

THE INSPECTION PANEL

Request for Inspection
Lesotho/South Africa: Phase 1B of Lesotho
Highlands Water Project

Panel Report and Recommendation

August 18, 1998

1. INTRODUCTION.....	3
The Loan.....	3
The Project.....	4
Basis of this Report	4
<i>The Request for Inspection</i>	5
Allegations.....	5
Actions/Solutions Sought.....	6
Earlier Draft Request.....	6
<i>Management Violation of Bank Procedure</i>	6
Confidentiality.....	6
Resolution Disregarded by Bank management.....	6
Unauthorized Use of Contents of Request.....	7
<i>Bank Management Response</i>	7
Rejection of Formal Bank Response	7
2. DISCUSSION OF ELIGIBILITY	8
<i>Scope</i>	8
Matters Outside Scope of the Panel’s Mandate.....	8
<i>Eligibility of the Requesters</i>	8
<i>Eligibility of the Request: Preliminary Analysis of Bank’s Observance of its Policies</i>	10
The Request for Delay in 1B	10
The Question of Consultation	11
Consultations by Project Authorities in South Africa	12
Consultations by Bank Staff.....	13
Assessment in the Staff Appraisal Report.....	13
The Question of Demand-side Management	13
The Cost Recovery and Price Link	15
Price Increases.....	16
Conservation	17
Poverty Reduction	18
3. FINDINGS ON HARM AND BANK’S OBSERVANCE OF ITS POLICIES	19
4. RECOMMENDATION	19

Attachment 1: Vaal River System: Schematic Diagram (1980 to 1993)

Annex 1: Request for Inspection

Annex 2: Bank Management Response to Request

The Inspection Panel

1818 H Street, NW Phone: (202) 458-5200
Washington, DC 20433, USA Fax : (202) 522-0916
Internet: <http://www.worldbank.org>

IPN Request RQ98/2

Report and Recommendation on Request for Inspection Lesotho/South Africa: Lesotho Highlands Water Project

The following provides (1) an Introduction (2) Discussion on Eligibility, (3) Findings, and (4) Recommendation of the Inspection Panel ("Panel") on whether or not there should be an investigation ("Recommendation") into allegations made in the above-referenced Request for Inspection ("Request"). Annex 1 contains the Request. Annex 2 contains the International Bank for Reconstruction and Development ("Bank") Management Response to the Request.

1. INTRODUCTION

On April 23, 1998, a group of residents (Requesters) from Alexandra in the Gauteng province of the Republic of South Africa (RSA) delivered a Request to the World Bank office in Pretoria. The Panel received the Request in Washington, D.C on May 6, 1998. The Requesters claim they have and will suffer harm because Bank Management has violated policies and procedures in the preparation of Phase 1A of the project for which financing was approved in 1991, and the then proposed Phase 1B of the Lesotho Highlands Water Project, (together referred to as LHWP).

The LHWP finances physical works located mostly in the Kingdom of Lesotho. Its purpose is to supply water to urban and industrial users in the Gauteng province. But the Requesters claim that the water is not needed for another few years and argued that Phase 1B should be delayed to allow demand side measures to work. They claimed that if it was not delayed poor communities in Gauteng will continue to suffer from lack of access to water, water supply cut-offs for inability to pay, and the resultant health and sanitation problems.

Before the Panel received the Request from the Pretoria office, Bank Management, on April 30, 1998, circulated documents to the Bank's Board of Executive Directors seeking approval of a proposed loan. The Bank Project Appraisal Document (PAD) includes a description of the Requesters and the Request.¹

On May 15, 1998, the Panel notified the Executive Directors and Bank President of receipt of the Request (meaning "Registration" under the Panel's Operating Procedures).²

THE LOAN

The Bank's Executive Directors approved a loan of USD45 million equivalent for Phase 1B on June 4, 1994.³ The borrower of record is the Lesotho Highlands Development Authority (LHDA) but the loan will be serviced directly by the Trans Caledon Tunnel Authority (TCTA) on behalf of South Africa. The Bank is accepting guarantees of performance and repayment from both the Kingdom of Lesotho and the RSA-as primary obligor.

¹ A problem with this is discussed further below at paras. 23-26.

² See The Inspection Panel, *Operating Procedures* (August 1994) at para. 17.

³ The Panel has been informed that the loan effective date (July 31, 1998) has been delayed.

THE PROJECT

The LHWP was authorized by the signing of an international *Treaty between Lesotho and the RSA* in October 1986 (Treaty), and contemplates implementation in five phases. Phase 1 is divided into A and B and the Treaty commits the parties to this Phase. The Treaty covers the rights and obligations of each party, lays down the quantities of water to be delivered, the cost sharing provisions, and the scope and calculation of the payments for water.

“Phase 1A, which transfers about 16.8m 3/s to South Africa, is about 97% complete and delivered first water in January 1998 and will deliver electricity by late 1998. Costing about US\$2.5bn, phase 1A comprises a 185m high dam at Katse, a 45Km tunnel (capable of delivering 30m 3/s) to a 72MW power plant and a 55m high dam at Muela, and a 37km tunnel to the Ash river in South Africa.” (PAD paragraph 2)

Phase 1B comprises a 145m dam at Mohale, a 15m weir at Matsoku, and water tunnels from each site to channel water to the Katse dam --- all in Lesotho. From Katse, the water will be transferred by gravity to Gauteng through a tunnel built under the first phase of the project, to the Vaal river system. The water will be used for municipal and industrial purposes. Phase 1B will transfer another 11.8m 3/s to Gauteng.

The main objectives of LHWP are: “(a) to put in place the physical and managerial capacity for Lesotho to transform its principal natural resource of abundance – water – into export revenues that can be applied to poverty reduction and economic stability while (i) protecting the environment and mitigating any adverse social and environmental impacts and (ii) maximizing the local development spin-offs of the project in Lesotho; and (b) assisting South Africa in developing its lowest cost alternatives for supply of water to the Gauteng Region.” (paragraph 1, PAD).

Under the Treaty the RSA will pay Lesotho royalties for water transferred. Included in the Treaty is the arrangement whereby the RSA designated TCTA as the authority responsible for ultimately bearing all project costs and for servicing the project debt. TCTA is the recipient of the LHWP water. It sells all bulk water to the Department of Water Affairs and Forestry (DWAF) in the RSA with the aim of full cost recovery.” DWAF in turn sells this water, together with bulk water from other sources, to the water boards and large industries in the South Africa.⁴

The Treaty provided for establishment of a Joint Permanent Technical Commission (JPTC) with equal representation of three delegates each from Lesotho and the RSA. Located in Maseru, its main responsibility is to agree on and to monitor the implementation and operation of the project in all matters related to the delivery of water to the RSA.⁵

Both the RSA and Lesotho are intended to benefit directly from the project. While the RSA is receiving and will continue to receive a much needed supply of high quality water, Lesotho is benefiting and will continue to benefit financially from the royalties received through the provision of the water, and through the money saved through the production of its own electricity supply.⁶ Lesotho is expected to gain about US\$40 million a year in revenue from Phase 1A & B of LHWP for at least 50 years. It is anticipated that the Phase 1B will create more local jobs and bring more basic infrastructure services to the country. Forty percent of the revenues from Phase 1B will be used for a social fund to support poor communities. The remaining 60 percent will support the country’s general budget.

BASIS OF THIS REPORT

⁴ The PAD notes that historically this has been on a financial cost recovery basis but in recent years more active use of economic pricing has lead to pricing above what would normally be required in any year for simple debt service. (PAD para. 4 (e) and Annex 5, Section 6)

⁵ See *Staff Appraisal Report* No. 8853-LSO for Phase 1A, July 2, 1991, paras. 1.48-1.49.

⁶ See *Environmental Assessment Executive Summary*, SecM97-489, June 16, 1997.

This report is based on the Request, the Response, additional information provided by the Requesters and Bank Management, the RSA, and individual Bank Executive Directors who recently visited South Africa and Lesotho.

In addition, the Panel considered information obtained during Mr. Jim MacNeill's ("Inspector") visit to Johannesburg, Pretoria and Cape Town during July 26-31, 1998. Prior to this the Inspector consulted with the Executive Director representing the Government of South Africa.

The purpose of the Inspector's visit was to seek information to help the Panel determine the eligibility of both the Requesters and the matters complained of in the Request.⁷ During his visit the Inspector met with the Requesters, representatives of Civic Associations of Alexandra and Soweto; he visited and met with poor consumers in several communities; consulted with the Minister for DWAF, the Rand Water Board, the TCTA and municipal authorities. After his visit, the Inspector consulted again with the Bank Executive Director representing the RSA.⁸

THE REQUEST FOR INSPECTION

The Request claims, in summary, that the following harm has and will occur as a result of the Bank's acts and omissions in violation of various policies and procedures:

16.1. "...the LHWP represents an expensive, ecologically unsound water supply project whose expansion is not needed for many years (by some estimates, two decades) and that has resulted and will result in a variety of problems that represent material harm to the claimants and our allies:

16.1.1. Rising water prices (thus adversely affecting the ability of low-income people to gain access to water, and in the process lowering public health status and environmental conditions, with particular costs borne by women, children and the elderly);

16.1.2. Less incentive to instigate demand-side management measures (hence leaving townships with failing infrastructure and limiting the ability of service providers to cross-subsidize);

16.1.3. Increased fiscal stress on municipalities (which in turn will cost workers their jobs and/or income, and will lead to greater pressure to reduce subsidies to low-income people and to cut off water in the event of nonpayment); and

16.1.4. Fewer resources for the capital and recurrent subsidies required to improve and construct water supply infrastructure appropriate for low-income communities."

ALLEGATIONS

The Requesters claim that as residents of the Alexandra township of Johannesburg they are part of the low-income consumer population who must pay a disproportionate part of the cost of the LHWP which they cannot afford. When they can't pay their bills their water is being cut-off.

The Requesters believe that current and potential harm is a result of the Bank's own failure to follow its policies and procedures relevant to both Phase 1A and 1B, citing the following:

- ◆ Environmental Policy for Dam and Reservoir Projects (Annex B)
- ◆ Economic Evaluation of Investment Operations (OD 10.04)

⁷ The Inspector did not visit Lesotho since, in the course of its preliminary review, the Panel concluded that this was not necessary for the purpose of establishing eligibility of this Request for Inspection.

⁸ The Panel wishes to thank the Requesters for their cooperation and assistance in arranging meetings and visits with affected people. It also wishes to thank the Executive Director representing the RSA and other representatives in his office for comments and guidance; Mr. Paul Roberts of the DWAF for arranging the Inspector's meetings with the Minister and officials in RSA; the Bank Team Leader for his assistance; and, staff of the Bank Pretoria office for logistical support in the RSA.

- ◆ Water Resources Management (OP 4.07)
- ◆ Poverty Reduction (OP 4.15)

ACTIONS/SOLUTIONS SOUGHT

In short, the Requesters ask for an investigation into their claims in order to resolve the current and potential problems of water consumers in poor communities of Gauteng. They believe their access to water, or continued access to water, has been adversely affected by the debt incurred to construct Phase 1A, and may be further adversely affected by premature debt incurred for Phase 1B. It should be noted that those suffering or fearing harm are not against Phase 1B per se – just its timing.

At the time the Request was filed, the Bank loan supporting LHWP Phase 1B had not been approved. Then the Requesters sought a delay in the Bank financing of this part of Phase 1 until their concerns regarding current and potential adverse affects were met. In support of this, they filed a claim with the Panel for an independent investigation into their allegations of the Bank failure to follow its own policies—in particular related to analysis of demand-side alternatives. During his field visit the Requesters told the Inspector that even though the Bank had now approved financing for Phase 1B (so the question of delay was moot) they still wanted the Panel to investigate the issues raised in the Request – namely the impact of Phase 1B on poor black previously disenfranchised communities.

EARLIER DRAFT REQUEST

The Requesters introduce the Request by explaining that it follows on a submission faxed to the Panel on March 3, 1998 by two civic associations representing the Alexandra and Soweto communities in Johannesburg. The Panel was informed that an original hard copy and list of signatories would follow. Instead the leaders of the two civic associations informed the Panel on April 20, 1998 that they wished to formally withdraw their Request. The current Request alleges that the civic leaders' withdrawal of their Request was prompted by intimidation. The letter from the civic association leaders is reproduced by Management in Annex 1 to its Response and lists a number of reasons for withdrawal.

