

THE WORLD BANK/IFC/M.I.G.A.

OFFICE MEMORANDUM

DATE: July 6, 2011

TO: Ms. Meg Taylor, Compliance Advisor/Ombudsman, CCAVP

FROM: William Bulmer, CESDR, Oscar Chemerinski, CM2DR, Atul Mehta, CMGDR

EXTENSION: x36703, x38750, x31889

SUBJECT: IFC Management Response to CAO Audit of IFC's Investments in Agribusiness in the Ica Valley, Peru

On behalf of Mr. Lars Thunell, IFC management thanks the Compliance Advisor Ombudsman (CAO) for its February 22, 2011 report entitled "*CAO Audit of IFC's Investments in Agribusiness in the Ica Valley, Peru*", and is pleased to provide herewith the IFC Management Response. Management welcomes the CAO's efforts to strengthen the environmental and social sustainability of IFC's operations and acknowledges the contribution made by this Audit to lessons learned. We will continue to engage the Compliance Advisor/Ombudsman as part of IFC's ongoing improvements to its internal processes.

Adoption of a more Strategic Approach

IFC Management agrees with CAO's recommendation that IFC should adopt a more strategic approach to sustainability issues when evaluating projects in environmentally or socially sensitive contexts. IFC has made a number of significant changes in recent months to improve the integration of broader environmental and social sustainability considerations in its decision-making process and ultimately assure positive outcomes on the ground (see Annex I). Many of these improvements are reflected in the recently completed update of its Environmental and Social Performance Standards and the new World Bank Group Framework and IFC Strategy for the Palm Oil Sector. These advances will exert considerable influence on investment selectivity, the advisory services agenda, and our due diligence approach with respect to future IFC engagement, particularly in the agriculture sector.

IFC Management understands the sensitivity often associated with water resources use and management. For this reason, IFC has developed a water strategy, including the hosting of the Water Resources Group, a multistakeholder partnership led by the private sector, focused on the analytical basis for joint problem-solving and investment in both demand and supply management. At the same time, the risks associated with water use received attention in the IFC agriculture strategy. With these developments in operational strategy, IFC Management believes that its current approach to investments where water is a risk has significantly evolved, including by learning from this case.

As the Audit indicates, the Agrokasa team did identify and evaluate a number of the broader issues; however, the focus was primarily on our client and the factors within its control. The application of our now revised approach to the Agrokasa situation would have resulted in an earlier and more comprehensive understanding of the broader water situation in the ICA Valley and of the roles that different stakeholders could play in reconciling evolving demand to water availability in the region. It is likely that the application of such an approach would have led IFC to revise the terms of its engagement with respect to the Agrokasa investment. In addition, IFC Management also agrees with CAO that its internal decision making documentation, including the Board report, should also reflect this more strategic assessment of project context.

Categorization and Adherence to IFC's Performance Standards

IFC Management acknowledges the CAO's concurrence that the project was categorized in accordance with IFC's Performance Standards and that the project's associated environmental and social due diligence was carried out to a high standard by the CES specialists involved. We also appreciate CAO's recognition that IFC correctly required the preparation of a tailored Environmental Assessment (EA) for the project to follow up on issues identified during the E&S due diligence. CAO takes issue, however, with the timing of the EA in relation to IFC's internal due diligence and approval process. IFC's Sustainability Policy and Procedures are not prescriptive in this regard and what information is required at what stage in IFC's process is a judgment call, and particularly so in the case of ongoing operations with existing clients. However, IFC decided to require additional data gathering and analysis in the form of an EA, the terms of reference for which reflected, in every material respect, the recommendations made by the team of CES specialists working on the project. Agrokasa had also committed in the Environmental and Social Action Plan SAP to develop a formal on-going stakeholder engagement plan that would have included the results of the EA. Given that the Company's plans were to reduce its overall water consumption and that the more fundamental and comprehensive assessment of the aquifer would be taken through the hydrological work supported by the World Bank, this was considered to be a reasonable approach for a company that had been an established water user for many years. IFC's legal commitment to the project was subject to the results and recommendations of the EA report.

