

OFFICE MEMORANDUM

DATE: June 17, 1998

TO: Alvaro Umaña Quesada, Chairman, IPN
FROM: James D. Wolfensohn, President, EXC

EXTENSION: 85120

SUBJECT: **LESOTHO: Lesotho Highlands Water Project (Phase 1B)**
Management Response to Request for Inspection

1. Reference is made to the Memorandum, dated May 15, 1998, to the President of International Bank for Reconstruction and Development (the Bank), by which the Chairman of the Inspection Panel requested the Bank Management to provide the Panel with written evidence that it has complied, or intends to comply, with the relevant policies and procedures in the implementation of the Project referenced above.
2. While the Panel requests the Bank Management's response on the merits of the Request, it is the view of Bank Management that the Request does not meet all the eligibility requirements set forth in Resolution No. IDA 93-10, dated September 22, 1993, as clarified by the Executive Directors on October 17, 1996.

Eligibility of Requesters

3. In accordance with paragraph 12 of the Resolution, the Panel shall receive requests from an affected party in the territory of the borrower who is not a single individual (i.e. a community of persons such as an organization, association, society or other grouping of individuals), or by the local representative of such party. Any such representative must present written evidence to the Panel that he is acting as agent of the party on the behalf of which the request is made. It is the view of the Bank Management on the basis of the reasons specified below, that the Requesters do not meet these requirements.
4. According to the Request, the Requesters are individual residents of Alexandra, a community located in the territory of the Republic of South Africa (hereafter referred to as South Africa). The Requesters have indicated to the Panel that they intended to remain anonymous. It is the Bank Management's view that the Requesters do not meet the eligibility requirements because: (a) the Requesters are not "in the territory of the Borrower," and (b) the Project referenced is not located in South Africa.
5. Indeed, the Project for which Bank financing has been requested by the Lesotho Highlands Development Authority (hereafter referred to as the Borrower) with the full backing and guarantee from the Kingdom of Lesotho (hereafter referred to as Lesotho) is exclusively located within the territory of Lesotho.
6. On the other hand, South Africa, a surrounding neighbor of Lesotho, is chronically short of water. To secure for itself a steady and reliable supply of fresh water for its projected needs over the medium and long term, South Africa has entered into a treaty with Lesotho, dated October 24, 1986 (hereinafter referred to as the Treaty) for the purposes of capturing the untapped water resources of Lesotho and channeling them into South Africa's Gauteng industrial region

which, as of the mid-1980's suffered from severe water shortages. As a result of the Treaty, South Africa has committed itself to purchase the water produced in Lesotho. Pursuant to the terms of the Treaty, South Africa has undertaken to support the proposed Project *inter alia* by providing its guarantee to all the lenders, including the Bank, which have agreed to finance the proposed Project, after a careful consideration of its merits. Hence, any connection that South Africa may have with the Project relates to its financial obligations as a guarantor of the Bank Loan, and as the purchaser of the water exported from Lesotho.

7. While the Requesters have stated in paragraph 1.1 of the Request that they "are individual affected community residents of Alexandra" and argue in paragraph 1.3 of the Request that the Alexandra community has resolved "to file the claim anonymously", the Bank Management would like to point out that the Requesters have not presented any written evidence that the Alexandra community has designated them as their representatives; thus, they are acting in their own capacity as individuals and are not qualified to act neither on the behalf of communities in Lesotho nor of the Alexandra township in South Africa as it is claimed in the Request. To the contrary, the Bank Management has received a detailed communication from the elected leaders of two civic associations from the Alexandra and Soweto townships voicing their full support for the Project. Similar correspondence has been received from the Lesotho Council of NGOs, which is also supporting the proposed Project. Copies of these documents are attached hereto as Annex 1.

8. The Requesters appear not to have taken any steps to bring the allegations to attention of the Bank Management. While some of the allegations made have been discussed between Bank staff and the representatives of certain NGOs' and of the Alexandra and Soweto townships, the Requesters have, however, failed to establish that they have at any time brought their complaints to the Bank Management for consideration as required under the Resolution. Indeed, those elected representatives of the civic associations of Alexandra and Soweto, with whom the South African government, the Borrower and the Bank staff have had discussions on these issues, have indicated in writing to the Bank and to the Inspection Panel that they support the Project (see Annex 1).

