



People, power, and pipelines

Lessons from Peru in the governance
of gas production revenues



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Executive summary

Countering the resource curse

For poor countries with abundant natural resources, extractive industries offer the potential of generating enormous revenues. These revenues can fuel economic growth and be directed to combat poverty and improve the well-being of local communities. Experience has shown, however, that large-scale mining and oil and gas prospecting and extraction carry serious environmental and social risks for host countries, with many of the impacts borne by local communities. Host countries also face the risk of the “resource curse,” where poor management of the revenues generated from extractive industries slows economic growth, increases economic volatility and corruption, and sometimes leads to conflict, rather than creating prosperity.

Developing countries that are advancing their extractive industries sectors face the challenges of managing and mitigating the associated risks of development, while ensuring that the economic benefits are channeled to alleviate poverty. Many of these countries are taking measures to address these risks with help from public international financial institutions (IFIs), such as the World Bank and the Inter-American Development Bank (IDB).¹ In this context, these institutions can play an important role by offering support for public-sector reforms to improve the transparency and accountability of extractive sectors at the national level.

Where fiscal decentralization schemes are in place, subnational governments (SNGs) assume a particularly vital role in managing extractive industry revenues. IFIs can help build the capacity, transparency, and accountability of SNGs, so SNGs can manage extractive industry revenues in a manner that provides long-term benefits to local communities. In many countries, IFIs also lend money to governments and the private sector in direct support of extractive projects, which enables them to use their influence as lenders and investors to empower government agencies to promote revenue-distribution schemes that benefit local community areas affected by projects.

This report suggests ways in which IFIs can improve their role in the extractives sector by giving greater support to SNGs in managing extractive industry risks and revenues and by drawing lessons from recent experiences in Peru. For IFI-supported initiatives in the extractive industries to be successful in reducing poverty and improving well-being, the initiatives must be linked to and preceded by support for programs to increase government capacity to regulate activities with high social and environmental risks and to manage revenue flows at both the national and subnational levels. Without this support, government agencies may find themselves unable to manage a myriad of challenges at each stage in the development of large-scale projects. The 2004 Extractive Industries Review (EIR),² an independent review of the World Bank's extractive industry lending, concluded that for the World Bank's interventions to lead to sustainable development, governance systems must be strengthened before investments in extractive industries sector are made. The EIR spurred a number of initiatives to strengthen the quality of governance by increasing the transparency of private and public extractive industry revenue flows at the national level (see Box 1). Nevertheless, more attention is needed—particularly from the IFIs—on building the capacity of SNGs to manage these flows and to ensure that revenues are invested in the well-being of local communities.

In context: Peru

Peru—which is highly dependent on income from extractive industries revenue—has been undergoing an aggressive process of political and fiscal decentralization and introduced policies to increase the transparency of its subnational revenue flows. As a result, SNGs³ in Peru must play a crucial role in managing the risks associated with extractive industries within their jurisdictions, while also ensuring that the revenues generated by the sector support local development that alleviates poverty and improves the well-being of local communities.

IFIs have supported the process of political and economic decentralization in Peru and have also invested in the extractive industries sector. They have provided technical and financial support to public-sector agencies, including support for public revenue management systems. IFIs also directly finance a number of extractive industries projects. The decentralization reforms and the expansion of extractive industries projects have increased the volume of funds being transferred to rural areas. However, official figures show that while national poverty rates declined steadily between 2005 and 2008 in Peru, as of 2008 close to 60 percent of the rural population remained in poverty.⁴ Given the important role IFIs have played in shaping this sector in Peru, they are well positioned to diagnose why poverty persists in the context of such wealth and to determine the role that IFIs, Peru's national government, and SNGs each should play to address this challenge.

To inform such a diagnosis, this report examines Peru's Camisea natural gas project and draws lessons from the challenges faced by SNGs in managing the revenues from that project. Between 2004 and 2009, the Camisea project generated approximately \$1.13 billion⁵ in public revenues for SNGs, which the Peruvian national government distributed through mechanisms called "the gas Canon" and the Camisea Fund for Socioeconomic Development (FOCAM). The Peruvian national government uses gas and mining Canons (transfers of natural-resource-based revenues) to distribute half the revenue it collects from extractive industries to SNGs. The government created the FOCAM inter-governmental transfer to allow all regions impacted by the Camisea project—not just those containing physical gas reserves—to receive compensation.

The Camisea project—the largest producer of hydrocarbons in Peru—benefited from both public and private financing. The public banks that provided financing included the IDB, the Andean Development Corporation, Brazilian National Development Bank, and Peru's Banco de Crédito. A second phase of the project, the Peru Liquefied Natural Gas Project (Peru LNG, also known as Camisea II) supports the export of natural gas from the Camisea fields through a new pipeline to a natural gas liquefaction plant on the Pacific coast. This \$3.9 billion project, due for completion in 2010, received financing from a consortium of lenders, including the IDB, International Finance Corporation (IFC), Export-Import Bank of the United States, Export-Import Bank of Korea, and SACE S.p.A. of Italy.

