CERRO DE ORO HYDROELECTRIC PROJECT COMPLIANCE REVIEW

APPRAISAL REPORT

This report documents the compliance appraisal process carried out by OPIC's Office of Accountability (OA) in response to a request it received to conduct a compliance review of the Cerro de Oro Hydroelectric Project. The report is organized as follows:

I. Description of the OA's compliance review process

II. Background on this case

III. Findings on the appraisal criteria

IV. Observations and recommendations

V. Conclusions

I. Compliance Review Process

The compliance review process is one of the OA's two primary functions. Both the OA's compliance review and problem-solving authorities are intended to enhance the environmental and social sustainability of OPIC financing. The OA does not conduct the two processes concurrently, and in this case the OA sequenced problem-solving first because it offered a more direct approach to addressing the requestor's concerns.

In general, a compliance audit examines whether the relevant OPIC policies and procedures in effect at the time that OPIC approved the project were appropriately applied and implemented in its due diligence, approval, and monitoring of the OPIC-supported project. Prior to conducting a full audit, the OA now first performs an appraisal in order to determine if an audit is the most appropriate response to the request. Several considerations inform the OA's appraisal of whether or not the potential benefits to OPIC, the requestors, and the client merit the time and resources involved in conducting a full audit. These include:

- the magnitude of the environmental and social impacts or risks posed by the project,
- the extent to which those risks could be realized as a result of any deficiencies in the implementation of applicable OPIC policies and procedures,
- the extent to which a detailed investigation is needed to identify and correct the underlying causes of these risks,
- the extent to which steps have been taken to remediate any recognized risks and deficiencies related to the project performance, and
- the extent to which a full audit is necessary to yield useful information that would improve the application of OPIC policies to future projects.

The appraisal would be followed by an audit if the OA finds evidence that OPIC's implementation of its policies did not provide adequate protection against harm from the project, if adverse environmental or social outcomes are likely in the future as a result of inadequate implementation, or if the OA did not have adequate information to make these determinations. The appraisal does not result in a formal determination of OPIC's compliance.

The OA Director submits an appraisal report to OPIC's President & CEO explaining the rationale for the decision whether or not to conduct a full compliance audit. The decision to audit will be taken in consultation with the P&CEO; however, the Director has the authority to make the final decision.

Regardless of whether the appraisal report calls for an audit, it may include recommendations relevant to OPIC's future processing of the subject project or of future projects. OPIC management may prepare a response to these recommendations. The OA may then conduct monitoring of the implementation of those recommendations adopted by OPIC.

If the result of the appraisal is to conduct a compliance audit, the OA will

- identify its scope and terms of reference;
- conduct an investigation;
- prepare a draft audit report to be circulated to OPIC management and relevant departments for factual review and comment;
- send final audit report to OPIC's CEO;
- post the report on the OA's website once OPIC's management responds to the report in writing;
- monitor the implementation of any recommendations accepted by OPIC management; and
- close the case.

If the appraisal determines that an audit is not warranted, the OA will close the case.

II. Background on the Case

Description of Project and Sponsor

Latin Power III Investment, LP, an OPIC-supported investment fund (the Fund), sought and received consent for a $17 million investment, $8.5 of which is to be funded by the OPIC guaranty, to finance the development of a small hydroelectric facility (up to 15 MW) in the Municipality of Tuxtepec, Oaxaca state, Mexico. The project is jointly owned by the Fund and a local partner. The Fund is managed by Conduit Capital Partners, LLC located in New York City, and the local partner is Comexhidro S.A. de C.V. located in Mexico City, which together have developed other hydroelectric projects in Mexico. The Fund is responsible for ensuring that the project company and local partner implement OPIC policy requirements in accordance with the OPIC consent for financing. Comexhidro initiated the project well before the involvement of Conduit Capital Partners, in terms of both investment and project design.

The project is directly adjacent to the pre-existing Cerro de Oro Dam and reservoir. This earthen dam has a minimum ecological flow requirement of 35 cubic meters per second, which the project developer intends to exploit by diverting water through an intake tunnel in a rock wall on one side of the dam curtain. The water would pass through turbines, and then be discharged into La Sal Creek which meets up with Santo Domingo River 2 km. downstream. To accomplish this project, the company's original plan required it to construct the intake tunnel, dredge La Sal Creek, clear vegetation for the construction of the transmission lines, and install hydroelectric generators. Other than the transmission line, much of the project's facilities under the original design would be sited on federal land.

A rough chronology of the project is as follows:

December, 2007 – Company initiated consultations with local communities.

June, 2009 -- Company submitted request for OPIC Consent.

March, 2010 – OPIC issued its Consent Letter to the Company.

