

**BANK MANAGEMENT RESPONSE TO
REQUEST FOR INSPECTION OF THE
GOVERNANCE PROMOTION ADJUSTMENT LOAN
TO THE INDEPENDENT STATE OF PAPUA NEW GUINEA
(Loan No. 7021-PNG)**

Management has reviewed the Request for Inspection of the Governance Promotion Adjustment Loan to The Independent State of Papua New Guinea, received by the Inspection Panel on December 6, 2001, and registered on December 7, 2001. Management has prepared the following Response.

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CURRENCY EQUIVALENTS

Currency Unit = Kina (K)
 US\$1 = K3.69
 January 2002

ABBREVIATIONS AND ACRONYMS

AusAID	Australian Agency for International Development
BP	Bank Procedure
CAS	Country Assistance Strategy
CELCOR	Centre for Environmental Law and Community Rights, Inc.
CEM	Country Economic Memorandum
FCP	Papua New Guinea Forestry and Conservation Project
FIA	Forest Industries Association
FMA	Forestry Management Agreements
GDP	Gross Domestic Product
GPAL	Papua New Guinea Governance Promotion Adjustment Loan
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
IPN	Inspection Panel
IRT	Independent Review Team
LDP	Letter of Development Policy
NEC	National Executive Council
NGO	Non-Governmental Organization
OD	Operational Directive
OP	Operational Policy
PAD	Project Appraisal Document
PNGFA	Papua New Guinea Forest Authority
SAL	Structural Adjustment Loan
TBAP	Time Bound Action Plan
WWF	World Wide Fund for Nature

EXECUTIVE SUMMARY

THE REQUEST

1. On December 7, 2001, the Inspection Panel registered a Request for Inspection, IPN Request RQ 01/4, concerning the IBRD-financed Governance Promotion Adjustment Loan (GPAL), entered into between the Independent State of Papua New Guinea (“the Borrower”) and IBRD (“The Bank”). The Request was submitted by the Centre for Environmental Law and Community Rights, Inc. (CELCOR), of Papua New Guinea, on behalf of a group of customary landowners in the Kiunga District of the Western Province of Papua New Guinea (“The Requesters”). All of the claims in the Request relate to the forestry tranche release conditions under the GPAL.

2. The Requesters assert that they are suffering adverse effects caused by an apparently illegal logging and road construction project on their lands. They assert that the project – the Kiunga-Aiambak Road, a project that the Bank is not financing – is degrading their land and forest, damaging their culture, and eroding governance, as well as inflicting economic losses on them. The Requesters also assert that the Borrower has not fully met the contractual provisions of the GPAL and that in releasing its second tranche, the Bank would be violating two of its own operational policies and procedures and failing in its duty to follow up on matters of compliance by the Borrower with the loan conditions.

3. The two operational policies that the Requesters claim to have been violated by the Bank are Operational Directive 13.05, *Project Supervision* and Operational Policy 4.36, *Forestry*. In its “Notice of Registration” regarding the Request, the Inspection Panel observes that the Requesters’ claims could also constitute violations of Operational Policy/Bank Procedure 4.01, *Environmental Assessment*. The Requesters claim that the Bank’s failure to comply with these policies and procedures has resulted in material adverse effects, including adverse environmental and social impacts and economic losses. The Requesters assert that they have previously brought their concerns to the Bank’s attention and that the Bank’s responses were unsatisfactory.

THE GOVERNANCE PROMOTION ADJUSTMENT LOAN

4. The GPAL was designed as a structural adjustment loan (SAL) to support a reform program prepared by the Borrower as described in the Borrower’s Letter of Development Policy (LDP), dated May 15, 2000, addressed to the President of the Bank. The Bank’s Executive Directors approved the loan on June 13, 2000, in the amount of US\$90 million. The Loan Agreement (Annex L) was signed on June 16, 2000, and the closing date was established as December 31, 2001. The loan proceeds were to be disbursed in three tranches: the first (US\$35 million), followed by a floating tranche (US\$20 million), and a second tranche (US\$35 million). The Borrower’s reform program was also supported by an IMF standby agreement of SDR 85.5 million (approximately US\$118 million), US\$30 million from Australia, and a US\$50 million loan from the Japan Bank for International Cooperation; all of these funds have been fully disbursed.

5. With regard to the second tranche, there were twenty specific conditions for release of the second tranche listed in Schedule 3 to the Loan Agreement (Annex E). There were two other general conditions for tranche release applicable to each of the tranche releases: (i) satisfactory progress in carrying out the Borrower's reform program; and (ii) a satisfactory macroeconomic policy framework. After due consideration of compliance by the Borrower with the two general conditions and eighteen of the specific tranche release conditions specified in the Loan Agreement, and a waiver by the Executive Directors of two specific conditions not related to forestry, the Bank disbursed the second tranche on December 20, 2001.

6. Among the twenty-two second tranche release conditions, there were three that concerned forestry. They address: reforms of the forestry revenue and royalty regime; completion of an independent review of pending applications for Forestry Management Agreements (FMAs) and timber permits; and amendments to the Forestry Act covering forest clearance, transparency and disclosure by the Forestry Board, delegation of the Forestry Board's powers, and the composition of the Forestry Board.

MANAGEMENT'S RESPONSE TO THE REQUEST

7. Management's response demonstrates that the Bank's activities at issue are in compliance with the applicable policies and procedures. As this Response shows, the Requesters' assertions of failures of the GPAL objectives and violations of the Bank's operational policies and procedures are unfounded and there is no link between the GPAL and any material adverse effects that the Requesters may have suffered. Indeed, the Bank believes that the best way to assist the Requesters in achieving their aims was to proceed with the reforms under the GPAL. In addition, the forestry-related tranche release conditions were all met prior to disbursement of the second tranche. As a result, Management recommends that the Request for an inspection of the GPAL by the Inspection Panel be denied.

8. The GPAL was one of two instruments identified in the Country Assistance Strategy (CAS) to address forestry issues. The other is the Forestry and Conservation Project (FCP), which was approved on December 18, 2001. While the GPAL was designed to deal with policy issues underpinning the forestry sector, the FCP is envisaged as the vehicle to assist the Borrower in addressing specific operational issues and to promote longer-term development objectives. Management believes that the policy objectives of the GPAL pertaining to forestry have been met and will be reinforced by appropriate implementation of the FCP, over a much longer period than the duration of the GPAL.

9. As demonstrated in the Response, the Bank has complied with all relevant Bank operational policies and procedures. Of the policies mentioned in the Request, OD 13.05 *Supervision* is the only one that applies to GPAL.¹ The project team for the GPAL included

¹ OP 4.36 applies only to investment operations in forestry and is therefore not relevant to GPAL, which is a structural adjustment loan. OP 4.01 explicitly excludes structural adjustment loans in the definition of what constitutes a project that is subject to its requirements and thus does not apply to GPAL (though OP 4.01 does apply to sectoral adjustment loans).

forestry specialists and the Bank carried out eight full-scale supervision missions and seven shorter missions or technical visits to Papua New Guinea, amounting to an average of one visit to Papua New Guinea by Bank staff every six weeks. Forestry specialists participated in nine of the missions, and progress on the forestry elements of the policy reform program was monitored on every mission. In addition, consultants to the Bank were posted in Papua New Guinea on a long term basis, including a resident project coordinator who was there until February 2001 to enhance GPAL supervision. Therefore, the Bank contends that its supervision was sufficient and in compliance with OD 13.05.

10. The Borrower's overall reform program supported by the GPAL includes selected policy measures reflected in the LDP. Specific tranche release conditions were selected to establish milestones for the release of funds while the program was being implemented. Three forestry reform measures were included as second tranche release conditions. The Borrower met all three of the individual second tranche release conditions related to forestry, to the Bank's satisfaction. In addition, the Borrower also met all of the other specific conditions except two, which the Bank's Executive Directors agreed should be waived, as achievement of the policy objectives of the GPAL had not been compromised. In addition, the Borrower made satisfactory progress on the overall reform program and it maintained a satisfactory macroeconomic policy framework. The Bank therefore disbursed the second tranche of the GPAL based on its satisfaction with the Borrower's compliance with the second tranche release conditions.

11. The adverse effects claimed by the Requesters are not attributable to any actions or omissions on the part of the Bank. The Requesters' claims of adverse effects are entirely related to the Kiunga-Aiambak road project. The Bank does not have any role in the construction, operation or maintenance of the Kiunga-Aiambak Road, and the activities that caused the adverse effects described by the Requesters were not financed under the GPAL, were not among the policy objectives of the GPAL and were not included among the GPAL conditions. For the most part they were the result of purportedly illegal actions by private entities, and they began prior to preparation of the GPAL. In Management's view, to hold the Bank responsible for unlawful practices carried out by private entities that have no relationship with the Bank's assistance program in Papua New Guinea and to recommend a full investigation would be contrary to the letter and spirit of the Resolution and Clarifications related to the Inspection Panel.

12. Management received information about adverse effects the Requesters may have suffered as a result of the logging in the Kiunga-Aiambak Road corridor, and brought these concerns to the attention of the Prime Minister in July 2000 (see Annex D), advising against any extension of the project. The pending application for an extension of the Kiunga-Aiambak project was also reviewed by the Independent Review Team (IRT).² The

² The Independent Review Team (IRT) reviewed all pending applications for logging permits as part of the second tranche release condition. The draft report of the IRT was disclosed in Papua New Guinea for public review in March 2001 and extensive consultations were held with a wide range of stakeholders throughout the review process. The review process and the IRT report have been well received in Papua New Guinea by the Borrower, most NGOs and other major stakeholders. Their recommendations form the basis of a Time

IRT was highly critical of the project and has recommended further pursuit of the legal actions already undertaken by the Borrower, commending the present staff of the Forest Authority for their efforts.

13. Having reviewed the information presented in the Request, Management takes the following position:

- There was no cause and effect between the adverse impacts described and actions or omissions on the part of the Bank.
- The adverse effects claimed cannot be attributed to violations by the Bank of relevant policies and procedures.
- As there is no link between the claims and the GPAL, withholding disbursement of the second tranche would not have provided remedy for the Requesters' claims of adverse effects.

On December 2001, the Bank disbursed the second tranche in response to adequate progress in carrying out the Borrower's reform program described in the LDP, a satisfactory macroeconomic policy framework, and fulfillment of the relevant conditions for tranche release, including all that applied to forestry, subject to the two waivers.

