AUDIT REPORT

CAO Audit of IFC
CAO Compliance

C-I-R9-Y10-F126
February 22, 2011

CAO Audit of IFC's Investments in Agribusiness in the Ica Valley, Peru

Office of the Compliance Advisor/Ombudsman (CAO)
for the
International Finance Corporation (IFC)
Multilateral Investment Guarantee Agency (MIGA)
Members of the World Bank Group

Executive Summary

Between 1999 and 2006, IFC approved three investments in Corporacion Drokasa, a leading Peruvian agricultural and industrial conglomerate, and its wholly owned subsidiary Agrokasa. The initial investment, in 1999, directly financed Agrokasa's expansion of its agricultural operations in the Ica Valley, south of Lima. The second investment, in 2004, involved refinancing of Corporacion Drokasa. The third investment (the second in Agrokasa), in 2006, expanded asparagus growing operations through the acquisition and upgrading of a farm north of Lima. These investments were appraised under IFC's 1998 Environmental and Social Review Procedures and Safeguard Policies. In 2009, a fourth investment (the third in Agrokasa-Agrokasa III) was circulated for approval by the IFC Board under IFC's streamlined procedures. The project objective specifically was to further develop Agrokasa's operations in the Ica Valley—the first direct IFC investment in the Ica Valley operations since 1999.

The investment was to partly restructure Agrokasa's debt obligations, develop one of the Ica Valley farms, and support "hydraulic improvements" for its other Ica Valley farm intended to provide water where it was most needed and "reduce stress" on the aquifer. The project was described as including an intra-aquifer water pipeline and, if approved by the government, new wells and/or surface water intake(s).This investment was to be the first for this client applying the IFC 2006 Performance Standards. While seeking IFC Board approval, IFC management became aware of unresolved issues identified during its due diligence, as well as the receipt by the CAO of, as yet, unassessed complaints regarding the social and environmental impact of the project. IFC management decided to withdraw the investment proposal from Board consideration.

Between June 1 and July 16, 2009, several complaints were filed with the CAO regarding the impact of Agrokasa's operations on the Ica aquifer. Complainants maintained that Agrokasa's operation, among others, was contributing to overexploitation of the Ica aquifer through a high concentration of wells, drilling of new wells, and/or deepening of existing wells—without appropriate permits and required licenses. A further concern was Agrokasa's construction project to convey water from one farm—where water is more plentiful—to another farm where the wells are no longer so viable, without appropriate consultation with potentially impacted villagers and farmers.

Through its dispute resolution function, the CAO recommended a process of assisted negotiation to address the critical water situation in Ica Province collaboratively. This process is ongoing. Several issues that the parties were not willing to negotiate were referred to CAO Compliance for compliance appraisal and audit.

A CAO compliance audit panel was established in September 2010 to assess, among other aspects, whether IFC's rationale and approach to the investment was reasonable and correct, taking into account its policies, procedures, mandate, and mission.

CAO Compliance auditing focuses on IFC and MIGA, and how IFC/MIGA assured itself/themselves of project performance. The audit findings therefore relate only to IFC, and whether it complied with its own policy provisions.

The Ica Valley is located some 300 kilometers south of Lima. Despite its aridity, farms in the valley have access to water from two sources: limited seasonal surface water, and more extensive underground water from the Ica aquifer. The local community and industry (mainly agribusiness) obtain water from both sources, but water remains scarce overall. About a decade ago, the Ica Valley was identified as suited to growing crops in demand for the export market, such as asparagus and grapes. Since then, water demand has increased significantly because of the extension of land under cultivation—particularly with crops that are highly dependent on water—as well as increases in the local population. World Bank studies note that extraction from the Ica aquifer system doubled between 2002 and 2007 and that the aquifer is overexploited. Those studies also recommend that the Ica aquifer be included in a pilot project to strengthen underground water management capacity. World Bank analysis also concludes that IFC investments in the increasingly important Peruvian agribusiness sector have had some positive developmental outcomes.

IFC due diligence on the environmental and social issues related to the proposed investment was undertaken under the 2007 Environmental and Social Review Procedures and 2006 Performance Standards. Overuse of the Ica aquifer was identified as a significant issue. IFC found that substantial further pressure on water resources due to intensification of agricultural use and increased population had led to significantly increased extractions from the aquifer since IFC's first investment in 1999. IFC required the client to prepare an Environmental Assessment (EA) to fully document existing practices and to assess the impacts of the proposed hydraulic improvement projects. IFC also required the client to conduct public disclosure and outreach programs consistent with the requirements of IFC's Performance Standards. An Environmental and Social Action Plan was prepared and agreed with the client. This included the requirement for an EA as a condition of IFC commitment to the investment—meaning that the EA would not be available for review and consultation before Board approval. In June 2009, after the investment had been circulated to seek Board approval, the client produced an EA. IFC had the EA peer reviewed by an independent third party. The peer reviewer concluded on July 15, 2009 that the EA did not meet the requirements formulated in IFC's Performance Standards.

Overexploitation of the Ica aquifer and the extent of local concern were well known to IFC throughout its due diligence process. Substantive concerns were raised internally and in IFC environmental and social documentation over potential noncompliances with multiple Performance Standards. Nonetheless, IFC proposed to seek Board approval in this sensitive situation without an appropriate EA—and therefore without appropriate information disclosure and consultation with potentially affected parties. Even though the client has committed to year-on-year reductions in water usage, without an underlying baseline assessment and understanding of the scale of aquifer depletion that would be provided by an EA, this commitment is without context and essentially meaningless as regards the impact on aquifer depletion.

In pursuing the Agrokasa III investment, IFC would have supported the actions of an existing client—and therefore its own financial interests—in protecting its access to

water through an intra-aquifer water transfer and other activities. By pursuing this investment before an adequate EA had been prepared and reviewed, IFC would have proceeded without taking into account potential negative long-term and wide-ranging development impacts on other more vulnerable users: impacts that could cause economic displacement, impoverishment, and loss of access to potable water.

The CAO finds that this is inconsistent with and in violation of commitments made within IFC's Policy on Environmental and Social Sustainability and its role as a development institution. This course of action is also inconsistent with and in violation of Performance Standards 1, 4, 5, and 6, as well as the IFC's Policy on Disclosure of Information.

The CAO also draws conclusions relating to IFC's underlying management processing of the investment. The scope and quality of environmental and social due diligence undertaken by IFC was appropriate to the level of risk identified. However, against a backdrop of community objection, commercial pressure to expedite the project, and an absence of effective IFC management support, the professional advice of IFC's environmental and social specialists was effectively overruled. No clear mechanism or process seems to exist to reconcile professional differences and/or bring them to a final conclusion. Thus significant project risks remained outstanding beyond the Investment Review Meeting, with no clear procedures in place for their resolution before circulation to the Board. This resulted in the removal of the investment from Board circulation by senior management at a very late stage.

Critical client interactions were also mismanaged, with resulting long-term damage to the client relationship. IFC strategy and procedures for developing and maintaining the client relationship were unclear. It was crucial that as an existing client, Agrokasa should have been clearly advised of enhanced due diligence requirements that IFC had to apply because of the adoption of the 2006 Performance Standards.

IFC continues to position itself as a global thought leader on issues relating to environmental and social sustainability. It has recently supported and co-managed leading edge work on the strategic importance of water resources at the country, community, and ecosystem level. In parallel to that work, IFC did not ensure that water resource issues were considered adequately in advance of an investment decision on Agrokasa III. The CAO finds this to be an indication that IFC struggles to align its strategic involvement in these issues with its investment practices. This inconsistency undermines the Corporation's reputation and credibility.

Contents

About the CAO

The CAO's mission is to serve as a fair, trusted, and effective independent recourse mechanism and to improve the environmental and social accountability of the private sector lending and insurance members of the World Bank Group, the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA).

The CAO (Office of the Compliance Advisor/Ombudsman) is an independent post that reports directly to the President of the World Bank Group. The CAO reviews complaints from communities affected by development projects undertaken by IFC and MIGA.