9. Since the Bank Management is of the opinion that the Request does not meet the eligibility requirements set forth under the Resolution, it concludes that the Panel should not recommend to the Executive Director that an investigation be carried out

10. However, for information purposes, the Bank Management wishes to submit an explanation of the actions taken by the Borrower and the Bank during the preparation of the Project. The attached Annex 2 discusses the allegations made by the Requesters and shows that the Bank has followed all relevant policies and procedures required, including those referred to in the Request In particular, the Bank Management confirms that:

(i) all the procedural and substantive requirements have been followed by the Bank, including the carrying out by the Borrower of an environmental assessment with meaningful consultation with affected persons and non-governmental organizations in Lesotho in the production of an Environmental Action Plan, Resettlement Action Plan and Compensation Policy. A summary of the environmental assessment was, as required, distributed to the Executive Directors on June 11, 1997;

(ii) the economic evaluation of the Project (Phase 1B), which follows on from the evaluation carried out prior to the appraisal of the Phase 1A Project, is in accordance with Operational Policy No. 10.04 in terms of the criteria utilized, the analysis of the alternatives (including demand management), the benefits, risks and sustainability issues considered and consistency with the Bank's poverty reduction strategy;

(iii) all the relevant issues related to O.D. 4. 00, specifically those with respect to consultation (Annex B, paragraph 19) and design alternatives (Annex B, paragraph 5), as well as all provisions of OD 4.30 have been considered and are summarized in Annexes 4, 4A, 11, and 12 of the PAD; and

(iv) the Project is fully consistent with the poverty reduction strategy spelt out in the Lesotho Country Assistance Strategy (CAS) which is consistent with the requirements of OD 4.15 on Poverty Reduction.

Attachments

RESPONSE TO THE ALLEGED VIOLATIONS

1. At the outset, it is worth noting that the Lesotho Highlands Water Project, as it is defined in the Treaty concluded in 1986 between Lesotho and South Africa, consists of a large water scheme to be progressively developed in five successive phases. Under the Treaty, the parties have committed themselves to proceed initially with the first phase of the Project, which is known as Phase 1. For technical and financial reasons, the Treaty has provided that Phase 1 would be developed in two stages known as Phase 1A and Phase 1B. The development of Phase 1A was started in 1988 and was supported with a Bank loan in an amount equivalent to \$110 million. Implementation of Phase 1A is very advanced and is nearing completion; an amount of the loan equivalent to \$20 million has been canceled by the Borrower, and to date the amount fully disbursed is equivalent to about US\$68 million with an additional \$3 million already committed. In May 1998, the Borrower indicated to the Bank its intention to cancel the remaining balance which amounts to \$15 million. The current closing date for the loan is March 31, 1999. A loan in the amount of US\$45 million for Phase 1B Project was approved by the Executive Directors on June 4, 1998.

2. In the Request, the Requesters allege that the following Bank policies and directives "may have been violated":
 - OD 4.00 Environmental Policy for Dam and Reservoir Projects
 - OP 10.04 Economic Evaluation of Investment Operations
 - OP 4.07 Water Resources Management
 - OD 4.15 Poverty Reduction

3. For ease of reference and for the purpose of responding to the Request, the requirements, which are mandated under those policies and procedures, may be summarized as follows:

While the Requesters refer to OD 4.00, we believe that they are referencing Annex B on Dam and Reservoir Projects and that they are concerned primarily with paragraph 5 which requires the Bank to consider all alternatives to Dam projects, and paragraph 19 which requires consultation with affected groups and NGOs. OP 10.04 sets the parameters to be followed in assessing the benefits of a proposed project and its viability and sustainability as well as the risks involved. OP 4.07 prescribes broad guidelines for providing Bank support to projects involving the development of water resources. OP 4.15 spells out specific procedures to be followed in the preparation of country poverty assessments reports.

 - I. Violation of consultation process as required under OD 4.00 Annex B, paragraph 19

4. The Requesters have alleged that "as consumers and citizens who will have to pay for the Project" they have not been "adequately consulted at any stage of this project they further assert that "because low-income water consumers have not been adequately consulted, they will suffer adverse consequences, including less access to Government officials and lower consciousness of [our] conditions than would have otherwise been the case had Bank staff taken seriously their mandate in the area of consultation".