Dealing with differences of opinions on sensitive projects

As articulated above, IFC Management believes it has significantly strengthened its operational approach to water as a sensitive issue. At the same time, IFC Management does respectfully but strongly differ with the Audit's conclusions and characterization of the internal process for dealing with differences of opinion and potential conflicts of interest. IFC prides itself on the professionalism and integrity of its staff, including their ability to exercise judgment. Given the E&S sensitivities involved in combination with the fact that Agrokasa was an existing client with an established relationship with IFC, it was not surprising that there was internal debate among the professionals working on this project. It was this debate that led to the decision to require an EA for the project that was designed to provide additional comfort on areas of concern pertaining to water resources. The timing of the EA was also the subject of a similar discussion. IFC Management believes that the agreed approach ensured that all substantive issues raised during the due diligence process were tabled and that there was an agreed process for dealing with them

and IFC Management stands behind the judgments of the managers in this case. These facts do not support CAO's contention that the due diligence process was compromised due to either commercial pressures or by disregarding concerns that were raised by relevant professionals. Management does however recognize that the professional differences of view that surfaced during the due diligence should have been addressed more promptly and effectively, possibly avoiding the deterioration of team relations and client discontent that ensued.

IFC Management welcomes the independent review afforded by the Audit process and respects the conclusions drawn by the CAO. We believe that this is an important mechanism to ensure accountability for our work and to help us continuously upgrade our environmental and social standards and processes so that we can meet the evolving expectations of our shareholders, our clients and other stakeholders. Additional IFC Management comments with respect to the Audit findings can be found in Annex II.

For the benefit of readers who may not be familiar with the CAO audit process, the audit confines itself to an assessment of the actions of IFC during its due diligence process. The audit is not an audit of Agrokasa, and the Audit Report presents no findings on the activities of Agrokasa. IFC notes that the investment in Agrokasa III was circulated to the Board but was withdrawn from consideration prior to Board action being taken, and that the company ultimately withdrew its request for IFC financing.

Actions Taken to Strengthen Integration of Sustainability Objectives at the Project Level

- The update to IFC's Sustainability Policy, including changes to categorization procedures, will incorporate sector risks more explicitly and thereby strengthen the due diligence process.
- Roll out of a Sustainable Learning Program (part of the implementation plan for the updated Sustainability Framework) will support improved and consistent communication with clients on E&S issues and IFC Performance Standard requirements and expectations.
- An Early Risk Assessment tool has been developed in connection with the Palm Oil Strategy and will be applied for other agriculture sector interventions which involve complex environmental and social issues. This new tool will help provide a more comprehensive and early picture of country and local context, inform project categorization, help identify potential mitigants, and go-no go decisions.
- Adoption of the IFC Water Sector Business Plan which calls for water to be treated in an integrated manner Corporation-wide given the relevance of water usage to most of the sectors in which IFC is active. This initiative will increase focus on water demand management and efficiency (at the project level).
- A new water foot-printing tool has been developed and is being rolled out. The new tool will enable clients to place their water footprint in the context of watershed/basin-wide water management.
- Preparation of a joint Bank-IFC Country Situation Analysis has been specified in the Palm Oil Strategy. While initially targeted at palm oil producing countries, it will also have probable relevance elsewhere when the agriculture sector is confronted with complex environmental, social and governance challenges).
- Establishment of a new Resource Efficiency Product Group within IFC Advisory Services which will be a consolidated base of capacity and expertise for water-related advisory work.

