So, on certain stretches of road close to the mill there will be incessant trucking volume. This will have undermined the condition of the road, and also result in considerable traffic delays to the farmers who rely on these roads to take their cattle and crops to market. No effort is made to estimate the latter impact. The national/municipal authorities may be responsible for road maintenance, but the critical issue is whether they will have enough funds. This depends not only on how taxes are shared between the central and municipal government, but also on whether any tax is actually being paid directly. Moreover, many large industrial companies are experts at using the tax code to their full advantage to minimise actual tax payments. In Botnia this point is even more relevant considering the free zone status granted to the company (although Spek did not mention this). The free zone status means that Botnia will only be paying the government a fixed annual fee of US\$ 30,000. Furthermore Spek argues that despite large reported profits, given the low actual level of income taxes paid on forestry activities, any unwillingness of the relevant department to carry out proper road maintenance works should not come as a major surprise.

As a result of the mounting criticism of the two projects, the IFC decided to make additional enquiries in the context of social and environmental due diligence. In early June 2005 the IFC decided to remove the 'Chinese wall' of secrecy kept between the CMB and Orion project teams with respect to social and environmental information in order to facilitate information and coordination. This 'Chinese wall' had been in place because the IFC was initially considering the two investment proposals simultaneously, and wanted to avoid any potential conflicts of interest between the two project teams (IFC 2006c). Later in 2005, as a result of these additional enquires, the IFC ruled that an additional study on cumulative impacts was needed.

4.1.2 CMB's environmental impact assessment

The CMB project had also already completed the process for review and disclosure of the EIA by the Uruguayan environmental authority DINAMA, and received the Environmental Permit prior to the IFC's disclosure of the EA and related documents in late July 2005. Indeed, the EA was submitted to DINAMA in January 2003, the public participation process commenced in July 2003 and the Environmental Permit was issued in October 2003 (see Box 4.3).

Box 4.3. DINAMA and the CMB's EIA process

In the CMB project, the EA was submitted to DINAMA on 8th January 2003, and following review by DINAMA it was publicly disclosed locally on 26th May 2003. The public hearing on the EA was held in Fray Bentos on 21st July 2003. The Environmental Permit was issued on 9th October 2003, and was valid for 48 months from the start of construction to the start of operations.

The permit for the CMB project included conditions such as the development of environmental management plans prior to construction and operation, monitoring and monitoring plan requirements, specifications for pollution control and other technical aspects, emission limits, requirements to present a solid waste disposal project for approval by DINAMA prior to construction, and participation in an Environmental Monitoring Commission led by DINAMA. The Environmental Permit was revised in April 2004, with an amended table of air emission limits.

The IFC determined that the EIA produced by ENCE for DINAMA needed to be supplemented to fulfil their requirements for a Category A project. The IFC therefore requested additional information on issues such as IFC policies and safeguards, cumulative assessment and social and economic impacts –including impacts on tourism on the Argentinean side of the Uruguay River (CAO 2006).

These additional requirements may be explained by the fact that the IFC started CMB's due diligence process during the 60-day public disclosure period on the Orion project. By that time, and as suggested earlier, the Orion project had already raised considerable concern on both sides of the Uruguay River, especially regarding issues such as cumulative impacts, socio-economic impacts and indirect effects on other sectors, employment and quality of life (CAO 2006). The CMB project sponsor produced the supplementary EA and sent it to the IFC team, who reviewed the draft and submitted detailed comments in June 2005. The IFC also arranged for specialists to visit CMB in July 2005.

Given that CMB conducted its public consultation before presenting the EA to DINAMA in 2003, the IFC asked ENCE to prepare a PCDP (Public Consultation and Disclosure Policy) according to IFC guidelines based on the process conducted for DINAMA. However, civil society groups from both sides of the Uruguay River and the Argentinean government all expressed concerns about the impacts of the CMB project. In particular, they argued that the supplement to the EIA still only superficially addressed the cumulative impacts of the projects and was also insufficient in addressing the indirect impacts and the effects on Argentina. They also challenged the adequacy of the public consultation process and IFC disclosure policy.