For more information about the CAO, please visit www.cao-ombudsman.org

Acronyms

English-language	
BTO	Back-to-Office Report
CAG	IFC Agribusiness Department
CAO	Office of the Compliance Advisor (World Bank Group)
CAP	Corrective Action Plan
CES	IFC Environmental and Social Development Department
CEO	Chief Executive Officer
CRC	Corporate Risk Committee
EA	Environmental Assessment
EHS	Environment, Health and Safety
EIA	Environmental Impact Assessment
ERS	Environmental Review Summary
E&S	Environmental and Social
ESAP	Environmental and Social Action Plan
ESCM	Environmental and Social Clearance Memorandum
ESIA	Environmental and Social Impact Assessment
ESRP	Environmental and Social Review Procedure
ESRS	Environmental and Social Review Summary
EVP	Executive Vice President
IEG	Independent Evaluation Group (World Bank Group)
IFC	International Finance Corporation (World Bank Group)
IRM	Investment Review Meeting
MIGA	Multilateral Investment Guarantee Agency (World Bank Group)
NGOs	nongovernmental organizations
PS	Performance Standards
PDS	Project Data Sheet
PDS-ER	Project Data Sheet Early Review
SEA	Social and Environmental Assessment
SPI	Summary of Proposed Investment
ToR	Terms of Reference
WBG	World Bank Group
Spanish-language	
ANA	Autoridad Nacional del Agua (National Water Authority)
IRENA	Instituto Nacional de Recursos Naturales (Department for Natural Resources, Ministry of Agriculture)
JUASVI	Junta de Usuarios de Aguas Subterraneas del Valle de Ica (Association of Groundwater Users in the Ica Valley)
PMGRH	Proyecto de Modernización de la Gestión de los Hídricos (Project for the Modernization of Water Resources Management)

Overview of the CAO Compliance Audit Process

When the CAO receives a complaint about an IFC or MIGA project, it first refers it to the CAO Ombudsman, which works to respond quickly and effectively to complaints through facilitated settlements, if appropriate. If the CAO Ombudsman concludes that the parties are not willing or able to reach a facilitated solution, the case is transferred to the compliance arm of the CAO, CAO Compliance, to appraise the concerns raised in the complaint for a compliance audit of IFC or MIGA. A compliance audit may also be initiated by request from the President of the World Bank Group or senior management of IFC or MIGA.

CAO Compliance auditing focuses on IFC and MIGA, and how IFC/MIGA assured itself/themselves of project performance. The purpose of a CAO audit is to ensure compliance with policies, standards, guidelines, procedures, and conditions for IFC/MIGA involvement, and thereby improve the social and environmental performance of investments and activities backed by IFC/MIGA. In many cases, in assessing the performance of the project and implementation of measures to meet relevant requirements, it is necessary to review the actions of the project sponsor and verify outcomes in the field.

A compliance audit must remain within the scope of the original complaint or request. It cannot go beyond the confines of the complaint, or request that other issues be addressed. In such cases, the complainant or requestor may consider submission of a new complaint or request.

CAO Compliance appraisals and audits consider how IFC/MIGA assured itself/themselves of compliance with national law, reflecting international legal commitments, along with other audit criteria. The CAO has no authority with respect to judicial processes. The CAO is neither a court of appeal nor a legal enforcement mechanism, nor is the CAO a substitute for international court systems or court systems in host countries.

In cases where IFC/MIGA is/are found to be out of compliance, the CAO will keep the audit open and monitor the situation until actions taken by IFC/ MIGA assure the CAO that IFC/ MIGA will move back in to compliance. The CAO will then close the audit.

1. Background to the CAO Compliance Audit of IFC Investments in the Ica Valley

This CAO compliance audit focuses on IFC's potential investment in an agribusiness project in the Ica Valley in Peru. The proposed investment was processed by IFC from September 2008 to June 2009. It was cleared for circulation to the IFC Board via streamlined procedure,[1] with a closing date of June 25, 2009. However, it was taken out of Board circulation by IFC before the closing date, and was not approved by the IFC Board. The focus of the CAO audit is therefore on IFC's process leading up to clearance of the potential investment for Board approval, with the objective of identifying observations, noncompliances, and underlying reasons for possible noncompliance that occurred while IFC processed the potential investment.

1.1 History of IFC Investments in Agrokasa and the Drokasa Group

Corporacion Drokasa is a leading Peruvian agricultural and industrial conglomerate owned by local and private South American investors. It started its operations in 1952 and has had three core activities: the manufacture, marketing, and sales of pharmaceutical products; the production and export of asparagus and table grapes; and the importation and distribution of chemicals, agrochemicals, liquor, and health and beauty products. In 2007 and 2008 Corporacion Drokasa divested the pharmaceutical, health, liquor and beauty product activities. Agrokasa is a wholly owned subsidiary of Corporacion Drokasa.

1.1.1 First investment in Agrokasa

On October 19, 1999, the IFC Board approved an initial direct investment in the Ica Valley by financing Agrokasa's expansion of its operations there **(Agrokasa #9528)**. Agrokasa had acquired the Santa Rita farm, where it began growing grapes and asparagus in a 150-hectare pilot operation. This IFC investment was intended to finance: (1) the extension of cultivated land area to 1,391 hectares by acquiring another farm, La Catalina; (2) construction of two packing houses; and (3) construction of an integrated feeding center to handle 1,500 head of cattle.

Among other environmental, occupational health, and safety issues, the "sustainability of irrigation water supply" was noted in the Environmental Review Summary (ERS) dated April 1999. It concluded that:

- Groundwater rights were allocated by the Ministry of Agriculture, which had also undertaken a number of groundwater studies in the area (1968, 1974, 1984, and 1992).
- Since 1995, the, Department for Natural Resources at the Ministry of Agriculture (Spanish acronym, IRENA) had been undertaking long-term monitoring of groundwater levels and indicated that that the levels had been stable for some 20 years.
- IRENA "had also restricted development of new wells in the valley and was confident that it could control demand and sustainability of supply" (p. 2).

[1] Under a streamlined procedure, in the absence of a request by an IFC Board Executive Director for the project to be discussed by the Board, IFC management may proceed with the proposed investment after circulating it to the Board.

- Agrokasa would use drip irrigation, which was considered "extremely efficient" (p. 2).
- "The sponsor has a well documented record of the methods by which water rights were obtained and this material forms part of a resettlement plan" (p. 2).

The 1999 investment in Agrokasa was reviewed according to the 1998 IFC Environmental and Social Review Procedure (ESRP)[2] and the 1998 IFC Safeguard Policies. The project was assigned a B categorization.[3]

1.1.2 First investment in the Drokasa Group

No further investments were made in the Agrokasa/Drokasa Group of companies until September 30, 2004, when the IFC Board approved financing for Corporacion Drokasa **(Drokasa #23010)** to fund the maintenance of capital projects, as well as to refinance the Group's outstanding short-term and long-term debt. The investment had an indirect link to Agrokasa's Ica Valley operations. Nevertheless, due diligence appraisal of the technical, environmental, and social conditions at the main facility sites, included those in the Ica Valley, was conducted. The Environmental Review Summary and Corrective Action Plan (CAP) note various issues related to the Ica Valley operations, but do not raise the sustainability of water use as an issue. No additional Environmental Impact Assessment (EIA) was done or community consultation activities organized as a consequence of IFC's involvement. The investment in Corporacion Drokasa was reviewed according to the 1998 Environmental and Social Review Procedure (ESRP) and the 1998 Safeguard Policies. This project was also assigned a B categorization.

1.1.3 Second investment in Agrokasa

On April 17, 2006, the IFC Board approved additional financing to Agrokasa **(Agrokasa Expansion #24873)** to expand Agrokasa's asparagus-growing operations through the acquisition and upgrade of the Las Mercedes farm (then called Agroguayabito), a 2,613-hectare agricultural operation situated some 200 km north of Lima. This farm acquisition virtually doubled Agrokasa's total operations and made its strategy to enter the global market viable. Although the link to the Ica Valley operation was indirect, the appraisal of the technical, environmental, and social conditions included both the new farm as well as Agrokasa's Ica Valley farms. The Board paper raised issues of sustainability of water for irrigation purposes at the new farm only. However, in the preceding IFC deliberations,

[2] IFC's Environment and Social Review Procedure (ESRP) outlines the process through which IFC staff implement the Corporation's commitment to promoting projects that are environmentally and socially sustainable. This commitment is a fundamental part of IFC's mission and is elaborated on in IFC's Policy and Performance Standards on Social and Environment Sustainability, as well as in IFC's Policy on Disclosure of Information.