Additional IFC Management Comments on Audit Findings

1. Procedural findings

Timing and Content of EA

IFC's Environmental and Social Review Procedure describes the environmental due diligence process that IFC specialists undertake. This task is a continuous process of evaluation and re-evaluation as information and material is collected to refine IFC's understanding of the risks and issues as well as need for and feasibility of mitigation measures. This often results in IFC requiring additional information, or specific studies either before or after presenting the project for Board consideration. IFC Management fully reviews E&S risks and impacts and how remaining open issues can be addressed through an Environmental and Social Action Plan (ESAP¹). Management then makes a decision as to whether to proceed to send the proposed investment to IFC's Board for consideration. An Environmental and Social Review Summary (ESRS) is prepared to present a comprehensive description of the company's plans, risks, impacts and mitigation measures and the ESAP which outlines any future actions in a time-bound plan. In accordance with IFC's Disclosure Policy, for Category B projects (the designation accorded Agrokasa III), these documents are then publicly disclosed both locally and on IFC's website for 30 days before the project is approved by IFC's Board.

For the Agrokasa III investment, an Environmental Assessment (EA) was a specific piece of analysis that IFC had insisted be prepared in order to better understand the company's impacts on the aquifer. There was, as the Audit indicates, extensive debate amongst the team members as to whether the EA should be received and reviewed by IFC prior to Board, commitment or first disbursement. There was however, consensus amongst the project team that this EA, qualitatively satisfactory to IFC, was a necessary pre-condition to be met before IFC would potentially agree to contractually commit its prospective loan to the client. Ultimately, management was comfortable with requiring delivery of a satisfactory EA prior to commitment because:

- a) the project would not be increasing the amount of water used by Agrokasa and under the terms of the ESAP the company would be required to make year-on-year water reductions;
- b) the pipeline project was intended to help reduce area-specific stress on the Ica aquifer by utilizing water in areas that benefit from intermittent surface water flows that enhance recharge and thereby avoid use of water in areas of slower recharge, thus reducing impacts on those specific communities;

¹ The ESAP is subject to further revision when/if additional information becomes available e.g. more information may become available as a result of additional environmental analysis.

- c) Agrokasa's specific commitments agreed in the ESAP, included undertaking the preparation of an EA document, which would have verified Agrokasa's water baseline, better documented the proposed intra-aquifer transfers (the pipeline), and verified the status of Agrokasa's water use rights and permits;
- d) the company had been consulting with a variety of local stakeholders, including communities (see Annex III), and there was public knowledge of the company's activities. Agrokasa had also committed in the ESAP to develop a formal on-going stakeholder engagement plan that would have included the results of the EA;
- e) through an agreement reached with the Government of Peru, the World Bank (IBRD), was planning to undertake an updated hydrogeological study of the aquifer and to establish a Water Basin Committee which was tasked with identifying and implementing better management of water resources in the ICA Valley. This was considered to be the only way of achieving a long term consensual solution for the Ica aquifer;
- f) it had been agreed that IFC would not proceed to commitment (signing of the loan documentation) without delivery of an EA document satisfactory to IFC; and,
- g) the approach was fully consistent with IFC's policies and procedures.

These facts were weighed against the backdrop of an extremely complex water situation where Agrokasa is one of many users in a large geographic area.

Adequacy of information and disclosure

The completion of a satisfactory EA document, together with public disclosure and outreach programs, was a condition of commitment of the loan (had the process proceeded to that point). The findings of the EA may also have resulted in additional requirements being added to the ESAP. These amendments would have been subject to agreement by the client and were agreement not obtained, commitment of the loan would not have occurred.

The Audit indicates that "the Board paper did not fully represent the water issues relevant to the Agrokasa III investment including the water-specific "hydraulic improvements" (i.e. the water transfer element of the project). Management acknowledges that the Board Paper could have included a more complete review of the water issues and it would have been more precise to have stated that the water transfer element would help reduce area-specific stress on the Ica aquifer.

There was considerable water-use related information available to stakeholders through other publicly accessible sources. The publicly available ESRS and ESAP focused considerable

attention on the water issues, and these documents had been disclosed locally in nine locations. An announcement in the local press as to the availability of these documents had been made more than a month prior to submission of the investment for Board consideration. IFC

Management believes that the sequence of disclosure and continued consultation by the client, as well as the pre-commitment requirement of a satisfactory EA to be a reasonable basis for proceeding to Board consideration at the time.