To put the Camisea project into context, the report describes Peru's turbulent history with extractive industries development as well as the recent decentralization process that has devolved revenue management authority to subnational governments. The report also examines the risks and governance challenges posed by the project and the mechanisms by which its revenues are distributed to subnational governments. Finally, the report analyzes SNG management of Camisea revenues generated between 2005 and 2007.

The report finds that planning failures by both the Peruvian national government and IFIs undermined governance by not building greater SNG capacity *before* massive extractives revenue transfers began to flow in 2006. The fragile SNG capacity places in question the long-term development impact of Camisea wealth.

IFIs have played an important role in catalyzing and providing investment in oil and mining projects, and thus they share with the Peruvian government the responsibility to ensure that the financial benefits of extractive industries projects are directed towards poverty alleviation and sustainable development. By highlighting the challenges of promoting good governance at the subnational level in the context of dramatic increases in revenue transfers in a region with limited strategic planning capacity, this report informs the design of future IFI investments in similar contexts.

In this report

Section 1 briefly examines the context of extractive industries development in Peru, including the decentralization process—which created regional governments and devolved authority and resources to local governments—and the role of public IFIs.

Section 2 provides an overview of the Camisea natural gas project, including its structure and financing and the associated risks and challenges. An overview of selected IFI programs to support SNGs revenue management capacity can be found in Annex 4.

Section 3 describes how Camisea project revenues are distributed to the regions directly and indirectly impacted by the project's operations.

Section 4 outlines key findings from the evaluation of SNG experiences in the region of Cusco in managing revenues from the Camisea project between 2005 and 2007. The evaluation examines government performance in managing these revenues at three levels: regional, district, and project. This section also provides an overview of the Cusco case study scope, methodology, and limitations.

Section 5 outlines recommendations for specific areas where IFIs could target their efforts as they support programs to increase the effectiveness and efficiency of SNG management of public revenues.

Section 6 suggests next steps that IFIs could take to address the report findings.

Section 7 provides a summary statement.

Key findings

The report findings—which inform efforts to support subnational government capacity building by IFIs and others—address SNG capacities for strategic planning, fiscal administration, and operational management. They also provide insights into SNG mechanisms for transparency and public accountability, as well as into local citizen awareness of Camisea revenue transfers.

The study produced a number of findings related to the management of gas production revenues from the Camisea project in Peru:

- SNG expenditures have increased substantially, with the majority of investment spending in infrastructure. However, SNGs are carrying over significant surplus revenues from year to year and are missing opportunities to address risks of oil price volatility and to prepare for the eventual decrease in gas revenues.
- SNGs have made progress in establishing the institutions and procedures needed for effective fiscal management.

- A lack of planning documents at the municipal level suggests that SNG strategic planning capacity is weak and that investment choices have not been based on a medium-to-long-term view or on a coherent strategy.
- SNGs have made progress in designing mechanisms for providing public access to information, but these mechanisms still fall short of what is required by Peruvian law and of what is necessary to enable citizens to hold SNGs accountable. Also, public knowledge of the gas Canon among urban residents of the municipalities benefiting from Camisea revenue is limited, decreasing citizens' ability to monitor public spending and to hold local governments to account.

Recommendations

Our analysis suggests a number of actions by IFIs to address the findings documented in this report:

1. Withhold project support to commercial extractive industry companies until in-country governance conditions and government capacity is sufficient to manage the financial windfall associated with these projects for development and poverty-reduction purposes. This recommendation is in line with the recommendations of the World Bank's independent EIR. Prior to investment, IFIs should determine minimum threshold governance indicators and disclose their assessment prior to project financing. When IFIs do choose to finance extractive industry projects, they should consistently include in their loans accountability performance indicators focused on local outcomes.
2. Provide support for programs to build SNG capacity for long-term strategic planning that are designed to address poverty alleviation while minimizing the environmental and social tradeoffs of infrastructure investments.
3. Provide support for programs that strengthen the transparency and accountability mechanisms that promote and facilitate public oversight at the local level in areas with extractive industries.
4. Provide support for initiatives that help SNGs review their progress, document lessons learned, and exchange this information with peer institutions and the public.
5. Evaluate and share lessons learned across IFI programs and projects aimed at building SNG capacity for extractive industry revenue management and foster multi-stakeholder dialogue to replicate successful approaches.

Next steps

IFIs can address these recommendations in Peru through a number of mechanisms—many of which can be applied more broadly—including country strategies, loans, grants, and technical cooperation. For example, in Peru existing IDB and World Bank instruments could be improved:

- **Country strategies.** Both banks are implementing strategies covering 2007 to 2011. New strategies will be developed in partnership with the new Peruvian administration, to be elected in 2011. Performance assessments, such as this report, can be used to set expectations for improvements; the results could then be used as the basis for discussion with the new government on programs that identify measurable indicators of success to include in the subsequent five-year strategy.
- **Policy-based loans for improved fiscal management.** The World Bank and IDB are supporting a series of programmatic loans focused on public-sector reform for improved fiscal management and competitiveness. Opportunities exist to address these recommendations in future loan operations within the series. However, to promote effectiveness and accountability, any new development-policy loans should be contingent upon external evaluation of prior development-policy loans and the creation of a more robust monitoring and evaluation framework.
- **Policy-based loans for energy sector development.** Since 2009, the IDB has been supporting a policy-based loan intended to support the design and development of a sustainable energy matrix in Peru. The loan comprises a series of operations to support the reform of regulatory and institutional frameworks for conventional and renewable energy sectors, addressing policies and mechanisms for environmental and social risk management and public participation mechanisms as well as SNG capacities for management of hydrocarbon revenues. These energy-sector policy-based loans are envisioned as a series of loans that will extend past the end of the Country Strategy period and into the next Peruvian presidency. The IDB should consider this report's recommendations in the design of these loans.
- **Project-specific investment loans.** Both the IFC and the IDB have invested in private-sector loans for the Peru LNG project, and IDB made similar loans for the Camisea project. According to their country strategies, future support for growth in the hydrocarbon sector is also envisioned. This type of financing will catalyze the generation of a vast amount of revenues for the SNGs in the project's area of influence. While steps have been taken to address local government revenue management capacity, there are opportunities to build in components that can measure the extent to which these lending operations will address gaps identified in this report.

- **Technical cooperation or advisory services.** Systematic analysis of SNG experience in strategic development planning, managing surplus revenues, and developing and implementing public accountability mechanisms is needed. This work could provide the basis for negotiations around country strategies and loan programs with the incoming Peruvian administration, while providing a practical basis on which to convene stakeholder dialogues on lessons learned at the national, regional, and local levels.
- **Elite-level engagement.** High-level representatives of IFIs should take advantage of visits to Peru (as well as other opportunities for engagement with Peru’s political leadership) to underscore the need to ramp up SNG capacity to manage extractive industry revenues, particularly in the areas highlighted in this report.

The debate on possible approaches for addressing the “resource curse”—the paradoxical situation in which countries receiving large revenues from extractive industries experience slower economic growth and poorer development outcomes than those without abundant natural resources⁶—has been informed by a number of initiatives undertaken during the past decade. For example, the World Bank 2004 Extractive Industries Review (EIR)⁷ provided useful recommendations that banks and countries can employ to address the risks of the resource curse. Announced in 2000, the EIR reflected a comprehensive, independent review of the World Bank’s activities in the extractive industries. The EIR concluded that for the World Bank’s interventions in the extractive industries to lead to sustainable development, national governance systems must be strengthened before investments are made. The EIR recommended specific governance improvements in key areas, including transparency in revenue flows, the disclosure of project documents, increased levels of national capacities to manage fluctuating revenues responsibly, the development of modern policy and regulatory frameworks, and the integration of the public in decision-making processes at local and national levels.

Following the World Bank EIR, several other initiatives have emerged, including:

- **Extractive Industries Transparency Initiative (EITI).**⁸ A voluntary, multi-stakeholder initiative comprised of governments, companies, civil society groups, investors, and international organizations, EITI provides an internationally recognized framework for companies to disclose what they pay to governments and for governments to disclose what they receive. The World Bank manages its implementation fund.
- **Publish What You Pay (PWYP) coalition.**⁹ An international nongovernmental organization coalition, PWYP monitors the implementation of EITI and campaigns in more than 77 countries to help citizens hold governments accountable for revenue management from the oil, gas, and mining industries.

Box 1: Initiatives to address the “resource curse”

Sources: World Bank; EITI; PWYP; US Senate.

- **Energy Security through Transparency Act (ESTT).**¹⁰ A bill introduced in the US Congress in 2009, ESTT seeks to ensure that company payments to resource-rich governments are transparent. The bill would require all companies listed with the US Securities and Exchange Commission (SEC) to annually publish the payments they make to foreign governments for the extraction of natural resources, including oil, gas, coal, metal ores, industrial materials, and minerals. It would also require the SEC to make this information public on its website.

1. Extractive industries in Peru: An overview

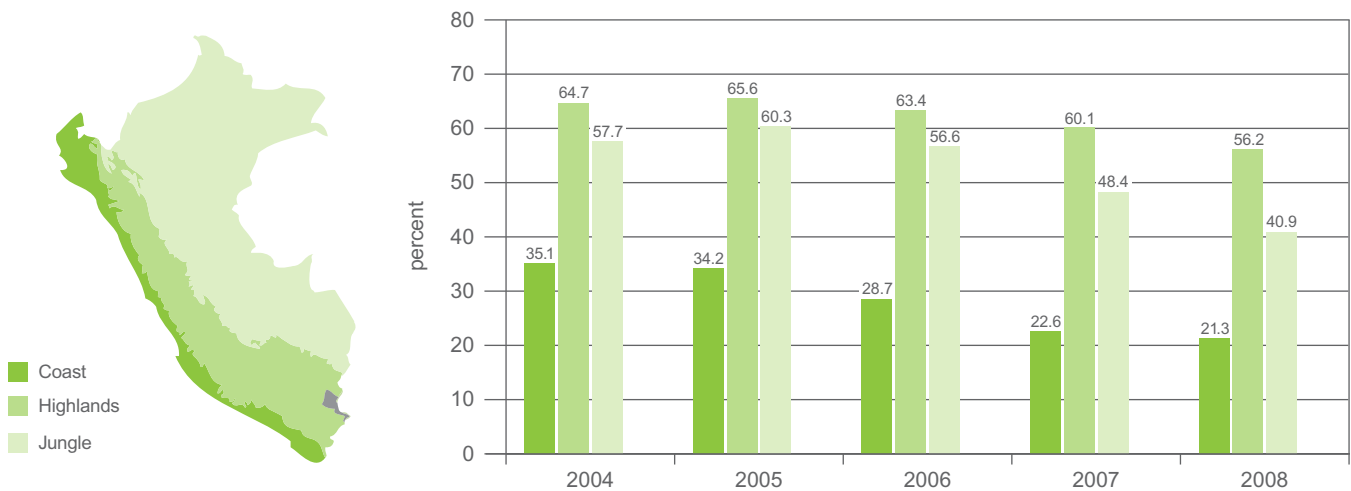
Extractive industries, wealth, and poverty