5. In the Management's opinion, this allegation has no merit. It should be noted that the Lesotho Highlands Water Project is a comprehensive water development scheme, which is being carried out by Lesotho to export water for various uses by a multitude of consumers in South Africa. The residents of Alexandra and Soweto townships represent only a small fraction of consumers who will benefit from the water purchased by South Africa for use in its territory. As such any burden borne by them is as residents of South Africa who purchase water imported by South Africa and thereby contribute indirectly to the South African Government's payments for the imported water. Consequently, the Project does not impose directly any disproportionate burden to the residents of Alexandra and Soweto townships as compared to all other consumers of the water imported by South Africa from Lesotho.
 6. The Bank Management is of the opinion that the requirements of OD 4.00 Annex B paragraph 19 could not reasonably require the Borrower under the Project to consider that all the ultimate consumers of a commodity (i.e. water) harnessed under the Project (including those residing in a third country) should be treated as affected by the Project for the purposes of mandatory consultation under O.D. 4.00.
 7. Nonetheless, the Bank team responsible for the Project has consulted not only with government officials but also with other interested parties and members of the civil society such as academia, the media and the NGO community who have shown an interest in the Project from a South African perspective. While the staff has done so firstly as part of the Bank's mission to contribute to a sharing of information and development experience it has gained worldwide, and secondly in the course of the Bank's dialogue on water pricing in South Africa, the Bank Management wishes to assert that O.D. 4.00 does not require as a matter of policy or of procedure that all consumers' of a commodity to be produced as a result of a Bank-financed project, and particularly those residing in a third country, be included in the consultation process. Furthermore, the Bank Management states that none of the NGOs with whom such discussions were held are parties to this Request and, more importantly, that the elected civic associations for Alexandra and Soweto townships, with whom both the Bank and the Borrower held consultations, have since, after a vote of their council, endorsed proceeding with the Phase 1B Project. In addition, further consultations were held with the relevant water authorities in South Africa which have confirmed their full support for the Project
 8. The Bank Management should like to indicate further that in the context of Project preparation, the Borrower has consulted extensively with communities directly affected by the Project, as well as with NGOs in Lesotho. This is documented in the Environmental Action Plan.
- II. Violation of consideration of project design alternatives as required under OD 4.00 Annex B, paragraph 5
9. The Requesters allege in paragraph 5.3 that "the Bank has not fully investigated demand-side management options during the planning of either phase of the LHWP". They state that "Bank staff have inadequately responded to findings relating to demand side management by failing to conduct rigorous evaluations prior to considering the provision of further funding for Phase 1B"; and that in their opinion, "it is possible that effective demand-side management could delay for many years the need for this massive project", and that "Bank staff's failure to consider this possibility seriously is a fundamental violation of Bank policy (and carries] considerable economic, social and environmental impacts