[3] Categorization as defined in IFC's "Environmental and Social Review Procedures" (http://www.ifc.org/). "**CATEGORY A**: Projects expected to have significant adverse social and/or environmental impacts that are diverse, irreversible, or unprecedented. **CATEGORY B**: Projects expected to have limited adverse social and/or environmental impacts that can be readily addressed through mitigation measures. **CATEGORY C**: Projects expected to have minimal or no adverse impacts, including certain financial intermediary projects."

water issues were raised by the Corporate Investment Committee.[4] The IFC Agribusiness Department (CAG) concluded that for the Ica Valley farms, water supply to Agrokasa was adequate and was expected to remain so in the future without relying on new wells to be drilled. This investment in Agrokasa was reviewed according to the 1998 Environmental and Social Review Procedure (ESRP) and the 1998 Safeguard Policies and was also categorized a B project.

1.1.4 Proposed third investment in Agrokasa

On June 25, 2009, a third investment in Agrokasa **(Agrokasa #26821)** was due to be approved by the IFC Board, under IFC's streamlined procedures. The project objective specifically was to develop Agrokasa's operations in the Ica Valley—the first direct IFC investment in the Ica Valley operations since 1999. The loan proceeds were intended to partly restructure Agrokasa's debt obligations and increase and enhance its farming operations in the Ica Valley. The La Catalina farm was to be developed and land use increased. The Santa Rita farm was to receive "hydraulic improvements" intended to provide water where it was needed and reduce stress on the Ica aquifer. The project was described as including an intra-aquifer water pipeline, and, if approved by the government, new wells and/ or surface water intake(s). In preparation for Board submission, the IFC appraised the project. This investment in Agrokasa was to be the first for this client applying the IFC 2007 Environmental and Social Review Procedure (ESRP) and the 2006 IFC Performance Standards (PS). It was categorized a B project. During circulation of the proposed investment in order to seek Board approval, IFC management became aware of unresolved issues identified during its due diligence, as well as the receipt by the CAO of, as yet, unassessed complaints regarding the social and environmental impact of this project. IFC management decided to withdraw the investment proposal from Board consideration. On September 22, 2009, Agrokasa confirmed its decision not to use IFC funding because of the uncertainties of IFC's decision process.

1.2 Complaints to the CAO Office

Between June 1 and July 16, 2009, various stakeholder groups filed six complaints with the CAO regarding the impact of Agrokasa's operations on the Ica aquifer. Two of the complaints were signed by two groundwater users' associations: Junta de Usuarios de Rio Seco, and Junta de Usuarios de Aguas Subterraneas del Valle de Ica (JUASVI). One complaint was signed jointly by two nongovernmental organizations (NGOs): Progressio, and Water Witness International. Before the CAO assessment, Progressio formally withdrew its complaint. The three other complainants requested confidentiality.

In addition, the Caserio de Puno community sent an open letter that complained about water issues and the impact on their community. The CAO received the letter on June 12, 2009.

Complainant concerns and the open letter complaints were all focused on IFC's compliance regarding the potential third investment in Agrokasa (**Agrokasa #26821**).

[4] The Corporate Investment Committee was renamed the Corporate Operations Committee in 2008. The Committee reviews and approves Tier I and Tier II projects under Project Data Sheet Early Review (PDS-ER) procedures, typically before appraisal.

The complainants maintain that Agrokasa's operation is contributing to overexploitation of the Ica aquifer through a high concentration of wells, drilling of new wells, and/or deepening of existing wells—without appropriate permits and required licenses.

A key concern was Agrokasa's construction project to convey well-extracted water from the Santa Rita farm—where water is more plentiful—to the larger farm, La Catalina, where the wells are no longer so viable.

The complainants state that public consultation with impacted villages and farmers about the conveyance project was inadequate, and that the Government of Peru has been inconsistent in regulating legal compliance of wells in the area. The complainants also believe the Water Authority failed to regulate ground and surface water use and has not enforced its own ban on drilling of new wells.

Complainants generally concede that Agrokasa is not solely responsible for depletion of the Ica aquifer. However they believe that extraction by the large Ica Valley agro-exporters is accelerating the drying up of wells, which in turn threatens and will eliminate the livelihoods of many smaller-scale farmers across the Ica Province. In this regard, several complainants note that small growers across the Ica Valley have traded or sold their wells to large agro-exporters, even though they continue farming by relying on the scarce, disputed, seasonal surface water. In addition, they say many unsold wells are drying up at an alarming rate, due in large part to the ability of agro-exporters to deepen their existing wells.

1.3 CAO Ombudsman Involvement

The CAO Ombudsman deemed the complaints to be eligible for assessment. In an Assessment Report distributed to the parties in December 2009, the CAO Ombudsman team identified areas of common ground shared by all the parties, and recommended they undertake a process of assisted negotiation to address the critical water situation in Ica Province collaboratively. The CAO Ombudsman team also identified several issues that the parties were not willing to negotiate, and recommended that those be transferred to CAO Compliance for appraisal and subsequent audit.

In March 2010, after a period of assisted negotiation, two groundwater users' associations (whose complaints are public) launched a Working Group involving the other two water users' associations (which depend primarily on surface water) and the two local water authorities from the Ica and Rio Seco sections of the Ica Valley. As a member of Junta de Usuarios de Aguas Subterraneas del Valle de Ica (JUASVI), Agrokasa participated in and supported the efforts of the Working Group to jointly address the shared concerns regarding the water situation—including the concerns raised in the complaints.

The CAO Ombudsman team continued to work with the parties and served as facilitator for the Working Group, whose aim was to jointly develop short-, medium-, and long-term strategies for managing the water resources in the Ica Valley.

However, the CAO Ombudsman stated in its report: “In the event the parties do not wish or agree to pursue the CAO Ombudsman proposal or an alternate collaborative strategy for resolving the complaints, and in accordance with CAO‟s Operational Guidelines, the Ombudsman will conclude its involvement and transfer the complaints to CAO Compliance for appraisal. In the event they do agree to proceed with the proposed Ombudsman involvement, only the non-negotiable issues will be transferred to CAO Compliance for appraisal.” Parties were not willing to negotiate several issues, and these were transferred to CAO Compliance in March 2010 for appraisal.

1.4 Involvement of CAO Compliance

On receipt of CAO Ombudsman’s decision, CAO Compliance gave notice to IFC that it would embark on an appraisal. In June 2010, CAO Compliance released its Appraisal Report and concluded that it found it unclear whether IFC policy provisions had been properly applied and whether IFC policy provisions had provided an adequate level of protection. The CAO found that a compliance audit could yield information or findings that might better inform the application of policies (or other audit criteria) to future IFC projects, and that an audit of IFC was merited (for details, see the “CAO Appraisal Report–Case of IFC’s involvement with Agrokasa/ Corporacion Drokasa” at www.cao-ombudsman.org).

The audit Terms of Reference (ToR) states that: “The overall scope of the Compliance audit is to assess the reasonableness of IFC’s approach to these investments based on its mission, experience, and guidance. The objective of the audit is to provide greater clarity in relation to how IFC assessed and assured itself of social and environmental issues connected to investments related to the Drokasa and Agrokasa client activities in the Ica Valley in Peru. The scope inherently includes assessment of IFC’s current and earlier review processes; how IFC decided to include or exclude issues and assessments, and how the issues identified, not identified, or left out, did influence, or should have influenced, IFC’s decisions and actions. This also includes developing an understanding of the immediate and underlying causes for any non-compliance.”

This includes an assessment of:

- Whether the current procedures, and established practices, provide sufficient and correct guidance to staff in assessing the outcomes of the investments made in order to meet the intent of applicable policies, as well as IFC’s mission and mandate.

- How IFC assured itself that these investments would achieve an outcome consistent with IFC’s development mission, and how IFC considered earlier experiences of achieving sustainable development outcomes within the region, the sector, and with the client during its review process.

- Whether IFC’s rationale for its investments was reasonable and correct, taking into account IFC’s policies, mandate, and mission.

The scope of the audit also includes developing an understanding of the immediate and underlying causes for any noncompliance identified by the CAO.

The focus of compliance auditing is on IFC, and how IFC assured itself of project performance.

1.5 CAO Audit Terms of Reference and Scope

When the CAO undertakes an audit of IFC, it typically hires a panel of independent experts that assists the CAO in conducting the audit. The panel members are selected at the discretion of the CAO, and provide input to the CAO audit report.

A CAO Audit Panel was convened for the period September 2010 through December 2010. The three professionals are independent of the CAO's operations and IFC's activities under review. The Panel concurred that the scope of work in their Terms of Reference was appropriate and recommended no changes. It considered:

- All the complaints
- All the investments made and proposed in Drokasa/Agrokasa
- The introduction and new requirements of IFC's 2006 Performance Standards.