In the context of the above it should be noted that, with some “expansion of the arguments” and updating, the text of the Request is largely identical to that submitted on March 3. The Request states that the technical advisors were the same as those for the draft Request submitted to the Panel on March 3. The Panel also understands that the text of the earlier draft Request was published on the Web.

MANAGEMENT VIOLATION OF BANK PROCEDURE

CONFIDENTIALITY

The Requesters asked that their names be made available only to the Panel members but otherwise remain confidential. In this case, the Panel could not guarantee anonymity since the Requesters revealed their identity to Bank staff at the Pretoria office and to the Editors of “Business Day”. Moreover, the Inspector was informed that when the Requesters delivered the Request to the Pretoria office on April 24, they asked the staff to sign a cover letter on which the staff agreed to keep their names confidential. Unfortunately the Requesters names appeared on that same cover letter. This was confirmed by both the Requesters and the Pretoria staff and the Panel has a signed copy of the cover letter. The staff signed it and the Panel has no reason to believe they have violated their undertaking to keep the Requesters' names confidential. Nevertheless, in the PAD that went to the Executive Directors on April 30, Bank Management abused this trust by revealing that the Request had been filed by “three individuals”.

RESOLUTION DISREGARDED BY BANK MANAGEMENT

Under the Resolution, as detailed by the Panel's *Operating Procedures*, it is clear that a Request must be delivered to the Panel. But for the convenience of Requesters, and in order to save them time and cost, the Panel suggests they may wish to deliver their Request to a World Bank local office. There is a Bank Procedure that mandates precisely how a World Bank office must handle a Request so delivered.⁹ In this case, the Pretoria office violated this procedure on April 24 by immediately faxing the Request to Bank Management in Washington.¹⁰ And only after doing so, did they forward it to the Panel by pouch in a sealed envelope. It was received by the Panel on May 6. When it received the fax on April 24, Bank Management in Washington informed the Panel Secretariat that it had received the Request and it sent a photocopy of the text to the Panel. Subsequently, in the PAD dated April 30, Bank Management revealed the number of Requesters and a summary of their allegations to the Executive Directors. This entire procedure represented an unprecedented disregard by Bank Management of the Resolution and the Panel's procedures, and it placed the Panel in the awkward position of receiving an opened Request from Management.

UNAUTHORIZED USE OF CONTENTS OF REQUEST

Under the Resolution, the Panel invites the Bank Management to deliver a formal Response to a Request for Inspection. In this case, Bank Management discussed and dismissed the allegations in the Request in presentations to the Executive Directors, and it did so on three separate occasions. These occasions were: (i) on April 30, 1998 in the text of the PAD circulated to the Executive Directors; (ii) at a Board meeting on May 21, 1998 — the date initially scheduled for approval of the loan; and (iii) at the meeting on June 4, 1998 when the Executive Directors approved financing for Phase 1B. Such serious disregard of the Panel process threatens its integrity.

The Panel is not a judicial entity. But, apart from ignoring the Panel's procedures, this would also appear to amount to a serious abuse of reasonable due process in any context. It must be recalled that there are two parties involved in the Panel process—the Requesters and the Bank Management. The Requesters do not have any direct access to those who were to vote on the loan they questioned. The Board did not have the benefit of the Panel's independent assessment of the eligibility of the Request.

BANK MANAGEMENT RESPONSE

REJECTION OF FORMAL BANK RESPONSE

The Resolution requires Management to provide the Panel "with evidence that it has complied, or intends to comply with" its own policies and procedures (paragraph 18) and the Panel to determine whether the Request is eligible or not (paragraph 19). The Panel Registration Notice, dated May 15, 1998, expressly reminded Management of its obligations under the Resolution in the following terms:

"In accordance with paragraph 18 of IBRD Resolution No. 93-10 and paragraph 18(d) of the Operating Procedures, Bank Management is hereby notified that it must provide the Panel no later than June 16, 1998 with written evidence that it has complied, or intends to comply with the relevant policies and procedures in the implementation of the above-referenced project. The subject matter the Management must deal with in a response to the Request is set out in paragraph 33 of the Operating Procedures. After receiving the Management response, the Panel will, as provided by paragraph 19 of the Resolution, "determine whether the Request meets the eligibility criteria set out in paragraph 12 to 14 and shall make a recommendation to the Executive Directors as to whether the matter should be investigated."

⁹ Paragraph 2 of Bank Procedures 17.55 states that "Under the Panel's Operating Procedures, requests for inspection are sent to the Office of the Inspection Panel either directly or through a Bank field office. If a request for inspection is delivered to a Bank field office, the head of the office issues a receipt to the requester and forwards the request to the Panel in the next pouch."

¹⁰ Paragraph 3 of BP 17.55 states clearly that "If a communication addressed to the Panel is delivered to any Bank staff member, that staff member promptly forwards it, unopened, to the Executive Secretary of the Panel...."

On June 16, 1998, the Panel received the Management Response to the Request. (Annex 2 of this Report). The Response does not provide the substantive information required by the Resolution as pointed out by the Panel in the above notification. Instead paras. 1-9 of the Response deal with the eligibility of the Request. Indeed para. 9 informs the Panel that Management has concluded that:

"Since the Bank Management is of the opinion that the Request does not meet the eligibility requirements set forth in the Resolution, it concludes that the Panel should not recommend to the Executive Directors that an investigation be carried out."¹¹

In line with this in paragraph 10 Management then offers to submit, in an Annex, what is required by the Resolution **but only** "for information purposes".

In other words, Management refused to provide the Panel with a response to the Request, as expressly required by the Resolution. The Panel, of course, rejected Management's refusal to respond in the proper way, and so informed the President of the Bank. He was also informed that, in the interests of avoiding delay in the preliminary assessment, the Panel had decided nevertheless to go ahead and treat the information provided in the Annex as the substantive Management Response.

In summary, the substance of the Management Response (found in the Annex) reiterates what Management had already told the Executive Directors, namely, that in its view all policies and procedures have been observed.

2. DISCUSSION OF ELIGIBILITY

SCOPE

This report will first examine the eligibility of the Requesters. It will then determine the eligibility of the substance of the Request for an investigation. To do this, the assertions made in the Request and Bank Management Response are compared and examined.

MATTERS OUTSIDE SCOPE OF THE PANEL'S MANDATE

This review does not address questions raised in the Request, and dealt with in the Bank Management Response, that are related to Bank application of its policies on resettlement and rehabilitation in Lesotho. They are outside the scope of the Panel's mandate because the Requesters in South Africa do not claim to represent those affected people.

ELIGIBILITY OF THE REQUESTERS

The Panel finds that the Requesters are eligible to file a Request in accordance with the Resolution establishing the Panel, subsequent "Clarifications" and the Panel's "Operating Procedures". The Panel is satisfied that:

34.1. The "territory of the Borrower" referred to in the Resolution includes the territory of the RSA and Lesotho as guarantors, since the LHDA, the Borrower of record, does not have a territory of its own. The word "Borrower" in the Resolution can only refer to the member or member countries which are the borrowers or guarantors of Bank loans.

34.1.1. This interpretation is consistent with the Bank's practice under the Articles of Agreement.

¹¹ For the record, it can be noted that Management appears to base this on the most odd conclusion that "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."

34.1.2. According to the draft guarantee agreements, both the Kingdom of Lesotho and the RSA have unconditionally guaranteed, as primary obligors and not merely as sureties, the punctual performance of all obligations of the Borrower (not only its financial obligations) as set forth in the Loan Agreement.

34.2. The project is located in both Lesotho and South Africa as described in the project documents and, last but not least, the project would make no sense without the South African component.

34.2.1. The Board's review and 1996 Clarifications of the Panel Resolution provide that "the word project as used in the Resolution has the same meaning as it generally has in the Bank's practice."

34.2.2. In this sense the Senior Vice President and General Counsel has defined the term "project" as used in the IBRD and IDA Articles of Agreement as:

"...the general rule is that loans made or guaranteed by the Bank should finance 'specific projects'. These words should be read in their ordinary and grammatical meaning, which generally forms the correct interpretation of treaty provisions. Such a meaning suggests that while the project to be financed has to be 'precise,' 'explicit' and 'exact in respect of fulfillment, conditions or terms,' it need not be limited to the construction of physical facilities. Indeed, the term 'project' is broad enough to cover any 'plan,' 'scheme' or 'design' according to which something is proposed for execution."¹²

34.2.3. South Africa entered into the Treaty with Lesotho in 1986 "for the purpose of capturing untapped water resources of Lesotho and channeling them into South Africa's Gauteng industrial region."

34.2.4. The PAD describes key aspects of the project as being in both Lesotho and South Africa: e.g.,

34.2.4.1. The project's development objectives are described to include "(b) assisting South Africa in developing its lowest cost alternatives for supply of water to the Gauteng Region;"

34.2.4.2. The components of the LHWP are collectively described as "a multipurpose project which, by a series of dams and tunnels, will control and develop the water resources of the highlands region of the Kingdom of Lesotho and will redirect a portion of the water presently leaving Lesotho in the Senqu-Orange River northward to the Vaal River basin where it will be utilized for municipal and industrial purposes in the Gauteng Province of the Republic of South Africa (RSA)." (See paragraph 7 and 8 above for a description of the physical components);

34.2.4.3. The "benefits and target population" include industrial and urban water users in the Gauteng region;

34.2.4.4. The Economics of Phase 1B, set out in Annex 4, considers "both partners of the project" (Lesotho and RSA) and draws the conclusion that Phase 1B "will generate considerable benefits to all parties to the project;"

34.2.4.5. The 1997 RSA Country Assistance note is offered as a part of the rationale for the project.

34.3. The three Requesters are located in South Africa and are affected parties in the project area.

34.3.1. The definition of "affected party" in the 1996 Clarifications to the Resolution states that the term "includes any two or more persons who share some common interests or concerns".

¹² *Authorized Purposes of Loans Made or Guaranteed by the Bank*, April 8, 1988, pg. 5

34.3.2. The Inspector established during his field visit that those submitting the Request are bone-fide residents of Alexandra who share some common interests or concerns,” and who believe they have and are likely to suffer as a result of the project.

34.3.3 The Inspector also established that the Requesters were actively involved in bringing the issues to the attention of Bank Management in accordance with the Resolution which requires them to "explain the steps already taken to deal with the issue" and to "specify the actions taken to bring the issue to the attention of Management." (Resolution paragraph 16);

34.3.4. The Requesters state that they were not satisfied with the Bank Management response to their concerns.

ELIGIBILITY OF THE REQUEST: PRELIMINARY ANALYSIS OF BANK’S OBSERVANCE OF ITS POLICIES

The remainder of this report deals with the eligibility of the Request itself for an investigation. Before making a recommendation to the Executive Directors the Panel is required under the Resolution to determine whether it has a reasonable belief that:

35.1. whether there is preliminary evidence that *prima facie* the Bank has failed to follow its policies and procedures; and,

35.2 if so, whether there is preliminary evidence of alleged material harm; and,

35.3 if so, whether such harm *prima facie* appears to be a result of a Bank failure to follow its policies and procedures.

THE REQUEST FOR DELAY IN 1B

Paragraph 3 of OP 10.04 on Economic Evaluation of Investment Operations states that: “Consideration of alternatives is one of the most important features of proper project analysis throughout the project cycle. To ensure that the project maximizes expected net present value subject to financial, institutional, and other constraints, the Bank and the borrower explore alternative, mutually exclusive designs. The project design is compared with other designs involving differences in such important aspects as choice of beneficiaries, types of outputs and services, production technology, location, starting date, and sequencing of components. The project is also compared with the alternative of not doing it at all.”

Throughout much of the claim, the Requesters argue for a delay of about 10 months in the funding decision on Phase 1B, until the expected 1999 assessment of the potential for demand management is available. In summary, they claim that a delay is feasible, would result in substantial savings, and would enable the parties to focus on other priorities, including increasing access to water and repairing and upgrading the inadequate water delivery systems in Alexandra, Soweto and other poor townships.

Bank Management recently concluded that there “is considerable evidence that the project could be delayed by at least 4-7 years, due to smaller than expected demand growth. Successful demand management policies could ensure a delay of up to 10 years, and some have claimed, but without proof, that longer delays may be possible with considerable investment in demand management activities.... While recognizing the uncertainties embodied in this analysis, it does not make sense to delay phase 1B for a year or two while the analysis is enhanced. First, the rough analysis to date suggests that the ultimate delay required would have to be very long indeed in order to make delaying 1B worthwhile – and a priori the analysis does not support this. Second, a short (say 18 month) delay now would have definite costs to SA – in the range of R150m-R300m depending on how contracts can be renegotiated, plus a major shock to the Lesotho economy in 1998 and 1999 – taking as much as R250m out of GDP. Most importantly, neither the Government, nor Rand Water (who first raised the possibility of such delays) are advocating such a move.”¹³

¹³ See Annex 4A, Paragraph 6 of the PAD.

