



June 22, 2015

Office of the Compliance Advisor Ombudsman (CAO)

COMPLIANCE APPRAISAL: SUMMARY OF RESULTS

IFC Investment in Hidromaule, Chile

Project #25568

Complaint 01

Hidromaule S.A. (the “company”) is a hydropower generation company owned by an Italian-Chilean consortium. Hidromaule’s initial project, Lircay, is a 20 Megawatt (MW) run-of-the-river hydropower project located along the Lircay River, approximately 30 kilometers to the northeast of the city of Talca, in Chile’s VII Region. Infrastructure required for the Lircay Project includes a diversion structure on the Maule Norte Bajo canal, a 2,950 meter-long canal to bring the diverted water to a point overlooking the powerhouse, a 520 meter-long steel penstock pipe to the powerhouse, and a powerhouse with two turbine-generator groups with a 9.7 MW capacity each.

The total project cost was estimated at \$23.3 million. The IFC investment consists of a \$6.2 million A Loan for its own account, a \$10 million syndicated B Loan, and a \$3.5 million subordinated C Loan for its own account. IFC’s Board approved the investment in June 2007 and IFC made five disbursements for the project between August 2007 and September 2008.

On October 28, 2014, a local individual filed a complaint with CAO on behalf of himself, his siblings and two cousins (the “complainants”) raising concerns that they had been negatively affected by the company’s land acquisition for the Lircay project. The complainants claim that they were not properly compensated for the value of their land, and that there were irregularities around the land acquisition and environmental permitting processes.

The parcel of land in question belonged to the complainants’ grandparents. There are approximately 120 heirs, and the complainants are part of two family branches. Part of the Lircay project is located on this parcel of land. The complainants claim that they were not paid a fair price for their ownership rights in the land in 2010, and two of them, who did not sell and still claim to own rights in the land, state that a fair price was never offered by the company.

The purpose of a CAO compliance appraisal is to determine if an investigation of IFC’s environmental and social (E&S) performance is required in response to a complaint. In deciding whether to initiate an investigation, CAO weighs factors including the magnitude of the concerns raised in a complaint, results of a preliminary review of IFC’s E&S performance in relation to these issues, and a more general assessment of whether a compliance investigation is the appropriate response.

In this case, it is not apparent, from the information reviewed by CAO, that the land dispute raised in the complaint is indicative of substantial concerns regarding the potential E&S outcomes of the project and/or issues of systemic importance for IFC such that would merit a compliance investigation in accordance with CAO’s Operational Guidelines. CAO has thus decided to close this case at appraisal. In reaching this conclusion, CAO makes no judgment on the merits of any ongoing disputes between the complainants and the IFC client.

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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Acronyms

Acronym	Definition
CAO	Office of the Compliance Advisor Ombudsman (IFC and MIGA)
E&S	Environmental and Social
ESAP	Environmental and Social Action Plan
ESRS	Environmental and Social Review Summary
ESRP	Environmental and Social Review Procedures
IFC	International Finance Corporation
PS	Performance Standards
SPI	Summary of Proposed Investment

I. Overview of the Compliance Appraisal Process

When CAO receives a 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 the CAO compliance function for appraisal and potential investigation.

A compliance appraisal also can be triggered by the CAO vice president, IFC/MIGA management, or the president of the World Bank Group.

The focus of the CAO compliance function is on IFC and MIGA, not their client. This applies to all IFC's business activities, including the real sector, financial markets and advisory. CAO assesses how IFC/MIGA assured itself/themselves of the performance of its 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 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.

To guide the compliance appraisal process, 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, 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 World Bank Group President, and the Board in writing. If a compliance appraisal results from a case transferred from CAO's dispute resolution, 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.

II. Background

Investment

As per IFC's Summary of Proposed Investment¹, Hidromaule S.A. (the "company") is a hydropower generation company owned by an Italian-Chilean consortium. Hidromaule's initial project, Lircay, is a 20 Megawatt (MW) run-of-the-river hydropower project located along the Lircay River, approximately 30 kilometers to the northeast of the city of Talca, in Chile's VII Region. The Lircay hydropower project (the "project") takes advantage of water rights owned by the Canal Maule Association, a long-established irrigation group formed mainly by medium and small scale farmers and with approximately 2,200 shareholders.

According to IFC, the Lircay project is made possible through a surplus of water during wet periods of the year and as a result of topographic relief at a point on the Maule Norte Bajo that overlooks the confluence of the Corel and Lircay rivers. Infrastructure required for the Lircay Project includes a diversion structure on the Maule Norte Bajo canal, a 2,950 meter-long canal to bring the diverted water to a point overlooking the powerhouse, a 520 meter-long steel penstock pipe to the powerhouse, and a powerhouse comprising two turbine-generator groups with a 9.7 MW capacity each.

The total project cost was estimated at \$23.3 million. The IFC investment consists of a \$6.2 million A Loan for its own account, a \$10 million syndicated B Loan, and a \$3.5 million subordinated C Loan for its own account.

