



APPRAISAL REPORT

CAO Compliance Appraisal

C-I-R5-Y14-F214

August 29, 2014

Case of

IFC Advisory Services to Government of Papua New Guinea (Special Economic Zones)

Summary

In May 2009 IFC initiated an Advisory Services (AS) project (the Project) with the Government of Papua New Guinea (GoPNG) as its client. The objective of the Project as originally articulated was to assist GoPNG in framing a viable legal framework for the development of special economic zones (SEZs) and in particular to advise on the economic and legal conditions for the proposed Pacific Marine Industrial Zone (PMIZ) in Madang.

In June 2010, IFC revised the scope of the Project to focus only on advice in relation to the national legal framework for SEZs, dropping the project component that was to support the assessment of the viability of the PMIZ.

In July 2011, CAO received a complaint from landowners living near the proposed PMIZ in Madang. The complainants expressed concerns about IFC's role supporting the establishment of the PMIZ and the impact it would have on local populations and the environment. They contend that the level of consultation with landowners in and around the site was inadequate; that an SEZ focused on tuna processing would deplete fish populations; and that it would have adverse social and environmental implications for the area. In response to the complaint, CAO initiated a voluntary dispute resolution process that led to the signing of a memorandum of understanding (MoU) between the parties. Disagreements around implementation of the MoU meant that CAO transferred the complaint to CAO's compliance function in July 2014.

The purpose of a Compliance Appraisal is to ensure that CAO compliance investigations are initiated only for those projects that raise substantial concerns regarding environmental and/or social outcomes and/or issues of systemic importance to IFC/MIGA. In this case, CAO finds that IFC has not had any substantive involvement in the development of the PMIZ. While this Appraisal raises questions as to IFC's environmental and social performance in relation to the AS Project, absent indications of significant adverse outcomes stemming from the AS Project, CAO finds that a compliance investigation is not warranted. As a result, CAO has decided to close this case.

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

About the CAO

CAO's mission is to serve as a fair, trusted, and effective independent recourse mechanism and to improve the environmental and social accountability of IFC and MIGA.

CAO (Office of the Compliance Advisor Ombudsman) is an independent post that reports directly to the President of the World Bank Group. CAO reviews complaints from communities affected by development projects undertaken by the two private sector lending arms of the World Bank Group: the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA).

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

1. Overview of the CAO Compliance Appraisal process

When CAO receives an eligible complaint about an IFC or MIGA project, the complaint is referred for assessment. If CAO concludes that the parties are not willing or able to reach a facilitated solution, the case is transferred to CAO compliance for Appraisal and potential compliance investigation.

A Compliance Appraisal can also be triggered by the CAO Vice President, IFC/MIGA management, or the President of the World Bank Group.

The focus of CAO compliance is on IFC and MIGA, not their client. This applies to all IFC's business activities including the real sector, financial markets, and advisory services. CAO assesses how IFC/MIGA assured itself/themselves of the performance of its/their business activity or advice, as well as whether the outcomes of the business activity or advice are consistent with the intent of the relevant policy provisions. In many cases, however, in assessing the performance of the project and IFC's/MIGA's implementation of measures to meet the relevant requirements, it will be necessary for CAO to review the actions of the client and verify outcomes in the field.

In order to decide whether a compliance investigation is warranted, CAO compliance first conducts a Compliance Appraisal. The purpose of the Compliance Appraisal process is to ensure that compliance investigations are initiated only for those projects that raise substantial concerns regarding environmental and/or social outcomes, and/or issues of systemic importance to IFC/MIGA.

In cases transferred to compliance after a CAO assessment, the scope of the appraisal is defined by issues raised in the complaint and identified during the CAO assessment phase.

To guide the Compliance Appraisal process, the CAO applies several basic criteria. These criteria test the value of undertaking a compliance investigation, as CAO seeks to determine whether:

- There is evidence of potentially significant adverse environmental and/or social outcome(s) now, or in the future.
- There are indications that a policy or other Appraisal criteria may not have been adhered to or properly applied by IFC/MIGA.
- There is evidence that indicates that IFC's/MIGA's provisions, whether or not complied with, have failed to provide an adequate level of protection.

