



FIRST COMPLIANCE MONITORING REPORT

*IFC Investment in Latin Renewables Infrastructure Fund (LRIF), Latin America Region, as related to the Hidroeléctrica Santa Rita complaint
Project #31458*

August 8, 2019
Office of the Compliance Advisor Ombudsman (CAO)

About 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 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

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Introduction

CAO's compliance function oversees investigations of IFC/MIGA's environmental and social (E&S) performance with a view to ensuring compliance with relevant requirements and improving the E&S performance of the institutions.

Following a CAO compliance investigation, CAO monitors actions taken by IFC/MIGA until such actions demonstrate to CAO that its compliance findings are being addressed.

CAO's monitoring considers IFC/MIGA's response to a compliance investigation at two levels:

- Firstly, CAO considers actions taken or proposed by IFC/MIGA that respond to CAO findings at the project level.
- Secondly, CAO considers actions taken or proposed by IFC/MIGA that respond to CAO findings at the level of IFC/MIGA policies, procedures, practices, or knowledge.

The first level of analysis is designed to address project-level concerns identified by CAO. The second level is designed to document progress in the IFC/MIGA's approach to the identification and management of E&S risk.

This is CAO's first monitoring report following CAO's investigation of IFC's investment in Latin Renewables Infrastructure Fund (LRIF, "the Fund").¹ This report documents IFC's response to the compliance investigation in the period August 2017–July 2019.

In preparing this monitoring report, the CAO team: (a) reviewed IFC's documentation and relevant publicly available documentation; and (b) held discussions separately with IFC staff, as well as the complainants and their representatives, and project staff in Guatemala City.

This report provides: (a) case background; (b) a summary of IFC's response to CAO investigation report; and (c) CAO's compliance monitoring observations.

Background

In June 2012, IFC committed to a US\$15 million equity investment in Latin Renewables Infrastructure Fund (LRIF, "the Fund"), a 10-year closed-end fund established and managed by Real Infrastructure Capital Partners (REAL) to invest in renewable energy infrastructure projects in Latin America and the Caribbean.² In 2014, IFC's Asset Management Company (AMC) made a US\$20 million equity investment in LRIF. At this point, REAL announced that it had reached final closing for the Fund with commitments of US\$100 million.³ IFC's and AMC's equity investments represented 15 and 20 percent of REAL LRIF, respectively.

In late 2012, the Fund acquired a controlling equity stake in the Santa Rita Hydroelectric Power Plant ("the project"), its first project. The project is a 23-megawatt hydro-electric power plant on the Río Icbolay in Alta Verapaz, Guatemala, managed by a local development company, Hidroeléctrica Santa Rita ("HSR"). Subsequently, the Netherlands Development Finance Company (FMO) also made an equity investment in the project.⁴ Construction of the project

¹ The CAO investigation, IFC's response to the investigation and related materials are available on the CAO website. See <http://bit.ly/RealLRIF-01>.

² IFC Disclosure, Summary of Investment Information (SII): <http://bit.ly/2KsoG2Z>.

³ Real LRIF, January 2014, Press Release - <http://bit.ly/2liUPri>.

⁴ CAO Assessment Report of IFC's investment in Real LRIF: <http://bit.ly/RealLRIF-01>. FMO, 2017, Public Statement on Hidroeléctrica Santa Rita, available at <http://bit.ly/2QJNYdW>.

commenced in 2013 but was quickly aborted due to project-related conflict. In July 2013, project opponents damaged project machinery and a road block was established by some community members opposing the project at the nearby village of Monte Olivo. In August 2013, two children and a former worker at the project were killed at an incident in Monte Olivo. The circumstances surrounding this incident remain unclear, with the Fund noting that the former worker who allegedly killed the children was drunk and acting on his own accord, while project opponents allege that he was acting on behalf of HSR. A Fund-commissioned third-party review of the incident supports the Fund's version of events.

Following an agreement between some community representatives and HSR to recommence construction of the project, in August 2014, police temporarily removed a road block erected by project opponents. However, opposition to the project persisted, and to date, construction has not recommenced.