The CAO decided that, to meet the objectives set out for the audit, it would focus predominantly on the proposed Agrokasa III project (**Agrokasa #26821**).

Throughout its work, the CAO confirms that it had full access to, and cooperation from, the IFC and World Bank staff it sought to interview, and received all documentation requested.

2. Strategic and Regional Context

2.1 Access to Water as a Strategic Issue for Investment

The issue of future access to water as both a constraint on economic development and a potential issue of social conflict has been broadly documented. In 2008, IFC co-sponsored the 2030 Water Resources Group, which produced its report, "Charting Our Water Future–Economic frameworks to inform decision making."[5] IFC staff were on the steering committee, including representatives of IFC senior management. In IFC's strategic road map paper,[6] IFC refers to the importance of a strategic approach to water scarcity, and points to the Water Resources Group report on cost-effectiveness analysis of policy and investment alternatives for addressing water scarcity, as well as the creation of a practice group, WaterNet, to disseminate the knowledge across IFC's investment and advisory businesses.

The report's strategic analysis is of direct relevance to IFC and its agribusiness (and other) investments, recognizing that agriculture is responsible for 71 percent of global

[5] "Charting Our Water Future–Economic framework to inform decision making," 2030 Water Resources Group, 2009.
[6] "IFC Road Map FY10-12, Background Paper, Creating Opportunity in Extraordinary Times," April 2, 2009.

water withdrawals and that the challenge is closely tied to the issues of food provision and trade. At current rates of improvement, agriculture (and industry) will address only 20 percent of the supply/demand gap by 2030. The issue is recognized as potentially destabilizing at the country, community, and ecosystem level, and requires the evaluation of water system solutions at those levels. The report goes on to provide a comparative fact base on the economics of technical measures for water resource management.

In advance of and in parallel to its processing of the Agrokasa III investment, IFC had helped establish an analysis of global significance that clearly identifies agricultural production as a fundamental part of the water resource solution, and emphasizes the need for governments and key stakeholders to identify options from which to chart pathways of development that balance water supply and demand.

2.2 Underground Waters in Coastal Valleys in Peru and Conditions in the Ica Valley
As part of the preparation for the Project for the Modernization of Water Resources Management (Spanish acronym, PMGRH), which was approved by the World Bank Board on July 2, 2009, the World Bank commissioned the GW-Mate Report[7] in 2008 to ascertain facts pertaining to "underground waters in coastal valleys" (p. 8). The GW-Mate Report provides relevant history and key data on water matters. It reports that until around 1976, Peru had an important database of the underground water situation in its coastal valleys. From that date on, Peru had "serious difficulties to keep it up to date" (p. 8). As of 1997, hydrological studies, inventories of water sources, and studies on geophysics prospection resumed. Upon resumption, a "diagnostic of underground waters in the coastal valleys of Peru was aimed at determining the exploitable potential of underground waters and evaluating the behavior of the aquifer system over time, so as to know about its present and current availability…and identify the problems that might arise as a consequence of the manner and magnitude of their exploitation" (p. 8).

The project was intended to support the new National Water Authority (Spanish acronym, ANA) in the consolidation and development of institutional capacity for the management of underground water. With the aim of focusing such support on management needs in the field and on the Peruvian government's priority regions, the project selected two coastal valleys as pilot areas for underground water management. These valleys represent the vast hyper-arid zone of the country, but are affected by quite different problems: on the one hand, aquifer depletion (the Ica and Rio Seco parts of the Ica Valley); and on the other, rising levels of water (Lambayeque Valley).

The Ica Department comprises five provinces, of which Ica is the largest. The Ica Province is divided into fourteen districts. The Ica Valley—located some 300 kilometers south of Lima—stretches across most Ica Districts and extends further into the Huancavelica Department. The Ica aquifer refers to the system of underground subsurface water in the Ica Valley. Despite its aridity, the Ica Valley has access to water from two sources: limited seasonal surface water, and more extensive water from the Ica

[7] World Bank GW-Mate MISSION REPORT "INRENA (IRH/ANA)–PERU, FORMULATION OF STRATEGIES AND PROGRAMS FOR THE MANAGEMENT OF UNDERGROUND WATER RESOURCES WITH EMPHASIS ON THE COASTAL VALLEYS OF PERU," November 2008.

aquifer.[7] The local community and industry (mainly agribusiness) obtain water from both sources, but water remains scarce overall. Thus the Ica Valley did not attract much new investment until about a decade ago, when it was identified as suited to growing crops in demand for the export market, such as asparagus and grapes. Since then, water demand has increased significantly because of extension of land under cultivation; introduction of crops that are highly dependent on water; and increases in the local population.

The GW-Mate Report notes that exploitation of the Ica aquifer system doubled between 2002 and 2007 as a result of increasing agricultural activity. Of the 27 reserves of exploitable waters then studied,[8] the Ica Valley was shown to be high risk, with decreasing trend of aquifer levels. The state of the aquifer system was defined as "negative imbalance–overexploited" (p. 8), with a 125 percent annual use of exploitable reserves.

The report recommends that the Ica aquifer, and another aquifer, be included in a pilot project to strengthen underground water management capacity.

2.3 Growth of Agriculture in Peru and the Ica Valley, and the Role of World Bank Group Interventions

The IFC Project Summary prepared for the Board, dated June 1, 2009, states that agribusiness represents only 5 percent of Peru's GDP. However there is scope to increase this due to the country's diverse climatic conditions, which allow a wide diversity of crops to be grown. The potential to develop export crops is greatest in the coastal plain. Vegetable and fruit crops (such as asparagus, table grapes, avocado, artichoke, and peppers) show the greatest potential to help meet Northern Hemisphere demand for counter-seasonal crops. Peru has been a small player in this market and sees opportunities to develop its agribusiness, thereby increasing its share of this growing market.

A report entitled "Peru–Country Program Evaluation for the World Bank Group 2003–2009*"* was published by the Independent Evaluation Group (IEG) of the World Bank Group (WBG) in June 2010. The report finds that "IFC's activities reflected a relatively high degree of additionality, particularly during the early 2000s….At the time, Peru was emerging from a period of political instability; perceived risks existed of backtracking on reforms; and the financial sector had limited risk tolerance and was largely confined to providing short-term finance to upper-tier companies in well-established industries. In this context, IFC's investments in areas such as agribusiness, microfinance, and tourism filled an important gap."

The report expands on IFC's role in the agricultural sector, noting that "the agriculture sector in Peru comprises the modern export-oriented agribusiness sector; medium-size

[8] Multisectoral Technical Commission (Ministries of Agriculture, Defense, Economy and Finance, Energy and Mines, Housing, Infrastructure and Sanitation, Health and Production), "National Strategy for Continental Water Resource Management in Peru," December 2004 (in process of official approval), as quoted in the World Bank GW-Mate report, November 2008, as referred to by IFC in its Environmental and Social Review Summary (ESRS), dated May 7, 2009.

traditional crop agriculture mainly oriented to internal markets; and small-holder subsistence agriculture." In relation to growth of industries that received IFC investment, IEG's report notes that "Growth in agribusiness has been a substantial achievement in Peru, with the industry representing high value addition to local raw materials; employment generation; linkages to small-farmer suppliers; stimulation of associated packaging, transport and other service industries; and offering strong growth potential due to its competitiveness in world markets."

The report states that between 2003 and 2009, IFC had nine agribusiness projects with investments worth $176 million, which represented 16 percent of its total Peru portfolio; that these investments reflect the range of positive effects of broader development of the agricultural sector in Peru; that these investments have helped shift small farmers from traditional crops to exportable crops; and that agribusiness is a significant employer.

In Outcomes Rating for WBG Support, the IEG rates the World Bank Group involvements as "moderately satisfactory" for Pillar 1: Enhancing Participatory and Sustainable Growth. The report notes that "IFC/MIGA performance standards were largely effective in helping realize sound environmental and social practices, although there were some lapses in agribusiness projects." It goes on to note that that "some of IFC's agribusiness clients have established integrated operations, with limited backward and forward linkages with outside parties. They produce raw materials on their own land, process, package, and then export directly. Among IFC's clients two firms have such integrated operations."