The Inspector found that some senior officials in Rand Water had indeed argued that a delay of up to 17 years was possible, with perhaps significant savings. The officials informed us, however, that since then they have become more aware of the full costs of delay, costs which are assessed in the Bank's report entitled "The Costs and Benefits of Postponing LHWP Phase 1B."¹⁴ These costs include higher capital costs resulting from foregoing the much lower bids for 1B that existing contractors can submit since they have already incurred most of the start up costs involved; certain continuing administration costs; certain continuing maintenance costs; and certain royalties and pumping costs foregone. Since South Africa is obligated under the 1989 Treaty to implement Phase 1B, and Lesotho has already installed the hydro generating facilities, South Africa would have to compensate Lesotho for lost hydro revenues. It would also have to compensate Lesotho for the lost SACU revenues.

Although a delay of 7 years and perhaps somewhat longer may be technically feasible, the same officials of Rand Water, and officials in DWAF, informed the Inspector that they now agree that a delay would not be desirable. The benefits that were initially expected from a delay are not there. Moreover, they now agree that the impact of a delay on the 2 million people of Lesotho, and on the economy of Lesotho, one of the poorest in the world, would be extremely negative.

As noted earlier, the Civic Associations of Alexandra and Soweto had originally submitted essentially the same claim and then withdrew it. Conversations with leaders of some of these associations revealed that they too were not initially aware of the full costs of delay, nor of the impacts of delay on the people of Lesotho and their development prospects. Following their meeting with the Minister on March 6, 1998, some of them had a first opportunity to visit Lesotho and to talk to their counterparts there. They stated that, partly as a result of the understandings and insights gained in that visit, they decided not to proceed with their claim.

South Africa is chronically short of bulk water, with only 1,300 cubic meters of available water per capita. Throughout history, the Vaal River Valley has experienced periodic droughts, the most recent during the early 1990s. Officials of the major water institutions are therefore pre-occupied with the risk of drought, and the economic and human costs of water restrictions should the region experience another severe drought before demand-side management and other policy measures succeed in securing a significant reduction in overall water demand. They consider that 1B provides them with a desirable cushion to eliminate the risk of future water restrictions that could carry significant economic and human costs.

The Request under consideration was submitted on April 23, 1998, several weeks before the Bank Board's meeting on June 4, 1998, when the Board decided to proceed with the loan for Phase 1B. During meetings with the Requesters, they indicated that they were aware of the fact that the Board had now so decided and they stated that, "since it was now a done deal", they no longer wished to pursue their request for a delay. As a result, the Panel will not deal further with this aspect of the Request.

THE QUESTION OF CONSULTATION

Paragraph 19 of OD 4.00 on Environmental Policy for Dam and Reservoir Projects concerns "Consultation with Nongovernmental Organizations (NGOs) and Affected Groups." It states in part that: "Community organizations, research centers, environmental advocates, and other NGOs can often provide valuable perspectives on improving both project design and implementation. To *tap* these *perspectives*, the Bank *encourages* consultations by project authorities (including consultants preparing the project) with appropriate NGOs, particularly local NGOs..... *Bank staff, too, should consult with NGOs as appropriate*, bearing in mind the capacity of NGOs to offer important *perspectives* on project design... In addition, the Bank *encourages* consultation between project executing agencies and the population affected by the project, as part of the project design process...The Staff Appraisal Report should describe and assess the consultations which took place." (Emphasis added)

¹⁴ See "The Costs and Benefits of Postponing LHWP Phase 1B" in the PAD.

CONSULTATIONS BY PROJECT AUTHORITIES IN SOUTH AFRICA

The Requesters cite steps taken by civic leaders, beginning in July 1996, to make their concerns known to the South African Government. Moreover, the Request mentions that Rand Water, together with Bank staff, was involved in earlier discussions in September 1995, and in an October 1995 DWAF conference. The Requesters claim that the South African Government has not responded in appropriate ways. More seriously, they claim that there has been “explicit intimidation by the South African government against the use of the World Bank Inspection Panel mechanism to help resolve the concerns.”

To take this last point first. During field consultations, this was raised with the parties involved, including the Requesters, and, separately, with leaders of the Civic Associations who, the Requesters claimed, were intimidated into withdrawing their original request. No evidence was found to support this claim of intimidation.

There was widespread agreement that, prior to May 1994, the concept of ‘meaningful consultations’ within the South African context of apartheid was an oxymoron, and that any requirement to encourage such consultations was then hardly realistic. Under apartheid, for example, releasing government-held information on water resource development plans in advance of formal decisions on those plans was illegal. Since May 1994, however, civil society organizations in South Africa have enjoyed those freedoms which are a pre-condition for meaningful consultations, and they rejoice in them. During the visit, the Inspector heard about growing demands for consultations on the part of national and local NGOs concerned with water related issues. He also heard statements of intent to consult on the part of authorities, even if those statements were sometimes shrouded with uncertainty – understandable, perhaps, given the early state of institutional learning on the nature and forms of dialogue with civil society.

The Inspector was also able to confirm the Requesters’ statements of actual consultations with RSA authorities dating back to September 1995. The most recent occurred on March 6, 1998, when civic leaders of two of the civic associations representing the Alexandra and Soweto communities met with the Minister and officials of DWAF to discuss their concerns. The participants agreed to work together to resolve the water access and wastage problems in Alexandra and Soweto. The civic leaders were invited to visit Lesotho to familiarize themselves with the project and to gain a perspective on the projects’ economic and social implications for that country. On March 29, 1998, following their return, the Alexandra Civic Association and the Soweto Civic Organization held a joint General Council meeting to discuss many community issues, including whether or not to go ahead with a Request for Inspection. Some 600 persons attended the meeting. The proposal to withdraw evidently provoked a lot of controversy among the twenty odd attendees who were familiar with the issue. In the end, a decision was taken to withdraw the Request and to rely, in good faith, on the Minister’s and DWAF’s promise to work together with them in several areas, including research on demand management, a joint community workshop, and improved access by the poor to water.

Some of the members of the Alexandra Civic Association did not agree with the decision to withdraw the Request and, on April 23, 1998, they submitted what is a slightly modified text as a Request for Inspection.

It is evident from the above that, beginning in September 1995, consultations did take place between project authorities in South Africa and local NGOs, which the Bank is supposed to *encourage* according to paragraph 9 of the above-mentioned OD 4.00. Some NGOs appear to consider the results disappointing, since the South African Government did not accept their “perspective” that Phase 1B should be delayed. It must be noted, however, that ‘consultation’ means just that: it does not necessarily mean that the parties must agree on the issues in question, nor that the decision-makers must adopt any particular NGO’s “perspective”.

Bank Compliance with OD: While some consultations did take place, as required by the OD, it is difficult to judge whether and the extent to which they stemmed from the “*encouragement*” of the Bank. Bank staff

stated that the most recent discussions were triggered by them and this could well be. Some months ago the Pretoria office engaged a former South African NGO leader who has been able to liaise between officials and NGO leaders.

CONSULTATIONS BY BANK STAFF

Under the OD, "Bank staff, too, *should* consult with NGOs *as appropriate*."

The Requesters cite a series of steps taken by civic association leaders, beginning in September 1995, to make their concerns known to the Bank. Noting that Bank staff held discussions with leaders of the Alexandra and Soweto communities, they express disappointment that opportunities to meet residents in the townships were declined. In sum, they claim that they have not had a truly adequate consultation with the Bank at any stage of this project and that this is of special concern in light of questions raised about demand-side management and project costs.

While the Bank Management's Response to the Request denies that it should have consulted with local South African NGOs, it states that the Bank team responsible for the project has consulted "with 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." Given this, and the Bank's new approach of dealing with the people on the ground, it is odd that Management should argue that the OD does not require them to undertake such consultations, and they did not respond to requests to meet with local community residents. They state that "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, and the Project does not impose directly any disproportionate burden on them."

Management also state that the OD "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." Clearly, this is true. The OD cannot intend that *all consumers* of any commodity produced as a result of a Bank-financed project be included in the consultation process, in whatever country they are located, first, second, or third. After all, tests of reasonableness and common sense must be applied. And they are not usually hard to find.

ASSESSMENT IN THE STAFF APPRAISAL REPORT

The "PAD" does address the consultation process. It states that, "until very recently, consultation in South Africa has only been at the bulk retailer level. It has been agreed that for any future projects there will be even more collaboration. *Until recently there has been little direct consultation withcommunities. However future consultations are now planned.*" The PAD also cites as an example of the Bank's open participatory approach in preparation of Phase 1B "recent commencement of dialogue with South African NGOs over the impact of the project on the poor in South Africa, and the issues surrounding the potential to delay phase 1B."

Bank Compliance with the OD. The NGOs appear to have brought their concerns to the Bank's attention. By its own admission, the Bank Management failed to observe the policy on consultation until shortly before April 30, 1998.

THE QUESTION OF DEMAND-SIDE MANAGEMENT

Paragraph 5 of OD 4.00 on Environmental Policy for Dam and Reservoir Projects concerns Design Alternatives. It states that: "Design of investment programs for supplying water or energy should consider demand management as well as supply options (e.g., conservation of water and energy, efficiency improvements, system integration, cogeneration, and fuel substitution)."

The Requesters claim that the Bank “has not fully investigated demand-side management options during the planning of either phase of the LHWP” and that it failed “to conduct rigorous evaluations of these options prior to seeking further funding for 1B.” They add that in their view, “it is possible that effective demand-side management could delay for many years the need for this massive project.” These claims concerning delay have been discussed earlier and will not be repeated here. Instead, the Panel will focus on the question of whether Management appears to have complied with paragraph 5 of the Bank’s OD 4:00 cited above.

Supply-side management has been the keystone of water policy in virtually all countries. Demand-side management has great potential but is a relatively recent development in the energy field and even more recent in the water field. In its response, Management notes correctly that when the Treaty was concluded in 1986, demand-side 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.

Based on the field visit, it is evident why Bank Management in its Response states that it was satisfied that the GSA has adequately considered demand-side management alternatives in relation to the decision to proceed with Phase 1B. Moreover, significant progress in implementing such measures was observed and is worth summarizing here.

Since November 1994, when it published its White Paper on Water Supply and Sanitation, the Government of South Africa has been fully committed to demand-side management goals that are frankly more ambitious than perhaps only a few OECD countries. Moreover, there is ample evidence that the GSA has been actively pursuing policies and programs to reduce water demand since early 1995, initially on a pilot scale and then on a gradually larger scale.¹⁵

During the field visit, the Inspector found general agreement that these policies and programs have enjoyed a considerable initial success. Estimates of the potential of these programs to reduce water demand in the Vaal River System Supply Area vary greatly, but they are all significant.

The Greater Hermanus Water Conservation Program, for example, was cited as a model program not only by officials of Rand Water and DWAF, but also by the Requesters and their advisors. Pursuing a broad mixture of policies, including steeply graduated block tariffs, beginning with a low lifeline tariff, the program is yielding what all agreed were spectacular results. Similar programs have been tailored for other communities and many are now underway. Officials insisted that the Program was well past the pilot stage.

The Requesters also claim that officials in the townships have failed to take demand-side management seriously, arguing that it is only now that attempts to address faulty, apartheid-era infrastructure are being made. The Panel did not consider this because it does not relate to Bank Management acts or omissions in compliance or non-compliance with the OD.

However during the field visit it became apparent that Gauteng municipalities are not yet in the forefront of demand-side management efforts but the need and potential are recognized. As the Requesters claim, it was evident that the poorer townships, including Alexandra and Soweto, suffer huge water losses through broken mains, ruptured pipes, leaky communal, yard and house taps, and otherwise inadequate water infrastructure. Officials from Rand Water and the municipal utilities stated that the financial implications of these losses are huge and disturbing.

In October 1995, the Department of Water Affairs and Forestry published a “Vaal Augmentation Planning Study” in which it assessed water demand management in the Vaal River System Supply Area.¹⁶ The Bank

¹⁵ See, for example, Department of Water Affairs and Forestry, “The Working for Water Program” Annual Reports, 1995-96 and 1996-97.