In July 2005 the IFC finally determined the need for a separate Cumulative Impact Study (CIS) for the CMB and Orion projects (see next section).

The CMB document package (supplementary EA, ESAP, PCDP, and Project Disclosure Sheet among others) was finally disclosed on 29th July 2005.

4.1.3 *The Cumulative Impact Study (CIS) process*

According to the IFC, the decision to request a more comprehensive CIS was needed both to inform the IFC's decision making and to ensure credibility of the due diligence process, particularly for external stakeholders (IFC 2006d). On the other hand, according to the IFC's Compliance Advisor Ombudsman (CAO), by taking the decision to commission an additional study of the cumulative impacts, the IFC essentially indicated there were shortcomings in its earlier due diligence process (CAO 2006 and see Section 4.1.4). Indeed in September 2005, civil society organisations complained to the CAO about perceived violations of the IFC and MIGA's due diligence processes (see Section 4.1.4).

The IFC then wrote separate terms of reference for the CIS study by August 2005, to which additional requirements were added by the CAO later in November 2001.²⁹ The CIS draft was released on 19th December 2005. It addressed more than 30 issues, ranging from social and economic impacts (e.g. the effects on traffic, labour supply, and tourism in the

²⁹ With regard to process, these include: transparency, participation, an agreed protocol and clearly defined timetable for consultation and disclosure. With regard to content, the CAO asked the IFC to ensure it includes an assessment of best available technology and social and environmental impacts – in particular effects on agriculture, tourism and fisheries – and possible options for mitigating any impacts. For more information see CAO (2006).

region) to environmental issues (e.g. air quality, water quality and biodiversity).³⁰ Once the CIS was released, the IFC began the 60-day consultation process prior to making their decision (IFC 2005).

However, the draft CIS received significant criticism by those opposing the construction of the pulp mills.³¹ The main concerns included partiality on the part of the consultants who conducted the CIS; failure of the technical team to give appropriate treatment to basic environmental issues in Uruguay; and failure to comply with the CAO's additional requirements. Criticism also included the CIS failing to properly address specific technical issues such as: choice of site; environmental impacts of massive eucalyptus plantations on ground water; the selection of second rate technology; impacts on drinking water for local communities; and social impacts derived from impacts on other sectors (i.e. tourism); as well as inconsistencies with earlier EIA reports (e.g. regarding available wood supply – see Box 4.2). The participatory consultation process was also criticised for its failure to involve all the key relevant stakeholders and the lack of rules of engagement, amongst other things.

4.1.3.1 *Auditing the EIA process: The Hatfield Report*

As a result of the controversy around the draft CIS, the IFC decided to hire two Canadian experts to audit the whole EIA process, including the individual EIA documents provided by the companies, the draft CIS, and the comments provided by the other stakeholders. The results – known as the Hatfield Report – were released in late March 2006. This report acknowledged several of the problems raised by civil society: 'assertions that the CIS, Botnia and CMB (Celulosas de M'Bopicuá - the ENCE project) have not provided sufficient information on the proposed design, operating procedures and environmental monitoring for the mills are generally valid.' (IFC 2006c). They identified a need for additional information and analysis to substantiate the environmental impacts of the CMB and Orion pulp mill projects and also recommended some technical improvements that could enhance the environmental performance of both mills.

The experts found that concerns that the mills would cause catastrophic environmental damage were unsupported, and they did not question the location of the two plants or the use of elemental chlorine free (ECF) technology to bleach the paper pulp. However, they acknowledged some environmental advantages in the TCF process, some of which could also be attained if the mill design was modified to an 'ECF-light' version. Thus the quantity of chlorine dioxide used would be relatively low, or the alkaline bleach plant effluent could be recycled into the mill's chemical recovery system. Moreover, the experts criticised the CIS for failing 'to provide a solid justification for the ECF approach versus the TCF option'. They highlighted a lack of supporting information to show that the mills would actually use best available technology (BAT) in all aspects of their design and operations. Indeed, in their comparison of 24 aspects of BAT with the available mill design data, they found that the Botnia and ENCE projects only complied with five.