Rich in minerals and hydrocarbons, Peru boasts one of the world's largest gold mines and booming silver and copper export industries, as well as widespread oil and gas exploration and production. By the time of the economic downturn of 2008, Peru had become the fastest growing economy in Latin America—although this economic growth has not been matched by equitable development, as described below. In addition to macroeconomic reforms and other initiatives that have improved the country's investment climate, Peru's rapid growth also can be attributed to the returns on its vast natural wealth. In 2007, for example, contributions from the extractive industries sector comprised more than half of Peru's total income tax (compared to only 11 percent in 2001) and 75 percent of total taxes generated from exports.¹¹ Rather than becoming more economically diversified, the country's dependence on the extractive industries has increased substantially.

Peru's unprecedented economic growth, and the exploitation of its natural resources, has yet to significantly reduce poverty for the close to 60 percent of Peruvians who live in rural areas and remain impoverished.¹² Although a slight decrease in poverty occurred between 2004 and 2008, a high incidence of poverty¹³ remains in the jungle (selva) and highland (sierra) regions, unlike the more developed coastal (costa) region (see Figure 1). As incomes of extractive industry companies soared during the recent commodity price boom, poverty remained high in areas where hydrocarbons and minerals are extracted.¹⁴

Figure 1. Comparison of poverty levels in geographic regions in Peru

Source: INEI, "Poverty Figures for Peru 2008."



At the heart of these poverty statistics are gaps in access to basic services, such as electricity, water, sanitation, and roads. In 2007, close to one third of the country had no access to potable water and almost half had no sewage system; in rural areas, nearly 70 percent of the population lacked access to potable water and close to 90 percent did not have a sewage system.¹⁵ Greater access to these basic services is central to providing communities in these impoverished rural areas a path out of poverty, enabling improvements in education and health services, job creation, and access to communications technologies.¹⁶ As shown in the following section, the responsibilities of providing many of these services have wholly or partially devolved to subnational governments (SNGs).

A new role for SNGs

In 2002, Peru's national government launched a decentralization process intended to improve the delivery of basic services to citizens by devolving authority and resources to local governments and by creating regional governments. As a result, SNGs now have greater responsibility for ensuring that revenues received from extractive industries result in tangible local development benefits.

Decentralization reforms were initially included as part of the bundle of political and economic structural reforms enacted by the government of Peru (GoP) in the early 1990s with help from the International Monetary Fund (IMF), the World Bank, and the Inter-American Development Bank (IDB). These reforms included the privatization of key economic sectors (including the extractive industries), reform of the tax code, and other incentives to attract foreign investment. Decentralization was not fully implemented until 2002, however, when a constitutional amendment estab-

lished a legal framework that granted greater autonomy to SNGs. With these laws, SNGs now comprise new regional governments¹⁷ and local or municipal governments (which refer to Peru's 194 provinces and 1,632 districts).

The laws marked an important milestone for SNG management of extractive industry revenue. The laws increased the proportion of centrally collected revenues that are disbursed to SNGs, put in place the mechanisms for transferring revenues, and devolved spending responsibilities from the central government to regional and local governments. The laws also outlined differentiated and shared regulatory, planning, and budget responsibilities for each of the three levels of government.¹⁸ (See Annex 1 for details.) With these reforms, SNGs assumed social infrastructure and investment spending responsibilities.¹⁹

The decentralization reforms phased in a system of participatory budgeting at regional and local levels, as well as a mandate to establish development spending priorities through the creation of regional and local development plans. Together, these mechanisms are intended to ensure more-efficient local spending on the most urgent needs (which can be a more cumbersome process if SNG budgets are left up to the distant and disconnected central government). To ensure fiscal transparency and accountability, SNGs are required to submit their budgets to the Integrated Financial Management System of the Ministry of Finance (SIAF, *Sistema Integrado de Administracion Financiera del Sector Publico*). SNG investment projects must meet the requirements of the National Public Investment System (SNIP, *Sistema Nacional de Inversion Publica*). (See Annex 1 for details.)

Extractive industries and challenges for SNGs

Extractive industry growth has put the nascent decentralization process and SNG capacity to the test.