¹⁶ See Department of Water Affairs and Forestry, “Vaal Augmentation Planning Study: Water Demand Management in the Vaal River System Supply Area,” October 1995.

reviewed this study and found it satisfactory. One may legitimately argue about the merits of the report, but its existence clearly demonstrates that demand-side management was 'considered' as required by the OD.

During the field visit, the reports that the Department of Water Affairs and Forestry is working with Rand Water on a comprehensive demand-side management study for the Vaal River System Supply Area were confirmed. The study is expected to be completed in 1999. It will be used to assess options for the future, including whether and when future phases of LHWP may be needed.

In light of the above, the Panel is satisfied that Bank Management appears to have considered' demand management as required by the OD.

THE COST RECOVERY AND PRICE LINK

Paragraph 1 of OP 4.07 on Water Resources Management states that: "Bank involvement in water resources management entails *support* for providing portable water, sanitation facilities, flood control, and water for productive activities in a manner that is economically viable, environmentally sustainable, and *socially equitable*." Paragraph 2 states that: "The Bank assists borrowers in the following priority areas..... (b) Adopting pricing and incentive policies that achieve cost recovery, water conservation, and better allocation of water resources...[and] ... giving priority to the provision of adequate water and sanitation services for the poor."

Not cited by the Requesters, but relevant to this project, is paragraph 31 of OD 4.15 on Poverty Reduction. Concerning "*Cost Recovery*",¹⁷ it states that: "To promote social goals, the government may wish to subsidize the poor's use, or to price services to permit better-off users to subsidize poor users. *Under existing guidelines, this approach is permissible in Bank-supported operations.* However, user charges are not necessarily inimical to the interests of the poor. A carefully designed and executed system of user charges can improve the government's ability to target subsidies to those who need them most. And, in many cases, unless there is cost recovery of operating costs, including maintenance and replacement costs, the project will not be financially sustainable. Cost recovery should be established first in better-off areas and for higher levels of service – such as hospitals and universities – to help finance basic services for the poor.... *For urban water and power projects, "lifeline" tariffs allow the poor to obtain some minimal consumption for a very small fee, with consumption beyond that level charged at a higher rate.*" [Emphases added]

The Requesters claim that since the Project will result in water cost increases for poor users and, since it will add supply that is not needed at this time, it does not meet the standard of social equity described in this directive. Furthermore, they feel that it will more likely be a disincentive for conservation in contradiction of the terms of OP 4.07.

According to the Management response, price increases would have been even higher without Phase 1A, and a delay in Phase 1B would more likely lead to higher rather than lower water prices.¹⁸ In addition, they maintain that since Rand Water pays a set rate per cubic meter consumed (not a fixed annual 'take or pay' rate) this will not provide a disincentive to conservation. According to their analysis, bulk water prices will not

¹⁷ This is part of the Financial Design section of the OD which covers, inter alia, **the Bank's financing of** local costs and recurrent costs and the project's cost recovery provisions. See para 32.

¹⁸ See analysis in Annex 4A of the PAD

be increased if Phase 1B is implemented on schedule together with conservation (demand management).¹⁹ Management has accepted TCTA's and DWAF's bulk water pricing as fully consistent with this OD.

PRICE INCREASES

In discussions with senior officials from TCTA, DWAF, Rand Water, and the municipalities of Alexandra and Soweto, the Inspector was informed that water prices have risen at all levels. These increases are a consequence of a number of factors, one of which is the LHWP. The relationships and linkages between these factors, however, are anything but direct; in fact, they are long, complex and tenuous.

Prices are levied at various points in a chain leading from the source to the end user. Thus the Department of Water Affairs and Forestry (DWAF) collects raw water *from various sources in the Vaal System*, one of which is LHWP (see schematic chart of the system). It sells water to Rand Water at a bulk tariff. It also sells water to other large consumers at the same bulk tariff. Rand Water in turn wholesales water to the municipalities in Gauteng at a bulk price. And the municipalities in their turn retail water to end users at a variable price.

Water from the LHWP enters this complex system upstream, at the point where the Ash River discharges into the Vaal. At that point, the TCTA, which is responsible for bearing all project costs and servicing the project debt, sells project water to DWAF at a bulk rate set to enable it to discharge the debt over a period of years (cost recovery). It is true, as Management states, that Rand Water pays a set rate per cubic meter consumed (i.e. if it doesn't take it doesn't pay). But this may not have any significance in practice. The fact is that TCTA and DWAF must recover the full costs of the project. If Rand Water does not take the volume of water on which the rates are calculated for a period of time, the rates will be adjusted upwards to produce the necessary revenue for full cost recovery. Or, alternatively, the debt repayment period may be extended.

Since April 1994, the bulk water tariff that TCTA charges DWAF has slightly more than tripled, rising from R0.242/Kl to R0.751/Kl. During the same period, April 1994 to April 1998, the tariff that DWAF charges its large consumers, including Rand Water, has slightly more than doubled, rising from R0.457/Kl to R0.945/Kl. This of course includes the amount that DWAF pays to TCTA for LHWP water.

The last increase levied by TCTA occurred in April 1998 and, contrary to the concerns reflected in the claim, both TCTA and DWAF stated that they foresee no further increases as a result of 1B. In other words, TCTA anticipates that the prices now in place at the point where it sells to DWAF should enable it to fully retire the debt for phase 1, including both 1A and 1B.

Rand Water's charges to the municipalities have also increased during this period. From April 1994 to April 1998, the bulk water tariff that Rand Water charges the municipalities increased by slightly less than half, rising from R1.201/Kl to R1.685/Kl.

How have the municipalities responded? At this point the linkages back to LHWP become very tenuous. At the municipal retail level in Gauteng, a host of factors impact on water charges, and on their collection, and it is simply not possible to isolate one factor against the others.

In July 1995, the Inspector was informed that progressive block rates were introduced for metered use, with charges rising in four steps according to use. In the cases, for example, of Sandton, which is the richest community in Gauteng, and Alexandra, which includes some of the poorest in the province, the first step charge for the smallest users (up to 10 Kl) is R1.85/Kl; the fourth step charge for the largest users (above 40Kl) is R4.80/Kl.²⁰ The existence of these block rates does not appear to bear out the assertions made by

¹⁹ See analysis in Annex 5 of the PAD.

²⁰ In the three years between July 1995 and July 1998, the levy for the first step increased from R1.20 to R1.85, or 35 percent. The levy for the fourth step increased from R2.90 to R4.80, or 65 percent. In Alexandra, where the poor are dependent largely on communal standpipes, there is a flat rate per month for each house in the environs of a standpipe.

the Requesters concerning block rates. In para 1.12, for example, they state that “the possibility of changing water usage patterns through progressive block rates has not been factored in.”

Obviously, block rates can only apply where there is the capacity to meter use. Only 20 percent of poor have metered water and they are not the poorest of the poor. The other 80 percent access communal facilities.

In Alexandra and Soweto, the poor are largely dependent on communal standpipes, not metered facilities. In these cases, there is a lower rate. It is a flat rate which is applied to each house in the environs of a standpipe. This flat rate is currently R18.15 (about \$3.00) per month.²¹ It too has increased somewhat. In July, 1996, for example, it stood at R16.26 per month. This is viewed as a lifeline rate, even by some of the NGOs. Again, this is contrary to assertions made in the claim concerning the ‘lack of lifeline tariffs.’

Indeed, the GSA and the DWAF actively support the adoption of lifeline tariff systems to ensure that every person has at least a basic level of service.²² Rand Water made it clear that they too support lifeline tariff systems, as do the municipalities.

During the field visit, the Inspector encountered a wide range of views concerning lifeline rates amongst NGOs and the poor users he spoke to at the standpipes. Some NGO leaders favor a lifeline rate of zero for the first 25-50 liters per day. Some are prepared to accept a real charge but would like to see it kept as low as possible. This is a local debate. Whatever their level, in principle the effect of these lifeline rates are to shield the very poor from most if not all of any extra burden imposed by the LHWP.

The Requesters assert that many hundreds of poor people simply cannot pay even these low lifeline rates and are being cut off for non-payment. Officials from Rand Water and the municipalities stated that, indeed, many people are being cut-off for non-payment. They also stated that non-payment is a widespread phenomenon in South Africa. It is not limited to water services and it is not necessarily tied to income or ability to pay. Non-payment for services began as a strategy in the struggle against apartheid. It has continued as a habit of non-payment if not a culture of entitlement. It is found not only in the poorer parts of Alexandra, Soweto and other townships, but also in the more well-to-do parts of those communities. It also affects residents of other communities, some of them very well-to-do, and even elected leaders and government agencies. Non-payment may result from other factors, including the costs of payment (time of travel to collection offices) and other institutional barriers. The Inspector was informed that the GSA, DWAF, Rand and the municipalities have taken a firm position on payment for services, including water and sanitation services.²³ Failure to pay is resulting in cut-offs. Given the many factors at play, however, it is clearly difficult, perhaps impossible, to determine the extent to which non-payment and hence cut-offs stem from this habit of non-payment or from a simple inability to pay.

CONSERVATION

As noted, Rand Water pays a set rate per cubic meter consumed (i.e. if it doesn't take it doesn't pay). Since TCTA and DWAF must recover the full costs of the project, if Rand Water does not take for a period of time, TCTA and DWAF stated that the rates may be adjusted upwards to produce the necessary revenue for full cost recovery. Or, alternatively, the debt repayment period could be extended. If the former, the higher rates would normally be passed on to consumers. In principal, higher water rates should encourage conservation. At the same time, if the lifeline rates are undisturbed, this should not place an extra burden on the poor.

On the basis of the foregoing preliminary assessment, Bank Management appears to have supported the RSA's approach to provide water in a manner that is socially equitable while assisting it in aiming for both

²¹ In July 1998, the rate for a house was R18.15 per month. In the two years, 1996 to 1998, this rate rose from R16.26 to R18.15, or 11 percent.

²² See Department of Water Affairs and Forestry, “Water Supply and Sanitation Policy” White Paper, Cape Town, November 1994.

²³ Ditto

cost recovery and conservation. In light of this, the Panel finds that the Bank appears to have complied with this OD.

POVERTY REDUCTION

Paragraph 28 of OD 4.15 on Poverty Reduction, concerning the *Role of the Bank*, states that “The Bank’s role in supporting poverty reduction through individual investment operations goes beyond financing. The Bank supports sustainable, high return projects and project components that benefit the poor and that would not be done, or would be done differently, without the Bank. Since an improved policy framework can increase the returns to individual projects, Bank project support should also encourage the authorities to eliminate policy and institutional biases against the poor. To enhance development effectiveness, Bank operations should support projects and programs – or approaches to public services delivery – that can be replicated or that define investment criteria that can be replicated in donor – and budget – supported programs and projects.”

The Requesters claim that Phase 1B “will create undue burdens on low-income people in Gauteng province, where water rates have already risen dramatically due to LHWP and are expected to rise further as the LHWP bills begin to rise.” They believe that rather than undertake a costly infrastructure project before actually needed, the poor would be better served “by changes in water allocation, repair of leaky infrastructure, a daily lifeline amount of water ... and other approaches.”

The Management Response addresses compliance with this policy only in terms of Lesotho, not South Africa. However, with respect to meeting the needs of poor water consumers in South Africa, it states 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.” The Response goes on to recognize “that there are important challenges remaining in the retail water sector in South Africa such as improvements in infrastructure and the maintenance of retail pricing systems that include a safety net for the poor...” While insisting that these challenges “are not related to the LWHP,” Management states that it “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.” (Emphasis added)

As pointed out in the PAD, access to water supply and sanitation is a critical issue in South Africa, with over 12 million people lacking adequate access. Delivery of water services – particularly to those who have been traditionally excluded – is a priority national issue, with as the PAD notes, significant poverty implications. Recognizing that retail water delivery is closely related, it points out that the PAD discussion focuses on the bulk water sector.

At the same time, there is an increasingly severe lack of funding for addressing retail water delivery problems at the municipal level. There is also an understandable problem of inexperienced institutional capacity at the municipal level since such institutions are post apartheid and their structures and systems are still evolving. In spite of this, South Africa is making impressive strides. For example, during the field visit it was learned that since 1994 nearly 3 million standpipes have been installed.

The question to be addressed by the Panel is whether the Bank Management is required to target poverty reduction in the context of this investment project. And if so, does it appear to have complied with OD 4.15.