Overall, after reviewing the main weaknesses of the three studies the experts set forth 70 critical recommendations, involving both the construction and operational phases of the plants.

³⁰ For details of the CIS draft please see IFC website: http://www.ifc.org/ifcext/lac.nsf/Content/Uruguay_Pulp_Mills_CIS.

³¹ For a complete list of comments on the CIS study sent to the IFC website please see: <http://www.ifc.org/IFCExt/CumulativeImpact.Nsf/Comments2?OpenView&count=10000000>

In May 2006, on the basis of the Hatfield Report, the IFC produced an action plan outlining the remaining steps needed to complete the environmental and social due diligence process for the two pulp mill projects in Uruguay. The plan addressed recommendations included in the Hatfield report and stakeholders' comments in the draft CIS, and specified the need to collate and analyse additional information on the following key issues:

- **Plant process technology:** evaluate possible technological and process improvements, and verify that plant operations will utilise best available techniques (BAT) and will at least meet the European Union's Integrated Pollution Prevention Control (IPPC) Directive on environmental performance standards.
- **Plan site selection:** provide additional information that substantiates the companies' decision to locate the plants near Fray Bentos.
- **Rio Uruguay water quality and aquatic resources:** provide a more detailed data review of baseline water quality and fisheries to assess the impact of effluent discharge.
- **Air quality:** revise emissions models.
- **Tourism:** provide additional baseline information and analysis of the tourism industry within the area of influence of the two proposed pulp mills.
- **Forest plantations:** undertake additional review of mill-related plantation forestry operations and their impacts.
- **Emergency response and environmental management/monitoring plans:** provide additional detail on each company's management plans.

On 21st July 2006 the Canadian environmental consultancy firm EcoMetrix was appointed by the IFC to revise the CIS. Once the CIS had been reviewed and updated by the consultants (in September 2006), it was reviewed by the panel of independent Canadian experts to verify consistency and responsiveness to the findings and recommendations in the Hatfield report.

The independent panel reviewed the final CIS once again and indicated that it addressed the key findings and recommendations of the Hatfield report. They found that the proposed mills were now designed in accordance with BAT as defined by IPPC and other regulatory agencies experienced with pulp industry issues. They also found the operations emissions and effluents would not pose environmental threats to or affect the health of local people on either side of the Rio Uruguay. They also suggested certain conditions that the IFC might wish to incorporate into any eventual agreement to finance the projects to ensure that future operations of the pulp mills are environmentally sound in practice. These included:³²

- Verify that DINAMA's monitoring programmes (both of effluent discharge and air quality) are implemented.
- Verify that all mill systems and personnel are ready before starting operations; many incidents in the past have occurred when new pulp mills attempt to begin operations before all equipment and environmental protection systems are fully installed and tested. This could be based on the mill's commissioning protocols.
- Verify that ambient air and receiving water monitoring is proceeding as planned after the mills are commissioned, and any outstanding issues are being resolved.
- Audit mills' environmental and social performance every six months for the first two years. This could be based on various programmes discussed in the CIS.

³² For details see IFC (2006b).

The report also highlights some potential positive environmental impacts:

- Installation of a plant to manufacture sodium chlorate will reduce dioxin discharges, which will also become available on the regional market. This will facilitate conversion of the existing bleached kraft mills that use only chlorine to bleach pulp to ECF bleaching in Argentina and Uruguay.
- A reduction in biological oxygen demand (BOD) discharges into the Rio Uruguay, as Botnia expressed a willingness to treat the domestic sewage of Fray Bentos in the mill's activated sludge plant. Improvements in BOD and pollutant levels are also expected due to Botnia's willingness to burn the untreated black liquor from the other pulp mill located in Mercedes.
- The burning of black liquor and wood waste would generate a surplus of electricity, supplying approximately 5 per cent of Uruguay's needs to the national grid. Botnia is proposing to implement the clean development mechanism (CDM)³³ in the electricity-generating power plant (Botnia 2006).