KEY ISSUES IN THE REQUEST

14. Besides the claimed adverse effects, there are two key issues that underlie the Request. The first is the Requesters' contention that the second tranche release condition was not met and the proceeds of the loan should not be disbursed. They claim the Borrower failed to maintain its own moratorium and failed to fully implement the findings of the forestry review presented in the report of the IRT. The second issue follows from the first: that in lifting its moratorium on issuance of new timber permits and Forest Management Agreements, the Borrower failed to fulfill its commitment under the LDP to maintain the moratorium until all existing logging operations had been reviewed.

15. Completion of an independent review of applications for Forest Management Agreements, timber permits and geographical extensions to existing permits (para. 17 in Part A of Schedule 3 to the Loan Agreement) was the only disbursement condition relevant to this particular claim. The moratorium forms part of the Borrower's reform program as set forth in the LDP, and was to be maintained until the independent review was completed and its findings duly evaluated by the Borrower. The IRT submitted its draft report in March 2001, which was subsequently reviewed by the Borrower and adopted by Cabinet in November 2001. The Borrower and the Bank went beyond the original scope of the reform program and as part of the FCP agreed that the Borrower would implement the recommendations of the IRT through a Time Bound Action Plan (Annex F).

16. The moratorium declared by the Borrower on November 5, 1999, submitted as an amendment on May 10, 2000, and specified in the LDP dated May 15, 2000, was to remain

Bound Action Plan (TBAP) adopted by the Borrower in November 2001 (Cabinet Decision) to implement reform in the sector (Annex F).

in place until a review of all recent major forest resource permit applications and approval processes was completed, and all projects included in this process were placed on hold until the results of the review were known and evaluated by the Borrower. The Cabinet Decision 84/2000 directed that the earlier decision (Cabinet Decision 99/99, November 1999) needed amendment because it used imprecise language. In various stakeholder meetings during late 1999 and early 2000 the Bank indicated that in its view a review of all existing operations would be inappropriate in the context of the GPAL, as the GPAL focused on implementing critical reforms necessary to improve overall sectoral governance as well as carrying out a review to address the recent set of problematic pending applications.

17. The Request claims that “The loan agreement’s Matrix of Policy Actions ... includes [as a tranche release condition] ‘Complete independent review of all FMAs, timber permits and geographical extensions to timber permits.’” This is not factually accurate. There is no Matrix included in the Loan Agreement. The language quoted by the Requesters is taken from the Matrix attached to the LDP, which serves only as a summary of actions taken or to be taken by the Borrower under the reform program that is fully described in the main text of the LDP. While the main text of the LDP clearly establishes the scope of the review to cover all recent major forest resource permit applications and approval processes, the summary in the Matrix does not accurately reflect the actions set out in the LDP. Unfortunately, this issue was not clarified in either the Report and Recommendation of the President on the GPAL or the Loan Agreement.

18. It was not possible to reach a complete consensus between the Bank and the Borrower and all stakeholders on the issue of the full scope of the moratorium and review, nor was the text of the various GPAL documents entirely consistent. Nevertheless, the extent of consultations with NGOs was considerable and civil society was kept fully apprised of developments with regard to the GPAL.

19. There will be continued attention to the challenges in the forestry sector and the centerpiece of the Bank’s continued involvement in the forestry sector in Papua New Guinea is the FCP (Annex C). One of the activities that will be conducted under the FCP is the review of existing forestry operations for which the Requesters are calling. The Borrower also agreed to include a covenant in the FCP Loan Agreement to implement the recommendations of the independent review of logging permit applications completed under the GPAL. These activities will follow the Time Bound Action Plan that has been already adopted by the Cabinet and was made public in December 2001.

I. INTRODUCTION

1. On December 7, 2001, the Inspection Panel registered a Request for Inspection, IPN Request RQ 01/4 (hereafter referred to as “the Request”), concerning the Governance Promotion Adjustment Loan (GPAL), entered into between The Independent State of Papua New Guinea (“The Borrower”) and IBRD (“The Bank”).

II. THE REQUEST

2. The Request for Inspection to the Bank’s Inspection Panel was submitted by the Centre for Environmental Law and Community Rights, Inc. (CELCOR), located in Papua New Guinea, which is acting on behalf of a group of customary landowners in the Kiunga District of the Western Province of Papua New Guinea (the “Requesters”) (see Map 1 and Map 2). The Requesters have asked for “anonymity”; their names and the locations of their landholdings are therefore being kept confidential by the Inspection Panel and are not known to Management.

3. Thirty-five appendices and three exhibits are attached to the Request. Appendix 1 (Names and addresses of Claimants, and their lawyers) and Appendix 2 (Map of the Claimants’ Land) have not been furnished to Management because they would compromise the confidentiality of the Requesters’ identities. There are also three exhibits – two videotapes and a set of photographs – of which Management has received only the photographs. It is presumed that the videotapes are being treated as confidential. No further materials were received by Management in support of the Request.

4. All of the Requesters’ claims relate to forestry. A succinct statement of the Requesters’ claims is presented in Section 4 of the Request:

“The Bank’s disbursement of the second tranche without:

- *Maintaining the moratorium;*
- *Fully implementing the findings of the partial review, including the requirements seeking the remediation of illegal activities; and*
- *Requiring a full review of the contractual provisions of the loan,*

constitute[s]

- *A violation of the contractual provisions of the loan by loaning to a borrower, who, with bad faith, defaults to implement its own promises. The loan, amongst other things was to give the Government support for on-going efforts to redress past policy and governance shortcomings in a sustainable manner, with components to improve forestry management. There are very clear examples set out in the body of this Claim above, that affect the Claimants land, and other examples referred to in evidence, showing the failures of the forest sector generally, indicating the development objectives of the*

governance loan have not been met, and are unlikely to be met, if the disbursement of the second tranche is completed;

- *A violation of Operational Directive 13.05 on supervision and monitoring because of poor judgment and imprudent lending to a borrower who promotes illegal practices; and*
- *A violation of the Bank's forest policy OP 4.36. The acts of the Government show that it did not implement, follow, adhere to, or is in fact committed to, sustainable forest management, sustainable forestry, conservation-orientated forestry, or good forestry practice.”¹*

5. The Requesters further claim that the Bank's failure to comply with the above-mentioned policies and procedures has resulted and will result in direct and adverse effects on them, such as: (i) degradation of the forests; (ii) economic losses estimated by the Requesters using two different methods at US\$36 million and US\$81 million; (iii) damage to the land, (iv) damage to the environment including loss of species; (v) adverse social and cultural effects; and (vi) damages due to trespass. Furthermore, the Requesters assert that they have previously brought their concerns to the attention of the Bank and that the Bank's responses were unsatisfactory.

6. The Requesters' specific claims and other matters of concern are set forth and addressed in Sections IV and VI of this Response, which deal also with the subject matter set out in paras. 3 and 4 of the “1999 Clarification of the Board's Second Review of the Inspection Panel.”

7. In Management's view the Bank's actions related to the GPAL were in compliance with the applicable policies and procedures. While Management notes the reports of possible adverse effects on the Requesters, any such adverse effects were in no way connected with the GPAL, and there is no cause and effect between the adverse impacts and any actions or omissions of the Bank. Indeed, the Bank believed that the best way to assist the Requesters in achieving their aims was to proceed with the reforms under the GPAL. In addition, the forestry-related tranche release conditions were all met prior to disbursement of the second tranche. Therefore, the Requesters' assertions of violations of the Bank's operational policies and procedures are unfounded and there is no link between the GPAL and any material adverse effects that the Requesters may have suffered. For these reasons, which are more fully discussed in Section IV, Management recommends that the Request for an inspection of the GPAL by the Inspection Panel be denied.

III. BANK'S ASSISTANCE STRATEGY IN PAPUA NEW GUINEA

A. OVERALL COUNTRY CONTEXT

8. Papua New Guinea faces significant development challenges. It is a country endowed with considerable natural and human resources. Yet, in the post-independence era, despite substantial donor support, successive governments have not been successful in putting the country on a course toward sustainable growth and development. Moreover, governance and

¹ The Notice of Registration states that the Requesters' claims could also constitute violations of OP/BP 4.01 *Environmental Assessment*, although the Requesters themselves do not explicitly assert such a violation.

economic management deteriorated substantially under successive governments, particularly in the late 1990s, as highlighted in the Bank's Country Economic Memorandum (CEM):²

“... severely deteriorating policy environment, characterized by an undermining of the basic institutions of government and poor budget management. The deterioration in governance was marked by inappropriate political intrusion in all aspects of public policy. There was a significant overhang of public sector debt and arrears, a budget deficit exceeding 5 percent of GDP, and, because of lack of confidence, interest rates on government debt that, at 25- to 30 percent, exceeded the cost of borrowing for major firms. Domestic interest payments amounted to nearly 20 percent of recurrent expenditures. The previous government had been unable to advance the agenda of structural reforms it had initiated through a program supported by the Bank's Economic Recovery Program Loan, and in certain sectors – forestry for one – some of the policy improvements achieved earlier had been reversed.”

B. THE COUNTRY ASSISTANCE STRATEGY AND THE STRUCTURAL ADJUSTMENT PROGRAM

9. In July 1999, a new Government took office with Sir Mekere Morauta as Prime Minister. The incoming Government pledged to work to stabilize macroeconomic conditions, improve the transparency and accountability of public institutions, and restore relations with international financial institutions and bilateral donors. It embarked on a wide-ranging program of governance reforms. In its first few months in office, the new Government: (i) passed a supplementary budget that undertook fiscal tightening; (ii) raised taxes on various luxury items and on log exports, thereby raising the equivalent of nearly 0.5 percent of GDP in the remainder of the year; and (iii) reduced the budget deficit to 1.3 percent of GDP.