In a concurrent study,[9] IEG reports that it carried out an impact assessment of "an IFC-supported asparagus producer"[10] in Peru to get an indication of the impact of the trader-processor model on poverty because such assessments are not done systematically by IFC. IEG found that IFC played a catalytic role by providing the client with long-term financing when it was not otherwise available. The impact evaluation found that the client had three encouraging impacts on the surrounding communities:

- The poor appear to have benefitted indirectly, because their nonwage income improved compared with that of the control group.
- The investment appears to have brought about positive direct impacts on nonpoor households.
- Both poor and nonpoor households with a female member in the client's industries have increased their net income and nonwage income significantly more than the control group.

3. IFC Processing of the Proposed Agrokasa III Investment

[9] IEG Report 2010: "Evaluative Lessons for World Bank Group Experience–Growth and Productivity in Agriculture and Agribusiness."
[10] Namely, Agrokasa (IEG Report 2010: "Evaluative Lessons for World Bank Group Experience–Growth and Productivity in Agriculture and Agribusiness," p. 53).

To map how IFC went about assessing its potential Agrokasa III investment (**Agrokasa #26821**), the CAO used the IFC investment cycle as laid out in its Annual Report.[11]

3.1 Business Development
IFC established a relationship with the Agrokasa/Drokasa Group of companies starting in 1999. Since that time, IFC has made three investments in the Group and developed a client relationship. The relationship was sustained by both the relationship manager/investment officer based in Washington, DC, who worked on the earlier investments, and a Lima-based officer. In 2008, IFC was approached to consider financing a fourth investment within the Drokasa Group, the third investment in Agrokasa—Agrokasa III. On September 26, 2008, IFC's Agribusiness Department (CAG) requested the Environmental and Social Development Department (CES) to provide an Environmental and Social (E&S) specialist to be assigned to this potential investment.

3.2 Early Review
The proposed project was described in the October 3, 2008 Project Data Sheet Early Review (PDS-ER). It stated that the investment would include "implementation of new areas and hydraulic improvements" and provision of broader corporate financing. The PDS-ER dated October 3, 2008 stated "Water use rights, water abstraction and its control and related environmental issues must be fully reviewed."

Sometime between October 3 and October 24, 2008, IFC decided to shift the role of Transaction Leader from the Lima-based officer to the Relationship Manager based in Washington, DC. The investment was cleared for further processing (Tier II) on October 24, 2008. The PDS-ER Expedited Tier II, dated October 24, 2008, changes the description used in the PDS-ER to state that "While the company uses sophisticated irrigation techniques, water use rights, water extraction and its control and related environmental issues will continue to be monitored."

3.3 Appraisal and Due Diligence
An Appraisal (Due Diligence) Questionnaire was produced by October 28, 2008, and a site visit by both a CES and a CAG team followed from October 28 to October 31, 2008. In November 2008, this was followed by an engineer's report, e-mails highlighting communications to the client on the 2006 Performance Standards, and e-mails on well authorization issues. CES conducted a second site visit on January 12–13, 2009, and on January 27, 2009, reinforced their view of the need to conduct an Environmental and Social Impact Assessment (ESIA). The CES appraisal team Back-to-Office Report (BTO) was finalized on March 6, 2009.

IFC assigned the potential investment a B categorization as a project that should have limited, specific environmental and social impacts that could be avoided or mitigated by good international industry practice, including IFC Performance Standards, Environment, Health and Safety (EHS) guidelines, and informed design criteria. CES due diligence was undertaken from first principles even though Agrokasa was a long-standing IFC

[11] *Where Innovation Meets Impact–IFC Annual Report 2010*, p. 104.

client, since prior investments in Agrokasa predated, and had not been assessed, under the 2006 Performance Standards.

Overuse of the Ica aquifer was identified as a significant issue. IFC found that substantial further pressure on water resources due to intensification of agricultural use and increased population had led to significantly increased extractions from the aquifer since IFC's first investment in 1999. IFC referred to the 2008 World Bank report:[12] "According to a World Bank mission report published in November 2008, overexploitation is attributable to a combination of factors from 2002–2007 after the establishment of Agrokasa farms in the area."[13] Contributory factors elucidated by the World Bank report included, according to IFC, rapid increases in agricultural production areas; population and economic growth; and construction of more than 150 clandestine (unpermitted) production wells. The appraisal also reviewed outstanding environmental compliance issues related to one of the earlier IFC investments in Agrokasa.

CAG staff recall that the requirements of the Performance Standards and how they would influence due diligence was the subject of a specific presentation to the client at the start of the appraisal mission. However, based on the observations of CES staff and the later complaint of the client, the detailed and forensic due diligence work undertaken by CES to ascertain the permitting position on levels of water extraction appears not to have been anticipated by Agrokasa management; similarly, the CES staff interactions with the local community to gauge levels of concern and gather evidence of community protest and objection to the proposed project was not anticipated.

IFC stated[14] that the company was preparing an Environmental Assessment (EA) to fully document existing practices and to assess the impacts of the proposed hydraulic improvement projects in the Ica Valley. IFC also stated that Agrokasa would conduct public disclosure and outreach programs consistent with the requirements of IFC's Performance Standard 1.

In June 2009, after the investment had been circulated for Board approval, the client produced an EA. IFC had an independent third-party peer review conducted of the EA. The peer reviewer concluded on July 15, 2009 that the EA did not meet acceptable IFC standards.

3.4 Investment Review

In the minutes to the February 9, 2009 Investment Review Meeting (IRM), several participants raised substantive issues concerning water usage. These were also discussed in responses to questions from the Chair. The minutes reflect an open discussion where the issues of water use and access to water was discussed in terms of commercial, environmental, and social risks. The country office, the Agribusiness

[12] World Bank GW-Mate MISSION REPORT "INRENA (IRH/ANA)–PERU, FORMULATION OF STRATEGIES AND PROGRAMS FOR THE MANAGEMENT OF UNDERGROUND WATER RESOURCES WITH EMPHASIS ON THE COASTAL VALLEYS OF PERU," November 2008.
[13] IFC–SUMMARY OF PROPOSED INVESTMENT (SPI), Project No.: 26821, May 7, 2009, p. 3.
[14] IFC–SUMMARY OF PROPOSED INVESTMENT (SPI), Project No.: 26821, May 7, 2009, p. 4.

Department (CAG), and Credit Risk Officer raised concerns about risk related to the water situation, in addition to the concerns raised by the CES team. Issues discussed and concerns raised in the IRM should have resulted in conclusions that should have been noted in the in Project Data Sheet (PDS). The PDS instead referred to water issues as something to be addressed in a coming Environmental Assessment (EA), said to be under preparation by the client. The PDS was approved on June 11, 2009.

3.5 Environmental and Social Analysis and Conditionality
The Environmental and Social Action Plan (ESAP) was developed over time. One version was produced on March 6, 2009. The final one was agreed on and dated May 7, 2009. In the final ESAP, the requirement for the client to prepare an EA and subsequently publicly disclose and consult on it was defined as a condition for signing the Investment Agreement. The Environmental and Social Clearance Memorandum (ESCM) of May 15, 2009 further stated that compliance with the ESAP must be a requirement within the Investment Agreement.

On June 12, the Investment Department requested to move the requirement for an EA from a condition of commitment to a condition of disbursement. The CES appraisal team did not accede to this request.

3.6 Public Disclosure
IFC produced the Summary of Proposed Investment (SPI) and Environmental and Social Review Summary (ESRS) on May 7, 2009, and they were publicly disclosed shortly after.

According to the SPI, this investment would have involved a loan to Agrokasa of up to US$ 10 million to "(i) improve its operations, thereby allowing the company to grow and expand further into existing and new markets; (ii) ensure appropriate financing facilities for its varied production cycle; and (iii) create more employment opportunities in some of the poorest areas of Peru. In addition, IFC will strength[en] the relationship with one of the leaders of the industry and further promote the development of the Peruvian agribusiness industry."

Also according to the SPI, the investment would "include implementation of new areas in the northern farm [La Catalina] and hydraulic improvements in the south. The hydraulic improvements element of the investment program includes measures to reduce stress on the Ica aquifer in southern Peru. Specifically, water from the Santa Rita site: (i) either from current wells, and/or (ii) four (4) new Ranney-type wells, (if approved by the government), and/or (iii) Ica River surface water (if approved by the government) will be conveyed in a PVC pipeline to La Catalina farm. If the authorities allow (ii) above, four existing groundwater wells servicing La Catalina, which is one of the most distressed portion[s] of the Ica aquifer, will be closed. Ground water from these wells will be replaced by the four new Ranney-type wells in Santa Rita, an area of the aquifer that is less stressed. These Ranney-type wells will be situated in the vicinity of the Ica River to take advantage of surface water recharge of the aquifer."