However, opponents of the projects comment that the EcoMetrix study and Hatfield reports fail to consider the impacts on other sectors – notably tourism – and that the pulp industry is a contaminant industry and thus is incompatible with the tourism industry. They also argue that the report fails to consider impacts on the Guarani aquifer (CEDHA 2006b, Godinot 2006).

Finally, on 21st November 2006 the boards of IFC and MIGA respectively approved a US\$ 170 million investment in and US\$ 350 million guarantee for the Orion project (IFC 2006a). Although the IFC was considering support for both the Orion and CMB projects, it decided to put CMB on hold after the decision of the company in early October 2006 to relocate the plant. The IFC will only consider financing the ENCE plant once the firm has had the opportunity to assess the project in its new location. IFC and MIGA are not taking any position on the eventual outcome of the pending case brought by Argentina with the International Court of Justice at The Hague.

4.1.4 Shortcomings in the due diligence processes: The Compliance Advisory Ombudsman ruling

In September 2005 the Argentinean NGO CEDHA complained about shortcomings in the IFC and MIGA's due diligence processes to the IFC Compliance Advisory Ombudsman (CAO). The CAO is the body that reviews policy compliance of IFC projects (CEDHA 2005). The complaint was based on violation of the following policies:

- IFC operational policy OP4.01 on Environmental Assessments in issues such as area of influence, choice of site, transboundary impacts and lack of a meaningful consultation process.
- IFC disclosure policy.
- IFC operational policy OP7.50 on projects on International Ways.

³³ The Clean Development Mechanism (CDM) is an arrangement under the Kyoto Protocol allowing industrialised countries to invest in projects that reduce greenhouse gas emissions in developing countries as an alternative to more expensive emission reductions in their own countries (Source: <http://en.wikipedia.org/> accessed 3/02/2009)

In November 2005, CAO requested an audit of the IFC's (and MIGA's) compliance with internal due diligence procedures up to the point of public disclosure of the environmental assessments of the two projects (July 2005). The audit did not review the IFC's decision to commission a separate cumulative impact assessment released in December 2005. However, on the basis of the audit, the CAO issued some specific requirements to be included in the CIS report.

The CAO concluded in its final report of March 2006 that the IFC's decision to commission an additional CIS in July 2005 essentially signalled a shortcoming in its earlier due diligence process. The CAO found that:

IFC's due diligence to satisfy itself that the EAs were complete in all material respects prior to disclosure was inadequate and not in compliance with the organisation's Disclosure Policy, resulting in disclosure of EAs that were not complete. In addition to the inadequacy of the due diligence pertinent to this specific EA, CAO concludes that IFC's ESRPs more generally are not currently supportive of compliance with IFC's Disclosure Policy requirements. In other words, although the procedures are followed, they are not rigorous or robust enough to sufficiently support an outcome that is in compliance with the Disclosure Policy. (CAO, 2006:25).

The CAO provided several recommendations for IFC's Environmental and Social Review of Projects (ESRPs):

- The IFC should systematically document its appraisal of the adequacy of clients' social and environmental processes and documentation before public disclosure of EA documents.
- The IFC should outline the findings of its environmental and social due diligence process in detail.
- Procedures are needed to clearly define the process to be followed where shortcomings are identified in the client's social or environmental documentation or processes after disclosure.
- When the IFC and MIGA are involved in the same project there should be clearly defined procedures for collaboration, including sharing information and documenting the rationale for key decisions.
- Procedures are needed to verify that the information posted on external web sites is accessible, correct and consistent during the entire disclosure period.

In response, the IFC argued that the CAO's audit was undertaken and completed while IFC's due diligence process was still underway (see Box 4.4). It also referred to the need to focus on outcomes and the intentions of policies and staff. It argues that in this sense staff decisions were fully consistent with practice and the broader objectives of IFC policy and procedures to improve development outcomes (IFC 2006d).

The IFC took the CAO recommendations into account in the new ESRP and Disclosure Policy.³⁴

³⁴ The ESRP and Disclosure Policy framework was reviewed and accepted by the IFC Board of Directors on February 21, 2006 and will be implemented from April 30, 2006.