10. The Bank accepted these initial positive steps as evidence of the Borrower's commitment to restore macroeconomic stability and to work towards improving governance. Indeed, the two issues formed the basis for renewed cooperation between the Borrower and the Bank. Following extensive stakeholder consultations³ a Country Assistance Strategy (CAS), covering the period 2000-2002, was presented to the Bank's Executive Directors on December 9, 1999. The overarching goal of the CAS is reduction of poverty and improvement of the quality of life for the people of Papua New Guinea. Its primary objective is “to assist Papua New Guinea in improving the foundation for a capable state that can be responsive to its people by addressing human and economic development challenges in a transparent and accountable manner” – in other words, an agenda focused on governance reform. With regard to the level of potential financial support from the Bank, the CAS proposed a base-case scenario with a lending volume of US\$200-250 million for three years, including both a structural adjustment loan – the GPAL, and an investment loan for the forestry sector. Access to the structural adjustment loan resources

² *Papua New Guinea: Improving Governance and Performance*, (Report No: 19590-Papua New Guinea), The World Bank, distributed to the Board on October 22, 1999.

³ Consultative meetings on the CAS were held in Port Moresby and two regional centers in May 1999 and involved discussions with more than 180 civil society representatives, including environmental NGOs such as Conservation Melanesia, Greenpeace, EcoForest Forum, and WWF; private sector organizations including the Forest Industries Association; and individual forest industry firms.

would be triggered primarily by substantive reengagement with the Bank and International Monetary Fund (IMF) on critical reform issues.

11. In light of the Borrower's encouraging policy actions noted above, the Bank offered the Borrower assistance to implement its broader reform program through the GPAL. With regard to reforms in the forestry sector, the main concern of the Requesters, the Bank would address key policy reforms under the GPAL and longer-term institutional development objectives under the Forestry and Conservation Project (FCP).

12. The Borrower's medium-term structural reform program was framed in consultation with the Bank and the IMF, and is set forth in the Borrower's LDP from the Prime Minister to the President of the World Bank, dated May 15, 2000. The Borrower's reform program addressed two main areas – economic management and improved governance. Reform of economic management encompassed measures to improve fiscal and debt management, to enhance macroeconomic stability and to improve the overall operating environment for business. The strategy for improving governance was multi-faceted, covering: improvement of the functioning of the Cabinet and the Public Service Commission; reform of the Rural Development Program; reduction of fraud, waste and corruption; civil service reform; and improvement in the quality and efficiency of service delivery in a number of sectors – health and education, financial services, and forestry sector management.

13. Financial support for implementation of the Borrower's reform program was comprised primarily of the US\$90 million GPAL, provided by the Bank, and an IMF standby agreement of SDR 85.5 million (approximately US\$118 million). This package was complemented by US\$30 million in cofinancing from Australia, and a US\$50 million equivalent loan from the Japan Bank for International Cooperation, along with other associated parallel donor financing. All of these funds have been fully disbursed.

14. The Bank's Executive Directors approved the US\$90 million GPAL on June 13, 2000. The Loan Agreement specified that the GPAL was to be disbursed in three tranches, the first upon effectiveness in the amount of US\$35 million, a floating tranche in the amount of US\$20 million, and the second tranche in the amount of US\$35 million. The GPAL became effective on June 21, 2000.

15. The GPAL was the first operation to support implementation of the Borrower's reform program described in the LDP. It was specifically designed to focus on priority policy actions, consistent with the Bank's CAS objectives. With regard to forestry, the GPAL was intended to be a first step focusing on key policy issues. The Bank recognized that improving governance in Papua New Guinea's forestry sector would require changing institutional behavior. That change would entail the Bank's involvement and assistance to the Borrower in the sector over an extended period of time. The Borrower and the Bank therefore agreed to tackle specific issues in the forestry sector in the follow-up investment project, the FCP, which has been negotiated and was signed on December 20, 2001.

C. GOVERNANCE ISSUES IN THE FORESTRY SECTOR

16. Papua New Guinea contains one of the world's four remaining significant tropical rainforest wildernesses. These closed forests cover 36 million hectares, or 77 percent of the country's land area, and range from high-altitude cloud forests to lowland mixed species and mangroves. They constitute one of the world's richest reserves of biodiversity harbored in an intact, contiguous, tropical forest. They also provide the basis of livelihood and cultural life for the 80 percent of Papua New Guinea citizens who live in rural communities. The forestry sector contributed between 5 and 6 percent of GDP in 1995-1997, the last period for which estimates were available. The Bank anticipates that, through implementation of appropriate policies and institutional framework in the forestry sector, a system could be put in place in which shares of both total government revenues and royalty payments to landowners could increase in a healthy and equitable manner.

17. Local clans own essentially all forested land in Papua New Guinea, under customary title. In theory, no major development activity can occur on a clan's land without its consent. In practice, however, major social and economic disruptions have occurred in the recent past, in which large areas of forest were destroyed, primarily by exploitative, uncontrolled logging operations. In a context of widespread illiteracy and inexperience in dealing with outsiders, individuals representing themselves as speaking on behalf of the clan have assisted logging companies in gaining access to the forest resources. Over the last decade, foreign-dominated and sometimes poorly managed industrial-scale logging, for the purpose of raw log exports, was virtually the only type of forestry activity pursued in the country.

18. Papua New Guinea's constitution and its national policy commit the country to sustainable forest management. However, in 1989 the Barnett Commission of Inquiry into Papua New Guinea's forestry sector concluded that logging practices were out of control, irreversibly damaging forests, land and local communities, and diminishing biodiversity and other environmental values. Causes noted by the Commission included: inadequacies in forest management infrastructure and human resource capacity; irregularities in planning, granting, and operating commercial logging concessions; treatment of the Forestry Act and supporting regulations as an obstacle to be circumvented rather than as a means to ensure equitable and sustainable allocation and implementation of logging operations; failure to utilize environmental assessment and monitoring as resource management tools; and an ambiguous legislative and regulatory regime for screening and monitoring of forest development activities.

19. Some governments in the early 1990s made efforts to improve forest management. In 1991, Papua New Guinea initiated the National Forest and Conservation Action Program in conjunction with the Bank and other donors. Subsequently, the Forestry Act (1991, amended 1993) was enacted to facilitate establishment of a sustainable forest industry. Other policy reforms have included surveillance of log exports, adoption of forest sustainability and logging code guidelines, establishment of a taxation structure intended to provide improved resource revenue capture for the Borrower and landowners, and enhanced legislative protection for the independent operations of the Forestry Board.

20. However, during the tenure of the 1997-1999 government, there were numerous attempts to undermine and reverse some of the most important reforms of its predecessors. These actions are listed in the Bank's CEM as follows:

- Avoidance of tendering processes and scrutiny under the Forestry Act and related regulations through the granting of extensions to existing areas, in one case more than doubling the original area;
- Attempts to fast track approval of new logging operations that appeared to circumvent the established procedure for approving new projects and to weaken the National Forest Authority by bypassing it;
- Plans to amend the Forestry Act to facilitate the fast tracking of new projects just described;
- Plans to terminate the pre-shipment inspection of log exports by an independent company;
- Withdrawal of financial support to the National Forest Authority and reduction of its staff; and
- Changes to the structure of log export taxes that enabled logging firms to avoid almost all tax payments.

21. The Bank had begun work on an investment loan in the forestry sector – the FCP – before 1997, following the positive steps taken in the early 1990s. However, it halted project preparation mainly due to the deterioration in governance before the present Government took office in July 1999.

22. The early initiatives of the Morauta Government during late 1999 and early 2000 included several positive actions in the forestry sector. The major actions taken between July 1999 and May 2000, were actions prior to the negotiations of the GPAL demonstrating the Borrower's commitment to the reform program set forth in the LDP, and were as follows:

- The Borrower prepared and passed a supplementary budget in August 1999 to address the burgeoning budget deficit it had inherited and, in that context, reinstated the previous forestry export tax regime.
- The Borrower maintained the independent inspection service for pre-shipment inspection of log exports.⁴
- Through a Cabinet Decision (NG 99/99 of November 5, 1999), and clarified in Cabinet Decision 84/2000 of May 19, 2000, the Borrower declared a moratorium on the issue of new permits that was to remain in place until a review of all recent major forest resource permit applications and approval processes was completed, and all projects included in this process were placed on hold until the results of the review were known and evaluated by the Borrower (see paras. 48-58 for further discussion of the moratorium and the scope of the review).

⁴ The latest contract for inspection services was signed in December 2001, for a period of 12 months.

- The Cabinet approved regulations to require non-commercial disclosure by the Forestry Board in respect of its deliberations on projects involving use of forested land (see para. 61 below).
- The Borrower rescinded Cabinet Decision No. 59/97 regarding agricultural conversion and road construction projects in forested areas and gazetted in its place new regulations to unambiguously establish the forest protection policies as contained in the previous Cabinet Decisions Nos: 113/96 and 15/97, and in accordance with the Timber Authority Guidelines 1995. The intent of this was to close an apparent loophole in the Act, which allowed agriculture and infrastructure projects in forested areas to clear forested land while bypassing the logging regulations and requirements under the Forestry Act.

23. These favorable developments prompted the Bank to resume processing of the FCP. It was agreed by the Borrower and the Bank that the project would have four major components: (i) Landowner Forest Decision Making, that would directly assist landowners to organize and negotiate more effectively on the management and conservation of their resources; (ii) a Conservation Trust Fund, that would provide and capitalize a non-governmental grant based facility to allow landowners to obtain financing for conservation-oriented and sustainable projects based on their forest and other natural resources; (iii) Sustainable Forest Management, that initially with the assistance of international experts would build capacity to prepare, monitor, enforce and review forest operations in the sector more effectively, with a view to developing more efficient and sustainable use of the forests; and (iv) Environmental Assessment and Monitoring, that would provide technical and other assistance to the Office of Environment and Conservation, and other stakeholders, to develop methodologies for and implementation of rigorous assessment and monitoring to apply to forest activities. A matrix outlining the FCP design summary is given in Annex C.

24. The Borrower has embarked upon a major program of reforms in forestry. Given the variety, magnitude and complexity of the problems that beset the forestry sector in Papua New Guinea, reform is expected to be a lengthy process. The Borrower and the Bank agreed that the GPAL would focus on selected key governance reforms necessary to lay the groundwork for subsequent in-depth and long-term forestry management activities, which could be supported by a possible Bank investment operation. In this way implementation of the Borrower's reform program supported by the GPAL could serve to develop an initial track record by the Borrower in the forestry sector as a basis for broader, subsequent support.