As noted, paragraph 28 requires the Bank to “encourage the authorities to eliminate policy and institutional biases against the poor.” This is hardly needed in the context of the unique case of post apartheid South Africa obviously committed to redressing past biases.

The current policy framework for South Africa is in the form of a Country Assistance note (1997). The note identifies “*poverty and inequality*” as one of the four priority areas where the Bank can be of assistance to

RSA. While Management's Response maintains that the Lesotho CAS is consistent with the provisions of this OD, it is silent on the RSA Country Assistance Note. Management explained that the formal CAS is due to be finalized in September 1998. It was also explained that the Bank approaches poverty reduction in the context of the CAS and its overall investment strategy for a country. Taken as a whole, the total portfolio investments in a country should address poverty reduction directly as opposed to any particular intervention. Since the RSA Country Assistance Strategy is not yet available, the Panel is unable to comment on whether the overall investment portfolio would compliment this particular project in terms of poverty reduction. Staff have indicated that the Bank is ready to consider a request from South Africa for financial assistance targeted at addressing the challenge of catching up on the huge inequitable legacy of the apartheid era: providing universal access to water, fixing the existing lack of infrastructure etc. This is the harm the Requesters complain of. It is well recognized. It is part of the enormous legacy of apartheid. However, it neither stems from, nor should it be aggravated by, the decision to proceed with 1B.

On the basis of this preliminary assessment, it would not therefore appear that the Bank has violated the letter of OD 4.15.

3. FINDINGS ON HARM AND BANK'S OBSERVANCE OF ITS POLICIES

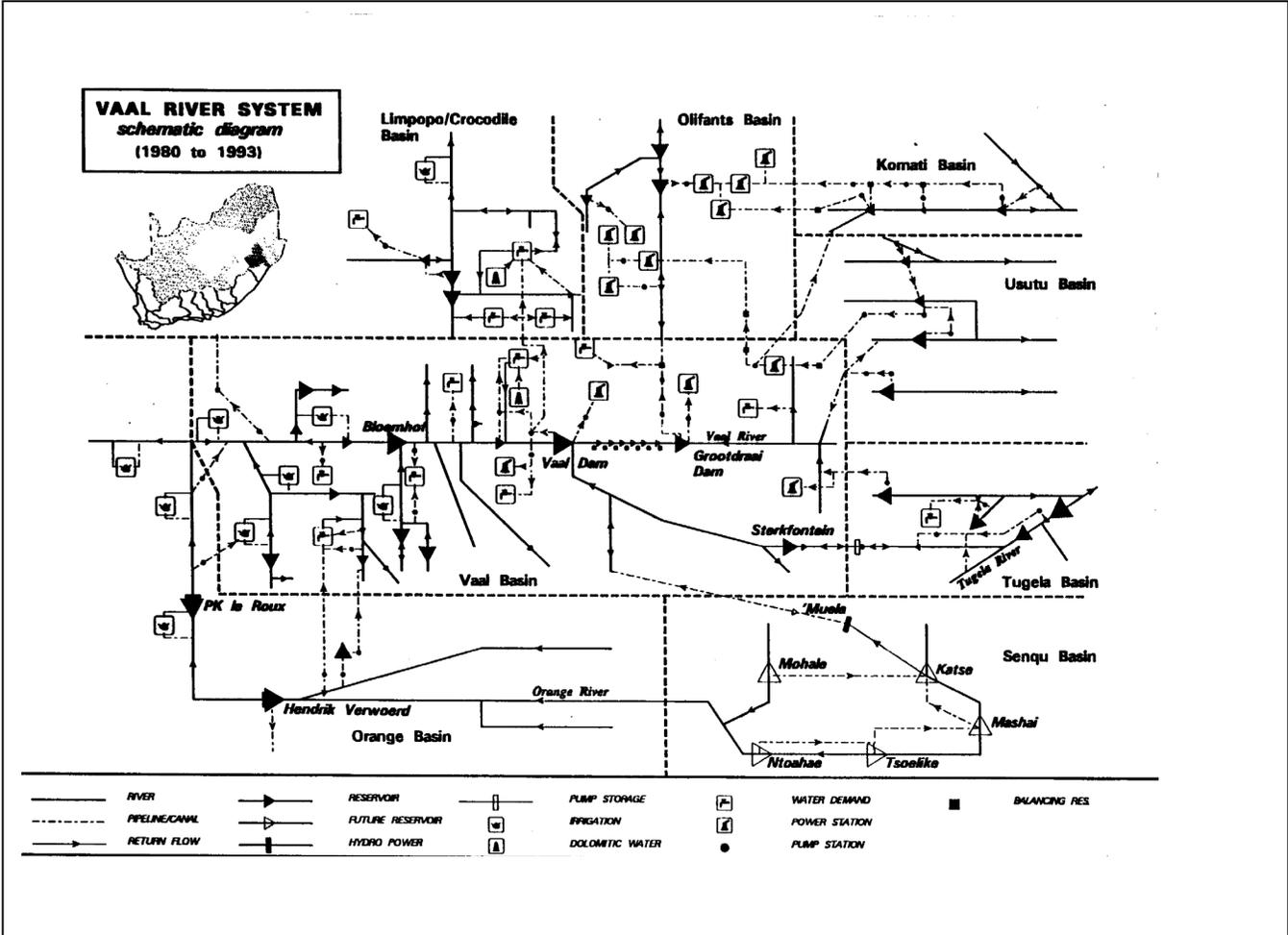
There is no doubt, as the Requesters claim, that for reasons of historical neglect poor communities suffer widespread inequities in terms of lack of or limited access to water. This imposes enormous hardships, especially on people dependent on communal access, who have to carry water in buckets and makeshift containers, often for great distances. Water prices have increased and some are unable to afford water sufficient for basic health and hygiene. Leaky infrastructure is causing severe wastage and health problems. Conditions are harsh and unsanitary for millions of people in Alexandra, Soweto and other poorer townships. But the Panel is not satisfied that there is prime facie evidence linking this situation to the Project, nor with the Bank's decision to proceed with financing 1B.

The Requesters' concerns about the conditions on the ground are valid but there does not appear to be a connection between these conditions and any observance or not by the Bank of its own policies and procedures. Rather, they appear to be a part of the enormous legacy and odious burden of apartheid.

4. RECOMMENDATION

In this context, the Panel recommends that the Executive Directors do not authorize an investigation into this Request for Inspection.

Attachment 1



Annex 1

Request for Inspection

23 April 1998

**The World Bank Inspection Panel
1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.
VIA FAX: 091-202-522-0916**

**c/o Judith Edstrom, Resident Representative, World Bank South Africa
Mission, Pretoria (HAND DELIVERED, SEALED ENVELOPE)**

RE: Inspection Panel Claim regarding World Bank involvement in the
Lesotho Highlands Water Project

To the Panel,

1. Introduction: Background

1.1 Introduction. We urgently request the Inspection Panel to investigate the World Bank's role in the Lesotho Highlands Water Project (LHWP) . This Panel Claim follows a submission made to you on 3 March 1998 by two civic associations in Alexandra and Soweto townships in Johannesburg, Gauteng Province, South Africa. That submission, which took the form of a letter faxed to your offices, was formally withdrawn on 20 April as a result of intimidation. However, the fundamental concerns over issues raised in the 3 March submission remain. As claimants, we are individual affected community residents of Alexandra whose signatures are on the attached page (but who wish to have our names held confidentially by the Panel) .

1.2 Intimidation on previous submission. The reason for our very late request, for which we apologize very sincerely, is that in the wake of explicitly clear South African government intimidation against going forward with the Inspection Panel submission -- which we can provide details about if the Panel requires -- the Alexandra community has been uncertain over how to proceed. The withdrawal was not based on any new, convincing information about the next stage of dam construction or its implications for low-income Gauteng communities, but rather on powerful political forces that operate in South Africa in a sensitive period just preceding the run-up to our country's second democratic election. We are providing you this information in the form of an Inspection Panel Challenge because, in our view, the underlying conditions that are generating pressure on low-income water consumers will only be exacerbated by allowing the LHWP to expand without the necessary studies about its impact and about alternative demand-side management approaches. While this Claim follows and expands upon many of the arguments put forward on 3 March -- for we have had access to similar technical information -- an additional point that requires mention is the incomplete study on the economics of delaying the LHWP, conducted by the Bank's LHWP task manager and released to the public in late March.

1.3 Community resolve to file Claim anonymously. We hereby request that the Inspection Panel urgently proceed with investigating our concerns as residents of

Alexandra township adversely affected by the LHWP, as laid out in this new Panel Claim. We ask that the Panel does so with the understanding that at this time we would rather remain anonymous in view of the chilling climate that now exists.

1.4 The LHWP. By way of background to the LHWP itself, concerns have often been expressed about design flaws associated with the first (completed) dam (Katse, Phase 1A). This Claim is based on the argument that "both Phase 1A and the next dam to be built -- Mohale (along with a diversion weir and tunnel to the Katse Reservoir), known as "Phase 1B" -- cause harm to the claimants and others similarly situated. Indeed we believe that a \$50 million World Bank loan for Phase 1B now being considered by the Executive Directors should be delayed until our concerns are addressed.

1.5 Original LHWP consultation with affected parties. The LHWP is the result of a 1986 treaty between the apartheid South Africa regime and a military regime in Lesotho that took power in a coup. By definition, hence, there was improper Bank consultation about the LHWP with these two states' citizens, many of whom in the mid-1980s were suffering imprisonment, torture and state-sanctioned murder for speaking out on behalf of democracy and development. This is not a theoretical issue, for during the 1980s the African National Congress formally opposed the LHWP. Under these circumstances, there was apparently no attention given by the World Bank design team to the concerns we have always had, in South Africa's impoverished urban townships, about the elimination of poverty, equity in resource allocation, universal access to water and water conservation. The result of not consulting was construction of a megaproject with many serious defects.

1.6 Recognition of flawed design process. The LHWP's legitimacy and the Bank's consultative process in project design have been called into question many times, and are beyond dispute. At an NGO conference on the LHWP in August 1996, for example, an official (Michael Potts) of the Development Bank of Southern Africa (DBSA) conceded, "Given the limited access to foreign funds by the South African government and the limitations on contractors' funding proposals --export credit was not available to South Africa -- a very complex treaty was negotiated to bypass [anti-apartheid financial] sanctions. In Lesotho the credibility of the treaty was also questioned because the military government ruling Lesotho at the time did not permit open debate on the treaty." In short, according to even the DBSA official, "The planning of the social aspects of the LHWP was subordinate to the technical planning. The environment within which the environmental action plan had to be implemented was not conducive to sustainable development."

1.7 Other social and ecological issues raised previously. Concerns about the LHWP are not limited to consumer issues. At 185 meters, Katse is the highest concrete dam in Africa and one of the largest infrastructure projects in the world. Phase 1A directly affected 2,000 people -- approximately 300 households and indirectly affected at least 20 000 more who lost the use of common resources or income through the submersion of 925ha of arable and 3000ha of grazing land. This has had enormous social, environmental, and economic impacts on the people of Lesotho. Recent surveys indicate dissatisfaction on the part of Lesotho residents with resettlement schemes and provisions for reimbursement. Phase 1B will inundate 550ha of extremely good cropland and will force resettlement of 400 families. Following erosion of much of

Lesotho's arable land over the past three decades, only 9% of the country's soil is presently available for cultivation. The proposed Phase 1B will exacerbate this situation, and in addition will destroy the habitat of the Maluti Minnow (an endangered species), bearded vulture and four other species considered "globally threatened."