Box 4.4. Timeline of the IFC's due diligence process

Mid-2004: Botnia approached IFC
10th August 2004: IFC released Orion project data sheet - early review
February 2005: IFC started Orion's due diligence process
Late March/early April 2005: IFC site visit to Orion project
April 2005: IFC posted Orion's Category A Disclosure Sheet on the Infoshop and 60-days disclosure process commenced
June 2005: ENCE sent supplementary EA to IFC; IFC removed "Chinese wall" kept between the Orion and CMB projects teams
July 2005: IFC specialists visited CMB; IFC decided that an additional CIS was necessary; IFC's disclosure of CMB EA and related documents
August 2005: IFC started with the CIS; IFC meetings with stakeholders and government officials in Gualeguaychú, Buenos Aires, and Montevideo
September 2005: CEDHA filed a complaint to the CAO and it was accepted
November 2005: CAO placed additional requirements on the CIS
19th December 2005: IFC releases draft CIS and begins a 60-day consultation period
January-February 2006: IFC stakeholder consultations on CIS in Uruguay and Argentina
End of February 2006: End of consultation period
March 2006: Canadian experts released audit's results; CAO concluded its final report
11th April 2006: Expert Panel's report is made public by IFC.
9th May 2006: IFC makes public the "Action Plan" to incorporate experts' recommendations into final CIS.
21st July 2006: EcoMetrix appointed to revise the CIS
September 2006: the final CIS is released
Early October 2006: ENCE announces its decision to relocate the CMB mill
14th October 2006: The Expert Panel's report with the conclusion is made available
21st November 2006: IFC and MIGA Board of Directors approve the loan and the guarantee to the Orion project, respectively

4.2 Commercial banks and due diligence

During recent years a growing number of commercial banks have been adopting policies to conduct environmental and social risk assessments of the projects they are involved in. Notably, in 2003 most of the major commercial banks endorsed the Equator Principles, a set of guidelines for managing social and environmental risks by the project finance industry. The EPs are based on the IFC's environmental and social safeguard policies and originally applied to project finance transactions over US\$ 50 million. A revised version of the EP (The EPII) was released in July 2006, which sets US\$ 10 million as the new threshold above which EPs apply.

Information on the due diligence processes being conducted by the key banks involved in the financing of the projects is provided below. The information is rather scarce as commercial banks do not have any disclosure policy and they are reluctant to provide information on clients due to the need for commercial confidentiality.

4.2.1 *The Orion project*

The ING Bank was originally appointed as the lead arranger of the B loan. ING is one of the leading advocates of the EPs, endorsing them in July 2003. Moreover, ING is one of only eight banks to have publicly adopted a human rights policy (Durbin et al. 2006).³⁵

However, ING's support to the Orion project was subject to sustained pressure from international civil society groups,³⁶ who argued that the bank's support for the project ran against its commitment to invest responsibly and did not comply with the EPs. In December 2005 an NGO filed an EP compliance complaint against ING over its loan to Botnia. The complaint built upon another complaint sent by the same NGO to the IFC's CAO in September 2005. The complaint identified the violations to the EPs and also informed ING of other legal and procedural actions that were underway and/or imminent against the government of Uruguay, against the IFC, and against sponsor-company representatives. It also identified human rights and environmental law violations (CEDHA undated). The complaint also highlighted the risks for ING to be involved in these projects in terms of legal process, public opposition, and mounting international advocacy against the types of 'unsustainable development' promoted by the project sponsors. It requested ING to cease any and all consideration of financing Botnia.

ING responded in a letter dated 20th December 2005.³⁷ It highlighted the importance for the bank that the projects it finances are environmentally and socially sound. The letter also stated that ING was awaiting IFC's CIS results. Moreover in another letter to the Business Rights Resource Center, referring to the same complaint, ING further stated the bank was considering financing the project subject to the results of the IFC's CIS (ING 2005). It stated that ING would re-evaluate the project's compliance by reviewing the CIS's results in light of: ING's Business Principles; applicable Uruguayan environmental and social laws; applicable regulations issued by the Comision Administradora del Rio Uruguay (CARU) established by Argentina and Uruguay; the EPs; and the best available technology (BAT) guidelines derived from the European Union's Integrated Pollution Prevention Control (IPPC) Directive.