In October 2014, representatives of indigenous community members opposing the project met with IFC and subsequently filed a complaint with CAO. The complaint was filed by *Colectivo Madre Selva* and the *Consejo de Pueblos de Tezulutlan*, two Guatemalan organizations, on behalf of several community members residing downstream and upstream from the project. The complainants raise concerns regarding a range of environmental and social issues related to the project. They allege that the project did not meet IFC's consultation requirements for free, prior, and informed consent (FPIC). They are concerned that HSR did not address their concerns regarding the project's design and did not consider its potential for adverse impacts on local water sources. They noted fear that the project would compromise their ability to generate income and to sustain their livelihoods. Further, they asserted that their opposition to the project was met with violence, repression, and criminalization of community leaders.

CAO's compliance investigation was released in October 2017 and made several non-compliance findings in relation to IFC's review and supervision of its investment in the Fund and the Santa Rita project in particular. In summary, CAO made the following findings:

- *IFC pre-investment review of the Fund investment:* IFC appropriately categorized the E&S risk of its investment in the Fund as having a level of E&S high risk given the investments it was targeting. However, IFC's pre-investment review was not commensurate to risk in that IFC did not present required analysis of country, contextual, or other third-party E&S risk factors in the Fund's target markets. Further, the framework which IFC negotiated for review of the Fund's projects limited IFC's ability to determine whether the client's E&S Management System (ESMS) implementation was robust.
- *IFC review of Hidro Santa Rita project:* IFC's review of the HSR project overlooked weaknesses in the Fund's E&S due diligence (ESDD). Key shortcomings in the ESDD that IFC did not identify included: (a) gaps in the environmental assessment regarding the project footprint; (b) lack of a social impact assessment; (c) inadequate analysis of project's expected impacts; and (d) weaknesses in the assessment of the application of Performance Standard 7: Indigenous Peoples.
- *IFC supervision:* IFC's approach to supervision of this investment, specifically in relation to the HSR project, did not provide IFC with sufficient evidence to conclude that the Fund was correctly applying IFC's E&S requirements to the project. Given the ongoing conflict around the project, and persistent concerns about local impacts, additional supervision was required by IFC, in particular, in relation to: (a) the adequacy of the E&S assessments required by the project ESAP; (b) the decision not to apply FPIC to the project; and (c) the client's security management plan.

See Annex A for a full list of CAO's compliance findings.

IFC's Management Response to the Investigation

A management response from IFC was released together with the investigation report in October 2017.⁵ In its response, IFC noted that it had strengthened its internal procedures for contextual risk analysis and had taken several actions to advance its framework for managing E&S risks in private equity fund investments and promoting greater transparency. IFC noted the following actions it had taken in recent years:

- In 2015, IFC “made a decision to employ even greater selectivity in its fund selection...new investments in high risk funds are intentionally limited.”
- IFC included in its legal requirements “specific remedies to address E&S non-compliance issues. A fund manager is given opportunities to bring a sub-project back into compliance through remedial plans and actions; if ultimately unsuccessful, the fund is typically required to use all reasonable efforts to dispose of the investment.” IFC also generally has “the right not to fund a capital call for an investment that remained in breach regarding E&S and was not moving into compliance.”
- With regard to disclosure, IFC noted that it publishes the name, sector, and location of every investment of its funds’ subprojects. In 2017, IFC asserted that it fulfilled this commitment.
- IFC developed new E&S procedural requirements to systematically screen projects for contextual risks. These risks are then factored into decision making, categorization, and overall risk management. IFC noted that it is improving its contextual risk analyses, making clear the limitations of private-sector clients to address these risks.
- IFC enhanced its approach to supervise FI clients, including visits from IFC E&S staff to a sample of fund subprojects to assess E&S risks and help fund clients manage them. IFC also offers regular E&S risk management training for clients.

Further, IFC made the following observations on CAO’s compliance report:

- The project was stopped early in the process, and thus, IFC noted that most of the potential E&S impacts discussed in CAO’s report did not materialize.
- IFC noted that the project’s E&S assessment had not been completed. Additional studies, community programs and mitigation measures as part of the project’s ESAP were expected to be completed to ensure compliance with the Performance Standards, had the project progressed.
- IFC’s approach to review a fund’s ESDD, prior to a fund’s investment, is the most rigorous review framework and is considered best practice in the investor community.

Observations from CAO Monitoring (August 2017–July 2019)

This section summarizes investor statements regarding the project, IFC’s supervision, and complainants’ views during the monitoring period.