The ESRS describes the key environmental and social issues and the application of the Performance Standards. It states that seven Performance Standards are applicable to

the project: Performance Standards 1 (Social and Environmental Assessment and Management Systems); 2 (Labor and Working Conditions); 3 (Pollution Prevention and Abatement); 4 (Community Health Safety and Security); 5 (Land Acquisition and Resettlement); 6 (Biodiversity Conservation and Sustainable Natural Resources Management); and 8 (Cultural Heritage). It also sets out the anticipated process of document disclosure.

In determining the categorization of the project as B, the ESRS notes the overuse of the Ica aquifer as a significant issue, but also refers to the findings by the World Bank that this is attributable to a combination of factors occurring over the 2002–07 period, with rapid increases in agricultural production, population, and economic growth. It also notes the introduction of new irrigation technology to Agrokasa operations to minimize water use (and therefore presumably to mitigate its impact on the aquifer). The ESRS extensively references the need for an EA to fully understand the potential impacts on the aquifer. Other social and environmental impacts noted in the ESRS under the Performance Standards are described in a largely positive sense from the perspective of how they are being managed and mitigated by Agrokasa.

The project description in the PDS–Approval and in the Board paper differs from the one in the PDS-ER and the one publicly disclosed in the SPI in the fact that all mention and references to hydraulic improvements, and construction of pipeline or wells, are absent.

3.7 Board Review and Approval

The third proposed investment in Agrokasa was first reported to the Board of Directors as a new item in February 2009. On June 11, 2009, it was approved by IFC for consideration by the Board under streamlined procedure. The closing date for the loan documentation was scheduled for June 25, 2009. However, on June 19, 2009, after informal discussion of the project at the Corporate Risk Committee (CRC) meeting on June 17, 2009, IFC senior management put the transaction on hold and instructed the project team to remove it from Board circulation.

In September 2009, Agrokasa formally notified IFC of its intent to terminate the request for finance.

3.8 Time Line: The Different IFC Investment Phases and the Potential Agrokasa III Investment

Business Development
CAG request to CES for an E&S specialist, dated September 26, 2008

Early Review
PDS-ER, dated October 3, 2008
Principal Transaction Leader shifted from Lima to Washington, DC, October 2008
PDS-ER Expedited Tier II, dated October 24, 2008

Appraisal and Due Diligence
Appraisal (Due Diligence) Questionnaire, October 28, 2008
Appraisal Itinerary/Site Visit, October 28–31, 2008
Engineers Report, November 2008
E-mail highlighting communications to client on new PS, November 8, 2008
E-mail regarding well authorization issues, November 21, 2008
Second CES Appraisal Site Visit to the Ica Valley, January 12–13, 2009
Need to conduct an ESIA stated, January 27, 2009

Investment Review
Investment Review Meeting, February 9, 2009, minutes

Negotiation
ESAP, dated March 6, 2009

Appraisal Due Diligence
BTO Report, dated March 6, 2009

Public Disclosure
ESRS, dated May 7, 2009
SPI, dated May 7, 2009

Negotiation
ESAP final, May 7, 2009
ESCM, dated May 15, 2009

Board Approval
PDS Approval, June 11, 2009
Request to move condition for EA to disbursement, June 12, 2009
Planned Board approval, June 25, 2009
IFC management decision to withdraw the proposal from Board approval, June 19, 2009

Appraisal Due Diligence
Third-party proposal letter for EA Review, June 29, 2009
Peer review of the EA, July 15, 2009
Client confirmation of its decision not to pursue IFC funding, September 22, 2009.

4. CAO Analysis, Findings, and Conclusions

4.1 Compliance of the Proposed Agrokasa III Investment with IFC Policies, Procedures, and Performance Standards

4.1.1 Policy on Social and Environmental Sustainability
On April 30, 2006, IFC approved and adopted its Policy on Social and Environmental Sustainability. It states that "IFC endeavors to invest in sustainable projects that identify and address economic, social and environmental risks with a view to continually improving their sustainability performance within their resources and consistent with their strategies." The Policy goes on to state that "when a project is proposed for financing, IFC conducts a social and environmental review of the project as part of its overall due diligence. The review is appropriate to the nature and scale of the project, and commensurate with the level of social and environmental risks and impacts." It concludes that "where there are significant historical social or environmental impacts associated with the project, including those caused by others, IFC works with its client to determine possible remediation measures."

It also states that IFC is "committed to ensuring that the costs of economic development do not fall disproportionately on those who are poor and vulnerable, that the environment is not degraded in the process, and that natural resources are managed efficiently and sustainably." To achieve the objectives of the policy, the IFC implements the Performance Standards (PS) for its different investments.

The focus of IFC technical and financial due diligence on the proposed Agrokasa III investment and its credit review requirements was on whether the client would be able to repay the loan. In this respect, IFC assessed the client as credible. Within this aspect of the due diligence, IFC technical and financial specialists considered the water issue only in a very narrow context: Would there be enough water for the client to operate effectively until it had repaid IFC? The answer to that question was probably yes. The due diligence undertaken by CES addressed the broader context of the sustainability of the aquifer and the potential impacts on other users, as required by the Performance Standards. The overall management of the investment did not effectively reconcile these "silos." In pursuing the Agrokasa III investment, IFC would have supported the actions of an existing client—and therefore its own financial interests—in protecting its access to water through an intra-aquifer water transfer and other activities. By pursuing this investment before an adequate EA was prepared and reviewed, IFC would have proceeded without taking into account potential negative long-term and wide-ranging development impacts on other more vulnerable users: impacts that could cause economic displacement, impoverishment, and loss of access to potable water.

The CAO concludes that this course of action is inconsistent with and in violation of commitments made within IFC's Policy on Environmental and Social Sustainability and its role as a development institution.

IFC positions itself as a global thought leader on issues relating to environmental and social sustainability. A particularly relevant example is the recent financial and

management support for the work of the 2030 Water Resources Group developing leading edge work on the strategic importance of water resources at the country, community, and ecosystem level. That work took place in 2008 and 2009, before and while decisions were made about the Agrokasa III investment. Although aspects of the due diligence were correctly focused on efficiencies in groundwater supply and irrigation, at the more strategic level IFC did not ensure that water resource issues were adequately and more broadly considered before an investment decision. The CAO finds this to be a possible indication that IFC struggles to align its strategic involvement in these issues with its investment practices. While recognizing that broader national, regional, and community solutions are difficult to apply in the context of an individual investment, the absence of an adequate EA in this case effectively ensured that such solutions were neither raised nor addressed. IFC also did not with efficacy consult and liaise with other members of the World Bank Group. These gaps undermine IFC's reputation and credibility in this area.

The CAO concludes that IFC should assess how it applies its strategic understanding of sustainability issues at the investment level. In this case, the assumed application of the Performance Standards failed to apply the necessary degree of analysis and rigor to the water resource issue in the investment process.

4.1.2 Project categorization

While the majority of the environmental and social impacts of the project are limited in scope and can be mitigated, the impact on the aquifer—and thus the potential for broader economic displacement as a result of its further overuse—are largely unknown. In particular, the impacts of the proposed water transfer within the aquifer are not assessed. The ESRS notes Agrokasa's ongoing commitment to reduce water consumption; however, this is somewhat meaningless in terms of impact without a better understanding of the aquifer baseline, which may well be deteriorating at a significant and wholly unsustainable rate. The basis for a B categorization is therefore heavily predicated on the production of an adequate EA and its disclosure.

The CAO finds that the initial categorization of the project as B by CES is supportable, but this is heavily dependent upon the production of an adequate EA addressing the key issues identified, particularly the sustainable use of water resources.

4.1.3 Environmental and Social Assessment requirements and the sustainability of water supply

IFC's ESRS discusses the issue of sustainable water use and the condition of the Ica aquifer under PS1 (Social and Environmental Assessment and Management Systems) among other things and references reports on the current status of the aquifer. It also sets out the concerns of other groundwater users and the intractable issues of overuse and limited recharge. The ESRS confirms the need for a detailed Environmental Assessment addressing the baseline situation, all project considerations, the potential for economic displacement, and broader regional impacts. Importantly, the EA is also intended to clarify the situation relating to the precise levels of extraction taking place and the regulatory approval of those extractions. The ESRS documents the client's

commitment to specific targets in reducing water usage and leading efforts to build local consensus on how to address the water issue with other stakeholders. It also states that the client will implement a public disclosure and outreach program based on the EA.