10. Regarding this alleged violation, it should be recalled that prior to the undertaking of the ongoing Phase 1A Project, Lesotho had solicited and obtained from IDA an engineering Credit under which preparation activities for Phase I of the LHWP were carried out. Those activities included feasibility studies and detailed engineering design for the initial phase of LHWP and considered a number of design alternatives for the Project LHWP was shown to be the lowest cost supply alternative. The Bank reviewed those studies and found that they were satisfactory for the purposes of financing the ongoing Phase I A Project.
11. The 1986 Treaty commits Lesotho and South Africa to carry out the initial phase of LHWP which pursuant to the Treaty has been divided- into Phase 1A and 1B (see paragraph I of Annex I to the Treaty). The Treaty does not contemplate any postponement of Phase 1B. Indeed, Article 5 (2) of the Treaty provides that "unless the Parties decide otherwise, each phase of the Project shall be implemented in time to satisfy the minimum water deliveries as specified in Annex H. Water deliveries to South Africa from sub-phase 1A of the Project shall be due to commence in the year 1995 and water deliveries to South Africa from sub-phase 1B of the Project shall be due to commence in the year 2002". Article 6 (1) of the Treaty further stipulates that "the Parties shall use their best endeavors to secure and facilitate the implementation of the Project: provided that the implementation of each phase of the Project subsequent to Phase 1, shall be subject to the consent of each Party prior to such implementation and provided further that, without prejudice to the provisions of Article 12, a Party not consenting to the implementation of any such subsequent phase of the Project shall compensate the other Party for any wasted Project implementation costs reasonably expended by such other Party in anticipation of the implementation of such subsequent phase."
12. Demand-side management is a technique which has been developed overtime. It should be noted that when the Treaty was concluded in 1986, demand side management techniques were not yet fully developed anywhere in the world, nor were they included in OD 4.00 at that time. As a consequence, the feasibility studies conducted for the Phase 1A Project could not have integrated demand-side management techniques as it is practiced nowadays.
13. In this connection, the Borrower and the South African water authorities have analyzed the Vaal River Augmentation Planning Studies which consider demand management as an alternative to the subsequent phases of LHWP beyond Phases 1A and 1B, the implementation of which is already mandated pursuant to the provisions of the Treaty referenced above. They have also examined in detail the costs and benefits of a potential postponement of the implementation of the Phase 1B Project. These analyses have concluded that it would be more beneficial for Lesotho and South Africa to proceed with the implementation of the Phase 1B Project as currently scheduled. The Bank has reviewed these studies and has found them satisfactory; summaries of these analyses are included in Annexes 4 and 4A of the PAD.
14. Contrary to the statement made by the Requesters in paragraph 2.8 of the Request, the ongoing demand-side management study which is expected to be completed in 1999 was commissioned by South Africa for the purposes of assessing the need to proceed with the subsequent phases of LHWP beyond Phases 1A and 1B to which South Africa is already committed as a matter of treaty obligations. Consequently, the terms of reference for that study do not relate to the Phase 1B Project; therefore the results of the said study are not expected to establish that the Phase 1B Project should not be carried out.
15. Hence, the Bank Management is satisfied that the Borrower has carried out careful studies for the Phase 1B Project and has adequately considered the implications of demand-side management alternatives on -the

economic viability, timing and financial justification of the said Project. This is why the Bank Management decided to submit the Phase 1B Project to the Executive Directors for approval which was granted on June 4, 1998. It should be further noted that the Borrower has dutifully followed the Bank's relevant policies, *inter alia*, by endeavoring to maximize the benefits and minimize the costs of the Project. The recommendations of the outside Environmental and Social Panel of Experts (endorsing the decision to proceed with Phase 1B, see Panel Report No. 13 of March 1998) and the decision of both the Governments of Lesotho and of South Africa (with the full support of all water sector institutions in both countries) to request the Bank support for the Project is, in the view of the Bank Management, a further warranty that outside experts have looked into the economics of the Project and have found them to be adequate and in the overall interest of the peoples of Lesotho and of South Africa. The Bank Management is of the view that, rather than showing that issues have not been addressed, the Requesters simply do not agree with the conclusion reached by Lesotho and South Africa regarding the implementation of the Phase 1B Project.

III. Failure to carry out economic evaluation of alternatives as required under OP 10.04

16. The Requesters' assertions that "there has been little or no analysis of how Phase 1A and Phase 1B will affect Rand Water and its end users", and that analysis of Phase 1B's optimum starting date "has not seriously incorporated demand side management possibilities" is not supported by the facts. A thorough economic analysis of the alternatives to Phase 1A was carried out as an integral part of the appraisal of that operation in 1989. Regarding the Phase 1B Project, it should be noted that a comprehensive economic assessment of the Project economics (including the alternative of demand management and an analysis of the economics of delaying phase 1B) was carried out by the Borrower and the South African authorities; this study was updated in April 1998. The Bank has evaluated this assessment as part of its appraisal of the Project and has found the analysis and its conclusions satisfactory. A summary of this analysis is in Annexes 4 and 4A of the PAD and copies of the background documents are available in the Project file. This analysis has been provided to interested parties including NGOs and civic associations both in Lesotho and South Africa. To the Bank's knowledge, no one has commented specifically on the economic and financial aspects of this analysis despite several requests made to the effect by the Borrower and the Bank. One of the major conclusions of that analysis is that a postponement of the implementation of the Phase 1B Project would not be justified either from an economic or financial view point nor from a social standpoint for both Lesotho and South Africa.
17. The Requesters also assert that the sustainability of the Phase 1B Project has not been established due to the potential impact that the Project may have on the Orange River. The Bank has reviewed and discussed with the South African authorities their "Orange River Replanning Study" that analyzed this issue and has accepted its conclusion that over and above the water needed for sub-phases 1A and 1B, about 20 m³/s could be taken for phase 2 (which would bring the off-take at the Lesotho and South Africa border to 25% of the original flow) proving that there would be no substantive problem with the Phase 1B Project.