IFC's Board approved the investment in June 2007 and IFC made five disbursements for the project between August 2007 and September 2008.

Complaint and CAO Assessment

On October 28, 2014, a local individual filed a complaint with CAO on behalf of himself, his siblings and two cousins (the "complainants") raising concerns that they had been negatively affected by the land acquisition process conducted by the company for the Lircay project. The complainants claim that they were not properly compensated for the value of their land rights, and that there were irregularities around the land acquisition and environmental permitting processes.

The parcel of land in question belonged to the complainants' grandparents. There are approximately 120 heirs, and the complainants are part of two family branches. Part of the Lircay project is located on this parcel of land. The complainants claim that they were not paid a fair price for their ownership rights in the land in 2010, and two of them, who did not sell and still claim to own rights in the land, state that a fair price was never offered by the company.

According to CAO's Assessment Report, the complainants expressed dissatisfaction with the way the land rights acquisition process was carried out by the company particularly given their limited levels of education, literacy, tenuous grasp of legal information and limited negotiating abilities.² They also claimed that there was a lack of information regarding the way the value of the property was assessed and that they were pressured to sell under the threat of lawsuit. On the other hand, the company expressed frustration at what it considered a lack of recognition by the complainants in relation to a long and complex acquisition process it had conducted. The CAO Assessment Report also indicated that the company was confident that a fair price was offered and that the complainants were adequately informed about the acquisition process.

¹ IFC Summary of Proposed Investment, February 2007 - <http://goo.gl/kPDPQ3>

² CAO Assessment report, Hidromaule-01 - <http://goo.gl/jpyPOG>

III. Analysis

This section outlines the IFC E&S policies and procedures as they apply to the project. It then analyses IFC's performance against these standards during preparation and implementation of the project and in the context of the issues raised by the complainants.

IFC Policy Framework

Applicable Policies and Procedures

IFC's investment in the company was made in the context of its 2006 Policy on Social and Environmental Sustainability ("the Sustainability Policy") and Performance Standards (PS), together referred to as the Sustainability Framework. Through the Sustainability Policy, IFC states that it seeks to "ensure that the projects it finances are operated in a manner consistent with the requirements of the Performance Standards" (para. 5).

IFC implements the commitments set out in the Sustainability Policy through its Environmental and Social Review Procedures (ESRP), which are updated periodically. The Hidromaule investment was approved under ESRP version 1.0³ and supervised under the subsequent updated versions of the ESRP.

Performance Standard 5

The requirements for land acquisition around IFC-supported projects are set out in Performance Standard 5: Land Acquisition and Involuntary Resettlement (PS5).

The objectives of PS5 underscore the importance of mitigating "adverse social and economic impacts resulting from land acquisition or restrictions on affected persons' use of land by (i) providing compensation for loss of assets at replacement cost; and (ii) ensuring that resettlement activities are implemented with appropriate disclosure of information, consultation, and the informed participation of those affected."

In relation to the issues raised in the complaint, PS5 states that "clients are encouraged to acquire land rights through negotiated settlements wherever possible, even if they have the legal means to gain access to the land without the seller's consent" (para. 3). However, the requirements of PS5 apply when the buyer can "resort to expropriation if negotiations fail" (para. 1). In this context, PS5 provides that negotiated settlements can be achieved by providing "fair and appropriate compensation" and by "mitigating the risks of asymmetry of information and bargaining power" (*Ibid.*).

PS5 applies to both physical and economic displacement with physical displacement being defined as occurring when "people living in the project area must move to another location" and economic displacement as occurring when "land acquisition for the project causes loss of income or livelihood, regardless of whether or not the affected people are physically displaced" (paras. 16 & 20).

When displacement occurs (either physical or economic) the client is required to offer "compensation for loss of assets at full replacement value and other assistance to help them restore their standards of living" (para. 8). "Standards for compensation" are required to be "transparent" (*Ibid.*). In cases of negotiated settlements covered by PS5, the client will "promptly

³ IFC Environmental and Social Review Procedures, version 1.0, April 30, 2006

compensate economically displaced persons for loss of assets or access to assets at full replacement cost” (para. 20).

In the context of the discussion below, it is important to note that the complainants claim relates exclusively to compensation for ownership rights to an asset (land) and not to physical displacement or impacts on land based livelihoods.

IFC’s Review and Supervision of the Project

When financing a project, IFC first conducts an appraisal aimed at assessing the full business potential, risks and opportunities associated with the investment. Once the project is approved and IFC has invested in a client, the investment is monitored throughout the project cycle to ensure compliance with the conditions in the loan agreement and IFC’s applicable policies and standards. The focus of this CAO compliance appraisal is on IFC’s performance at these two stages in the project cycle as relevant to the issues raised by the complainants, and more specifically, in relation to the application of PS5 requirements.