IV. CLAIMS OF VIOLATIONS OF BANK POLICIES AND PROCEDURES AND MANAGEMENT'S RESPONSE

25. According to the Resolution establishing the Inspection Panel, the Requester "must demonstrate that its rights or interests have been or are likely to be directly affected by an action or omission of the Bank as a result of a failure of the Bank to follow its operational policies and procedures with respect to the design, appraisal, and/or implementation of a project financed by

the Bank.... provided in all cases that such failure has had, or threatens to have, a material adverse effect.”⁵

26. The Requesters have claimed that their rights or interests have been adversely affected as a result of the Bank’s failure to comply with two policies: OD 13.05 and OP 4.36. In addition, the Inspection Panel raises the possibility of a violation of OP 4.01, although this claim was not specified in the Request.

27. In responding to the Requesters’ claims, Management first demonstrates that there is no connection between the claimed adverse effects and the Bank’s GPAL in Papua New Guinea. Management then analyzes the Requesters’ claims of policy non-compliance and demonstrates that the Bank has followed its operational policies and procedures with respect to the GPAL. Management therefore concludes that there is no causal relationship between the GPAL and any material adverse effects that the Requesters may have suffered, and the Requesters’ assertions of violations of the Bank’s operational policies and procedures are unfounded.

A. CLAIMS OF ADVERSE EFFECTS

28. The Requesters claim that they have suffered from a range of adverse effects caused by the “unlawful and uncontrolled activities of logging” along the Kiunga-Aiambak Road corridor. The claimed adverse effects relate to inadequate governance as well as damage to their culture and economic well-being. Based on these claims, they request that the “Second tranche should not be paid until full review and Kiunga-Aiambak stopped.” [Request, Section 2, p. 9]

Specifically their requests are stated as follows:

ADVERSE EFFECTS ON GOVERNANCE

“The unlawful and uncontrolled activities of logging companies de-stabilises governance. In this case the logging company is able to affect political, judicial and administrative checks and balances, to the end that it can log with impunity, along the Kiunga-Aiambak Road and the feeder road known as the ‘Barramundi Highway.’”
[Request, Section 5.1, p. 16]

ADVERSE EFFECTS ON CULTURE

“The Claimants fear an impending destruction of their culture (“a kind of genocide”). The evidence of this harm will be given by the Claimants to the Inspection Panel in the form of direct testimony on a video tape Exhibit 1 [not furnished to management]. The testimonies describe:

1. The empty promises the logging company made to the landowners to get their consent for the logging project to be developed on their land.

⁵ Resolution No. IBRD 93-10, “The World Bank Inspection Panel”, September 22, 1993, para. 12.

2. *The destruction that has been caused to the forest, wildlife and culture of the people as a result of logging.*

3. *The impact of logging on the social life of the people.”*

[Request, Section 5.1, p. 16]

ECONOMIC LOSSES

“Economic Loss. The Claimants’ forest assets have been irreversibly damaged by the decision to allow logging on their lands, the omission during the currency of the loan to remedy the illegal logging, in violation of the laws of Papua New Guinea, and also a violation of the conditions of the Bank’s loan....The Claimants do not know the full extent of the value of damage to their forests....The Claimants have had to gather material for a valuation of their losses from a number of sources, informally....Commercial value of logs removed from their land and the land belonging to other customary landowners may be calculated thus: the concession holder exported at least 160,556 cubic meters of logs from the concession...in the year ending March 2001.”

The Requesters then offer two estimated valuations: US\$81 million as the gross amount of money foregone since 1995 (6 years x 150,000 cubic meters/year x US\$90/cubic meter average f.o.b. price) and US\$36 million as the net value of the logs (the gross estimate reduced by cost of production of US\$50/cubic meter).

The Requesters also cite entitlement of the Claimants for compensation equal to the value of the cost of restoring the land to its pre-logging condition (no estimate given) and refer to admittedly not readily quantifiable costs of environmental damage including: loss of plant and animal species, adverse social impacts including exotic diseases and the effects of drugs and alcohol imported by highway construction crews; and damages for trespass.

[Request, Sections 5.31-5.36, pp. 25-27]

RESPONSE

29. The Requesters claim that the Bank’s failure to comply with its policies and procedures has resulted and will result in direct and adverse effects. However, there is no cause and effect between the impacts described and actions or omissions on the part of the Bank. The Bank does not have any role in the construction, operation or maintenance of the Kiunga-Aiambak Road, and the activities that caused the impacts the Requesters describe were not financed under the GPAL, were not among the policy objectives of the GPAL and were not included among the GPAL tranche release conditions. For the most part, they were the result of purportedly illegal actions by private entities, and they began in 1994 prior to preparation of the GPAL. In Management’s view, to hold the Bank responsible for unlawful practices carried out by private entities that have no relationship with the Bank’s assistance program in Papua New Guinea and to recommend a full investigation would be contrary to the letter and spirit of the Resolution and Clarifications related to the Inspection Panel. Thus, the Bank disagrees with the Requesters’ claim that because the period of the GPAL preparation and implementation partly overlapped

with the much longer period over which the alleged unlawful activity had been taking place the Bank was responsible for the adverse effects.

30. The approval and apparently unauthorized extension of the Timber Authority for Concord Pacific Pty. Ltd.⁶ (Concord Pacific) under the Kiunga-Aiambak Road that occurred in 1994 and 1995 took place more than three years before the GPAL was first discussed with the Borrower. Legal action by the logging company has stymied subsequent administrative efforts by the Borrower to halt the logging.

31. The Borrower has attempted (and continues in this effort) to terminate the Aiambak operation, by both regulatory and legal means. The current state of the legal proceedings are as follows:

- In November 1999, in accordance with the pertinent provisions of the Forestry Act, the Managing Director of the Forest Authority issued an order to cease operations against the company involved, Concord Pacific. The order was issued on the grounds of procedural errors in the issuance of the original Timber Authority (the logging permit), and the failure of the company to comply with the terms of its agreement.
- Concord Pacific, the logging operator, commenced court proceedings seeking to restrain the Managing Director from terminating the Timber Authority. In November 1999, the National Court (the lower court) granted interim injunctions restraining the Forest Authority from terminating the Timber Authority.
- The Forest Authority then placed the matter with the Solicitor-General's office, which engaged a private law firm to handle the case.
- In April 2000, the Managing Director of the Forest Authority sought again, through administrative procedures, to close the Concord Pacific operation. These procedures were based on the argument that the Timber Authority awarded to Concord Pacific lapsed during that month. Concord Pacific contested this administrative measure and brought contempt of court proceedings against the Managing Director. These proceedings were successful, and the Managing Director was held in contempt for contravening the prior National Court injunction.
- Thereafter, the National Court encouraged the parties to negotiate a settlement. As part of the negotiations, Concord Pacific proposed a three-year extension to the Timber Authority. This proposal was unacceptable to the Forest Authority. The Forest Authority also retained legal counsel to pursue a final determination of this matter through the courts.
- In early December 2001, prior to the release of the second tranche, the Prime Minister instructed the Attorney General to join this case, on behalf of the State.

⁶ Concord Pacific Pty. Ltd. is the Papua New Guinea registered timber harvesting company that is implementing the Timber Authority on behalf of the local landowners' company, Paiso Company Pty. Ltd. While the four listed shareholders of Paiso are all Papua New Guineans, Concord Pacific is owned by two Malaysian shareholders.

- The Chief Secretary of the Prime Minister’s Department instructed the Attorney General to investigate problems related to the claimed behavior of some police in the Aiambak area and to take appropriate action.

32. The original license application for Aiambak was lodged in 1994, and was awarded for only one year. The Managing Director of the Forest Authority⁷ at the time, and the General Manager of the National Forest Service were aware of the dangers of this project, and they agreed that this license would not be renewed. However, the Minister for Forests signed an extension of the Aiambak project license without any prior consultation with these officials.

33. At the time Aiambak was licensed in 1994, the regulations governing large agricultural conversion projects and road construction projects – some of which were clearly intended primarily to reap the benefits of logging the sites without the controls of a normal FMA applying – were extremely weak and allowed this unilateral action to go unchallenged. Part of the policy reforms envisioned under the GPAL included reinstatement of a stronger set of regulations governing these projects, including provisions for public disclosure of the Forestry Board decisions on the awarding of timber harvesting permits and consultation with landowners on such proposals. As a result of legislative changes under the Borrower’s reform program, supported by the GPAL, the Minister for Forests no longer has the power to unilaterally approve applications for an extension or new operation. Instead, the Minister must obtain prior concurrence of the Forestry Board which, in turn, must publicly disclose information on the proposed new applications for an extension or new operation, and consult with landowners upon the details of such applications. The Minister also cannot devolve the powers of the Forestry Board to an individual for purposes of approval of applications for an extension or new operation, as was the case in the past.

34. An application to extend the Kiunga-Aiambak logging operation was part of the independent review carried out under the GPAL. The recommendations of the Independent Review Team (IRT)⁸ on the Aiambak project were that: (i) further court action should be taken forthwith to review previous court orders permitting the logging operations since November 1999; (ii) any application to extend the scope of the Timber Authority should be soundly rejected; and (iii) any further application for road line clearing should be properly considered under the Forestry Act in light of Amendments made to the Act in 2000, and certified in January 2001.

⁷ Pursuant to the Forestry Act of 1991, as amended in 1993, the Forestry Board is a statutory board with independent powers to decide upon matters of permit allocation, regulation, and management of the forestry sector. The Forest Authority provides secretariat support to the Forestry Board (of which the Forest Authority’s Managing Director is a member) and advises the Minister of Forestry on matters of policy, regulation and related matters. The National Forest Service (under the General Manager) is the field operation division of the Forest Authority. In recent years, the Forestry Board has become increasingly empowered by the Borrower to take major decisions on the allocation of permits. These decisions were originally made by the Minister of Forestry alone, often without proper consultation.

⁸ The Independent Review Team (IRT) reviewed all pending applications for logging permits as part of the second tranche release condition. The draft report of the IRT was disclosed in Papua New Guinea for public review in March 2001 and extensive consultations were held with a wide range of stakeholders throughout the review process. The review process and the IRT report have been well received in Papua New Guinea by the Borrower, most NGOs and other major stakeholders. Their recommendations form the basis of a Time Bound Action Plan (TBAP) adopted by the Borrower in November 2001 (Cabinet Decision) to implement reform in the sector (Annex F).