FMO Statement

Following the release of CAO’s investigation report, FMO announced that it had exited its direct shareholding in HSR as of September 29, 2017. FMO stated:

⁵ IFC. Oct. 2017. Response to CAO Compliance Investigation Report of IFC’s investment in REAL LRIF as related to HSR: <http://bit.ly/RealLRIF-01>.

“After stakeholder engagement to address identified environmental & social (E&S) risks proved unsuccessful, the management of the fund, in coordination with FMO, subsequently made the decision not to proceed with the HSR project, thereby limiting the potential for any future adverse impacts and disruption. As such, the E&S assessment for the HSR project has not been completed and the level of compliance with the IFC Performance Standards cannot be judged entirely by the current outcomes: various additional studies, programs, mitigation measures and independent reviews, in line with the IFC Performance Standards, would have been pursued, had the project progressed.”⁶

IFC’s Supervision

In September 2017, IFC completed a combined review of the Fund’s 2016 AEPR and site supervision report. In preparing this report, IFC conducted a supervision visit to the Fund’s office in New York City, a site visit to a Fund investment in El Salvador.

The objective of IFC’s site supervision visits was to: (a) evaluate the Fund’s ESMS implementation; (b) verify implementation with a site visit of a Fund investment; (c) obtain updated information on the E&S performance of the Fund’s portfolio; and (d) assess the Fund’s general E&S performance.

IFC reviewed the Fund’s ESMS procedures, noting that it details the steps and responsibilities of the Fund during the entire investment cycle. The Fund’s ESDDs are prepared by local and international external consultants based on the requirements of national law and IFC’s Performance Standards. The Fund conducts site visits to all projects, and in some cases, hires an external consultant to monitor project-level E&S action plan implementation.

As part of its site supervision report, IFC visited a Fund project in El Salvador and completed a desk review of a Fund project in Mexico. IFC summarized both projects’ performance (preparation and implementation) with reference to IFC Performance Standards. With regard to the El Salvador project, IFC stated that it verified that the project had an ESMS with staff capacity to implement it. Regarding the Mexico project, based on discussions with the Fund and review of external consultant reports, IFC noted that most ESAP items had been implemented with only minor items outstanding.

IFC’s site supervision report included a summary of the Hidro Santa Rita project from early project development to the status at the time (April 2017), noting that the project remained on hold and that social problems in the Alta Verapaz region continued.

Based on these supervision activities, IFC recommended improvements to the Fund’s ESMS, which included the following:

- Update its ESMS procedures to record the Fund’s approach for conducting project ESDDs and monitoring;
- Implement a system at Fund level to log and respond to external communications (such as complaints about the projects it is funding);
- Complete a monitoring report, at least annually, for the El Salvador investment; and
- Include contextual risk assessments as part of the Fund’s ESDDs and monitoring.

IFC concluded that the Fund’s ESMS and its implementation was satisfactory. The ESRR was upgraded to 2-Satisfactory.

⁶ FMO, 2017, Public Statement on Hidroelectrica Santa Rita, available at <http://bit.ly/2QJNYdW>.

In April 2018, IFC completed its review of the Fund's 2017 AEPR. IFC noted that the Fund had satisfactorily implemented IFC's ESMS recommendations, as outlined above. The ESRR was maintained at 2-Satisfactory.

In July 2019, IFC completed a review of the Fund's 2018 AEPR. IFC's review considered (a) updated E&S performance data; (b) three calls with the Fund's E&S officer; (c) IFC's review and comment on a Fund prepared ESDD; and (d) a review of an ESIA prepared for a prospective Fund investment. Based on available information, IFC concluded that E&S aspects of the Fund were being properly managed.

Neither IFC's site supervision report nor AEPR reviews document IFC action regarding the HSR project. During this CAO monitoring phase, IFC noted to CAO that it met with some representatives from the communities around Santa Rita and that IFC remains open to these types of dialogue.

As of December 2018, the Fund reported to IFC that it owns nearly 100 percent of HSR and that HSR continues to own the land, permits, and certain rights-of-way necessary to construct the project.

Complainant's update

CAO spoke to the complainants and their representatives in the preparation of this monitoring report. The complainants affirm that HSR construction remains halted. They continue to raise concerns about residual project impacts, in particular, project land status and criminalization of opposition leaders. The complainants request that project lands be returned to communities to be administered by the ancestral authorities and that the project be canceled definitively. The complainants do not know if the Fund will seek to proceed with the project. They are concerned about what may happen to the project land if HSR is sold to another project developer. The complainants maintain that community division between those in favor and those opposed to the project continues to this day. They assert that this is as a result of a poor consultation process. The complainants note arrest warrants remain outstanding for project opponents.