Fall, 2010 – The company initiated construction activities (which included blasting to create the intake tunnel, removing vegetation along the creek in preparation for it to be channelized, and preparing a canal connecting the channelized creek with the Santa Domingo River).

November, 2010 – Communities file complaint with the OA through the NGO Accountability Counsel.

January, 2011 – The OA initiates a problem-solving dialogue.

February, 2011 -- Project sponsors voluntarily and abruptly suspended all construction activities at the request of the complainants. (As of February, 2012, all construction remains suspended.)

November, 2011 – The OA terminates problem-solving dialogue, without parties reaching agreement.

The social context for the project is complicated by several factors:

1) Cerro de Oro dam was constructed for flood control in the 1980s, and resulted in a reservoir that caused the displacement and relocation of about 26,000 people. The OA was informed of widespread ill-feeling among local affected communities due to their perception of broken promises for compensation by the government.

2) The traditional ejido system, which prevails in the region, confers stronger political rights to landowners (ejiditarios) than non-landowners (avecindados) in local government decisions.

3) One of the communities near the project considers itself indigenous.

4) The state of Oaxaca has a history of political turbulence and citizen activism.

5) The OA was informed of general distrust of public institutions and external private investment.

6) Formal communication channels seem weak, allowing rumors to easily spread.

7) In the fall, 2010, elections resulted in a change in political leadership at the community, municipal, and state levels.

<u>OPIC policy requirements</u>

In general, OPIC's environmental and social requirements for proposed projects are based on those policies in effect on the date of the client's application for OPIC's consent. On the date of the application for the Cerro project, 6-30-09, OPIC formally relied on its 2004 Environmental Handbook to determine the client's environmental and social requirements. Although OPIC also used the 2006 Performance Standards of the International Finance Corporation (IFC) to inform its appraisal of the project, it did not at the time have the formal authority to require OPIC's clients to comply with them.

According to OPIC's Initial Project Summary, the following international standards are applicable to the project:

- International Finance Corporation's (IFC) Performance Standards (April 2006):

1 (Social and Environmental Assessment and Management Systems),

2 (Labor and Working Conditions) the Occupational Health and Safety section,

3 (Pollution Prevention and Abatement),

4 (Community Health, Safety and Security),

5 (Land Acquisition and Involuntary Resettlement), and

6 (Biodiversity Conservation and Sustainable Resource Management).

- The IFC's General Environmental, Health, and Safety Guidelines (April 2007).
- The IFC's Environmental, Health, and Safety Guidelines for Electric Power Transmission and Distribution.

Once OPIC identifies applicable policy standards, it notifies clients of their corresponding obligations, including associated studies and reporting requirements, as a condition of receiving OPIC financing. In this case, despite OPIC's lack of formal authority at the time to enforce the IFC Performance Standards, OPIC notified the client that it needs to comply with PS 1, 2, 3, 4, and 6. OPIC also notified the client that a 3rd party assessment of dam safety is to be provided to OPIC by the end of the year following completion of construction.

At the same time, OPIC did not require the client to take actions to comply with PS 5 (land acquisition and involuntary resettlement), PS 7 (indigenous peoples), and PS 8 (cultural heritage). According to OPIC's Office of Investment Policy (OIP), OPIC did not include PS 5 because voluntary land acquisition negotiations had been completed by the time OPIC gave its consent for financing. PS 7 and PS 8 were not included because OPIC concluded that there would be no adverse impacts on indigenous populations or cultural resources. The Initial Project Summary states that "Based on the information currently available, no indigenous people and cultural heritage sites near the project have been identified."

Request for compliance review

The initial November 30, 2010, request for both problem-solving and compliance review came to the OA from the communities of Santa Ursula and Paso Canoa through the NGO Accountability Counsel. Subsequently, OA received a request from the community of Cerro de Oro and duly added that community to the complainants. Accountability Counsel also sent a letter to OPIC CEO Elizabeth Littlefield requesting that she use her authority to add unidentified (because of concerns about repercussions) members of the community of Los Reyes to those requesting a compliance review. (The community of Los Reyes was subsequently accepted by the other parties to join the problem-solving process. As a matter of practice, the OA considers confidential but not anonymous requests to be eligible for compliance review and problem solving services.)

The OA sequenced problem-solving first and deferred a decision on whether/when to initiate compliance review until the outcome of problem-solving became clear. On November 14, 2011, the OA closed out the problem-solving phase after having concluded that continuing to support it further was unlikely to lead to a resolution of the dispute. Shortly thereafter, the OA initiated an appraisal for compliance review. (Further information on the problem-solving phase of this case can be found on the OA's webpage.)