In conducting the appraisal, CAO will engage with the IFC/MIGA team working with the specific project and other stakeholders to understand which criteria IFC/MIGA used to assure itself/themselves of the performance of the project, how IFC/MIGA assured itself/themselves of compliance with these criteria, how IFC/MIGA assured itself/themselves that these provisions provided an adequate level of protection, and, generally, whether a compliance investigation is the appropriate response. After a Compliance Appraisal has been completed, the CAO can close the case or initiate a compliance investigation of IFC or MIGA.

Once CAO concludes a Compliance Appraisal, it will advise IFC/MIGA, the President, and the Board in writing. If a Compliance Appraisal results from a case transferred from CAO's dispute resolution role, the complainant will also be advised in writing. A summary of all appraisal results will be made public. If CAO decides to initiate a compliance investigation as a result of the Compliance Appraisal, CAO will draw up terms of reference for the compliance investigation in accordance with CAO's Operational Guidelines.

2. Background

In 2009 IFC initiated an Advisory Services (AS) project (the Project) with the Government of Papua New Guinea (GoPNG) as its client. The objective of the Project as originally articulated was to assist GoPNG in framing a viable legal framework for the development of special economic zones (SEZs) and, in particular, to advise on the economic and legal conditions for the proposed Pacific Marine Industrial Zone (PMIZ) in Madang.

The Project as approved in 2009 included three components:

1. *Legal and regulatory regime* - including advice on the establishment of a sound legal, regulatory and institutional framework for the development of SEZs in PNG;
2. *Policy and regulatory framework (aside from law)* – including advice on phytosanitary, labor environmental and other standards needed to ensure access to global markets; and
3. *Commercial viability and site assessment* – including detailed analysis of the proposed Madang site and its suitability for development as an SEZ.

IFC did not develop a Cooperation Agreement with its Client regarding the AS Project.

In June 2010 IFC revised the scope of the AS Project to focus only on advice in relation to the national legal framework for special economic zones, dropping the project component that was to support the assessment of the viability of the PMIZ in Madang.

The AS Project delivered a key output to GoPNG in the form of a draft SEZ legislative framework. Other than facilitating an initial meeting of the PNG SEZ Taskforce, which was held in Madang in June 2009, IFC did not support any activities related to the proposed PMIZ.

IFC formally completed project implementation in May 2011, however, post implementation activities continued until June 2012.

In July 2011 CAO received a complaint from representatives of landowners living near the proposed PMIZ in Madang. The complainants express concerns about IFC's role in supporting the establishment of the PMIZ and the impact it would have on local populations and the environment. They contend that the level of consultation with landowners in and around the site was inadequate and that an SEZ focused on tuna processing would deplete fish populations and have adverse social and environmental implications for the area. The complainants also raise concerns that IFC's support in relation to the regulatory framework for SEZs is not in the interests of the environment or improved social conditions.

In response to the complaint, CAO supported a voluntary dispute resolution process. In the course of this process, key parties (including a local tuna processor in Madang, affected communities and representatives of government) signed a memorandum of understanding (MoU) in relation to community concerns regarding the PMIZ.¹ Issues around implementation of the MoU, however, led to a determination that the case should be transferred to CAO's compliance function for appraisal.

3. Scope of the Appraisal for Investigation of IFC

The scope of a CAO Compliance Appraisal is defined by issues raised in a complaint and identified during the CAO Assessment phase.

¹ MoU available on CAO website: http://www.cao-ombudsman.org/cases/case_detail.aspx?id=175

In the context of this CAO Compliance Appraisal, the Complainant's concerns regarding the E&S impacts of the PMIZ require CAO to consider:

- a. whether the issues contained in the complaint raise substantial concerns regarding the E&S outcomes of the AS Project; and
- b. whether IFC acted in accordance with relevant policy requirements in its review and implementation of the AS Project.