Two additional letters were sent by the same NGO to the ING Group in February and March 2006. The letters informed the bank of the latest developments in the Botnia process, especially the lack of agreement between the Argentinean and Uruguayan governments. It also criticised the ING Group's lack of transparency in its due diligence of the project (CEDHA 2006d) and its failure to provide evidence that it was addressing the EPs' Compliance Complaint.³⁸ Finally, in April 2006, two weeks before the annual shareholders meeting, ING decided to pull out of financing Botnia's project.

There has been a lot of speculation about the reasons for ING's decision to pull out. ING declined to explain its decision on the grounds of client confidentiality. In a letter to campaign groups, however, the bank explicitly said that the decision was made jointly with the project sponsor and was not related to the project's compliance with the EPs. Others argue that ING withdrawal was related to the project's inconsistencies with IFC safeguards and the EPs, but that the banks would never admit this since they might face lawsuits from the sponsors.³⁹ Still others attribute the bank's decision to the negative publicity generated by the project.

³⁵ The other banks are ABN AMRO, Barclays, HBOS, Rabobank, Société Générale, Standard Chartered and Westpac.

³⁶ For example, BankTrack and CEDHA in Argentina.

³⁷ Letter available at: http://www.cedha.org.ar/en/initiatives/paper_pulp_mills/letter-ing-equator-principle.pdf.

³⁸ Daniel Taillant, Executive Director CEDHA, personal communication, July 2006.

³⁹ Daniel Taillant, pers. comm., July 2006.

Overall, it is argued that when banks decide to pull out of a project, they never give an environment-related reason; while the EPs might not be the only reason for ING pulling out, it is undoubtedly an important one (FT 2006).⁴⁰

After ING pulled out, the Swedish finance group Nordea and the French bank Calyon were appointed by Botnia as the main arranging banks for financing Botnia's pulp mill project in Uruguay (Botnia 2006).⁴¹

Like ING, Nordea was also criticised by civil society groups for its support of the project and the lack of transparency in its due diligence process. There are also accusations about Nordea not complying with international corporate social responsibility and human rights obligations. Nordea responded by stating that the bank could not disclose information on how it conducts its due diligence process due to the company's strict banking confidentiality rules (Nordea 2006).

Calyon is the corporate and investment banking arm of Crédit Agricole, and is one of the original EPs signatory banks. Calyon argues it has integrated the EPs into the credit process by investing in people through an extensive training scheme involving the IFC (Euromoney 2004). In July 2005 Calyon endorsed the revised version of the EPs (the EPs II).

Calyon's involvement in the financing of the project was also heavily criticised by civil society groups. In May 2006, nine civil society organisations filed a complaint against Calyon for violations of the EPs due to its support of the Orion project (CEDHA et al. 2006). The complaint was modelled on that made to the ING group in December 2005. The bank was also accused of using client confidentiality to avoid disclosure of its involvement in the project. Calyon responded that it was awaiting the results of the IFC's assessment to determine the environmental and social impacts of the mills (Daniel Taillant, pers. comm. 27 July 2006, FT 2006). Moreover, it stated it would abandon the project if the IFC environmental impact assessment proved to be negative (Mercopress 2006).

4.2.2 The CMB project

The Spanish Banco Bilbao Viscaya Argentaria (BBVA) is the lead arranger of the commercial banks' loan to ENCE. The BBVA endorsed the EPs in 2004 and also adopted the EP II in 2006.⁴² However, as with other banks supporting the Uruguayan mills, civil society institutions opposing the project lodged an EP compliance complaint against BBVA in December 2006.

BBVA responded that it was considering financial support for ENCE but is waiting for the IFC's environment assessment report before advancing with the project (FT 2006).