Addressing environmental and social risk from individual operations

Although the proliferation of mining and other extractive projects has generated substantial new sources of revenue for local governments, it also has challenged SNGs to address a myriad of environmental and social impacts. Oil and gas concessions, for example, now cover more than 70 percent of the Peruvian Amazon.²⁰ These concessions overlap indigenous territories and reserves, as well as the buffer zones of protected areas. Even though the percentage of land used during exploration and extraction activities may be a relatively small proportion of the total area of a concession, the quality of a company's environmental and social risk management, as well as its community consultation and engagement process, can have significant implications for SNGs. For example, the inappropriate disposal of oil drilling wastes in even a small area can affect the quality of drinking water in an entire watershed. Project-related

roads and infrastructure can undermine SNG capacity to regulate land-use planning, and unplanned in-migration may lead to deforestation or social unrest due to competition for jobs, land, and natural resources.

SNGs must also manage the expectations raised when a company initiates activities in their jurisdictions, particularly during community consultations and negotiations. An oil company beginning exploration activities, for instance, might hire local workers and contract local services to support its operations, raising community expectations of long-term employment and local development benefits. If the company does not find viable oil fields, it could cease its employment of local workers, and the district will not benefit from the revenues that might have been generated by production. If exploration is successful in another district, and the company makes long-term investments in that area's workers and services while generating revenues to fuel development in that locale, an inequality among districts could be created, which could drive conflict.

Addressing a legacy of social and environmental conflict

Following the privatization of Peru's oil, gas, and mining sectors in the 1990s, the government enacted institutional reforms to address environmental management.²¹ Despite the intentions of the reforms, environmental and social governance of the extractive sector remains weak. Extractive industries have frequently harmed the land and the livelihoods of local communities, and for many communities the activities of extractive industries have brought few real benefits. SNGs have struggled to mitigate and manage these harms but have lacked the capacity to channel revenues into local services that compensate victims and improve living standards.²²

As a result, the extractive sector has a history of conflict and poor public reputation.²³ A variety of factors can lead to conflicts around extractive industries projects, including:²⁴

- Negative impacts from land acquisition and resettlement (for example, water consumption at the expense of household and agricultural uses).
- A lack of information and communication among companies, communities, and the government during contracting processes, project development, and operations.
- An increase in prostitution and violence in project zones.
- Weak or absent enforcement of regulations.
- A lack of local capacity for negotiations and management.
- A legacy of pollution of air and water resources, with negative impacts on public health.
- A lack of credible public information that demonstrates improvements in environmental and social performance.
- Unfulfilled expectations of employment or economic benefits by local populations.

Box 2 highlights several important conflicts directly related to the performance of extractive industries projects that have erupted since 2000. Included is Peru's most recent violent conflict, in June 2009, which while not directly related to a specific project, demonstrated that extractive industries are seen by indigenous communities as synonymous with a government initiative to open up their lands for development without their consent. This distrust stems from the history of poor performance in the extractive sector, as well as a failure of the government to ensure that the economic benefits of extractive industries development outweigh the negative impacts.

Extractive industries conflicts are common in Peru and have been growing in recent years, as growth in this sector has increased. Between January and June 2008, the Peruvian Human Rights Ombudsman's Office registered 123 active social and environmental conflicts; during the same period in 2009, 273 conflicts. Of these, about 80 percent centered on extractive industries.²⁵ The challenging conflicts around extractive industries manifest themselves in a variety of ways, as these examples illustrate:

- **2000: Northern Sierra region, Department of Cajamarca, at the Yanacocha mine, run by US-based Newmont Mining Corporation.** A mining truck spilled 650 pounds of liquid mercury on a road that cut through several communities. As a result, nearly 1,000 villagers were exposed to some level of mercury, and 200 were hospitalized for mercury poisoning.²⁶ In the following years, communities violently protested what they perceived to be an inadequate response to the spill on the part of the company. In 2004, when the company hoped to expand the mine to the area of Cerro Quilish (a mountain considered by many to be a key water source), communities protested the expansion. Ultimately, Newmont withdrew from the area and issued an apology to local communities.²⁷ Estimates indicate that withdrawing from Cerro Quilish represented approximately \$1.69 billion in lost earnings for the company.²⁸
- **2006: Northern Peruvian Amazon, Department of Loreto, in the Corrientes River basin.** In October 2006, Achuar indigenous communities took control of oil facilities run by the Argentine oil company, Pluspetrol. In an attempt to pressure the Peruvian government to stop Pluspetrol from employing the outdated practice of dumping the untreated water produced during drilling into local rivers, the communities blocked road, river, and airport access in the area. (The practice had been abandoned by the United States and many other industrialized countries several decades earlier.) Ultimately, the Peruvian Government and Pluspetrol agreed to meet the Achuar's primary requests, including commitments to re-inject all produced waters in blocks 1AB and 8, agreements to build a new hospital, assignment of a multimillion dollar budget for health care in the area, and the allocation of five percent of oil royalties received by the region of Loreto to Achuar community development. According to Pluspetrol, the two-week protest cost the company approximately \$2 million per day.²⁹ In addition to losses by Pluspetrol, the government lost revenues from taxes and royalties, as well the cost of importing the crude oil needed to satisfy domestic demand.