PS1 (Social and Environmental Assessment and Management Systems) sets out the requirements for a Social and Environmental Assessment (SEA). The SEA must address the risks of the project in terms of its area of influence and cover impacts that might be predictable at another location. Where issues are complex, it requires that independent experts be retained and that qualified experienced persons assess the issues. The EA in this case could potentially have drawn on World Bank assistance or support from IFC's own Advisory Services to help in mitigating the broader aquifer depletion issues and consequent friction with the local communities so to enable an investment to proceed.

PS4 (Community Health, Safety and Security) requires clients to avoid or minimize adverse impacts due to project activities affecting soil, water, and other natural resources in use by affected communities. Under PS4, IFC's ESRS acknowledges the potential for overexploitation of the Ica aquifer to deprive communities and other agricultural users of access to groundwater, while noting that Agrokasa is not intending to increase usage, and that hydraulic components of the project are designed to alleviate pressure on resources in areas of high demand. This was to be fully addressed in the EA.

PS5 (Land Acquisition and Involuntary Resettlement) makes it clear that "in the event of adverse economic, social or environmental impacts from projects other than land acquisition (i.e. loss of access to assets or resources or restriction on land use)," such impacts should be dealt with under PS1. "If …significantly adverse at any stage of the project, the client should consider applying the requirements of Performance Standard 5, even where no initial land acquisition was involved." Under PS5, in the ESRS, IFC recognizes the as-yet nonquantified risk of economic displacement of adjacent land users due to water loss. PS5 recognizes economic displacement (the loss of assets or access to assets, leading to loss of income sources or means of livelihood) as resettlement. Whether it is involuntary is a more complex issue. While land acquisition resulting in resettlement includes purchase of access rights, it was not necessarily an involuntary acquisition that might result in displacement. In the context of this investment, it was crucial that potential local impacts on adjacent land users were properly assessed. This would include consultation with them as part of the project preparation.

PS6 (Biodiversity Conservation and Sustainable Natural Resource Management) specifically requires that IFC clients "manage renewable natural resources in a sustainable manner": that is, the management of use, development, and protection of resources in a way or at a rate that enables people and communities to provide for current well-being while sustaining resources for future generations. Under PS6 in the ESRS, IFC again focuses on the overexploitation of the Ica aquifer. IFC due diligence established that there were local concerns that Agrokasa extraction rates were already partly to blame for the drying up of other wells, and that the possible impacts of drilling additional wells in Santa Rita and the intra-aquifer transfer to La Catalina were unknown and potentially damaging for local users. The November 2008 World Bank report on

groundwater in the Ica Valley documents the rate of groundwater depletion. The ESRS references the World Bank report.

The CAO finds that the issue of overexploitation of the Ica aquifer and the extent of local concern was well known to IFC throughout its due diligence. Substantive concerns were raised internally and the ESRS documented potential noncompliances with multiple Performance Standards. Nonetheless, IFC proposed to seek Board approval in this sensitive situation without an appropriate EA—and therefore without appropriate information disclosure and consultation with potentially affected parties. Even though the client has committed to year-on-year reductions in water usage, without an underlying baseline assessment and understanding of the scale of aquifer depletion that would be provided by an EA, this commitment is without context and essentially meaningless as regards the impact on aquifer depletion. The CAO finds IFC's course of action to be inconsistent with Performance Standards 1, 4, 5, and 6. The CAO therefore concludes that in this regard, IFC violated Performance Standards 1, 4, 5, and 6.

The CAO also finds that the failure to require an EA early in the process prevented a proper discussion and analysis of alternative strategies for the client from taking place.

4.1.4 Disclosure of Information

The IFC's Policy on Disclosure of Information requires the client to disclose information in a manner commensurate with the risks and impacts that its project poses to affected communities. The ESRS sets out the anticipated process for information disclosure on the project. IFC proposed to require the Environmental Assessment for the project and its disclosure as a condition of commitment for the project. Effectively, this meant that it was not available to other stakeholders and affected communities before a decision by the IFC Board, since such a decision would have been taken well in advance of disclosure of the EA. Aspects of the project related to hydraulic improvement (such as the proposed pipeline) were already under construction or completed by July–August 2009. The overall effect of moving the requirement for an EA to a condition of commitment—rather than requiring its completion before internal "approval" to go to the Board—rendered the process an effectively meaningless exercise in the context of the part of the project referred to as "hydraulic improvements" because by the time the EA would be completed and available for consultation with affected parties, the suggested pipeline project would already be constructed.

The CAO finds IFC's approach to require the Environmental Assessment for the project and its disclosure as a condition of commitment for the project to be inconsistent with the IFC's Policy on Disclosure of Information. The CAO therefore concludes that in this regard, IFC violated its own disclosure policy.

4.1.5 Consultation and Broad Community Support

The IFC Environmental and Social Review Procedure provides that the Lead CES Specialist may determine a need for Broad Community Support for a project where the project may not have a significant adverse impact but where it is "nonetheless associated with significant community concerns and where there is a need to build

community support." A specific example of this is for large category B projects with legacy issues, cumulative impacts, and incremental risks. IFC did not make a determination on whether or not there was a *need* for Broad Community Support— *even though* IFC was aware of significant community concern about the project, *even though* the Corporation was in parallel contributing to strategic studies that highlight the significance of access to water as an issue of global significance, and *even though* IFC had identified the importance of community support for a wider solution to the issue of sustainable use of groundwater. Indeed, by consenting to production of an EA as a condition of commitment, IFC effectively excluded communities from informed consultation on the project until after Board approval would have been granted.

The CAO finds that, consistent with the IFC Environmental and Social Review Procedure, greater consideration should have been given to a determination of the need for Broad Community Support in the circumstances of the Agrokasa investment.

4.2 IFC Management Approach and Decision Making

4.2.1 Project definition

The description of what the Agrokasa III investment intended to finance changed significantly during the IFC appraisal process. This change has a potential impact on the scope and nature of due diligence and on the understanding of what the investment includes for external interested parties. In the PDS-ER and PDS-ER Tier II, the description includes "'hydraulic improvements" and provision of broader corporate financing. In the Investment Review Meeting notes, the description does not refer to the issues of water usage, although the substantive issues were raised by several participants and in responses to questions from the Chair. In the SPI of May 7, 2009, the focus of the investment seems to be on hydraulic improvements in the client's southern operations, including funding of an intra-aquifer water transfer and new extraction wells, along with the expansion of production areas in the northern operations. In the PDS approval and Board Paper, all references to hydraulic investments are absent.

While the issue of sustainability of water supply in the Ica Valley is well represented within the project documentation, the headline description of what IFC would be financing changes substantively—to the point that any reference to potential impacts or improvements to the sensitive situation with respect to water are effectively removed. This substantive change took place in parallel to IFC's due diligence, which progressively established the scale of such sensitivity and local objection to any expansion in water use.

The CAO finds that the final Board paper did not correctly reflect the outcome of IFC's due diligence in that it did not represent the water issues discussed and the sensitivity, nor did it include the water-specific "hydraulic improvements" stated elsewhere as part of the project. The CAO therefore concludes that in this regard, the Board paper wasincorrect.

4.2.2 Quality of due diligence

The ESRP procedure states that IFC must review potential projects and determine if projects can be expected to meet the requirement that "IFC does not finance new business activity that cannot be expected to meet the Performance Standards over a reasonable period of time." During appraisal, CES is instructed to conduct a gap analysis to define areas of project noncompliance with requirements of IFC's Performance Standards, and design an ESAP addressing all deficiencies and noncompliances discerned during the appraisal. The gap analysis must contain specific tasks designed to close all significant gaps.

Environmental and social appraisal (due diligence) on this investment included several visits to the client and the area by CES staff and numerous telephone and e-mail interactions. Three experienced CES professionals were extensively involved in the process. They were supported by other specialist colleagues in areas such as dispute resolution mechanisms and resettlement. Extensive guidance was provided to the client in the preparation of appropriate documents and in key processes that would be crucial for IFC's assessment. The due diligence identified the critical path issue of sustainable water supply and the sensitivity of intra-aquifer transfer of water at an early stage. CES review staff were clear and consistent in their recommendations.