35. As part of the country dialogue with civil society in Papua New Guinea, the Bank sometimes receives communications containing claims of unlawful activity in various sectors, including forestry. As a matter of practice, and as part of dialogue with the Borrower, the Bank refers such matters to the Borrower for review and action in an appropriate manner. In the case of the Aiambak project, the Country Director wrote to the Prime Minister on July 16, 2000 (Annex D) and forwarded a letter dated November 1, 2001 from CELCOR concerning the Aiambak project. The Country Director replied to the CELCOR letter on November 28, 2001, explaining that the Bank shared CELCOR's concerns with regard to the Aiambak project and reiterating the agreement reached between the Borrower and the Bank with regard to the review of pending applications (see Annex E).

36. A key long-term objective of the Bank's approach in the forestry sector is to foster improvements in governance and management capacity in its member countries. The GPAL, as conceived in the Country Assistance Strategy (CAS), laid the basis for systematically addressing this objective through the subsequent FCP, which was approved on December 18, 2001. The FCP is a vehicle to assist the Borrower in addressing specific issues in the forestry sector in Papua New Guinea, including some of the concerns identified in the Request.

37. The Bank has been and remains seriously concerned about the plight of the people who may have suffered adverse effects because of the claimed unlawful activity, in particular because of the difficulty the people are experiencing in obtaining appropriate responses from the enterprises involved. The Bank has worked with the Borrower to place the Aiambak project on a priority list of projects to be reviewed under the FCP, and will work with the Forest Authority to direct that review towards collection of evidence and facts relating to operations on the Kiunga-Aiambak Road. The Bank will also work with the Borrower to bring the resources of the Landowner Forest Decision Making Component of the FCP to bear on the problem of ensuring that landowners in remote areas are equipped to negotiate and represent themselves effectively in deciding upon future operations.

B. CLAIMS OF VIOLATIONS OF BANK POLICIES AND PROCEDURES

38. The Requesters claim that the Bank failed to properly supervise the GPAL and that the three forestry-specific conditions were not met. Management demonstrates below that supervision was fully adequate and that except for the two duly waived conditions, all the conditions for the release of the second tranche were met.

39. The three forestry-related conditions for the release of the second tranche, with which the Borrower complied are listed among the twenty specific second tranche release conditions in Part A of Schedule 3 to the Loan Agreement (attached as Annex L), as follows:

“16. Implementation by the Borrower of reforms to its forestry revenue and royalty regime, satisfactory to the Bank.

“17. Completion of an independent review of Forest Management Agreements (FMAs), timber permits and geographical extensions to timber permits.

“18. Adoption by the Borrower’s Parliament of amendments, acceptable to the Bank, to the Forestry Act 1991 (as amended in 1993) covering: (a) the regulatory framework for the clearance of forested land; (b) non-commercial disclosure by the Forestry Board; (c) delegation of powers of the Board to an individual; and (d) composition of the Forestry Board.”

CLAIMS OF VIOLATION OF OD 13.05 ON PROJECT SUPERVISION

“The Claimants allege that the disbursement of the second tranche of the SAL without the maintenance of the moratorium and full review of logging concessions would constitute a violation... of the Bank’s obligation to supervise and monitor its projects pursuant to the Bank’s Supervision and Monitoring Policy, Operational Directive 13.05....”

[Request, Section 3.1, p 10]

“In addition, the Requesters claim that disbursement of the second tranche would constitute “a violation of Operational Directive 13.05 ... because of poor judgment and imprudent lending to a borrower who promotes illegal practices.”

[Request, Section 4, p.15]

40. As OD 13.05 states, it is the Bank’s responsibility to supervise the progress towards implementation of the Borrower’s reform program as well as the specific conditions for tranche release. OD 13.05 further indicates that: (i) supervision activities must receive adequate priority in the allocation of Bank staff and other resources commensurate with the nature, complexity, size of the Bank-assisted operation, the problems experienced, and the Borrower’s institutional capabilities and needs; and (ii) efficient resolution of implementation problems is the joint concern of the Borrower and the Bank.

41. The Bank’s approach towards preparation and supervision was fully geared to the scope and content of the reform program under the GPAL. This involved an intensive and thorough process as follows:

- Maintaining continuity of supervision. The task team leader and members did not change during the life of the project;
- The Bank carried out eight full-scale missions and five smaller missions, amounting to one mission every six weeks, on average (see Table 1 below). The status of forestry conditionality was discussed in all these missions.
- Providing in-depth support for supervision. Long-term consultants were posted to Papua New Guinea, including a full-time program coordinator (from prior to Board approval until February 2001).
- Ensuring adequate capacity to supervise technical aspects of the GPAL. A forestry specialist participated in nine of the missions. Consultants were also made available.
- Maintaining high-level engagement by Bank and Borrower. Table 1 shows that the Country Director participated in high-level meetings in Sydney and made a point of attending various mission events. Senior government officials were consulted on almost every mission.

- Providing adequate budget for supervision. Trust funds were mobilized to supplement the Bank supervision budget. Financing from trust funds made the long-term posting of consultants possible.

Table 1. Summary of Formal GPAL Supervision Activities

Date	Location	Type	Key Bank Participants	Key Government Participants
1. July 31-August 11, 2000	Papua New Guinea	T	FS	M. Dir. FA; Gen. Mgr. FA; Sec.Env.&Cons.
2. October 2-6, 2000	Papua New Guinea	S	TTL	Sec. Finance; Chief Sec. PM's Dept.
3. Oct. 23-Nov. 10, 2000	Papua New Guinea	F	CD*, TTL, FS	Sec. Finance; Chief Sec. PM's Dept.
4. January 15-19, 2001	Papua New Guinea	T	FS	M. Dir. FA; Gen. Mgr. FA; Sec.Env.&Cons.
5. February 13-15, 2001	Papua New Guinea	S	CD, TTL	Prime Minister, Sec. Finance; Chief Sec. PM's Dept.
6. February 28, 2001	Sydney	H	CD, TTL	Chief Sec. Prime Minister's Dept.
7. March 1, 2001	Sydney	H	CD, TTL	Chief Sec. Prime Minister's Dept.
8. March 5-16, 2001	Papua New Guinea	F	CD, TTL, FS	Sec. Finance; Chief Sec. PM's Dept.
9. April 3-6, 2001	Papua New Guinea	F	CD, TTL	Sec. Finance; Chief Sec. PM's Dept.
10. May 1-4, 2001	Papua New Guinea	F	TTL, FS	Sec. Finance; Chief Sec. PM's Dept.
11. May 14, 2001	Sydney	H	CD, TTL	Chief Sec. Prime Minister's Dept.
12. June 28, 2001	Sydney	H	CD, TTL	Minister of Foreign Affairs
13. July 29-August 3, 2001	Papua New Guinea	F	TTL	Chief Sec. Prime Minister's Dept.
14. August 8-10, 2001	Papua New Guinea	F	CD, TTL, FS	Prime Minister, Chief Sec. PM's Dept.
15. October 8, 2001	Sydney	H	CD, TTL	Chief Sec. Prime Minister's Dept.
16. October 16-19, 2001	Papua New Guinea	F	TTL, FS	Chief Sec. Prime Minister's Dept.
17. October 22-25, 2001	Papua New Guinea	S	TTL	Chief Sec. Prime Minister's Dept.
18. October 26, 2001	Sydney	H, T	CD, TTL, FS	Chief Sec. Prime Minister's Dept.
19. November 21-30, 2001	Papua New Guinea	F	CD, TTL, FS	Min. of Foreign Aff., Chief Sec. PM's Dep't

Notes: "Key Bank participants" only highlights whether the Country Director (CD), Task Team Leader (TTL), Forestry Specialist or Forestry Advisor (FS) were present. Supervision missions generally included other sectoral staff and specialists. "Type of Mission": T=Technical; F=Full-Scale; S=Short; H=High-level Meeting.

*Country Director was not a full-time member of full-scale missions but attended selected meetings when in Papua New Guinea.

42. During supervision of the GPAL, satisfactory progress with the Borrower's reform program and with each tranche release condition was thoroughly reviewed. The Bank also assessed the Borrower's performance in maintaining a sound macroeconomic policy framework in accordance with agreed upon performance indicators. Since assuming office in July 1999, the present Government had demonstrated its seriousness in tackling head on the acute governance crisis it had inherited. Achievements were broad in scope, ranging from improving the integrity and restoring the independence of the civil service, strengthening capacity within a number of oversight agencies, pursuing corruption investigations, enhancing the effectiveness of the rural development program, focusing limited resources on the delivery of health and education services, returning the National Provident Fund (NPF) to financial health and improving its corporate governance structure, privatizing the country's largest bank, as well as reversing the prior deterioration in forest sector governance.

43. At the macroeconomic level, the Borrower's achievements were considerable: government arrears of about 4 percent of GDP were cleared; inflation and interest rates were halved; foreign reserves were tripled; and an IMF standby arrangement was successfully concluded in September 2001 for the first time in Papua New Guinea's history. These achievements were judged to be particularly significant when viewed in light of the difficult external environment and political conditions that had to be confronted.

44. With regard to the second tranche release, the final supervision mission in December 2001 and Management's recommendation to the Board concluded that the Borrower had fully complied with all conditions except two (not related to forestry) that were duly waived by the Bank's Executive Directors on December 18, 2001.

Borrower's Compliance with Second Tranche Release Conditions

45. *Review of Forestry Revenue and Royalty (Condition #16)*. According to the Requesters:

"The State did reinstate the forestry log tax regime, and a review is being carried out into forestry revenue and royalty. But that review is already under pressure. The consultants have been told to fastrack an interim report to enable the State to decrease the tax burden on the loggers in the November 2001 budget. Preliminary results from the review show:

- *a sharp decline in log prices;*
- *a need to increase landowner royalties significantly;*
- *a need to adjust the log tax."*

[Request, Section 2, p. 6]

Response

46. As required by this second tranche release condition under the GPAL, the Borrower carried out the requisite review, with a focus on taxation reforms and transfer pricing. On the basis of the review's findings, the Borrower implemented adjustments to the log export tax in the 2002 budget, including the exemption of plantations from this tax. It was important to implement these adjustments, because of the volatility in the market for logs, and the fact that the sliding export tax scale that has been applied over the last several years has been denominated in Kina, instead of US\$. The effect of this depreciation has been that – in an era of declining international prices for logs – as the Kina has depreciated against the US dollar, the actual export taxes paid by companies as a proportion of total price have increased significantly. The purpose of the export tax sliding scale was not to achieve this effect but to ensure that if prices rose internationally, the proportion collected as rent by the Borrower would increase. The log export tax adjustment in the 2002 budget was therefore necessary to deal with this issue.