Box 2. Conflict around extractive industries

The 2008 and 2009 conflicts described below, while not directly related to a specific project, demonstrate that extractive industries are synonymous to indigenous communities with government initiatives to open up their lands for development without their consent. This distrust stems from the history of poor performance in the extractive sector, as well as a failure of the government to ensure that the economic benefits of extractive industries development outweigh the negative impacts.

- **August 2008: Throughout the Peruvian Amazon.** Indigenous people throughout the Peruvian Amazon protested against government decrees that would have eased requirements for the sale of native land for oil and gas extraction. An estimated 12,000 indigenous people occupied oil and electricity plants in the Amazon. After 11 days of protests, the Peruvian congress repealed the decrees.³⁰
- **April–June 2009: Bagua, Department of Amazonas.** New laws enacted after the August 2008 protests above were found by indigenous groups to be unsatisfactory.³¹ When combined with a larger suite of laws aimed at catalyzing development in the Peruvian Amazon, the entire suite of laws was perceived by communities as a threat to their right to self determination. In protest, indigenous communities held two months of protests and blockades of roads and major oil pipelines throughout the country. Communities directed their protest at the oil and gas sector, fearing that these laws would facilitate entry into their territories by this and other sectors. This reflects lack of public trust in the extractive sector as well as its poor reputation. In June 2009, clashes between indigenous protesters and police led to fatal violence in the region of Amazonas after police attempted to break up a road blockade by protesters. After an international and domestic outcry in response to the killings in Bagua, the government was forced to repeal the laws that led to the public protest,³² a national dialogue to determine next steps has been established.³³ Unfortunately, as of January 2010, the Amazon Interethnic Development Association of the Peruvian Rainforest (AIDSESEP), a major national federation representing indigenous peoples in Peru's Amazon, had pulled out of the dialogue, citing lack of progress and reluctance on the part of the government to accept its share of responsibility for the violence in Bagua.³⁴

Managing revenues

The gas and mining Canons allocate public revenues linked to the extractive sector among producing SNGs according to unique formulas that give different weights to poverty, population, and/or production. The distribution is progressive, with poorer districts and provinces receiving a greater share per capita than wealthier districts and provinces.³⁵ In 2006, the Canon transfers covering royalties and corporate income tax revenues from natural gas, oil, mining, forestry, hydroelectricity, and fisheries amounted to 30 percent of SNG revenues.³⁶ The GoP places spending conditions on the Canon transfers, and resources are earmarked primarily for capital expenses (development and infrastructure investments) rather than current operating expenses (such as salaries and facilities).³⁷

It is critical that SNGs effectively apply extractive industry revenues to local development to address poverty and manage the tensions around projects. Since the 2002 decentralization law was passed, various studies have pointed to gaps in the technical and logistical capacity of SNGs to manage these funds and to implement quality development projects. The World Bank's 2007 compendium of essays for the incoming Peruvian administration³⁸ signaled that there was limited capacity within local governments to "handle newly transferred public service delivery responsibilities." The UK Overseas Development Institute (ODI) has identified a number of capacity-related problems for SNGs that manage natural resource revenues. Those relevant for Peru are summarized in Box 3.

- **Leakage prior to the disbursement of funds** (Can be due to embezzlement.)
- **Poor fiscal reporting**
- **Disincentives for investment** (Could result from an absence of clear rules, regulations, and laws regarding intra-governmental revenue assignment.)
- **Insufficient institutional and administrative absorptive capacity**
- **Limited or no monitoring of expenditures after they have been made**

Box 3: Problems and risks of natural resources revenue management by SNGs

Source: Adapted from Overseas Development Institute 2006.^{39, 40}

The Peruvian government has created a number of tools for improving coordination among varying levels of government, building SNG capacities, and increasing fiscal transparency and accountability. Focus areas of the tools include financial management, investment project management, citizen participation, and outcomes-based management, all of which, in theory, must be adapted and applied by SNGs to manage their budgets, investments, and projects. (See Annex 1 for more detail on decentralization tools.) Implementation has proved a challenge, however. Not all SNGs are yet represented in the centrally tracked financial management system, which provides public access to government budgets, and the investment project management process has created bureaucratic obstacles for inexperienced local governments. The participatory budgeting process, which allows citizens to influence decisions on projects to be financed at the local level, is a democratic process; however, it is open to capture by powerful local stakeholders.⁴¹

Managing dependency and resource price volatility

SNGs are highly dependent on intergovernmental transfers from the GoP.⁴² While SNGs have the authority to levy taxes, most have not developed the capacity to do so and are therefore reliant on transfers from the central government.⁴³ These transfers tend to be volatile. For example, the Canon fluctuates with commodity markets and production, and Fondo de Compensación Regional (FONCOR, or Regional Compensation Fund) and Fondo de Compensación Municipal (FONCOMUN, or Municipal Compensation Fund) are based on value-added taxes centrally collected by the GoP. These transfers fell dramatically during a recession period in 2000. Since SNGs rely heavily on these transfers for capital expenditures, their resource base for investment projects was severely reduced.⁴⁴