⁴⁰ FT (2006), "Uruguay: Mills act as test case" *Financial Times*, 9th July 2006

⁴¹ Nordea is the leading financial services group in the Nordic and Baltic Sea region whose major shareholder is Sweden (19 per cent).

⁴² The BBVA has also endorsed the Global Compact, in which banks commit themselves to applying the core four labour standards/eight labour conventions to their own operations. However there is criticism that, to date, none of them has developed a specific labour policy applicable to their lending operations (Durbin et al. 2006).

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

These case studies of the pulp mills Orion and CMB in Uruguay show 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 opportunities

There are some positive effects that can be linked to IFC's involvement in the project finance arrangement:

- **IFC involvement sends a strong signal to other financial institutions about the environmental and social 'health' of the projects:** 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. It also has the mandate to increase the development contribution of the projects it funds. Due to the IFC role in the political risk mitigation of the projects, the IFC's decision on whether or not to finance projects or to ask for additional requirements on environmental and social grounds sends a strong signal to the rest of the financing institutions (i.e. commercial banks).
- **IFC involvement creates an EIA process that is more open to public scrutiny.** The IFC has a disclosure policy, which means their due diligence processes are more open to public scrutiny than, for example, when only commercial banks are involved. This provides an opportunity for other stakeholders to influence the process, either by flagging unaddressed or poorly addressed areas or non-compliance with policies for conducting environmental and social assessments. Stakeholders' comments on the process meant that the IFC had to make several modifications and additional requirements to the original EIAs for the pulp mills. It also had to commission a separate CIS study, which was in turn revised following criticism from civil society. Enforcing the recommendations of the Hatfield report as a condition for approving the credits would imply that Botnia and ENCE would have to adjust their plans for the factories. This would thus lead to an increment in the sustainable development impacts of the projects.
- **The CAO offers a clear mechanism in case of non-compliance, providing opportunities to improve environmental and social practice.** Following an investigation into NGO complaints about shortcomings in the IFC's due diligence process, the CAO filed some recommendations to improve IFC practice. These were taken into account in the new IFC policies.
- **IFC intervention provides an opportunity to improve domestic environmental and social performance.** Several of the additional requirements for the pulp mills included in ESIA studies for the IFC and in the later CIS were not addressed – at least not with the same level of detail - in the EIA studies that the project sponsors conducted for the environmental authority (DINAMA). The IFC's additional requirements and the whole debate on the impacts of the projects held between the IFC and civil society provoked further debate within DINAMA on the impacts of the projects. Some of these elements are now being included in later updates of the projects for the DINAMA or are being required for new projects.⁴³ Some examples include a requirement for the tertiary treatment for effluents, analysis of site viability

⁴³ See DINAMA comments on the Hatfield Report.

and the introduction of an environmental permit for operation that will be granted for only three years, after which it has to be renewed.⁴⁴ More broadly speaking, IFC participation and the debate held with civil society have helped to raise standards in Uruguay in terms of transparency and public participation in the EIA processes.⁴⁵

- **Commercial banks' commitment to the EPs provides an opportunity to improve environmental and social practice.** Two of the three main loan arrangers in the projects have endorsed the EPs. The EP banks are committed to conduct environmental and social assessments according to IFC guidelines. The introduction of the EPs is expected to lead to an improvement in the sustainable development impacts of the projects funded through project finance.
- **EPs provide a window of opportunity through which to scrutinise commercial banks' practice.** 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. One of the principal motivations of the banks to engage with the EPs is to have some assurance that their financing actions will not become subject to negative publicity (Spek 2006). Therefore, damage to the banks' reputation through NGO accusations of non-compliance with the EPs can be a key factor in a bank's decision about funding a project. Furthermore, as EPs are based on IFC guidelines, serious questions will arise regarding commercial banks' social and environmental due diligence if they decide to finance a project which the IFC has rejected.