47. The analysis and recommendations of the review with regard to landowner royalties raised a number of unanticipated issues that require further detailed analysis. Through a letter from the Prime Minister to the Bank's President, dated December 5, 2001, the Borrower

committed itself to deal systematically with the royalty issues raised by the review during implementation of the FCP. Taken together with the revenue system amendments implemented in the 2002 budget, the steps towards implementing changes in the royalty system initiated through the review process and the Prime Minister's letter pledging commitment were therefore considered by Management to be sufficient to comply with this second tranche condition.

Independent Review of FMAs and Timber Permits (Condition #17)

“The Claimants allege that the disbursement of the second tranche of the SAL without the maintenance of the moratorium and full review of logging concessions would constitute a violation of the contractual provisions of the structural adjustment loan.”

[Request, Section 2, p. 10]

“The Bank's disbursement of the second tranche without...fully implementing the findings of the partial review, including the requirements seeking the remediation of illegal activities... constitute[s] a violation of the contractual provisions of the loan”

[Request, Section 4, p. 15]

“A moratorium on all new timber concessions, pending a complete review of all existing concessions. The issue we wish to raise here is the lack of good faith of the State in honouring this condition. The thrust of our submission here, is that as soon as the second tranche is paid, the State will slip back into its old ways: business as usual. As will be seen from the text of our submissions the State broke both the letter and the spirit of the condition with the following logging concessions [9 items cited].”

[Request, Section 2, p. 7]

“The loan agreement's Matrix of Policy Actions says under “Actions Taken/Outcomes Achieved” that there was a ‘moratorium declared on all new Forest Management Agreements (FMA), timber permits and geographical extensions to timber permits’ A column entitled ‘second tranche’ contains conditions that must be met before a second tranche disbursement. That column includes, ‘Complete independent review of all FMAs, timber permits and geographic extensions to timber permits’”

[Request, Section 3.1, p. 10]

Response

48. The Requesters contend that the second tranche release condition was not met and the proceeds of the loan should not be disbursed because the moratorium⁹ was not maintained, and because the findings of the forestry review presented in the report of the IRT were not fully implemented. With regard to OD 13.05, completion of an independent review of applications for Forest Management Agreements, timber permits and geographical extensions to existing permits

⁹ The moratorium declared by the Borrower on November 5, 1999, submitted as an amendment on May 10, 2000, and specified in the LDP dated May 15, 2000, was to remain in place until a review of all recent major forest resource permit applications and approval processes was completed, and all projects included in this process were placed on hold until the results of the review were known and evaluated by the Borrower. The Cabinet Decision 84/2000 directed that the earlier decision (Cabinet Decision 99/99, November 1999) needed amendment due to imprecise language used in it (see para. 52).

(paragraph 17 in Part A of Schedule 3 to the Loan Agreement) was the only disbursement condition relevant to this particular claim. The moratorium forms part of the Borrower's reform program as set forth in the LDP, and was to be maintained until the independent review was completed and its findings duly evaluated by the Borrower. The Borrower and the Bank went beyond the original scope of the reform program and as part of the FCP agreed that the Borrower would implement the recommendations of the IRT through a Time Bound Action Plan (TBAP) (Annex F). The implementation of this action plan, which was adopted by the Borrower on November 15, 2001, by Cabinet's approval, constitutes a legally binding obligation under the FCP. As the Bank supervision mission was able to determine that the independent review was completed in accordance with the Loan Agreement, consistent with the LDP and the intent of the parties, in Management's view the Bank is in full compliance with its responsibilities under OD 13.05.

49. The Bank's determination of compliance with the second tranche release condition relating to the review was based upon the following achievements:

- An initial draft of the report of the IRT was released in March 2001 for public comment and further review, and a final version was presented to an inter-departmental committee that had been established under the Department of the Prime Minister to evaluate the findings of the review as provided for in the LDP. Some excerpts from this report are in Annex I. The full IRT report is available on the Prime Minister's website: www.pm.gov.pg.
- In November 2001, Cabinet adopted the recommendations set forth in the report of the IRT as the basis of the TBAP to address the resource allocation problems identified in the sector. This was made public in December 2001, on the Prime Minister's website. The TBAP is attached as Annex F.
- The TBAP commits the Borrower to: (i) implement the recommendations of the IRT report on the pending applications that were reviewed; (ii) review all existing logging operations¹⁰; and (iii) review all new applications for logging permits in the same manner as the IRT reviewed the group of pending applications for permits, dealing substantively with each application.

50. The work of the IRT and the consultations with civil society, including the public review of its initial draft report, has initiated a process of public debate on the forestry sector in Papua New Guinea which, aided by new legislation on disclosure of considerations by the Forestry Board on new applications for permits, is leading to increased transparency and accountability in the sector.

51. ***Link between the Forestry Review and the Moratorium.*** The Borrower, the Bank and most stakeholders had agreed on the need for a moratorium on processing of forestry applications when the new Government took office in July 1999. This was especially needed given the previous Government's attempts to fast track the processing of logging operations,

¹⁰ In the conditions agreed between the Borrower and the Bank under the FCP, coverage of the review of existing operations is defined to include all operations that are scheduled to continue beyond December 31, 2003, (or are renewed or extended within that time frame), and to take appropriate action on the basis of results of that review.

thereby circumventing the Forest Authority. In a speech in July 1999, the Prime Minister announced the intention of his Government to introduce a moratorium on new forestry licenses and to proceed with a review of all existing licenses (permits). Following the Prime Minister's announcement, Cabinet took a decision in November 1999 (NG 99/99) to introduce a moratorium on all new forestry licenses, extensions and conversions. The November 1999 Cabinet decision imposed a moratorium that was not specifically linked to the timing or scope of a review process.

52. Unfortunately, the November 1999 decision used the term "licenses" erroneously (instead of "permits"). Technically, "licenses" (as opposed to "permits") are issued on an annual basis to projects that have already been approved. As a result, the November 1999 Cabinet decision caused confusion within the Forest Authority, in the industry, amongst resource owners and the wider community. A new Cabinet submission (NG 84/2000, dated May 10, 2000) was therefore prepared that amended and clarified the November 1999 decision (NG 99/99). The Cabinet Decision of May 19, 2000, directed that, while the moratorium was in place, a review of all pending applications subject to the moratorium would be undertaken, by an Independent Review Team, to ensure full compliance with the requirements of the Forestry Act and supporting regulations, legislation, plans and procedures. The Cabinet Decision did not indicate any commitment to retain the moratorium after the review of pending applications was completed. In addition, the Borrower's reform program as set forth in the LDP indicates that all projects subject to the review process will be placed on hold until the results of the review are known and have been evaluated by the Borrower.

53. In November 1999, at the same time as the first Cabinet decision on the moratorium was taken, a meeting took place between the representative of Greenpeace Pacific (Papua New Guinea) and a Bank FCP post-appraisal mission. In the meeting, the Bank indicated that in its view a review of all existing operations would be inappropriate in the context of the GPAL, as the GPAL focused on implementing critical reforms necessary to improve overall sectoral governance as well as carrying out a review to address the recent set of problematic pending applications. From the Greenpeace Pacific (Papua New Guinea) follow-up letter dated November 4, 1999, it appears that Greenpeace Pacific's representative came away from the meeting with a different impression. The task team leader's reply (November 18, 1999) to Greenpeace Pacific (Papua New Guinea), reiterated the Bank's commitment to talk to the Borrower about "the moratorium and associated review of recent applications," but did not explicitly address the link between these undertakings, and left unchallenged the view expressed in the representative's letter concerning the maintenance of the moratorium, as it had already been addressed in the earlier meeting.

54. As the preparation of the Borrower's reform program progressed in early 2000, the Borrower and the Bank reached an understanding on the scope of the moratorium. The nature of this understanding was conveyed at a meeting between the Bank and Greenpeace Pacific on May 2, 2000. A summary of the meeting, which reflected the Bank's position, was widely distributed to stakeholders in Papua New Guinea (see Annex G). The Borrower also clarified its intentions with regard to the moratorium under its reform program through the Cabinet decision of May 19, 2000.

55. Further correspondence and meetings involving the Bank's Country Director for Papua New Guinea on this issue took place during June-July 2000. After the Bank became aware that Greenpeace Pacific (Papua New Guinea) continued to misinterpret the provisions of the Borrower's reform program (in e-mails dated June 26, 2000 (Annex K) and August 25, 2000 (Annex A)), the Bank indicated to stakeholders the intent of the GPAL's conditions, as agreed with the Borrower, regarding the scope of the review in various communications: (i) in a letter of the Country Director to Greenpeace Pacific (Papua New Guinea) on July 7, 2000; (ii) in discussions in Port Moresby during July 2000; and (iii) in a second letter from the Country Director, September 6, 2000 (Annex H). The Bank also explained its position during the visit of the Bank's Vice President for East Asia and the Pacific Region in November 2000, when he met with a number of NGO representatives in Port Moresby, including CELCOR and Greenpeace Pacific (Papua New Guinea). Finally, discussions with NGOs and interested parties continued during the remainder of 2000 and 2001, and in response to written inquiries a forestry *Questions and Answers* document was prepared. A summary of that document was widely disseminated, and the full text was sent to several major NGOs and was also posted on the *forests.org* website.

56. The Request claims that "The loan agreement's Matrix of Policy Actions ... includes [as a tranche release condition] 'Complete independent review of all FMAs, timber permits and geographical extensions to timber permits.'" This is not factually accurate. There is no Matrix included in the Loan Agreement. The language quoted by the Requesters is taken from the Matrix attached to the LDP, which serves only as a summary of actions taken or to be taken by the Borrower under the reform program that is fully described in the main text of the LDP. While the main text of the LDP clearly establishes the scope of the review to cover all recent major forest resource permit applications and approval processes, the summary in the Matrix does not accurately reflect the actions set out in the LDP. Unfortunately, this issue was not clarified in either the Report and Recommendation of the President on the GPAL or the Loan Agreement.