The oil price boom between 2003 and mid 2008 and the subsequent fall in prices highlights an important risk for SNGs. Local dependency on natural resource funds can also lead to an erosion of the local tax base and can increase government exposure to fiscal volatility in the form of falling prices for natural resource commodities.⁴⁵

The role of public IFIs

Over the past two decades, public international financial institutions (IFIs) have helped shape the institutional and regulatory landscape for extractive industries in Peru, catalyzing private investment and expansion in the sector.⁴⁶ Public IFI programs have provided significant financial and technical support in four key areas:

- Structural reforms in the mining and hydrocarbons sectors
- Regulatory reforms aimed at improving environmental and social management
- Decentralization reforms
- Support for private mining and hydrocarbons projects

The sequencing of these programs by IFIs can help address the challenges faced by SNGs in managing the risks and maximizing the economic benefits of extractive industries development.

To date, the key institutions involved in Peru include the IMF, the World Bank Group⁴⁷, the IDB, Andean Development Corporation (CAF), Brazilian National Development Bank (BNDES), and the German Development Bank (KfW). The IDB and the World Bank Group have been the most influential since the early 1990s, due to the combined influence of their public- and private-sector lending programs.

IFI technical support in these four key areas is discussed below.

Structural reforms in the mining and hydrocarbons sectors

In the mid 1990s, the World Bank and the IMF helped create an attractive investment climate for extractive industries in Peru by supporting reforms to privatize these sectors and by encouraging private investment. Specific financing included support for new investment rules and structural benchmarks requiring the GoP to award extractive industry concessions to the private sector. IMF also required an open bidding process for mining and hydrocarbon concessions. These sectoral reforms complemented macroeconomic reforms supported by the World Bank and IDB that aimed to create financial stability and a favorable investment climate.⁴⁸

Peru's participation in the voluntary Extractive Industries Transparency Initiative (EITI) also has been encouraged. The World Bank has supported the Peruvian government to participate in the EITI at the national level and in two subnational pilots in the Cusco and Cajamarca regions.^{49 50} The IDB endorsed the EITI global initiative in August 2009.⁵¹ Annex 2 contains additional information on EITI implementation in Peru.

Regulatory reforms aimed at improving environmental and social management

In 1993, the World Bank supported the privatization of the extractives sector and the GoP's transition from operator to regulator through a loan to support the development of a new regulatory framework for environmental management for mining and hydrocarbons. Support included improvements in the institutional capacity of the General Directorate of Environmental Affairs within the Ministry of Energy and Mines. These activities paved the way for large-scale private investment in the extractive industries.⁵²

Public IFIs also supported the creation of a new Ministry of the Environment. In May 2008, the Ministry was granted \$175,000 by the IDB to support its initial priorities.⁵³ In February 2009, the World Bank provided the Ministry of Finance with a \$330 million Environment Development Policy Loan, which included support to strengthen the Ministry of Environment. The first of a three-tranche support loan, this operation endeavors to improve environmental management in mining, urban transport, fisheries, and biodiversity conservation.⁵⁴

Decentralization reforms

Public IFIs also have provided more than \$2 billion in loans to develop and enact various components of Peru's decentralization process. Since 2002, IFIs and other donors⁵⁵ have provided the GoP with financing, analytical and technical support for the creation of new national and regional institutions, the devolution of significant fiscal and operational responsibility to SNGs, and the development of mechanisms for fiscal transparency and for monitoring SNG budgeting and investment.

The World Bank has provided the largest amount of assistance to date, approximately \$1.4 billion in structural adjustment, development policy, and technical assistance loans since 2002.⁵⁶ Over the same period, the IDB has provided approximately \$555 million via loans to support improvements in public expenditure management quality. Complementary financial and technical support for the decentralization process was also provided by the CAF and the US Agency for International Development (USAID).⁵⁷

Support for private mining and hydrocarbons projects

Since the mid 1990s, public IFIs have provided private-sector financing for a number of extractive industries projects, during roughly the same period as their loans to the public sector. The IFC, for example, has co-financed major mining projects, including Antamina and Yanacocha.⁵⁸

In the 2000s, however, such investments reached a new level with two hydrocarbon megaprojects, the largest in Peru's history. The IDB co-financed the transport component of the \$1.7 billion Camisea natural gas project in September 2003, joined by regional public banks, CAF, and BNDES. Although IDB's investment was small relatively to the total size of the project, its financial backing was catalytic in attracting private capital to the project (more details in the following section). In 2008, the IDB joined the IFC, the Export-Import Bank of the United States, and others in financing the \$4 billion Peru Liquefied Natural Gas Project (Peru LNG, also known as Camisea II).⁵⁹

These megaprojects, supported by public IFIs, have had a transformational impact. For example, the sheer size and complexity of the Camisea project has required a revamping of Peru's governance regime to address the variety and multitude of financial, environmental, and social risks. These have required new laws, new institutional arrangements, and new revenue-distribution mechanisms.⁶⁰ SNGs in the area of influence of the Camisea project have been putting these mechanisms to the test as they manage the revenues generated by the project while concurrently trying to ensure that the project's benefits outweigh its impacts at the local level. To illustrate these challenges, the following section provides an overview of the Camisea project, the revenues it generates, and the SNGs that benefit.