1.8 Other implementation issues raised previously. Numerous complaints have arisen about the LHWP's implementation to date, including the lack of an initial Environmental Impact Assessment; a woefully inadequate social plan; flooding of ancestral burial grounds; an upsurge of social problems (including sexually transmitted disease and increased stock theft); poor labour relations that led to the murder of several workers by Lesotho police in September 1996; cost overruns due to an unanticipated need to line the Katse tunnels with cement; corruption on the Muela hydropower component of the project and funds established to devolve LHWP financial benefits to Lesotho's citizens; failure to account for soil erosion and sedimentation of the reservoir; and reservoir induced seismicity that in the village of Mapeleng generated a crack 1,5 km long that damaged nearly 70 houses. According to the leader of the Highlands Church Action Group, "The project shows no sensitivity to the impact on gender issues and roles of women." In addition, according to a leading academic at the University of the Free State, the effects on the Orange River catchment include a "considerable shortfall of water at the mouth... This will result in a river mouth that is either dry for years on end apart from exceptional floods or will be inundated by seawater intrusion." NGOs in Lesotho, South Africa and internationally have repeatedly brought these issues to the attention of World Bank staff (for example, at the 1996 conference and in continual correspondence between NGOs and the Bank LHWP task manager since)

1.9 World Bank role. The responsibility of the World Bank for social and ecological design problems, as well as the economic miscalculations described in more detail below, is also beyond dispute. The LHWP was initially funded by the World Bank with a US\$110 million loan on condition that South Africa stood surety. The Bank has repeatedly stated that its work on this project is small (just 5% of total project costs), thereby somehow implying that it is less liable for project problems. However, the following description from the Lesotho Highlands Development Authority implies a much more critical role: "The World Bank acted as a catalyst to bring all the financing together... It is also working to ensure that World Bank guidelines on resettlement and social impacts are met. The World Bank has the capacity to advise on ensuring that adequate attention is given to sensitive environmental issues. The World Bank's involvement assures lenders that the Project is a worthwhile investment opportunity." Thus the World Bank's role in this project extends beyond its role as a financial partner.. The presence of the Bank provides the catalyst that allows the project to exist, and is supposed to provide guarantees of technical assistance and leadership on mitigation of social and environmental impacts. By rushing this project and requesting approval for financing from Bank Executive Directors before necessary studies and public participation have taken place, Bank staff are undermining the credibility of the institution and the LHWP, and, we argue, are causing material harm to the people of South Africa and Lesotho.

1.10 South Africans' financial obligations. Part of that harm can be measured in rands and cents. According to the Bank, "In terms of the Treaty, South Africa bears the full costs of the project as well as the associated debt, except for a hydroelectric

component which will supply all of Lesotho's power requirements and which is being financed 100% by Lesotho with donor assistance. Lesotho bears none of the 'costs linked to the water transfer component of; the project." As Water Affairs and Forestry Minister Kader Asmal put it in a speech to the 1996 Group for Environmental Monitoring Workshop on the LHWP, "The debt related to the water transfer part of this project will be redeemed by South Africa through income generated by the project. In other words, the end users will pay for the project, at tariffs well within the capabilities of the beneficiaries, making it economically viable." This is the crucial point of debate, and we want to assert that, in hindsight, Minister Asmal -- and World Bank staff who have advised him on water pricing, at retail level, for low-income residents of Gauteng townships are incorrect in this statement.

1.11 Relative water access by low-income consumers. Gauteng consumers bear the bulk of the LHWP costs, both for capital and recurrent expenditures. But millions of the province's low-income citizens are already beset by severe problems of poverty, disease, environmental decay, geographical segregation and women's oppression due to the inadequate levels and high costs of water and sanitation services. South Africa's inequality in access to water is striking. According to a recent Central Statistical Services Household Survey, only 27% of African households have running tap water inside their residences and only 34% have access to flush toilets. By consuming less than 2% of all South Africa's water, the country's black township residents together use less than a third of the amount used in middle- and upper-income swimming pools and gardens, not to mention white domestic (in-house) consumption or massive water wastage by white farmers who have had enormous irrigation subsidies over the years and who use 50% of South Africa's water. Moreover, out of every 100 drops that flow through Gauteng pipes, 24 quickly leak into the ground through faulty bulk infrastructure. Still more waste occurs in leaky communal, yard and house taps. In the higher elevations of Alexandra township, these problems are witnessed in the perpetual lack of water pressure. Hundreds of thousands of low-income people in Alexandra and other townships have no immediate house or yard access to reticulated water supplied by our Johannesburg municipality, and instead receive at best only communal access, with all the public health problems that this implies. Indeed, the lack of available water on a universal basis means that public health conditions are worse; geographical segregation of low-income Gauteng residents (from wealthier residents) is more extreme; women are particularly inconvenienced, and their income-generation and care giving capacities are reduced; and the environment is threatened (in part because of the shortage of water-borne sanitation) . For reasons established below, we believe that the LHWP expansion will exacerbate rather than ameliorate our access, equity and quality problems. This could not come at a worse time, as Gauteng municipalities - including Johannesburg -- are suffering extremely serious financial difficulties that are forcing them to dramatically increase the pace of water cut-offs to low-income consumers, as well as the retail price of water.

1.12 Alternatives not explored sufficiently. Are there alternatives to Phase 1B? Bank staff do not know, for as far as we can determine, the desire by communities to address our townships' own water-infrastructure shortcomings especially leaky connector pipes, but also leaky water taps that together cost Sowetans approximately 40% of our water -- has never been fully explored or supported by Bank staff. The possibility for changing water usage patterns through progressive block tariffs has not

been factored in (in part because Bank staff explicitly oppose differential pricing of water). The impact of water conservation education has not been considered. The possibilities for regulations prohibiting excessive watering of suburban gardens has not been addressed by Bank staff. The potential for saving water through clearing invasive alien trees has not been calculated. The physical replacement or installation' of low-flow showerheads, dual-flush toilets, and similar mechanical interventions have not been addressed. These are crucial alternatives which could ameliorate the need for the remaining phases of the Lesotho project. These alternative options have not been taken seriously, as far as we can tell from analyzing Bank-supplied information.

2. The Inspection Panel Claim

2.1 Claimants as affected parties. As residents of Alexandra township, we are part of the low-income consumer population who must pay a disproportionate bill for the LHWP. As "affected parties," the claimants and others similarly situated have suffered and will suffer harm because of violations of Bank policies associated with LHWP Phases 1A and 1B, as outlined below. We 'live within the country or an area immediately affected by the Bank-financed project. Finally, through the contacts of our technical advisors, Non-Governmental Organisations here and abroad, community organisations in Alexandra with which we are allied, and more general public pressure and publicity, our concerns have been repeatedly raised with Bank management. We are not satisfied with the response, particularly in relation to the possibilities of combining demand-side management with universal access to water.

2.2 Summary of Claim. To briefly summarise our concerns, the LHWP represents an expensive, ecologically unsound water supply project whose expansion is not needed for many years (by some estimates, two decades) and that has resulted and will result in a variety of problems that represent material harm to the claimants and our allies:

2.2.1 rising water prices (thus adversely affecting the ability of low-income people to gain access to water, and in the process lowering public health status and environmental conditions, with particular costs borne by women, children and the elderly);

2.2.2 less incentive to instigate demand-side management measures (hence leaving townships with failing infrastructure and limiting the ability of service providers to cross-subsidise);

2.2.3 increased fiscal stress on municipalities (which in turn will cost workers their jobs and/or income, and will lead to greater pressure to reduce subsidies to low income people and to cut off water in the event of nonpayment); and

2.2.4 fewer resources for the capital and recurrent, subsidies required to improve and construct water supply infrastructure appropriate for low-income communities.

2.3 Phase 1B delay is feasible. Over the past six months, information has been presented publicly and privately by South African authorities as well as Bank staff, that lead us to conclude that a significant delay in further LHWP construction is not only possible but would save hundreds of millions of Rand per year (even considering the

continuation of payments to Lesotho for water that would have been delivered with Phase 1B, and the economic loss to Lesotho if 1B was delayed). As stated by an official of Rand Water and reported in Johannesburg newspapers on 13 March 1998, "we could drop supply by 40%" and in the process delay the LHWP "by years," hence "conservatively" saving R800 million per annum. That money could be spent on demand-side management alternatives that would conserve water and assure equity.

2.4 Demand-side alternatives not yet investigated. We understand that Bank staff still have not required a full study of demand-side management alternatives before recommending a new LHWP loan, despite its own policies on Alternatives, Economic Evaluation of Investment Options and Water Resources Management, among others. Communications from Bank staff concede that demand-side management should have been studied in much greater detail at the outset, but the concluding argument is that the project is "too far along" to make a delay economically viable. Despite requests and extensive publicity about the issue in the South African press, information or studies that would clarify the economic consequences of enhanced demand-side management have not been made available to us.

2.5 Shortcomings in Bank study on economics of a delay. The Bank's March 1998 study on the economics of a delay in the LHWP downplays the possibility of substantial demand-side management interventions. The new report assumes a 3.3% annual water demand increase in Gauteng, and therefore clearly does not take demand-side management arguments seriously. Specifically, the new study makes the following comments about demand-side management, which indicate a lack of serious consideration of the issues under debate: "It is not clear what the scope is for further demand management ... Demand management capabilities and their impact in South Africa are theoretical and have not yet been tried and tested... The last thorough analysis of water demand in the Vaal system was done in the mid 1980s."

2.6 Implications of proceeding too rapidly with Phase 1B. Thus we are concerned that the decision to proceed based largely on sunk costs ignores the significant economic benefit of demand-side management (thereby failing to seriously consider a viable and important alternative, in violation of several Bank policies). Bank staff seem intent on moving this forward despite clear and obvious problems and policy violations, and we question the incentive structure that appears to encourage Bank staff to throw good money after bad. Bank staff appear to be motivated to move money for the sake of moving money, rather than carefully considering the implications of moving forward with the project or the cost savings, social and environmental benefits inherent in a delay. We question the wisdom of throwing more money at a project when important questions about the need for the project exist. We also note that, as discussed more fully below, continuing with this project will have an enormous effect on South Africa's future water management planning.

2.7 Implications of delaying Phase 1B Than decision. A reconsideration of this project in accordance with the Bank's policies on environmental assessment, consultation, and consideration of investment alternatives would allow the parties concerned to save money and would give further incentive to South African state agencies -- at national, catchment-area and municipal levels -- to focus on steps that are consistent with the objectives of poverty alleviation and access to water for the poor. The authorities could

take steps to fix the region's badly leaking delivery system, install water-conserving appurtenances, and implement measures such as tariff reform to reduce use by the biggest and most wasteful users. Otherwise, we believe this very costly project will force Rand Water --responsible for 18% of debt-service costs of the project -- to sell greater amounts of higher cost water. The requirement that Rand Water pays for the unneeded water will generate a strong disincentive for conservation. We believe that the Bank has failed to adequately consider the impacts that the project will have on South African consumers and the environment.

2.8 Delay of approximately ten months required. A delay in a funding decision is necessary until a demand-side management report is prepared, which is anticipated in early 1999. We understand there have been no public studies that document the economic impact on Rand Water of bringing this water on-line before it is needed. Given the inaccuracy of earlier Bank demand estimates (which were overoptimistic by a factor of 40%), the project's economic analysis could be profoundly affected by new information on demand. Moving ahead before the information is complete violates policies on Economic Evaluation. To wait ten months for more scientific demand-side management studies would not, Bank staff concede in the study on the economics of delay, result in the withdrawal of favourable bids by construction companies.

2.9 Implications for retail water pricing and investment. Finally, the claimants are also concerned that the high cost of LHWP water will worsen the impact that follows directly from other Bank advice to the South African government regarding fiscal management, water pricing and infrastructure investment. The Bank's policy advice and the Bank's promotion of LHWP are integrally linked, as was demonstrated during an October 1995 presentation by Bank staff to a Department of Water Affairs and Forestry (DWAF) conference. At that conference, detailed water pricing principles contrary to those advocated by civic associations and even the main purchaser of LHWP water, Rand Water, were promoted during a Bank slide presentation on the LHWP, notwithstanding explicit suggestions to the contrary by civic movement representatives and Rand Water in consultations prior to the conference. Indeed the Bank's South African policy advice - in the water sector for both urban consumers and low-income rural farmers (during the October 1995 conference and in subsequent communications with DWAF) and regarding infrastructure investment (the Urban Infrastructure Investment Framework of March 1995) -- has consistently contradicted the traditional civic movement demand, and constitutional guarantee, that water is considered a human right, and that a universal entitlement be provided. The Bank staff's advice is also opposite to that found in the 1994 World Development Report: Infrastructure for Development, and is fundamentally incompatible with the Bank's mission of poverty reduction, as discussed below.