The range of allegations of non-compliance in the request is broad and tends to focus on deficiencies in the project itself, as OPIC's actions must largely be inferred by requestors. Most of the alleged

deficiencies relate to the client's non-compliance with IFC Performance Standards. The allegations are as follows:

Performance Standard 1 -- Social and Environmental Assessment and Management Systems

- Inadequate disclosure of project information – environmental and health impacts
- Insufficient consultations with project affected people
- Inadequate identification of adverse social and environmental impacts
- Inadequate compensation for land acquisition and livelihood impacts
- Overstatement of project benefits; failure to fulfill promises to undertake community development projects
- Inadequate and ineffective grievance mechanism

Performance Standard 2 – Labor and Working Conditions

- Overstatement of project benefits; failure to fulfill promises to undertake community development projects

Performance Standard 3 – Pollution Prevention and Abatement

- Inadequate identification of adverse social and environmental impacts
- Inadequate waste disposal mechanism

Performance Standard 4 – Community Health, Safety and Security

- Inadequate identification of adverse social and environmental impacts
- Water resources affected

Performance Standard 5 – Land Acquisition and Involuntary resettlement

- Failure to comply with Mexican national and local laws related to land acquisition and environmental impacts
- Bad faith negotiations and inadequate compensation for land acquisition
- Lack of compensation for loss of livelihood, loss of fishing opportunities

Performance Standard 6 – Biodiversity Conservation and Sustainable Natural Resource Management

- Inadequate identification of adverse social and environmental impacts
- Threat to biodiversity, including impacts on local bird sanctuary

Performance Standard 7 – Indigenous Peoples

- Inadequate disclosure of project information – environmental and health impacts
- Insufficient consultations with project affected people
- Inadequate compensation for land acquisition and livelihood impacts
- Non-compliance with the indigenous peoples requirements

Performance Standard 8 – Cultural Heritage

- Impacts on La Sal Creek, which is considered a cultural resource in the complaint

In addition to the IFC Performance Standards, the request alleges non-compliance with aspects of Mexican law: 1) minimum notification period and quorum requirements for public consultations under

Mexican Agrarian Law, and 2) Mexico's treaty obligations under ILO Convention 189 and the UN Declaration on the Rights of Indigenous Peoples.

III. Evaluation of appraisal criteria

In conducting this appraisal, OA applied the five aforementioned criteria to the available information:

- Magnitude of potential impacts from project
- Sensitivity of actual impacts to OPIC's policy implementation
- Need for audit to identify and correct causes of risk
- Efforts to date to mitigate risk
- Need for audit to develop systemic recommendations

The OA has informed the parties to this case of these appraisal criteria. To support the appraisal, the OA reviewed various documents, conducted several meetings with OPIC staff in the Office of Investment Policy (OIP) which is responsible for administering OPIC policies, and drew extensively from information generated from the problem-solving phase of the case.

<u>What is the magnitude of potential environmental and social impacts or risks posed by the project?</u>

This project was classified by OPIC as Category A because it could have impacts that are diverse and irreversible. According to the project's Initial Project Summary, "the main environmental concerns are related to impacts from constructing the intake tunnel, the tailrace channel, and the associated transmission line. The intake tunnel will be constructed with the use of explosives and is in close proximity to the existing dam. The project is also located in an area of high seismic activity as well as subject to major floods and landslides associated with hurricanes. While these conditions are not prohibitive, they do pose engineering challenges and require evaluation and attention to issues of dam stability. Additionally, the discharge of water to the Santo Domino River requires the dredging of the existing Arroyo Sal Creek. The associated environmental impacts associated with this dredging and construction of the transmission line will be closely evaluated."

Besides the risk to public safety if the dam were to fail, the original design of this project would have irreversibly altered La Sal Creek, which is used mainly for recreation and livestock watering. It also could have posed a potential risk to La Sal spring, which provides drinking water to two communities.

Although not determinative of whether an audit is warranted, the OA notes that the magnitude of impacts from Category A projects varies widely. This project's potential impacts are modest in scale relative to those posed by the two other Category A projects for which the OA has previously conducted compliance audits, namely, a large mining project in Bolivia and an oil and gas pipeline traversing three countries -- Azerbaijan, Georgia, and Turkey. The Cerro project is also relatively small among other hydroelectric facilities that have received international financing and unlike many of them, does not require creating a new impoundment.

<u>What is the likelihood that environmental or social risks would be realized as a result of any deficiencies in how OPIC implemented applicable policies and procedures?</u>

With this criterion, the OA evaluates how sensitive the realization of potential environmental and social risks would be to possible deficiencies in how OPIC implemented its policies. Since the complaint referenced all eight IFC performance Standards, this section is organized accordingly.