CAG staff confirmed that they were broadly supportive of the scope and quality of due diligence undertaken by CES. However, following a complaint from the client about IFC CES staff, changes were made to the CES due diligence team. Despite these changes, the CES specialists' approach, and views, remained consistent and professionally robust—even though they were undermined by their management's response to the emerging tensions. However, the issues raised in the due diligence process and fundamental differences of opinion as to how to proceed were not resolved between CES and CAG. As a consequence, the CES due diligence team's approach of requiring the client to prepare an EA before project approval was never followed and the client assumed that CES conditions were subject to negotiation. Thus CES found itself in an adversarial position to both the CAG and the client. In addition, although a World Bank team was examining water issues in the Ica Valley at the time of project preparation, no substantive dialogue appears to have taken place between the IFC and World Bank teams with respect to long-term impacts and mitigating actions.

CES made efforts to try and develop an acceptable approach through an appropriate local aquifer study that did not commit the client to an unrealistic requirement to study the entire aquifer. The views expressed by the various CES specialists involved were consistent. The June 2009 client-produced EA was reviewed independently by a consultant hired by CES, who found that the EA did not meet the required standard in respect to several significant issues.

Despite meetings in Washington, DC with the client to seek to resolve issues relating to the environmental and social due diligence, there was not a resulting common understanding of what was required: in particular, that the Environmental Assessment was required before progression of the project to the Board. As a result, CES and CAG management agreed that the Environmental Assessment would be required only as a condition of commitment, subsequent to Board approval.

The Environmental and Social Action Plan produced by CES was comprehensive, including the requirement for an Environmental Assessment, clarification of extraction permits, and a client decision to reduce water usage. However, the investment proposal linked its implementation to a condition of commitment. An enhanced understanding of potential impacts from the "hydraulic improvements" proposed was crucial to other stakeholders whose livelihoods depend on the Ica aquifer. The client's decision to reduce its water usage lacked necessary context in the absence of the baseline that the EA would provide.

There was a clear recognition within the investment team that the availability of sufficient groundwater constituted a commercial risk to the project and the client, and that it was an issue of wider environmental and social conflict with the broader community. There is no evidence that the collective skills of the team were focused on seeking an approach that was broadly supportable and might allow the investment to proceed with confidence that the issues had been adequately addressed in a way that was consistent with IFC standards and mandate. The approach to the groundwater issue in the technical/engineering and credit assessment elements of the due diligence was proscribed by whether the groundwater would be accessible long enough for IFC's loan to be repaid.

While there may have been adequate access to water for the client for the period of the IFC loan, this was a long-standing client and it was in the broader interests of IFC and the client that agribusiness production in the Ica Valley remain sustainable on a long-term basis. Instead, the broader sustainability issues were left largely with CES to resolve in isolation. Professional differences over the environmental and social issues were therefore allowed to persist.

Late in project preparation, a compromise was struck to include the requirement for an EA as a condition of commitment. However, it is evident from reviewed documentation that pressure was applied by CAG, culminating in a request to CES to move the requirements for the Environmental Assessment articulated in the ESAP to a condition of disbursement rather than commitment.

The CAO finds that the scope and quality of E&S due diligence undertaken by CES was appropriate to the level of risk identified, but that against a backdrop of community objection, commercial pressure to expedite the project, and an absence of effective support by CES management, the specialists' professional advice was overruled.

The CAO also finds that no clear mechanism or process seems to exist to reconcile professional differences, and/or bring them to a final conclusion. IFC management did not play its role in seeking ways to broker agreement and consensus within the project team to establish the position to be adopted.

4.2.3 Client relationship management

At a very early stage, the investment officer role switched from Lima to the Washington, DC-based relationship manager. Overall responsibility for liaison with the client during

the appraisal and processing of the loan application for Agrokasa III rested with one officer. During the processing period, many IFC staff interacted directly with the client, many at the level of Agrokasa's Chief Executive Officer (CEO). Although this was the client's first exposure to IFC's Performance Standards, no clear responsibility was assigned at IFC for the task of introducing the standards to client management, explaining the impact on the due diligence process, and helping the client understand how to deal with the outcomes. The IFC Environmental and Social Review Procedure requires the transaction leader to communicate IFC's indicative requirements to the client. In this case, it is clear that, despite assertions from both CES and CAG that the client was made fully aware of the enhanced due diligence requirements under the Performance Standards, until very late in project processing, these requirements were a matter of disagreement and dispute. As a result, the client did not come to terms with the scope of the due diligence required by IFC and the requirements that would be placed on the client as a condition of lending.

Ensuing complaints from the client relating to the scope and quality of the E&S due diligence were then unduly influential in affecting the CES management. The production of an EA, and appropriate disclosure and consultation on the EA before going to the Board, were central to meeting the IFC standards. CES management negotiated away the requirement, thereby undermining the role of its specialists, its own position, and effectively compromising the position of IFC.

The CAO finds that critical interactions were mismanaged, with resulting unnecessary long-term damage to IFC's client relationship. As an existing client, Agrokasa should have been clearly advised at a much earlier stage of the enhanced due diligence requirements placed on IFC by the Performance Standards. This may have averted the significant tension and bad feelings generated by the due diligence process and enabled the EA to be prepared at the appropriate point in the preparation cycle. The CAO concludes that the IFC strategy and procedures for developing and maintaining client relationships were unclear.

4.2.4 IFC management issues

CES review staff were clear in their recommendations regarding the investment. In the face of resistance from the CAG and commercial pressure to move ahead with funding of an existing client, CES management were complicit in sidelining specialist(s) assigned to the investment who intensified their concern about the sustainability of the situation in Ica and had pointed out inconsistencies in the apparent permitting of water extractions. The concerns of CES specialists relating to the environmental and social impacts of groundwater extraction in the Ica Valley were not reconciled by consecutive layers of IFC management through engagement with the project team. The resulting capitulation on the requirement for an EA in advance of taking the project to the Board exposed IFC to increased risk and was inconsistent with IFC procedural and disclosure requirements. CAG staff assured the CAO that commercial pressure was not applied to seek to ensure inclusion of the commitment within the 2008/09 program. However, the CAO has reviewed documentation showing clear pressure, culminating in a request from CAG to

move the requirements in the ESAP to a condition of disbursement rather than a condition of commitment.

The CAO concludes that CES management did not play an effective role in supporting the professional judgment of CES specialists, in protecting the broader interests of the IFC in applying its standards, and in protecting the interest of weaker parties in the emerging water conflict over scarce water resources in the Ica Valley. This, in combination with mismanaged client communications, produced an incoherent IFC approach, undermining and fragmenting IFC's position. The consequence was that the issues became external, IFC lost control over the process, and IFC damaged a client relationship.

4.2.5 Internal IFC incentives and risk management

The incentives for CAG staff pursuing a "deal" and CES staff responsible for ensuring that the project meets IFC environmental and social standards understandably differ. This naturally generates an internal tension. Some interviewees expressed the view that this tension is healthy. Such a tension can reach an unhealthy breaking point when unequivocal conflicting views exist over the significance of an environmental or social issue, as was the case on this investment. The tension is healthy only if an appropriate management process exists by which such tensions are actively managed and resolved to a mutually acceptable outcome. It also requires CES management to "draw a line in the sand" when commercial objectives, pursued by CAG, are overriding IFC standards—to the detriment of IFC as a whole. CES did not do that in this case, allowing incremental pressure from the client and the CAG to override the professional views of a number of their own specialists. Staff within CAG, the region, and the credit function also raised warning flags before Board circulation.

At the Investment Review Meeting, the Chair asked questions about the E&S risks, and the responses are documented in the minutes. The process by which the outstanding issues were to be closed out is not clear or specified. The process did not close out all the risks identified at the IRM, either by reconvening the meeting or by addressing the issues identified in the PDS approval process. Thus concerns around groundwater and the approach to be adopted remained contentious right up to preparation of the Board papers and Board circulation

The CAO concludes that due to the lack of clarity and transparency around IFC's internal processing, the potential investment was circulated for Board streamlined approval with identified risks left unattended. The management processes within IFC did not work to resolve the fundamental conflict between the incentives within CES and CAG, and failed because the process of upward consultation within IFC management was inadequate.

The CAO concludes that IFC lacked an effective risk management process to ensure that different points of view of the project team were properly aired and either resolved or followed a process for proper disposition and conclusion before Board presentation.

The CAO also concludes that it is not evident that IFC at any time proactively identified or acted on the risk that a conflict that was mainly internal could have consequences for its client relationship.