4. Discussion

4.1 IFC Project Pre-Implementation and Implementation: General Compliance Issues

Advisory Services Project Preparation and Implementation: IFC Policy and Procedures

This Project was prepared and implemented under IFC's 2006 Policy on Social and Environmental Sustainability ("Sustainability Policy (2006)"). The key requirement from the Sustainability Policy (2006) in relation to IFC AS projects is as follows: "when IFC is providing advice for large scale investment projects, the Performance Standards are used as a reference in addition to national laws" (para. 30). The Sustainability Policy (2006) also provides that "IFC ... encourages recipients of IFC advisory services to enhance opportunities to promote good social and environmental practices" (*Ibid.*).

IFC implements its commitments in the Sustainability Policy through its Environmental and Social Review Procedures (ESRPs). These procedures outline how IFC staff evaluates the potential impacts of a proposed AS project and determine if the project could have potential E&S risks. This project was approved under ESRP v.3 (February 2009) and supervised under subsequent versions of the ESRPs.

In accordance with ESRP v.3 (para.11.3.3) the transaction leader for an Advisory Services (AS) Project will:

- a. Consider the impacts and outcomes of the AS project and determine whether the impacts and outcomes could have potential E&S risks.
- b. If there are no potential E&S risks associated with the impacts or outcomes, the project may be processed without any further requirements.
- c. If there are E&S risks, the Transaction Leader will include the AS Sustainability Champion and the CESI Sustainability Champion/Specialist on the AS team as peer reviewers and consult with them on how to incorporate the E&S best practices into the project.²

Neither the Sustainability Policy (2006) nor the ESRPs in place at the time the Project was processed provide specific guidance in relation to the supervision of AS projects.

The 2006 Sustainability Policy does, however, include more general provisions, for example in the "Purpose of this Policy" section, which provides that IFC "seeks to ensure that the projects it finances are operated in a manner consistent with the requirements of the Performance Standards" (para. 5). Similarly, under the heading of "IFC's Commitment," the 2006 Sustainability Policy provides that efforts to "carry out its investment operations and advisory services in a manner that 'do no harm' to people and environment," are "central to IFC's development mission" (para. 8).

Preparation of the PNG-SEZ Project

² The Transaction Leader is the IFC staff with primary responsibility for the AS project. Sustainability Champions are IFC AS technical staff trained to provide advice on E&S issues in relation to low and medium risk AS projects. CESI specialists are technical specialists with IFC's E&S department.

IFC commenced preparation of this Project in late 2008 with project approval granted in May 2009. CAO's review of IFC's project approval documentation does not indicate that a review of Project E&S risk by an E&S specialist or sustainability champion was conducted. Reference is, however, made in the project approval document (PDS Approval) to potential significant environmental risks associated with the PMIZ, both with regard to the sustainability of the tuna resource and local impacts of processing. In terms of project scope, advice on environmental standards attached to SEZs was included under component 2 (SEZ Policy and Regulatory Framework).

Supervision of the PNG-SEZ Project

IFC's supervision of the Project is documented in supervision documents which were filed every six months during project implementation.

According to IFC's initial project supervision document (dated August 2009), the first activity undertaken by IFC under the Project was to support a June 2009 meeting of the PNG SEZ Taskforce related to the PMIZ in Madang. At this meeting it is noted that IFC staff together with the national management committee of the PMIZ and representatives of the private sector worked on a strategy for the PMIZ. The same supervision document identifies risks associated with the Government's pre-selection of the site for the PMIZ. To mitigate this risk the project team indicates that it will provide clear and frank advice on site selection based on objective criteria.

In November 2009, IFC prepared a communications strategy with a view to increasing stakeholder understanding of IFC's role in the development of SEZs, and in particular, the PMIZ project. The communications strategy notes the emergence of an anti-PMZ campaign. A key message presented in the communications strategy is that the focus of IFC's work is on the legal and regulatory framework for the implementation of SEZs in PNG.