PS 1 (social and environmental assessment and management systems)

The OA focused on two aspects of PS 1 – the analysis of project alternatives and community consultation. According to PS1, more detailed environmental and social assessment and more careful community consultations are normally required for Category A projects than for projects assigned other environmental assessment categories.[1]

The OA interprets the text of PS1to require that an examination of the technical and financial feasibility of alternatives to the proposed project be prepared for all projects that have potentially significant impacts that are diverse, irreversible or unprecedented. By definition, this covers all Category A projects, except projects where no alternatives exist. The results of this examination and the rationale for choosing the proposed project should be included in the ESIA. This interpretation is consistent with the OA's understanding of international good practice.

In this case, the client prepared an Environmental and Social Impact Assessment (ESIA) and submitted it to the Mexican authorities prior to OPIC's involvement with the project. The ESIA does not contain the results of an examination of alternatives. The OA was told that an alternative design had been evaluated early on, but was ultimately rejected for technical reasons. Once OPIC became involved, it did not require the client to supplement the ESIA with an examination of the technical and financial feasibility of alternatives to the original design. Early in OA's problem-solving process, the complainants stated that avoiding La Sal Creek was a priority to them. In response, the company developed a new design that avoids La Sal creek (but requires digging a new channel from where the conduction tunnel to where the water re-enters the Santa Domingo River). According to the company, this new alternative is technically and financially feasible (albeit with a higher cost), and the company has committed to implementing it if the project proceeds.

OPIC's implementation of PS1 up to this point would not cause the risk to La Sal Creek to be realized because the company has committed to the alternative design. Moreover, even if OPIC had required a feasibility study of generic alternatives to supplement the ESIA, the concerns about the creek had not yet been expressed through the complaint[2]. *With respect to systemic implications of the OA's interpretation of PS1, however, the OA believes that OPIC needs to strengthen and clarify its requirements for when feasibility studies of alternatives are reflected in ESIAs.* (See Section IV)

With respect to public consultations, these consultations occurred over the period December 9, 2007 to June 27, 2009. Based on Mexican agrarian law and the company's determination of affected communities, the consultations were targeted to landowners in those communities which have communally and/or individually-owned land parcels that intersect with or are directly adjacent to project infrastructure (Los Reyes, San Rafael, Sebastopol, and Santa Ursula). When a formal agreement was reached between the company and the community, the Procuraduria Agraria was present to record it. The consultations in these communities were targeted to landowners, although non-landowners constitute a majority in some of them. Two other nearby communities whose members use the creek or river (Paso

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[1] According to PS 1 "Projects with potential significant adverse impacts that are diverse, irreversible, or unprecedented will have comprehensive social and environmental impact assessments. This assessment will include an examination of technically and financially feasible alternatives to the source of such impacts, and documentation of the rationale for selecting the particular course of action proposed."

[2] Once the company settled on locating this infrastructure on the right margin of the dam, it negotiated contracts with land owners along the La Sal Creek to use the creek as the outflow channel. The company's process of negotiations with land owners for the right to use the creek did not stimulate expressions of opposition to the company's plans. Although the OA cannot determine if such concerns were present at that time, local concerns were expressed about other issues -- the impacts of the project on livestock watering in the creek and the spring.

Canoa and Cerro de Oro) were not included in the consultations. According to OPIC, the consultations did not apparently surface concerns about dam safety, impacts on the creek, or other concerns that subsequently emerged during the OA-convened dialogue. When the OA first visited the area in January, 2011, it found a lack of understanding or misunderstanding about the project among some community members.

During the problem-solving phase, the OA learned that the communities of Paso Canoa and Cerro de Oro believe that they could be affected by the project due to its perceived impacts on water resources. The OA's understanding is that OPIC was not aware that the communities of Paso Canoa and Cerro de Oro feel left out of the original consultations. Moreover, OPIC was not aware that members of the Los Reyes and Santa Ursula communities who do not own land were not included in the consultations. Beyond questions about the consultations' inclusiveness, the OA notes the contrast between the apparent absence of concerns about the project expressed during consultations and the vehement wide-ranging concerns subsequently expressed by the community of Santa Ursula.

As these consultations occurred prior to OPIC's involvement with the project, OPIC could not monitor them, much less affect their scope or quality. OPIC relied on ex post client-provided information to confirm that the consultations were conducted in a manner adequate to meet the standard of "free, prior, and informed" consultation. The OA is not aware of other actions taken by OPIC regarding the consultations.