2. Findings on client relationships

The Audit raises concerns as to how IFC managed client interactions and that Agrokasa was not clearly advised of the enhanced E&S due diligence requirements of the Performance Standards. CES and the investment department informed Agrokasa at an early stage of the changes in the E&S requirements concomitant upon the introduction of the 2006 Performance Standards, which were not in place during the previous Agrokasa investments. However, it is acknowledged that the client relationship could have been managed with greater consistency and coordination of communications between CES and investment staff and that doing so may have reduced misunderstandings that arose between the client and IFC staff at certain points in the process. The Audit finding reinforces the importance of good practice which is that, while differences of opinion amongst members of an IFC transaction team are a normal course of business, the team has the responsibility to resolve their internal differences and speak with one voice to the client.

3. Findings on IFC motivation for pursuing the Agrokasa investment

The Audit states that, in pursuing the Agrokasa III investment, IFC was supporting its own financial interests by protecting Agrokasa's access to water, the implication being that IFC was concerned about its existing financial investment in Agrokasa. However, such a conclusion is not accurate given that IFC did not consider its existing exposure to Agrokasa to be at risk with or without the water transfer project. By continuing to support Agrokasa, IFC was supporting a company that has demonstrated the practical application of the best in drip-irrigation technology, while supporting rural employment and a key export industry.

Community Consultations

Date	Attendees	Subject
3-Jan-08	Mayor of Pueblo Nuevo, Mayor of Los Aquijes, Board of Agua Pariña Chica plus Residents(250 people)	To discuss the water problems of the population which resulted in the support of a new well and distribution system
17-Jan-08	Authorities and Water Users	To discuss water Problems Ica Valley and Villacurí - Ica Growers/Farmers Association
1-Feb-08	Mayor of Pueblo Nuevo, Mayor of Los Aquijes, Board of Agua Pariña Chica + Residents of Pariña Chico (10 people)	Signing of support agreement for the well construction and improvement of the water distribution (lines) in Parina Chico
4-Nov-08	Mayor of Tate + Residents (35 people)	Agrokasa Water Supply Project Presentation
1-Dec-08	Notable Puno + Authorities (Dominga, Lieutenant Governor, Mayor, Governor)	Agrokasa Water Supply Project Presentation
6-Jan-09	Mayor of Tate	Agrokasa Water Supply Project Presentation
9-Jan-09	Mayor Tate + Notables Puno	Agrokasa Water Supply Project Presentation
19-Jan-09	Puno Residents (70 people) + Mayor + Law Makers	Agrokasa Water Supply Project Presentation
2-Feb-09	Neighboring Farmers (Chiaway)	Agrokasa Water Supply Project Presentation
4-Feb-09	Committee of Groundwater Irrigation (South Zone)	Agrokasa Water Supply Project Presentation
10-Feb-09	Notable Puno (Dominga, Ramon Ramos, Willy Hernandez, Lieutenant Governor, Governor, President of Puno Neighborhood' committee)	Agrokasa Water Supply Project Presentation
19-Feb-09	Puno Residents (80 people)	Agrokasa Water Supply Project Presentation
30-May-09	Authorities - Water Users	Workshop: General Water Law Review - ALA
13-Jun-09	Ica ALA Manager	Agrokasa Water Supply Project Presentation
25-Jun-09	Authorities - Water Users	Workshop: Regulatory Framework, Use and Management of Water Resources - ALA
30-Jun-09	University of Piura + JUASVI	Monitoring Network of wells Georeferenced
Mar 09 - Jun09	Board Directors of JUASVI	Weekly meetings of the Board of JUASVI to analyze and propose solutions to the water problem in Ica
Sept '08 – Feb '09	Ica's Farmers - Central Zone	Bi-monthly meetings for formation of Groundwater Commission Central Zone