2.10 Implications for municipal fiscal stress. Municipalities have borne the costs of rising water prices and limited retail affordability in recent months, and are passing them on to workers, who are increasingly suffering wage and retrenchment pressure, and to communities, in the form of increased levels of water cut-offs. This reflects both overall municipal fiscal stress (as central to local grants declined by 85% in real terms from 1991/92 to 1997/98) as well as higher priced bulk water costs. Debts by Gauteng municipalities for bulk sewerage and bulk water supplies that are more than 60 days overdue amounted to R69 million at the end of 1997, and another R20 million in water-

related debts were between 30 and 60 days overdue. The 24 Gauteng municipalities raised total income of R968 million from water bills to all classes of consumers in 1997 and spent R1 019 million on water services (a deficit of R51 million). In contrast, of the 236 municipalities that report across South Africa, water bills raised R 2414 million in 1997, and expenditures were just R 2388 million (a surplus of R 26million). This is surprising given that Gauteng is South Africa's wealthiest province. The fiscal stress caused by deficits on the water account are part of the reason that the following Gauteng municipalities were declared, in December 1997, to be in default of government "viability" criteria (sufficient cash and investments to meet one month's personnel bill): Johannesburg, Pretoria, Alberton, Brakpan, Randfontein, Bronkhorstpruit, Walkerville and Vereeniging Koponong.

2.11 Implications for low-income residents. The direct consequence of rising indebtedness has been intensified municipal "credit control" against those households who can not afford to pay for increasingly costly water. Rand Water price increases announced in February 1998 - which were more than 50% above the inflation rate, because 75% of the increase is from the LHWP -- will affect the claimants at a time that unemployment is increasing, overall municipal bills are being increased and some Wealthy ratepayers are offering stiff resistance to paying their fair share. The implications of rising water prices and the lack of a "lifeline tariff" -- a basic water service available to even to the very poor -- include not only switching of funds in household budgets away from other necessities, but also a dramatic increase in residential water cut-offs in Gauteng since early 1997. According to the Department of Constitutional Development's "Project Viability," 24 out of the 30 Gauteng local authorities (representing a population of more than 12 million people) that replied to an official questionnaire, engaged in water cut-offs. These cut-offs affected 512 households in the first quarter of 1997, 932 households in the second quarter, 1 210 households in the third quarter and 5472 households in the fourth quarter. The ability of many of these households to afford their bills was limited, as witnessed by the fact that only 252, 449, 613 and 1 064 Gauteng households were reconnected in those four quarters of 1997, respectively. There are many other potential indicators of the costs of increasing water tariffs associated with the LHWP, including public health costs and ecological problems (as excessive water-borne sanitation costs lead to informal sanitation arrangements), most of which generate a bias against low-income women, which should also be researched and factored into the water pricing and access policies. However, these are at present not being adequately considered, due to the intensive pressure municipalities face to balance their books in the very short term.

3. Contact with the World Bank

3.1 Contact with the World Bank. Prior to filing the Inspection Panel submission of 3 March, civic association leaders took the following steps to resolve differences with the World Bank:

3.1.1 initial discussions were held between Bank staff, South African National Civic Organization (SANCO) staff and Rand Water officials in September 1995, in which the civic position (endorsed by Rand Water) in favor of lifeline water supplies and cross-subsidies was recorded but formally opposed by Bank staff (indeed the civic position was specifically rejected by Bank staff during a October 1995 DWAF conference, in

spite of lifeline supplies being recommended in the previous year's World Development Report as well as the ANC's Reconstruction and Development Program, which was its campaign platform in 1994 and hence its mandate to govern);

3.1.2 there was a subsequent identification and 'discussion of the problem of inadequate demand-side management analysis at an NGO consultation meeting (attended by a researcher who serves Gauteng civic organizations) at the World Bank in Washington, DC on 23 October 1997, where once again Bank staff rejected without serious consideration the position put forward on behalf of lifeline water supplies and cross-subsidies;

3.1.3 there were subsequently several e-mail requests to World Bank staff for information concerning the relationship of the LHWP to Bank policy advice on water pricing and tariffs, in October-November 1997;

3.1.4 several e-mail invitation letters and oral invitations were sent to World Bank staff (based in both Washington and Pretoria) in November 1997, to join 80 Alexandra and Soweto township leaders at--and present information to, and learn from a large workshop (on 16 November in Johannesburg), specifically about the LHWP and its implications for Gauteng communities (Bank staff did not attend, notwithstanding indications they would);

3.1.5 an e-mail letter was sent to World Bank staff on 26 November 1997, clarifying the position of the civic associations and requesting information on how to bring a Claim to the Inspection Panel;

3.1.6 an e-mail invitation was sent to World Bank staff to tour Alexandra township in December 1997 (the invitation was initially accepted but then rejected);

3.1.7 a public statement was made by many Non-Governmental Organizations concerning the need for a delay in Phase 1B on the occasion of the 20 January initial transfer of water;

3.1.8 there was a meeting between Alexandra and Soweto civic leaders and World Bank staff on 21 January 1998; and

3.1.9 a follow-up letter was sent to World Bank staff on 27 February 1998, specifying the civic movement's objections to the LHWP.

3.2 World Bank reactions. World Bank staff had private discussions with leaders of the Alexandra and Soweto communities, but it is disappointing that there was not direct Bank contact with larger groups of low-income Gauteng residents affected by the LHWP. Opportunities to visit the affected townships and meet their residents in order to experience firsthand the water problems were declined by Bank staff. The Bank also made public its responses to civic concerns through two newspaper articles' that appeared in Business Day: "Delaying water project 'would increase risk of severe shortages'," 5 February; "SA advised to proceed with Lesotho project," 25 March. Business Day is not, however, widely available within Alexandra township.

3.3 Inadequate response to concerns. The Bank's response to legitimate community concerns has, to date, been inadequate. The need for attention to the demand related issues raised is largely unmet, even though the Bank has enormous resources available to conduct demand-side management studies and make staff available for consultations with affected communities. The acknowledged lack of scientific demand-side management research conducted by the Bank is disturbing, particularly when considering the enormous cost implications for our region's consumers. Bank staff owe it to those paying the LHWP's bills to ensure that their research is water-tight, and that they have communicated this research to Gauteng consumers in a proactive manner.

4. Contact with the South African Government

4.1 Contact with the South African government. In addition to making concerns known to the Bank, additional steps were taken by civic leaders to address the problems within South Africa (prior to the withdrawal of the Inspection Panel submission on 20 April)

4.1.1 an initial statement of concern was made to South African authorities, in the form of a protest march from Soweto to the Johannesburg Southern Metropolitan Local Council over dramatic increases in water bills (which were entirely attributed by Johannesburg councillors to the LHWP) on 22 July 1996;

4.1.2 a meeting /workshop with Rand Water was held on 16 November 1997;

4.1.3 a letter setting out these concerns was sent to Minister Asmal in January 1998, and a meeting was held on 6 March 1998.

4.2 Government support for Phase 1B. The South African Government has not responded with detailed studies as to whether Phase 1B can be delayed through a demand-side management strategy. It is possible that Minister Asmal may, over time, be successful in implementing more sensible water policies with a demand side management orientation. However in the short term, high levels of pressure from vested interests, including World Bank staff, appear to have generated an official South African Government decision in favour of proceeding with Phase 1B, notwithstanding documented opposition from technical experts employed by Rand Water. There has also been explicit intimidation by the South African government against the use of the World Bank Inspection Panel mechanism to help resolve the concerns. For these reasons, it is imperative that the Inspection Panel mechanism be brought to bear as a neutral referee.

5. Applicable World Bank Policies and Operational Directives

5.1 Relevant policies. The World Bank abides by numerous policies and procedures that may have been violated by the LHWP. These policies are applicable (though not universally) to Phase 1A as well as (universally) to the next phase of the project, Phase 1B, now under consideration by the Bank. The following are relevant policies which we believe were violated by Phase 1A (though some did not apply at the time 1A was constructed) and that will be violated by Phase 1B.

5.2 OD 4.00, Environmental Policy for Dam and Reservoir Projects (Consultation) Para 19. Consultation with Non-governmental Organizations (NGOs) and Affected Groups, states: "Community organizations, research centers, environmental advocates, and other NGOs can often provide valuable perspectives on improving both project design and implementation. To tap these perspectives, the Bank encourages consultations by project authorities (including consultants preparing the project) with appropriate NGOs, particularly local NGOs ... In addition, the Bank encourages consultation between project executing agencies and the population affected by the project, as part of the project design process."

5.2.1 As consumers and citizens who will have to pay for the LHWP, we have not had a truly adequate consultation with the Bank at any stage of this project, but the failure to consult more widely, notwithstanding opportunities presented to World Bank staff, is especially evident and problematic in light of the questions raised about demand-side management and project costs.

5.2.2 We believe it essential that civil society be brought into a public debate about the expansion of the LHWP, in part through a project delay. Because low-income water consumers have not been adequately consulted, we 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.

5.3 OD 4.00, Environmental Policy for Dam and Reservoir Projects (Design Alternatives). Para. 5, Design Alternatives, states: "Design of investment programs for supplying water or energy should consider demand management as well as supply options (e.g., conservation of water and energy, efficiency improvements, system integration, cogeneration, and fuel substitution)

5.3.1 The Bank has not fully investigated demand-side management options during the planning of either phase of the LHWP. As noted above, Bank staff have inadequately responded to findings relating to demand-side management, by failing to conduct rigorous evaluations prior to seeking further funding for 1B. It is possible that effective demand-side management could delay for many years the need for this massive project, and Bank staff's failure to consider this possibility seriously is a fundamental violation of Bank policy with considerable economic, social and environmental impacts. Moreover, the Bank's initial 1A demand calculations were terribly inaccurate -- 40% higher than actually occurred -- and it is worrying that scientific analysis associated with 1B-related water demand will not be available for some time.

5.3.2 Demand-side management in the townships has not been taken seriously by officials, for it is only now that attempts to address faulty, apartheid-era infrastructure are being made, and even now only in a tentative way without sufficient financial commitment. It is true that there are (very minor) financial commitments now being made in these areas, but in the context of municipal fiscal stress discussed above these are not likely to make a substantial difference. We are aware that the Bank has made its own contributions to South

African debates over demand-side management, but in these contributions, Bank staff have overstressed financial (not economic) efficiency measures (through a proposed pricing system) and downplayed -- often even arguing explicitly against - entitlement access through the kind of lifeline tariff and progressive block tariff measures supported widely in South African townships, and endorsed in the World Development Report 1994 and the Reconstruction and Development Program. The latter document clearly specified the need for tariff restructuring, cross-subsidies and lifeline services to the poor:

- To ensure that every person has an adequate water supply, the national tariff structure must include the following:
- a lifeline tariff to ensure that all South Africans are able to afford water services sufficient for health and hygiene requirements;
- in urban areas, a progressive block tariff to ensure that the long-term costs of supplying large volume users are met and that there is a cross-subsidy to promote affordability for the poor, and
- in rural areas, a tariff that covers operating and maintenance costs of services, and recovery of capital costs from users on the basis of a cross-subsidy from urban areas in cases of limited rural affordability (section 2. 6. 10).

5.3.3 Similar points were also made repeatedly in the World Development Report 1994, though they were rejected by Bank staff operating in South Africa (both in the water pricing advice and in the Urban Infrastructure Investment Framework):

There are, however, ways in which infrastructure subsidies can be structured to improve their effectiveness in reaching the poor. For example, for water, increasing-block tariffs can be used -charging a particularly low "lifeline" rate for the first part of consumption (for example, 25 to 50 liters per person per day) and higher rates for additional "blocks" of water. This block tariff links price to volume, and it is more efficient at reaching the poor than a general subsidy because it limits subsidized consumption. Increasing-block tariffs also encourage water conservation and efficient use by increasing charges at higher use. These tariffs are most effective when access is universal. When the poor lack access, as is frequently the case, they do not receive the lifeline rate and typically end up paying much higher prices for infrastructure services or their substitutes (pp.80-81).

5.3.4 The Bank staff's acts of omission are having and will continue to have serious material, adverse consequences for low-income residents -- such as water cut-offs, water wastage and unhygienic conditions associated with leaky township water systems -- and will in the process exacerbate the dramatic inequalities between races and income groups inherited from the apartheid era.

5.3.5 As mentioned above, many design alternatives to the LHWP are now being seriously explored within DWAF. Yet various demand-side techniques have apparently not been factored into demand schedules or demand curves for

the Vaal basin. They include repairing our townships' leaky connector pipes and leaky water taps, modernizing and fixing meters, changing water usage patterns through progressive block tariffs, promoting water-sensitive gardening and food production, intensifying water conservation education, regulating or prohibiting excessive watering of suburban gardens, implementing other water use regulation, clearing invasive alien trees, promoting school water audits, billing consumer with more informative material, and installing low-flow showerheads, dual-flush toilets and similar mechanical interventions. The Bank has the resources to -- and-should as a matter of policy -evaluate such. options, but in the case of both phases of LHWP, did not. In violation of Bank policies, alternative options have not been considered seriously.