The OA does not believe that an audit would yield further useful information about OPIC actions that were or were not taken to bring about this project's compliance with consultation requirements. *For future projects, the OA has a systemic recommendation* (See Section IV).

PS 2 (the occupational health and safety portions of labor and working conditions)

The complaint includes allegations about project benefits that are addressed below in the discussion under PS5. The complaint did not allege violations of workers' rights.

PS 3 (pollution prevention and abatement)

In this project, water, air, and land pollution could potentially result from project construction activities, which had not begun when OPIC issued its Consent. The OA notes evidence that these risks are addressed by OPIC through the reference to PS 3 in the Consent, OPIC's communications with the client on dredging La Sal creek, and relevant requirements in the client's environmental program.

PS 4 (community health, safety, and security)

The primary risk to community security has to do with the continued safety of the pre-existing dam. The OA judges the likelihood to be low that these risks could be realized as a result of deficiencies in OPIC's application of policy. There are several reasons for this:

- The project's approvals from Mexican authorities were accompanied by design and construction requirements to protect the dam. The protocol for the use of explosives is tightly controlled by Mexican authorities, and can occur only under the supervision of the Mexican military.

- The pre-existing dam is under the authority of the Mexican water ministry, CONAGUA, which has both a strong incentive and the technical expertise to protect the dam's integrity.

- Prior to the OA's involvement, the company had commissioned a report from the Institute of Engineering of the University of Mexico which concluded that the Cerro de Oro dam is safe.

- For the problem-solving phase of this case, an independent dam safety expert was commissioned to study the dam and the potential impacts of project construction on its security. Both parties agreed to the selection of this consultant out of a slate of four candidates presented to them by the OA. The expert concluded that, as long as the company followed the blasting protocol allowed in its permit, there would be no risk to the dam's safety.

- Each detonation that occurred during construction was seismically monitored and recorded by the company. Readings taken when detonations for the conduction tunnel occurred in the latter part of 2010 indicate that the shock waves produced were well within velocity limits allowed in the construction permit. The State of Oaxaca also maintains a local seismic monitoring station, which did not register waves from the detonations.

The primary risk to community health relates to drinking water quality and availability. The OA finds that the future risk to the communities' continued access to water resources (La Sal Creek and the spring) is insensitive to possible deficiencies in how OPIC applied its policies. This is because the company changed the project's design as a result of the problem-solving process to ameliorate community concerns about water resources. If the project becomes re-activated, the company said that it would implement this new design.

PS 5 (land acquisition and involuntary resettlement)

PS 5 applies when there is resettlement, or when either land acquisition is involuntary or land acquisition is negotiated but could revert to an involuntary approach if negotiations were to fail. The complaint alleges that compensation paid was inadequate, especially with respect to compensation for impacts on community resources which the complaint argues affect non-landowners disproportionately. For this project, no resettlement is needed, and voluntary land negotiations were largely completed by the time OPIC issued its Consent. During the problem-solving phase, however, the company offered to establish a community development fund that would be capitalized throughout the construction and operation phases of the project.

The OA does not take a position on the adequacy of compensation, either paid to date or promised for the future. The appraisal has not uncovered evidence that OPIC examined the negotiation process leading to compensation paid to individuals or compensation paid for impacts on community resources. Also, OPIC is unsure whether a failure of negotiations could have ultimately led to subsequent expropriation (thus triggering PS 5). OPIC's approach to examining legacy community consultations is relevant to the compensation issue, since those consultations did not include non-landowners, who have a stake in the project's impacts on community resources.

The OA does not believe that an audit would yield additional information needed to address the adequacy of legacy compensation because of the two possibilities for the project's future. If the project is not re-activated, no land will be needed for it, and the adequacy of legacy payments becomes moot. If the project is completed, it will use a new design. Under this scenario, some compensation contracts will need to be re-visited because different land parcels will be affected. Also, if the project proceeds, a community development fund will be established with the participation of local communities. If the project proceeds, the OA encourages OPIC to monitor future compensation protocols. (See Section IV)

PS 6 (biodiversity conservation and sustainable natural resource management)

The OA finds that risks to biodiversity are unlikely to be sensitive to deficiencies in OPIC's compliance with PS 6 because:

- The Environmental and Social Management Plan includes provisions for aquatic and terrestrial biodiversity monitoring and mitigation measures.

- OPIC's requirements include water level and quality monitoring, biodiversity monitoring, and specific requirements to reduce potential impacts on local avian and bat populations.

PS 7 (indigenous people)

Information obtained during the problem-solving phase allowed the OA to determine that harm to indigenous people is unlikely to be realized, despite the absence of a reference to PS 7 in the Initial Project Summary. At the same time, the OA disagrees with the Initial Project Summary that no indigenous people near the project have been identified.