Requirements

As required by the Sustainability Policy, IFC’s E&S review should be “appropriate to the nature and scale of the project and commensurate with the level of social and environmental risks and impacts” (para. 13). In conducting the E&S review, IFC considers the E&S risks as assessed by the client and “the commitment and capacity of the client” to manage these risks (para. 15). IFC also considers the client’s “track record” in relation to E&S issues.⁴ A central principle of the Sustainability Policy is that “IFC does not finance new business activity that cannot be expected to meet the Performance Standards over a reasonable period of time” (para. 17).

IFC is also required to supervise its client’s E&S performance throughout the life of the investment. As set out in the ESRP, “the purpose of E&S supervision is to develop and retain the information needed to assess the status of compliance with the Performance Standards (PSs) [...] and the Environmental and Social Action Plan (ESAP)”.⁵ A key source of information for project supervision is the client’s annual environmental and social monitoring report (AMR). Where IFC becomes aware of E&S compliance issues IFC will “work with the client to bring it back into compliance to the extent feasible and if the client fails to reestablish compliance, exercise remedies where appropriate” (Sustainability Policy, para. 26).

Project cycle

IFC’s early review of the project identified the land acquisition process as a potential risk. As a result, in January 2006, IFC and the company agreed on an E&S Action Plan (ESAP) which required the company to develop procedures to compensate persons for economic displacement caused by the construction of the transmission line in a manner consistent with the requirements of PS5, and submit these procedures to IFC.⁶

In relation to the land needed for the main project site, IFC’s published pre-investment E&S Review Summary (ESRS),⁷ underscores the importance of the land acquisition process noting that the company’s policy was to acquire land rights through amicable agreements with the landowners, whenever possible. At the same time, IFC observed that the company could resort to expropriation or impose easements through the application of the law in the event that

⁴ ESRP 3, para.3.2.3, version 1, April 2006.

⁵ ESRP 6, para.1, version 5, August 16, 2010.

⁶ CAO notes that the ESAP for this project was not disclosed on IFC’s website as required by IFC’s Access to Information Policy (2006, para. 13).

⁷ IFC Environmental and Social Review Summary, February 2007 - <http://goo.gl/6w9oIq>

negotiations with owners fail. The ESRS states that 92% of the inheritance rights to the land owned by members of the community of heirs had already been purchased by the company. The ESRS also notes that the person who had lived on this land for 25 years and had “material possession” of the property had already sold his inheritance rights to the company, enabling the company to secure possession of the property. Acquisition of the remaining heirs’ rights to the land, it was assumed, would be resolved through ongoing negotiation.

Following Board Approval, legal agreements for the investment were signed in June 2007.⁸ The legal agreements incorporated the requirements for the client to comply with both the Performance Standards and the ESAP. IFC also required the company to provide, through its AMRs, information on the status of its land acquisition program, including evidence that compensation had been provided in accordance with PS5. IFC made five disbursements for the project between August 2007 and September 2008.⁹

Commencing with its first AMR review in 2009 and following each supervision activity thereafter, IFC requested additional information regarding the process and outcomes of the company’s land acquisition process, with a focus on the transmission lines. This information was requested to provide assurance that the land was purchased following good faith negotiations and in compliance with PS5. IFC did not, however, take further action in relation to this issue noting that there was no evidence of no legal cases against the client or other indications to suggest that the land acquisition process resulted in negative outcomes for the landowners.

From the material considered in the course of this compliance appraisal, it appears that IFC was made aware of the specific issues raised by the complainants through a letter sent in June 2014 by a representative of the complainants. Following this letter, IFC contacted its client and the client sent a detailed response to IFC in relation to the issues raised in the letter.

Conclusion

IFC considered the client’s approach to land acquisition as part of its pre-investment E&S review of the project, concluding that its client had or would acquire most of the land required through negotiated agreements. Although land acquisition was not considered a major risk, IFC incorporated requirements based on PS5 in the legal agreements and ESAP for the project. On the basis of the information available, however, CAO is unclear how IFC assured itself that the client’s approach to the acquisition of land through negotiated agreements met the requirements of PS5. The client’s success in reaching negotiated settlements with landowners is, however, cited at multiple points and appears to have given IFC confidence that a fair market price was being offered.

⁸ IFC Summary of Proposed Investment, February 2007 - <http://goo.gl/kPDPQ3>

⁹ *Ibid.*

IV. Decision

The purpose of a CAO compliance appraisal is to determine whether an investigation of IFC's environmental and social performance is required in response to a complaint. In deciding whether to initiate an investigation, CAO weighs factors including the magnitude of the E&S concerns raised in a complaint, results of a preliminary review of IFC's E&S performance in relation to these issues, and a more general assessment of whether a compliance investigation is the appropriate response.

In this case, is not apparent that the land dispute raised in the complaint is indicative of substantial concerns regarding the potential E&S outcomes of the project and/or issues of systemic importance for IFC such that would merit a compliance investigation in accordance with CAO's Operational Guidelines. CAO has thus decided to close this case at appraisal. In reaching this conclusion, CAO makes no judgment on the merits of any ongoing disputes between the complainants and the IFC client.