Project status

As of September 2018, the Guatemalan Ministry of Energy and Mines lists the HSR project as an authorized hydroelectric project "under construction."⁷

Conclusion

IFC made its investment in the Fund in 2012. Since then, and as acknowledged by CAO in its monitoring reports of its *Audit of a Sample of IFC Investments in Third-Party Financial Intermediaries*,⁸ IFC has strengthened their internal procedures for appraising and supervising financial intermediary investments. Regarding private equity funds, in its response to CAO's investigation report, IFC noted improvements it has made regarding fund selection, disclosure and supervision of fund subprojects, legal requirements for E&S non-compliance, and contextual risk analysis. However, IFC's response did not commit to take any action with its client regarding project level issues raised by the complainants.

⁷ Ministry of Energy and Mines, Autorizaciones definitivas para la instalación de centrales hidroeléctricas otorgadas, September 28, 2018, available at <http://bit.ly/2ERuFuW>.

⁸ CAO compliance audit and monitoring reports of IFC's financial sector investments, available at <http://bit.ly/2HVJTkc>.

Since the finalization of CAO's investigation report, IFC has completed supervision reports documenting IFC visits to the Fund, a Fund investment in El Salvador, and review of the Fund's 2016, 2017, and 2018 AEPRs. On the basis of these supervision activities IFC has determined that the Fund's E&S performance has improved and is now satisfactory.

Since the publication of the CAO investigation report, IFC has not documented engagement with the Fund on the HSR project, or issues related to the impacts of the project as raised in the complaint. In this context, CAO notes that: (a) the complainants continued assertions that residual project impacts remain unaddressed; and (b) the Fund owns a controlling share in the project. While IFC's supervision documentation summarizes the history of the HSR project and the complaint to CAO, IFC has not adequately supervised the Fund to ensure that it has assessed residual project impacts and, as appropriate, minimized, compensated for or otherwise remedied them in accordance with IFC's Sustainability Policy (para. 6) and Performance Standard 1 (paras. 4 & 14).

As neither IFC's response nor supervision activities to date provide assurance that the Fund has assessed and, as appropriate, addressed residual impacts of the HSR project in accordance with IFC's Performance Standards, CAO will keep the investigation open for monitoring and plans to issue a follow-up monitoring report no later than July 2020.

Annex A: Summary of Investigation Findings

CAO FINDINGS

IFC's Pre-investment Review and Risk Mitigation Measures

- IFC appropriately categorized the investment as F11 (high E&S risk) and required the Fund to ensure that projects it supported were operated in accordance with the Performance Standards.
- IFC's E&S review of its investment in the Fund was not commensurate to risk.
- Given the high E&S risk profile of the Fund's prospective investments and the client's limited capacity, the framework which IFC negotiated for review of the Fund's projects limited the ability of the E&S specialist "to determine whether the client's ESMS implementation [was] robust" as required by ESRP 7.2.10.

IFC ESDD Review of HSR Project

- IFC failed to identify shortcomings in the project's E&S assessment compared to good international industry practice and the requirements of the Performance Standards, in particular:
- IFC did not assure itself that the Fund had adequately assessed potential impacts on water and dam safety risk associated with the project particularly given the change in the size of the plant and the dam.
- IFC did not take adequate steps to assure itself that the project met IFC's requirements for consultation and disclosure.
- IFC's review was not sufficient to ensure that the Fund had correctly assessed the application of Performance Standard 7 to the project, in particular the requirement for Free Prior Informed Consent for projects impacting land and natural resources under traditional ownership or customary use.
- IFC did not assure itself that the Fund had adequately assessed potential economic displacement as a result of the project.
- IFC's ESDD review was not sufficient to ensure that the Fund had correctly applied its E&S requirements to the project.

IFC Supervision post-ESDD Review

- IFC's supervision did not provide sufficient evidence to conclude that the Fund was correctly applying IFC's E&S requirements to the project.
- Given the ongoing conflict around the project, and persistent concerns about local impacts, additional supervision was required by IFC, particularly in relation to: (i) the adequacy of additional E&S assessments required by the project ESAP; (ii) the decision not to apply FPIC to the project; and (iii) the client's security management plan.