Among the complainants, the community of Cerro de Oro self-identifies as an indigenous community. For this community, the OA observed the following:

- This community is located near the project, but the project's likely effects on it during construction and operation are marginal.

- During meetings with the community, members spoke an indigenous language (Chinanteco) among themselves but understood presentations in Spanish. Their understanding of Spanish reduces the potential for miscommunication due to their indigenous status.

- The concerns and doubts that the Cerro de Oro community expressed in the complaint addendum and to the OA about the project are similar to those expressed by other communities that the OA visited, and do not appear related to its indigenous characteristic.

Regardless of whether PS 7 is applicable to this project, information that indigenous people are present in the area could have been used to expand the scope of community consultations. The combination of the Cerro de Oro community's proximity to the project and its indigenous characteristic suggest that OPIC might have required the client to make sure that this community at least understood the project. Under the problem-solving phase, the client did visit this community to explain the project.

PS 8 (cultural heritage)

The complaint treats La Sal Creek as a cultural resource. The OA does not take a position on whether the Creek is a cultural resource under PS8, and addresses OPIC's role with respect to La Sal Creek elsewhere in this report. The project's environmental documentation does not mention the presence of other cultural resources. Nor did the OA receive any indication during the problem-solving phase that resources that fall more clearly under the definition of cultural resources in PS 8 are at risk from project activities.

<u>To what extent is a detailed investigation needed to identify and correct the underlying causes of major environmental and social risks?</u>

There are two reasons why an audit is not necessary to identify and correct underlying causes of major risks (dam failure and loss of access to water resources). First, as discussed above, information provided to the OA by OIP and by the project sponsor, combined with information obtained during the problem-solving phase, is adequate for the OA to have identified the underlying causes (the proximity of construction activities to the dam curtain and the spring, the pre-project condition of the dam, and the canalization of La Sal Creek). Second, some actions have already been taken to mitigate risks. Since the request for compliance review was filed:

- The company has agreed to redesign the project away from La Sal Creek and the spring.

- Mexican authorities' have recognized the need for strengthened monitoring to ensure that construction activities follow the protocol allowed under the permits. In particular, CONAGUA has committed to strengthening its capacity to monitor the condition of its dam, including the re-activation of some of its instruments.

Also, OPIC has required that a 3rd party assessment of dam safety be provided to OPIC by the end of the year following completion of construction.

What steps have been taken to remediate any recognized risks and impacts?

Well before the complaint was received, OPIC had clearly recognized that project construction could pose a possible risk to the dam. This recognition is evidenced by language in the Initial Project Summary, OPIC's 2-26-10 clearance, and by requiring the company to submit a third party assessment of dam safety after completing construction. OPIC was not apparently aware in 2010, however, that much of the originally-installed instrumentation in the dam was no longer operational.

In November, 2010, OPIC conducted a site monitoring visit, and in mid-December, 2010, transmitted a list of supplemental actions to be taken by the company. OPIC's communication indicated that it was aware of other issues needing company attention; for example, strengthening and operationalizing the company's grievance mechanism and public communications. These mechanisms were not operational prior to when construction began in the fall of 2010, and they were not yet fully operational when the OA visited the site in January, 2011. For example, although a community liaison office nominally existed in Tuxtepec, it was also the home of a community liaison officer and community members expressed reluctance to use it for that reason.

On February 22, 2011, all project construction was voluntarily and indefinitely suspended by the company as a goodwill measure to build trust with the communities. Therefore, OPIC also suspended its engagement with the company on environmental and social management action items, pending resolution of the project's future. Because construction stopped abruptly, the company has since gone back at the request of the Los Reyes community to stabilize the worksite and prevent erosion. As of February, 2012, construction is still suspended; consequently, there is no time-sensitivity to addressing construction related impacts for which an audit might otherwise be needed. The construction suspension and processes required for receiving approvals for the new design should allow ample opportunity for OPIC, the client, and Mexican authorities to address any residual issues if the company decides to reactivate the project. The OA believes that OPIC needs to conduct sufficiently frequent monitoring to confirm the implementation of required time-sensitive actions (See Section IV).

Is conducting a full audit necessary in order to inform recommendations for strengthening the application of OPIC policies to future projects?

A formal finding on each allegation of non-compliance made in the complaint is not necessary for the OA to make systemic recommendations. The OA reaches this conclusion for the following reasons:

- Combining the information previously gleaned from the problem-solving process and that obtained explicitly for this appraisal, the OA is sufficiently well informed to develop systemic recommendations for strengthening the future application of OPIC's environmental and social policies.