5.2 Challenges in the sustainable development performance of project finance

- **Legal frameworks can undermine the sustainable development benefits of the projects.** The need for predictability in the revenue derived from the projects gives project sponsors the incentive to enter into contractual arrangements to reduce or allocate risk between partners. Such arrangements might include stabilisation clauses or financial arrangements that interfere with the achievement of sustainable development goals in the host country. This scenario is illustrated by Botnia's decision to sign the project investment agreement only on the condition that they were granted free zone status by the Uruguay government.
- **Poor timing.** Project construction began before the due diligence processes of the IFC and other commercial banks had been completed. This means there were less opportunities for the IFC and other commercial banks to have a real influence on the environmental and social impacts of the projects as there was less flexibility in terms of the scope for amending an action or, for example, to change the choice of site. Though this is consistent with IFC policy it is a point for improvement. *It is important to start construction activities only once the due diligence activities have finished.* This recommendation also widens to include national governments that issue permits to begin project construction before all relevant environmental and social studies have been conducted.

⁴⁴ Daniel Collazo, Head of Environmental Assessments, DINAMA, personal communication July 2006.

⁴⁵ Ronald Beare, Managing Director of Botnia SA, personal communication July 2006.

- **Poor implementation of environmental and social policies by the financial institutions.** This can be explained by different factors including:
 - Lack of institutional capacity to assess the environmental and social issues associated with the projects. While the IFC has environmental and social experts on its staff, there are few of these experts within commercial banks, possibly for reasons of cost (Spek 2006). However, Calyon, assisted by the IFC, is training its staff in the implementation of EPs.
 - Poor communication between those responsible for financing the project and those conducting the environmental and social assessment. The latter are usually relegated to conducting a checklist of environmental and social issues rather than affecting the terms of the loan.⁴⁶ This applies both to the IFC and commercial banks.
 - A lack of sectoral (pulp mill) technical expertise within the commercial banks, which may also undermine the understanding of the environmental and social risks associated with the projects. In the pulp mill sector, companies rarely use project finance to fund their projects. Indeed, between 1990 and January 2005 only US\$ 1 billion was devoted to project finance transactions in the pulp mill sector, which corresponds to only 2.8 per cent of total pulp mill projects (Spek, 2006).

- **Lack of transparency.** A common criticism of commercial banks is that they use 'client confidentiality' to avoid disclosing their involvement in project finance transactions. This has been found to be the case for all three commercial banks known to be involved in these projects: Calyon, Norea and BBVA. This highlights the need for commercial banks to endorse some type of disclosure policy.

- **Passive attitude of commercial banks.** Commercial banks prefer to rely on the social and environmental due diligence process conducted by the IFC or on the information provided by the sponsors rather than conducting their own assessment. This is suggested by the fact that all the commercial banks known to be involved in the projects were awaiting the results of the IFC's due diligence process before deciding on the loan. On the one hand, this might reflect the aforementioned 'political risk mitigation effect' the IFC has on loans, which means commercial banks often follow IFC decisions. On the other hand, it might reflect poor in-house capacity to carry out environmental and social assessments, especially in the forestry-pulp mill sector.

- **EPs lack mechanisms/procedures when things do not work.** This case reveals the lack of an independent mechanism or set of procedures for addressing complaints. Indeed, EPs have a whole set of procedures to follow for assessing environmental and social risk. But when things do not work or there are non-compliance complaints made, there is no ombudsman or equivalent mechanism to whom plaintiffs can address their concerns (except the commercial banks themselves). In order to address this weakness several civil society organisations working on international responsible banking have suggested that the EP banks follow the model of the CAO set by the IFC (FT 2006).

- **Compliance after the loan is repaid.** Financial institutions should be responsible for the entire life of the projects they fund and not only until the loan has been repaid. In the Orion and CMB projects, financial institutions have provided funds for monitoring activities during the construction phase. However, there are several impacts that

⁴⁶ Daniel Taillant, Executive Director of CEDHA, personal communication, July 2006.

might occur during the pulp mills' operation which will also require monitoring. At present there is no evidence that the financial institutions involved are providing funds for monitoring activities or considering any leverage points for project sponsors to remain in compliance with what has been agreed on the ESAs once the loan has been repaid.

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