57. In sum, it was not possible to reach a complete consensus between the Bank and the Borrower and all stakeholders on the issue of the full scope of the moratorium and review, nor was the text of the various GPAL documents entirely consistent. Nevertheless, the extent of consultations with NGOs was considerable and civil society was kept fully apprised of developments with regard to the GPAL.

58. Issues relating to the appropriate scope of the moratorium and review under the GPAL revolve around different views on the appropriate sequence of reforms to the forestry sector in Papua New Guinea. The Borrower, civil society and the Bank are in broad agreement on the need for an overall review of forestry operations in Papua New Guinea, including existing operations and pending applications. Given the variety, magnitude and complexity of the problems that beset the forestry sector in Papua New Guinea, effecting reform is a lengthy process. The Borrower and the Bank therefore agreed that the GPAL would focus on selected key governance reforms necessary to lay the groundwork for subsequent in-depth and long-term forestry management activities, which could be supported by a possible Bank investment operation. In this way, the benefits of the structural reforms supported by the GPAL could be sustained and enhanced over time as the institutional capacity to implement the reforms was strengthened. The FCP as a specific investment loan would be the most appropriate vehicle for developing this capacity.

59. As noted earlier, there had been a major decline in forestry governance during the 1990s and there was a concern that the authorities had not followed correct procedures, especially in the years between 1997 and 1999. Completing the review of pending applications therefore reflected the importance of addressing the recent set of problematic pending applications, and of gaining solid experience with and demonstrating the effectiveness of the review methodology. It also enabled testing of new forestry governance arrangements for these most recent pending applications under local conditions, prior to the subsequent review of the larger set of existing applications. That subsequent review is included and programmed as an activity under the FCP (see Annex C), which aims to support the allocation of sufficient technical resources and capacity to carry out this significant task.

60. ***Claim of Violation of the Moratorium by Government Officials.*** The Bank shares the concerns highlighted by the Requesters with regard to apparent efforts by some senior ministers and officials to push through logging applications relating to the three cases cited by the Requesters – Pondo, Tuwapu and Aiambak – without due process. Annex I to this Response outlines information the Bank has obtained, including individual project reports from the IRT. The Bank agrees that in the case of the Pondo project approved in 2001, a small amount of logging occurred before the permission granted to this project was revoked. Available information indicates that all operations have since been terminated in this area. Similarly, in the Tuwapu project, it appears permission to harvest logs was inappropriately issued by the Forest Authority. The Board withdrew this permission shortly thereafter and operations in this project have ceased in response to the Borrower’s order issued on September 20, 2001. In the Aiambak case, the Request notes that the Minister for Forests himself withdrew approval for a permit to extend the clearing for a proposed highway, under advice from the Forestry Board. The findings and recommendations of the IRT indicated that the operations cited by the Requesters have either been terminated or suspended, and no logging is proceeding. There is no question that commencement of operations should not have occurred. However, by applying the institutional changes implemented through the GPAL, the Borrower successfully terminated these potential breaches and thus maintained its announced moratorium.

Adoption of Forestry Act Amendments, Acceptable to the Bank (Condition #18)

61. The Requesters contend that the tranche release condition relating to reform of the Forestry Act of 1991 was not met. Specifically they claim as follows:

“New laws on forest clearances for roads and agricultural schemes.... The issue we wish to raise here is the lack of good faith of the State in honouring this condition... The required legislation has been put in place. But the Minister for Forests ignores it. There is evidence from the Review Team reports that the Minister for Forests gave approval for a major road line clearance during the currency of the moratorium... [3 items cited]. In our submission the failure of the State during the currency of the moratorium to stop the logging on the Kiunga-Aiambak is a clear demonstration of its lack of good faith.”

[Request, Section 2, p. 7]

“New laws on transparency and non-commercial disclosure by the Forest Authority Board. It was a condition of the loan that the State pass a law that would give transparency to all alienations of forestland. The State has not passed a law to require

public notification (press advertisements and public meetings) to the intention of the Forestry Authority to establish a Forest Management Agreement. Although other necessary amendments to the Act were made, the Forest Authority does not as a matter of practice follow the new law on transparency and non-commercial disclosure [1 example cited].”
[Request, Section 2, p.9]

“New laws insisting on a better balance on the Board of the Papua New Guinea Forest Authority. The intent of these reforms was to remove from the Board the Forest Industries Association (FIA) representatives, because they had come to dominate the Board. The FIA representatives were replaced by a member of the Papua New Guinea Chamber of Commerce. A women’s representative was also provided for in the new legislation.

- *A woman has not yet been appointed to the board.*
- *Further, at the meeting held on Saturday 13th of October 2001, the Chair of the Board allowed a representative of the FIA to be present in a Board meeting.*

These matters show a lack of good faith on the part of the State.”

[Request, Section 2, pp. 8-9]

Response

62. The LDP and the second tranche release conditions called for adoption by the Borrower’s Parliament of amendments to the Forestry Act of 1991 covering: (i) the regulation of clearance of forested land; (ii) non-commercial disclosure by the Forestry Board; (iii) delegation of powers of the Board to an individual; and (iv) the composition of the Forestry Board. These amendments were passed in (see Annex B), and the condition has therefore been met.

63. This response deals elsewhere with the Requesters’ claim of an approval of a major road line clearance during the moratorium (paras. 30-31), and the failure of the Borrower to stop logging in the Aiambak project (paras. 32-34).

64. Under the GPAL, legislation has been enacted to establish a more transparent and participatory process in the review and approval of applications for new logging operations. Based on the commitment shown by the Borrower, it is expected that these laws will be enforced accordingly. The Landowner Forest Decision Making component under the FCP will contribute to meeting these objectives by making resources and expertise available for landowners to for properly representative groups to decide on and negotiate the utilization of their resources (see Annex C).

65. The Request details a case in the Josephstaal FMA where it is claimed landowners encountered difficulties in obtaining the FMA documentation and maps from the Forest Authority. The Forestry Act and its supporting regulations requires disclosure of the nature described in the Request. Through the Sustainable Forest Management component (Annex C), the FCP will enhance the capacity of the Forest Authority to prepare and disseminate this type of information effectively.

66. With regard to the amendments covering the composition of the Forestry Board, the Borrower and the Bank agreed that these amendments were needed. The Borrower has complied with the second tranche release condition under the GPAL and passed the required amendments to the Forestry Act and Regulations as set forth in NEC Decision 84/2000 of May 19, 2000. The Cabinet Decision clarified the intent of the amendment to the Forestry Act, namely to redress the dominating influence of overseas business interests in the industry; it states that: “a representative of the Papua New Guinea Chamber of Commerce and Industry [be] nominated by the Chamber who shall not be a principal or employee of a foreign owned or controlled company dealing in, trading in or contracting to timber.”

67. The Chamber of Commerce has recently nominated an owner of a locally-controlled forestry company as its representative on the Board, and in an acting capacity for this person, an employee of the Forest Industry Association has participated in two Board Meetings in November 2001, and on one occasion, in October 2001, by special invitation of the Chairman of the Board. Technically the nomination and delegation are in compliance with the amended legislation but the Bank is concerned that the intent of the reform as specified in Cabinet Decision NG 84/2000 might be compromised. The Bank is taking up this matter with the Borrower.

68. A woman has not been appointed to the Forestry Board to date. The Borrower has informed the Bank that it is awaiting the nomination of a candidate from the National Organization of Women.

CLAIM OF VIOLATION OF OP 4.36 ON FORESTRY

“In our submission the failure to secure the moratorium on new logging concessions, pending a review of existing concessions, was a breach of OP 4.36, because it failed to implement the policy objectives of OP 4.36. The loan allowed logging operations to proceed (the new concessions) where there was in fact no sustainable forest management.”
[Request, Section 3.2, p. 14]

“OP 4.36 bans the Bank from financing commercial logging operations or the purchase of logging equipment for use in tropical moist primary forest. OP 4.36, para. 1(a), ‘Where a country has made a commitment to undertake conservation-orientated forestry, the Bank may finance improvements in planning, monitoring and field control of logging operations.’”
[Request, Section 3.2, p. 14-15]

“The acts of the State show that it did not implement, follow, adhere to, or is in fact committed to, sustainable forest management, sustainable forestry, conservation-orientated forestry, or good forestry practice.” *[Request, Section 4, p. 15]*

RESPONSE

69. OP 4.36 is not applicable to SALs; it specifically applies to investment lending operations, and GPAL is a SAL. However, by including conditions to improve governance in the forestry sector, the GPAL was designed in part to promote progress toward many of the goals of OP 4.36. As the Requesters themselves agree, the forestry conditions in GPAL were appropriate:

“The Bank acted quite properly when it imposed forest conditions in the SAL. Why was forest conditionality proper? Because the forests were in crisis, the loan was to improve ‘governance’, and governance had been particularly poor in the area of forestry (see Prime Minister’s statement on the cover of this claim), hence the crisis, hence the appropriateness of the conditions.” [Request, Section 2, p. 5]

CLAIM OF VIOLATION OF OP 4.01 ON ENVIRONMENTAL ASSESSMENT

In the Notice of Registration for the Request, the Inspection Panel alluded to a possible violation of OP/BP 4.01. The only mention of the possibility in the Request is an indirect one – a quotation from OP 4.36 to the effect that, in the case of Bank lending operations in the forest sector, government commitment to sustainable forest management requires policies and a legal framework to “*promote active participation of local people and the private sector in the long-term sustainable management of natural forests (see paras. 19-20 of OD 4.01, Environmental Assessment).*” [Request, Subsection 5.10, p. 19]

RESPONSE

70. OD 4.01 was replaced by OP 4.01 in 1998. Neither OD 4.01 nor OP 4.01 is applicable to the GPAL. OP 4.01 explicitly exempts SALs from the definition of types of projects requiring environmental assessment, as did its predecessor: “‘project’ covers all operations financed by Bank loans or guarantees except structural adjustment loans [OP 4.01, footnote 1].”