5.4 OP 10.04, Economic Evaluation of Investment Options. Para. 3, Alternatives, states: "Consideration of alternatives is one of the most important features of proper project analysis throughout the project cycle. To ensure that the project maximizes expected net present value, subject to financial, institutional, and other constraints, the Bank and the borrower explore alternative, mutually exclusive, designs. The project design is compared with other designs involving differences in such important aspects as choice of beneficiaries, types of outputs and services, production technology, location, starting date, and sequencing of components. The project is also compared with the alternative of not doing it at all." Moreover, Para 5. Sustainability, states: "To obtain a reasonable assurance that the project's benefits will materialize as expected and will be sustained throughout the life of the project, the Bank assesses the robustness of the project with respect to economic, financial, institutional, and environmental risks. Bank staff check, among other things, (a) implementation to ensure that the project functions as designed, and 9b) whether critical private and institutional stakeholders have or will have the incentives to implement the project successfully."

5.4.1 There has been little or no analysis of how building either 1A from 1986-97, or building the proposed 1B now, before the water is needed, has affected and will affect Rand Water and its end-users, especially low income users with inadequate access to water or who suffer the effects of failing infrastructure. Analysis conducted to date does not sufficiently evaluate alternatives to 1B, by fully considering the costs and benefits -- including social and environmental benefits of not building the project. In short, Bank analysis regarding 1A was innocent of any of the economic and sustainability concerns we raise now, and analysis of 1B's optimum starting date has not seriously incorporated demand-side management possibilities, and hence is weighted toward funding and completing the project at the earliest opportunity. A more thorough analysis of 1B may reveal that a major delay is not only cost-effective but also desirable.

5.4.2 One important economic justification for building the project now is the possibility of a major drought. The detailed economic analysis of drought, and possible scenarios for dealing with it other than building this dam, have not been shared with affected communities. Whether demand-side management that could reduce the supply need by 40% would mitigate the drought costs has not been considered by the Bank. Moreover, the expansion of water storage

(through Phase 1B's construction) beyond that presently required will have the effect of hindering conservation efforts, compared to the option of dam delay, thus exacerbating problems in the event of a drought.

5.4.3 The sustainability of Phase 1B has not been securely established, since a thorough study on its impacts on the downstream environment is not yet complete and will not be for a few years. The Orange River is already suffering from over-allocation problems downstream, and this project will add to that problem. Again, the Bank is proceeding with a project without considering the important social and environmental impacts of its actions, in violation of its policies.

5.4.4 This project is also not sustainable economically, due to the burden it will place on Rand Water and its end-users. To illustrate, according to 1995 Bank reports, a cubic meter of water from the Vaal Dam costs ..(in SA currency) 8 cents (US\$0,016), from Bloemhom 10 cents, from Tugela Vaal 21 cents, and from the combination of Lesotho's Katse (complete) and Mohale (proposed), a staggering R1,50 (US\$0,30). Bank staff have told Minister Asmal that it would be "economically appropriate" to raise the price of Vaal water from 30 cents to R1,50 per cubic meter. To put this in perspective, the three other projects provide Gauteng with 2,3 billion cubic meters a year, while the two Lesotho dams together would add just another billion. There has been no published information on whether the economy of Gauteng can absorb such price increases.

5.5 OP 4.07, Water Resources Management. Para. 1 states: "Bank involvement in water resources management entails support for providing portable water, sanitation facilities, flood control, and water for productive activities in a manner that is economically viable, environmentally sustainable, and socially equitable." Moreover, Para. 2 states: "The Bank assists borrowers in the following priority areas: (a) Developing a comprehensive framework for designing water resource investments, policies and institutions. Within this framework, when the borrower develops and allocates water resources, it considers cross-sectoral impacts in a regional setting (i.e. a river basin). (b) Adopting pricing and incentive policies that achieve cost recovery, water conservation, and better allocation of water resources. (c) Decentralizing water service delivery, involving users in planning and managing water projects, and encouraging stakeholders to contribute to policy formulation. The Bank recognizes that a variety of organizations 'private firms, financially autonomous entities, and community organizations may contribute to decentralizing water delivery functions. Thus it supports projects that introduce different forms of decentralized management, focusing on the division of responsibilities among the public and private entities involved. (d) Restoring and preserving aquatic ecosystems and guarding against overexploitation of groundwater resources, giving priority to the provision of adequate water and sanitation services for the poor."

5.5.1 Because the LHWP will result in water cost increases (9% this year, following a 30% increase last year) of above the inflation rate (last year below 8% and presently below 6%) for poor users (according to Standard and Poors analysis of Rand Water, and-in a press conference on 27 February, according to Rand Water itself), and because it will add supply that is not needed at this time, the LHWP

does not meet the standard of social equity described in this directive, and fundamentally contradicts the terms of OP 4.07. It will likely reduce the incentive to force the biggest users to practice water-conservation and will not encourage better allocation of resources -- in fact, more likely Phase 1B will have the opposite effect.

5.6 OD 4.15 Poverty Reduction. Para. 28 states: "The Bank's role in supporting poverty reduction through individual investment operations goes beyond financing. The Bank supports sustainable; high return projects and project components that benefit the poor and that would not be done, or would be done differently, without the Bank. Since an improved policy framework can increase the returns to individual projects, Bank project support should also encourage the authorities to eliminate policy and institutional biases against the poor." Moreover, Para. 39. states: "Popular Participation and NGOs Effective implementation and operation of most poverty-reduction projects require the active involvement of the beneficiaries. Active beneficiary participation also should be built into earlier stages of the project cycle. Participation is most critical to the success of projects designed to help specific groups of people. It is important, for example, in family planning, community health, food security, urban upgrading, nutrition, and community water supply projects."

5.6.1 In contradiction of the terms of OD 5.16, this project will create undue burdens on low-income people, not only on project-affected people in Lesotho, but in Gauteng Province, where as noted, water rates have already risen dramatically due to the LHWP and are expected to rise further as the LHWP bills begin to rise. Bank staff have in fact helped to undermine attempts to serve the needs of low-income people and rather than eliminating, are encouraging "policy and institutional biases against the poor." To undertake such a costly infrastructure project well before it is needed shows, we believe, a bias against low-income people (in favour of those associated with-the very profitable construction of the LHWP), who would be better served by changes in water allocation, repair of leaky infrastructure, a daily lifeline amount of water (50-60 liters per capita per day is the Reconstruction and Development Program medium-term objective) and other approaches.

5.6.2 As noted above, affected people have not been fully consulted, not at early stages nor more recently, about the impact of the water pricing implications of the LHWP on poverty. Within the past six months, hundreds of thousands of low-income South Africans have had their personal water supplies cut off as municipal authorities have had to come to grips with persistently lower Intergovernmental Grants (in 1997-98, 85% below the real 1991-92 levels, according to the Financial and Fiscal Commission). These diminished transfers, which explicitly harm low-income consumers, are apparently required because of the ambitious deficit reduction targets in the Growth, Employment and Redistribution strategy adopted in June 1996, following extensive World Bank staff inputs and Bank modelling, but without an adequate safety net for those in default on municipal water accounts.

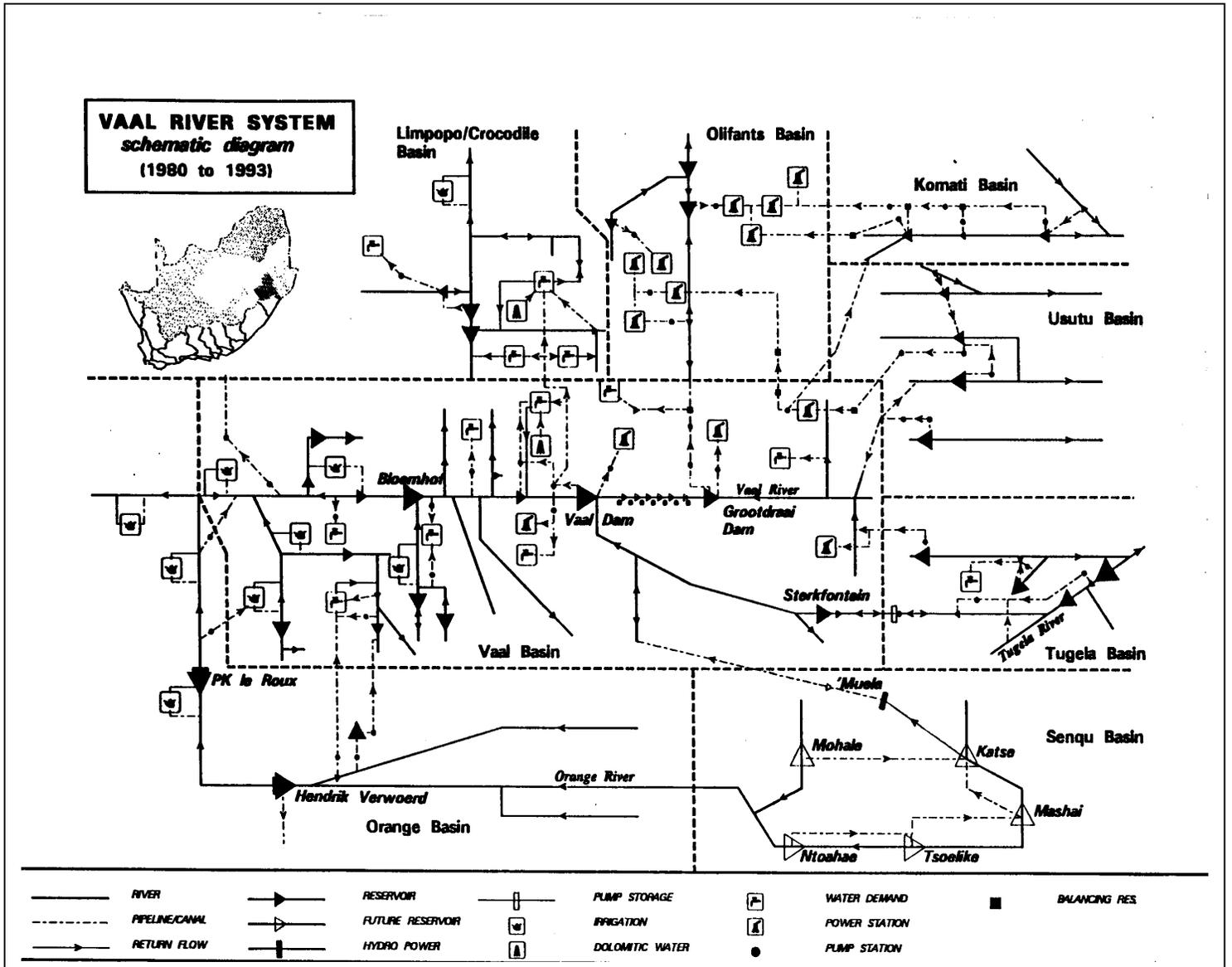
6. Conclusion

6.1 Summary information. We state the above concerns as summary information. There is a great deal of backup documentation available to justify all of our concerns, including detailed e-mail discussions with World Bank staff that record the Bank's failure to adequately carry out conservation and equity measures, and Bank acknowledgement that a long delay in the next phase of the project is not unreasonable. The claimants will provide the panel with this information, much of which needs to be kept confidential to protect claimants' identity, in a supplemental package.

6.2 Wide support for demand-side management approach. There is, in fact, little controversy over the need for South Africa to focus more on demand-side management. The case for a delay in the LHWP's expansion is strongly supported in South Africa, and indeed the environmental reporter for Business Day newspaper recently (on 19 March) concluded that "calls for delay [in Phase 1B] ... may be justified in order to allow SA to clean up its own backyard concerning water wastage." As the Bank's LHWP task manager himself expressed the shortcomings of previous Bank studies (in an October 1997 memo), "All of this shows that if demand management had been on the table in 1986 at the time of the treaty negotiation, and if the commitment to 1B had not been made on the terms that it was -- then the whole story would be different. Lesson: push the demand management stuff."

6.3 Conclusion. It is therefore logical both for the Bank Inspection Panel to initiate an investigation, and for the Executive Directors of the Bank to delay any funding approval until a clearer picture emerges of whether the Lesotho Highlands Water Project should go ahead as is currently envisaged, or whether viable alternatives should not, perhaps, first be given a chance. Please contact us at your earliest convenience to record receipt of this request, and to inform us of any follow-up steps that we can take to facilitate your investigation.

Attachment 1



ANNEX 2

MANAGEMENT RESPONSE

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 (falling 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.