- The OA acknowledges that systemic recommendations more typically emerge from cumulatively similar observations gleaned from multiple cases than from a single case. This would be true for a full audit as well.

- The need to remedy some deficiencies is obviated by changes since OPIC's due diligence on this project. OPIC's 2010 Environmental and Social Policy Statement (ESPS) is stronger and more comprehensive than the set of policies that are in effect for this project and is to be accompanied by a new procedures manual that clarifies how the ESPS is to be implemented.

- The OA will track how OPIC addresses the recommendations below from this appraisal.

IV. Observations and Recommendations

In order to maximize the potential for institutional learning, the OA has developed the following observations and recommendations on several issues that surfaced during this appraisal. They should not be interpreted as correcting non-compliances with OPIC policies, but may have potential implications for different procedures and requirements across the OPIC project cycle.

Social context for projects

Observation: As early as its January, 2011, site visit, the OA became aware of the social conditions that the project faced, as described in Section II. The OA did not find evidence that OPIC was aware of how challenging these factors, in the aggregate, made the local investment environment despite its due diligence on the client's compliance with applicable standards. Information normally provided to OPIC by U.S. embassies on a host country's human rights status at the national level may not adequately capture investment-relevant dimensions of the sub-national (state or local) social and political context.

Recommendation: OA encourages OPIC to: 1) review its project screening and categorization procedures to better identify elevated risks associated with a project's social context, and 2) strengthen its social review procedures for mitigating these risks through required elements of clients' social management action plans. It may be possible to cost effectively generate sub-regional contextual information, such as through more targeted guidance to OPIC's information center and requests to U.S. embassies. When elevated risks warrant special consideration, OPIC should encourage clients to incorporate measures to address the risks via project action plans.

Client capacity to address social risks

Observation: As discussed earlier, the local social context includes several factors that in the aggregate would appear to elevate the level of risk facing the project. The above recommendation notwithstanding, it is not realistic that emerging conflicts around projects can always be predicted by OPIC or its clients. The OA understands that OPIC seeks evidence of client capacity to manage environmental and social risks. However, OPIC did not appear to calibrate, to the level of social risk associated with this project, its efforts to ascertain the capacity of Conduit and Comexhidro to manage relations with local communities and to invest in social capital.

Recommendation: The OA understands that, for OPIC-supported funds that invest in Category A projects, OPIC now requires fund managers to appoint a qualified environmental and social expert to assist in implementing OPIC's environmental and social policy requirements. The OA encourages OPIC to require such individuals to have explicit community development and social analysis expertise and experience. When a Category A project is an investment fund subproject, the OA encourages OPIC's due diligence to

include evaluating the organizational and technical capacities of the portfolio company and the local partner to effectively address community questions and concerns through staffing and external consultants.

Analysis of project alternatives

Observation: The design of the Cerro project as presented to OPIC would have transformed a 2 km. creek into a canal. An expressed desire for the company to consider alternatives did not apparently arise during community consultations and in decisions about the scope of the ESIA. By the time OPIC began its due diligence, an ESIA had already been prepared to comply with Mexican legal requirements. OPIC did not require evidence that analysis of project alternatives had been considered. When the OA dialogue process called for it, a new design alternative that avoids impacting the creek was analyzed and publicly presented. According to the company, the new design is technically and financially viable, albeit at a significantly higher capital cost than the original.

Recommendation: The OA encourages OPIC to clarify its interpretation of PS1 with respect to Category A projects. According to the OA's interpretation of PS1 and of international good practice, the results of an analysis of the technical and financial feasibility of alternatives should be included in the ESIA of Category A projects. When OPIC is presented with a previously prepared ESIA of a Category A project that does not include evidence of such an analysis, the ESIA should be supplemented with written documentation of what alternatives were analyzed, how they were compared, and the reasons for selecting the preferred alternative. Although OPIC may wish to specify conditions in which exceptions would be made to this requirement, the default presumption should be to require such documentation, regardless of host country requirements.

Clarification of applicable standards

Observation: The year preceding and the year following the date of submission of the project's application for consent, June 25, 2009, represented a period of policy flux at OPIC. Although OPIC did not have formal authority to compel compliance with IFC performance standards, the client asserted that the project would be in compliance with them and OPIC required the client to conform with those that it felt were applicable. This situation might have contributed to a lack of clarity among external stakeholders about applicable standards.

OPIC has now adopted all of the IFC performance standards and specifies in project summary documents which subset of them it deems to constitute minimum requirements for each project. These summaries are posted on OPIC's public website. Therefore, a lack of clarity about applicable standards is less likely to occur in the future.