IV. Failure to follow the requirements of OP 4.07 relating to Water Resources Management

18. The Requesters claim that as a result of the proposed Project, "Water costs will increase by 9% this year, following a 30% increase last year; this will hurt the poor, particularly since the additional supply is not needed at this time". They further claim that the Project will create a disincentive for water conservation. This assertion has no merit. The bulk water price increases experienced to date result from water shortages suffered by the Gauteng

region in the 1980s. According to the law of supply and demand, water price increases could have been even higher if Phase 1A of LHWP had not been constructed.

19. Also, it should be noted that since Rand Water pays a variable rate (i.e. a set rate per cubic meter consumed and not a fixed annual "take or pay" rate) for the water they consume, and since they pass these costs on to consumers in the same form, the Project will not create a substantial disincentive for demand management. Furthermore, the analysis presented in Annex 5 of the PAD (based on the most recent Vaal River pricing analysis performed by the Borrower) shows that if phase 1B is pursued on schedule and demand management is implemented - then bulk water prices will not be further increased as a result of the execution of the Phase 1B Project. However, since the analysis in Annex 4A of the PAD shows that a delay in phase 1B would be more costly than proceeding now, any delay in Phase 1B would more likely lead to higher water prices than lower water prices.
20. OP 4.07 paragraph 2 (b) recognizes that pricing should aim to achieve cost recovery, water conservation and better allocation of water resources. It is generally agreed that water conservation and allocation is served by pricing up to the marginal cost of water. The Bank Management is of the opinion that the bulk water pricing policy employed by South Africa provides for an acceptable combination of cost recovery and better allocation of resources (failing just under the long run marginal cost). Hence South Africa's bulk water pricing policy is fully consistent with OP 4.07

V. Failure to promote poverty reduction measures as required under OD 4.15

21. The Requesters are asserting that the Phase 1B Project "will create undue burdens on low-income people, not only on project-affected people in Lesotho, but in Gauteng Province because of increases in water prices". This claim is without merit. This is because the Bank Management is satisfied that a central aspect of the Project is its poverty related dimension which is anchored in the Lesotho CAS. This CAS is consistent with the provisions of OD 4.15. In particular, the Project includes the following poverty related features:

(a) With respect to affected peoples in Lesotho, a comprehensive assessment of social and resettlement issues was carried out during the preparation of the Project, with the full, participation of the concerned peoples throughout the Project area. A comprehensive environmental action plan, a full compensation policy and a detailed resettlement action plan have been adopted by the Borrower. In addition to a comprehensive review within the Bank, these plans have been reviewed and endorsed by both the outside Environmental and Social Expert Panel and an independent review panel from UNDP/UNESCO. A summary of social and resettlement issues is included in Annex 12 of the PAD while copies of the detailed studies are available in the Project file.

(b) With respect to meeting the needs of poor water consumers in South Africa, it is noted above, that any postponement of the Phase 1B Project would carry net economic and financial costs to South Africa and hence would more likely harm than help poor water consumers. Significant delays in Phase 1B would also carry increased risks of water restrictions, which would further harm the poor. Recognizing that there are important challenges remaining in the retail water sector in South Africa which are not related to the LHWP, such as improvements in infrastructure and the maintenance of retail pricing systems that include a safety net for the poor, the Bank Management remains committed to pursuing a constructive policy dialogue with the relevant South African authorities with regard to South Africa's policies applicable to its retail water sector.

(c) In addition, the revenues earned by Lesotho as a result of the LHWP are crucial to support Lesotho's poverty reduction strategy and Lesotho's macro economic stability. A substantial share of those revenues is channeled through a social Rind established under the ongoing Phase 1A Project which is being restructured under the Project to increase its efficiency as well as its focus on supporting targeted sustainable poverty alleviating micro projects throughout Lesotho. These two concerns are at the center of the Bank's CAS for Lesotho. Delaying or canceling Phase 1B of LHWP will have the effect of undermining these two most important pillars of Lesotho's poverty reduction strategy.