Also in November 2009, the IFC transaction leader filed an E&S due diligence form in relation to the Project. This was done as part of an AS department wide push to ensure compliance with project E&S review requirements, including backfilling of E&S due diligence where this had not been conducted prior to project approval. The scope of this review indicates that the Project was to assist the Client to develop a legal framework for SEZs and that specific advice in relation to the Madang PMIZ was not anticipated. On the basis that the outcomes of the project would be laws and regulations, the E&S review concludes that the Project will have no E&S impact. An IFC E&S Specialist was not engaged in this review or in Project implementation more generally.

IFC's subsequent supervision document (dated September 2010) sets out a formal change in Project scope. At this point it is agreed that IFC's support will focus on the development of the legal and regulatory regime and that component 3 of the project, which was to support the development of the PMIZ, would be dropped. The change in project scope is explained on the basis that the Client had independently selected and announced the location for the PMIZ, as well as having contracted a firm to undertake the demand assessment for the site. The supervision document further notes that IFC played no role in the selection of the site for the PMIZ.

Consistent with the change in project scope, IFC's advice focused on the development of a draft SEZ law. This included presenting the government with recommendations on a best practice legal framework for the development and operation of SEZs in PNG in late 2010. As described in IFC's June 2011 project completion report the SEZ legal framework presented by IFC was expected, if effectively implemented, to provide a streamlined and effective regulation of SEZs in PNG, including from an E&S point of view.

IFC's project completion report outlines lessons learned by IFC in the course of the Project. In relation to project design, IFC acknowledges that an E&S Specialist should have been engaged early in the project cycle, in particular to analyze risks related to land and environmental impacts. In relation to project implementation IFC notes that the absence of a formal Cooperation Agreement meant that the scope of the Project was not clearly established with the Client.

5. Decision

The decision about whether CAO should initiate a compliance investigation requires the weighing of factors including the likely E&S impact of a project, a preliminary appraisal of IFC's compliance with E&S requirements, as well as a more general assessment of the adequacy of IFC's E&S requirements in the context of the issues raised by a complaint.

On the question of E&S impact, CAO notes that IFC's AS Project focused on the provision of advice in relation to the legal framework for SEZs in PNG. While the initial Project description envisaged a component to support the development of the PMIZ, IFC restructured the project and dropped this component before giving any substantive advice in relation to the PMIZ. Further, as at the date of writing, IFC's advice in relation to the legal framework for SEZs had not been incorporated into legislation. As a result, CAO finds it difficult to establish a link between the IFC's AS Project and the potential adverse E&S impacts raised by the complainants.

In relation to IFC's E&S performance, CAO has questions as to whether IFC met the requirements of the ESRP in terms of assessing the E&S risk attached to the project prior to approval. IFC has, however, subsequently acknowledged that an E&S specialist should have been engaged early in the project cycle with a particular view to analyzing risks related to land and environmental impacts. Given the challenging nature of E&S issues raised by the Project, CAO has questions as to IFC's conclusion that the Project, with its focus on inputs to the regulatory framework, would have no E&S impact. On the contrary it is widely acknowledged that policy and regulatory reforms may have E&S impacts. In this context CAO has questions as to whether IFC's approach to the Project was supportive of the institution's higher level sustainability commitments including its commitment to encouraging IFC AS clients to enhance opportunities to promote good E&S practices.

On the question of the adequacy of IFC's E&S requirements, CAO notes the relatively undeveloped policy framework which prevailed in relation to IFC's AS work at the time this project was processed. In making this observation, CAO acknowledges subsequent work that IFC has done to articulate its approach to the identification and management of E&S risk in AS projects. Recent steps in this regard include the development of an early risk screening tool which guides AS teams to consider a range of factors including sector risk, project specific risk, host country regulatory risk and Client capacity in conducting their initial AS project E&S risk categorization. CAO also notes IFC's development of more detailed ESRPs for AS projects and the incorporation of E&S risk management aspects into IFC's AS Project Governance Procedures.

In conclusion, while this Appraisal raises a number of questions as to IFC's E&S performance, absent indications of significant adverse outcomes stemming from the AS Project, CAO finds that a compliance investigation is not warranted. As a result, CAO has decided to close this case.