Time-sensitive actions

Observation: As part of its Environmental and Social Management Plan, the client was required to establish a community communication strategy and a grievance mechanism. OPIC's 12-10 comments to the client included reminders on these items, given that construction had begun by then. The timing of these actions is important since community questions and concerns about a project may be latent until construction actually commences. During its January, 2011, site visit, the OA observed thatthere did not appear to be effective communication between the communities and the client, and local concerns about construction impacts were escalating.

Recommendation: In order for grievance mechanisms and communication strategies to serve their intended purpose, they need to be well-designed, fully operational, and publicized to stakeholders at the right time. While receiving written plans for and client reports on these actions is important, the OA encourages OPIC to strengthen its site monitoring such that it can determine whether the functionality of

these measures on the ground matches the client's written plans and strategies, especially at sensitive phases of the project cycle. OPIC needs to retain the leverage to expedite remedial measures whenever it detects deficiencies in the design or implementation of any time-sensitive actions.

Legacy consultation and compensation issues

Observation: The information available to the OA indicates that community meetings conducted to discuss the project did not include two communities that subsequently expressed concerns about it – Paso Canoa and Cerro de Oro. Also, the meetings were not required by agrarian law to include non-landowners. Consultations about the project were conducted prior to OPIC's involvement with it. This timing situation precluded OPIC's ability to monitor or influence who was invited, the scope of issues discussed, and the quality of the consultations. The OA is not aware of a record of expressed concerns that could otherwise have flagged environmental or social issues for mitigation or compensation measures to be considered.

Recommendation: If the Cerro project is re-activated, the OA encourages OPIC to monitor whatever compensation negotiations need to be conducted in order to accommodate land requirements and other impacts associated with the new project design.

With respect to future Category A projects for which disclosure and consultation processes occurred before or outside of OPIC's involvement, the OA encourages OPIC to review relevant procedures so that it is able to confirm that some basic objectives of consultation were achieved, consistent with PS1. These include: 1) the range of invited participants was appropriate; 2) affected communities understand the project; and 3) community members had ample opportunity to provide input into the ESIA process and to have their questions and concerns about the project addressed. OPIC's procedures should provide for remedial measures to fill any gaps it identifies in legacy consultation procedures.

Regarding legacy compensation negotiations where expropriation can be invoked, OPIC should have the ability to confirm that the objectives of PS 5 had been met. In legacy compensation situations even where PS 5 is not relevant, it is particularly important for OPIC to confirm the existence of an effectively designed and operating grievance mechanism.

V. Conclusions

The key findings from this appraisal are as follows:

- Given the project design on which OPIC's due diligence was based, the environmental and social impacts and risks posed by the project were potentially significant, consistent with its Category A assignment. Since then, impacts and risks have been lessened by the generation of new information about dam safety and by the adoption of a new project design.

- Even if an audit were to identify deficiencies in how OPIC applied its policies up to this point, potential future impacts and risks from the project would be attenuated because the problem-solving process resulted in: 1) focused attention of relevant federal regulatory authorities on the project; 2) engagement of Oaxaca state government with local communities, which has stated that it will not impose the project against their will; 3) improved communication and coordination among the affected communities; and 4) sensitivity by the company in how local concerns are addressed.

- The OA's appraisal process has generated sufficient information to identify and correct the underlying causes of key impacts and risks. The appraisal process also found that OPIC had already recognized most of these causes, an important exception being the apparent lack of awareness of local objections to dredging La Sal Creek. Now that a technically and financially feasible alternative has been brought forward, however, an audit would not further improve potential outcomes in this regard.

- OPIC has previously identified aspects of environmental and social management to be strengthened; further measures can be pursued if and when the project is re-activated by the client.

- The OA was able to access information during the dialogue process and from the appraisal that is sufficient for it to have developed the systemic recommendations in Section IV. The OA believes these systemic recommendations warrant careful consideration by OPIC management, recognizing that they are based on observations from this single case.

- The OA finds that OPIC was previously aware of most issues subsequently raised in the complaint that relate to compliance with OPIC policies then in effect, and that OPIC had identified the need for several mitigating measures. OPIC also took a precautionary approach by assigning a Category A to the project and by invoking international standards that it currently follows, but that were not then under its formal authority.

- The suspension of construction and uncertainty as to whether the company will choose to re-activate the project further weakens the rationale for conducting an audit as a vehicle to address outstanding issues.

Based on its evaluation of the appraisal criteria and its generation of several recommendations, the OA finds that conducting a full compliance audit would yield little additional value to the requestors, OPIC, or the client beyond what this appraisal has already identified. For all the above reasons, the OA has determined that a full audit is not appropriate and hereby closes the compliance phase of this case.