V. MANAGEMENT’S CONCLUSION

71. Management concludes that the Bank’s actions in connection with the GPAL operation are in compliance with the applicable policies and procedures. While Management notes the reports of adverse effects on the Requesters, any such adverse effects were in no way connected with GPAL, and there is no cause and effect between the adverse effects and any actions or omissions of the Bank. Indeed, in Management’s view, moving ahead with the GPAL was far more likely to assist the Requesters in achieving their aims. The forestry-related tranche release conditions had all been met prior to disbursement of the second tranche. In Management’s view, the FCP, which was approved by the Bank’s Executive Directors on December 18, 2001, is the most appropriate operation through which the Bank can assist the Borrower to address issues in the forestry sector in Papua New Guinea, including many of the issues identified in the Request. Therefore the Requesters’ assertions of violations of the Bank’s operational policies and procedures are unfounded, and there is no link between the GPAL to any material adverse effects that the Requesters may have suffered. As a result, Management recommends that the Request for an inspection of the GPAL by the Inspection Panel be denied.

VI. OTHER MATTERS OF CONCERN TO THE REQUESTERS

72. The matters in this section do not raise claims of violations of Bank policy or procedure, or of material adverse effects suffered by the Requesters. Management recognizes, however, that

the Requesters are concerned about other forestry related issues and therefore addresses them in this section.

PRESIDENT’S REPORT UNDERSTATES THE PROBLEMS OF POLITICAL INTERFERENCE IN THE FORESTRY SECTOR

“The President’s Report to the Executive Directors does not tell the full story.... The important all-embracing political influence of the logging industry is not described.”

RESPONSE

73. The Bank disagrees. The CEM which was distributed to the Board in October 1999 contained an exhaustive presentation on risk, including risk in the forestry sector. The topic of risk is discussed in two sections in the “Report and Recommendation of the President” for the GPAL. It notes a number of types of risk:

- Political opposition that could compromise the reform program;
- Weaknesses in implementation capacity that could affect sustainability of a wide-ranging reform effort;
- The country’s vulnerability to commodity price fluctuations and natural disasters; and
- High crime rates.

74. With respect to the issue of political risk, the Report and Recommendation of the President for the GPAL noted the fragility of the governing coalition and the possibility that commitment may weaken and progress toward reform may slip in the course of political compromise. It pointed to lengthy stakeholder consultations during preparation of the GPAL as one strategy used to manage this risk. Another element of the risk mitigation strategy was to await the implementation of a significant portion of the Borrower’s reform program before presenting the GPAL for Board approval. Management believes that the treatment of risk provided the Executive Directors with adequate information for consideration in their decisions on the proposed GPAL.

INADEQUATE ATTENTION TO THE RISK OF POOR FOREST MANAGEMENT

“Forest management is so poor as to cause actual harm to the forests. The Bank made the loan knowing that the State had no effective ability to protect the forests of the Claimants through the implementation of management policies or practices on fragile forests, 10% conservation set-asides, rotation cycles. There is no ‘National Forest Plan’. This was a risk for the Bank.”

[Request, Subsection 5.13]

“In our submission, the State does not have the ability to manage and conserve the rainforests in the country.”

[Request, Subsection 5.25]

RESPONSE

75. Good quality national level forest information is available through the Papua New Guinea Forest Information Mapping System, and the IRT noted in its report that this is an excellent tool for sectoral and project-level planning. The IRT further noted that Forest Authority staff were able to use this data base to produce project level maps and area information, of sufficient quality to allow estimates of net loggable area to be made. There is a strong technical argument that the priority in Papua New Guinea be on building capacity to produce good field inventories for forest areas being considered for logging, upon which sustainable cut estimates can be based. This is a different form of inventory from national level inventory. The IRT recommended that a national forest plan should be developed from an updating of provincial level forest management plans, jointly prepared by the Provinces, the Forest Authority and the Office of Environment and Conservation. In support of this arrangement, the IRT suggested that clear directions be formulated to guide the development of cutting cycles at the FMA level, and that these must include provision for conservation set-asides and also be subject to initial environmental assessment.

76. The IRT did note that in its view the sustained timber yield principle has been strongly adopted by the Forest Authority as the basis for planning forest operations, and that it also figures significantly in Forestry Board deliberations.

77. The Sustainable Forest Management component of the FCP is focused on the priority tasks that need to be completed to improve sustainability. There is ample scope within this component to assist the Borrower in the development of the analytical and procedural elements referred to in the Request and in the IRT's recommendations, and the Bank will engage the Borrower in discussions on this issue during the course of implementation of the FCP.

FUNDING FOR PRE-SHIPMENT INSPECTION OF LOG EXPORTS

“Although funds have been provided for the Swiss firm Société Générale de Surveillance (SGS) to monitor log exports and the work is being done, the funds are not part of the Papua New Guinea Forest Authority's formal budget. The funds have been donated through the European Union. The Papua New Guinea Forest Authority has opposed the employment of SGS, and tried to give this work to a local contractor.”

[Request, Section 2, pp. 6-7]

RESPONSE

78. The Borrower continues to recognize the importance of the inspection function. In the past, the budget for the log export inspection operation has been funded by the European Commission. In the view of the Bank, it is entirely appropriate for the Borrower to utilize donor funds for such purposes, and it is also appropriate for the Borrower to select any firm it chooses to carry out this task, provided that firm is competent and independent. A new 12 month contract with SGS was negotiated in December 2001. The FCP also includes ongoing support to ensure that the surveillance function is maintained.

INADEQUATE SUPPORT FOR COMMUNITY FORESTRY

A sub-section of the presentation on harm states: “It is unfortunate that methods of forest utilization that assist people to control their own development, such as community forestry are not well supported by the Bank, the State, or the Papua New Guinea Forest Authority.... Community forestry conforms with Bank policy, see OP 4.36.... The Claimants have never been assisted by the State to participate in community forestry... [therefore] the State is in breach of these policies.” [Request, Subsection 5.10]

RESPONSE

79. As discussed in para. 24, the GPAL focused on implementing key structural reforms in the forestry sector. It did not finance any specific forestry investments as structural adjustment loans are not intended to provide this type of support. However, now that the governance reforms in the forestry sector have been put in place, the FCP will support a range of specific forestry investments, including community forestry activities. More than half of the total proceeds of the FCP will be directed towards the empowerment of landowners to organize, decide and negotiate the use of their resources, and to provide financing for landowners interested in developing their own sustainable resource projects: under the FCP (Annex C) communities that wish to make investments in forest projects on their land, and those that seek to assist them in this, will be eligible to apply to the Conservation Trust Fund for support to do so. Moreover, communities will benefit directly from activities the Borrower will initiate with the assistance of the Landowner Forest Decision Making component of the project, which will support the formation of effective landowner representative groups, and develop knowledge and training on forest issues among those groups.

80. As a complement to these efforts, the Australian Agency for International Development (AusAID) remains engaged in the Papua New Guinea forest sector and has expressed interest in working on aspects of community forestry there. It will also support the continuation of the National Forest Conservation Action Program, which has supported many activities aimed at developing community involvement with forests in the past, and will continue to do so. The European Commission also has a program operative in Papua New Guinea at present which focuses on community forestry.

INDUSTRIAL-SCALE FORESTRY IS NOT ECONOMICALLY OR ECOLOGICALLY FEASIBLE IN PAPUA NEW GUINEA

“...but, most importantly, for the purposes of this submission: an industry whose sales revenue is less than its out-goings, an industry that is uneconomic.

“The uneconomic nature of the logging industry has been apparent for some time. Logging could only be justified in very narrow profit-and-loss terms, from the point of view of an export logger. In terms of real economy, externalities were never taken into account. However, now prices are low, the industry is uneconomic, even in a narrow profit-and-loss sense. Good faith requires a government to look at the real, full or true economic impact upon its economy of an activity.” [Request, Section 2, p. 6]

“The policy mandate in OP 4.36 of sustainable management of natural forests is problematic in Papua New Guinea’s mixed-species forests. The evidence points to industrial scale sustainable forestry not being either economically or ecologically feasible.” Reasons given in the Request are that the cost of restoring the forest to its original condition is very high; selective logging on an industrial scale tends to kill off high value, slow-growing hardwoods; logging companies do not observe the Logging Code of Conduct and often manage to clearcut their concessions; and mortality of 53 to 79 percent of the trees left standing after selective logging has been reported in Papua New Guinea.

[Request, Subsections 5.14 – 5.24]

RESPONSE

81. The Request makes broad assertions as to the economic viability of logging in Papua New Guinea’s rainforests, the general feasibility of sustainable forest management in tropical forests, and issues related to appropriate cutting cycles, selective logging and stand damage. These questions relate to complex analytical issues that are presented in detail in Annex M. As far as the economic argument is concerned, the potential viability of the logging sector cannot be judged on the basis of its performance under conditions prevailing in the immediate past. It is in the nature of the logging sector for the market to be volatile, and its long-term viability will depend on the overall trends in both costs and prices. There is no basis for judging the direction of either on the evidence available at the present time. The role of government, in this situation, is to ensure that reasonable economic rent and returns to landowners are gleaned from the sector, and that the broad values inherent in the forest are protected and maintained.

82. Logs have value on the international market and it is evident that pressure to utilize forests to produce them will remain strong in Papua New Guinea as elsewhere. Under these circumstances, the real choice available is not between utilization of the forests for logging, among other uses, or large scale withdrawal of forests from this form of use. Rather the choice is between whether utilization for logs is carried out with due regard to the sustainability, the protection of vital areas and the important externalities of forests, or whether it is done destructively and unsustainably.

83. Annex M discusses some recent work that has been carried out on the general subject of sustainability in tropical forests. It is clear that sustainable management of tropical forests is not only feasible, but that key operational techniques to achieve it have been well known for many decades. The problem has been that there have been few large-scale attempts to implement these, because of the financial attractiveness of highly exploitive and non-sustainable operations in situations where poor governance and capacity problems permit this to occur. The challenge for Papua New Guinea is to develop the means to implement sustainable management effectively. In the view of the Bank, the same problems of governance, capacity weakness and institutional failure that make implementation of sustainable forestry a difficult task also apply to all proposed alternatives to sustainable management under selective logging. Unless appropriate measures – such as enhanced monitoring, enforcement and participation by all interest groups in resource decision making – are implemented to address perverse incentives and vested interests, governance issues and unsustainable forestry are likely to prevail in Papua New Guinea. Taken together the GPAL and the FCP constitute a serious effort by the Borrower, the Bank and other donors to address governance problems in the forestry sector in Papua New Guinea, and to

support efforts to implement activities that empower communities and promote greater sustainability.