2. Camisea natural gas project: An overview

The Camisea natural gas project is Peru's largest energy infrastructure project. Originating in the jungle, the Camisea project intersects highland and coastal regions, reserves for indigenous peoples, and environmentally sensitive zones renowned for biodiversity.⁶¹ Several groups of indigenous peoples—both contacted and living in “voluntary isolation” within a state-protected reserve—inhabit the fragile ecosystems of the project zone. The Camisea project gas production infrastructure and pipeline physically impact five of the 24 regions of Peru, three of which are among the poorest in the nation (see Map 1).⁶²

Camisea's gas fields, the Cashiriari and San Martín, were discovered by Shell in the 1980s during exploration activities in hydrocarbon concession Block 88, which falls within the jurisdiction of the Amazonian district of Echarate, in the region of Cusco. Together these two gas fields hold the richest natural gas reserves in Peru, with proven reserves of 8.12 trillion cubic feet of gas and 516 million barrels of natural gas liquids (NGLs). After discovering the Camisea fields, Shell maintained a presence in the area until 1998, but during that time it was unable to reach an agreement with the government of Peru (GoP) to develop the reserves.⁶³ In 1999, after Shell had decided to abandon the project, it was divided into three distinct components by the GoP: upstream, downstream, and distribution (see Map 1).

The GoP issued a bid for each part and awarded contracts to three consortia, each of which comprises several different companies. In 2000, the GoP awarded the Block 88 contract to the upstream consortium Pluspetrol Camisea SA, a Peruvian subsidiary of Argentina-based Pluspetrol, and in 2004 awarded the contract for Block 56 to the same consortium. Pluspetrol extracts gas and liquids from Block 88 and Block 56 and separates natural gas from NGLs⁶⁴ at the Las Malvinas processing plant. Pluspetrol then transfers control to the transportation consortium, Transportadora de Gas del Peru (TGP), which transports gas and liquids through separate but adjacent pipelines from Las Malvinas over the Andes to a fractionation plant and offshore export terminal on the Pacific coast. The gas

pipeline then splits to the north and gas is transferred to the distribution consortium, Tractebel, which distributes natural gas to Peru's largest metropolitan areas, in Lima and Callao.⁶⁵

When the adjacent pipelines split near the coast, the NGL line goes to Playa Lobería, where ownership transfers back to Pluspetrol. At a Pluspetrol-operated fractionation plant and distillation unit at Playa Lobería, the liquids are separated into various products and exported via an offshore marine terminal located near Paracas Bay. The export of NGLs is by far the more lucrative part of the operation, since the gas itself cannot yet be exported. It should be noted that while the consortia have different names, the same three companies—Pluspetrol, Hunt Oil, and SK Corp—have a majority stake in both the upstream and downstream consortium.

Map 1: Overview of the Camisea project

Source: Camisea Project.⁶⁶



Although the Camisea project was designed to provide gas for domestic consumption and for export to foreign markets, the Peru Liquefied Natural Gas Project (Peru LNG, also known as Camisea II) supports the transportation and export of natural gas originating in the Camisea fields (blocks 56 and 88). Infrastructure includes a natural gas liquefaction plant, a marine loading terminal and related facilities on the Pacific coast, and a new 253 mile (408 kilometer) pipeline to carry gas from the existing Camisea pipeline to the LNG plant. Construction is due to end in 2010, and operation will last until 2029. Notably, three of the companies that make up the Camisea upstream consortium also participate in the Peru LNG project: Hunt Oil is project operator for Peru LNG, with 50 percent participation, and SK Energy and Repsol each maintain 20 percent participation (Marubeni Corporation controls the remaining 10 percent).

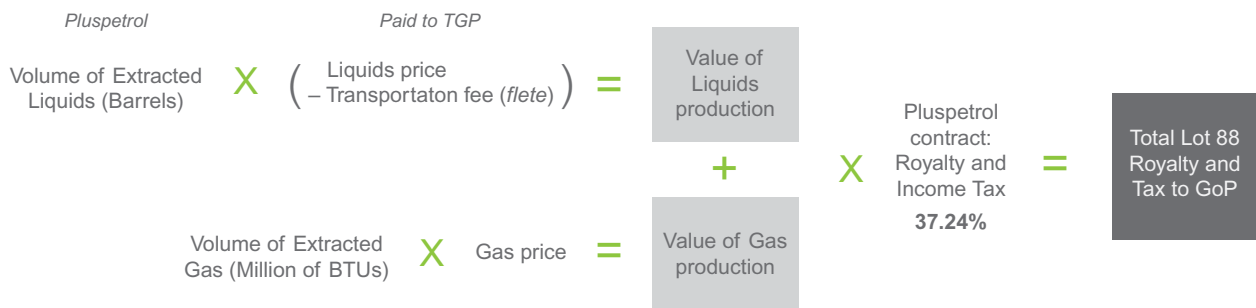
Royalty determination

The GoP’s selections of upstream and downstream consortia maximized the share of royalties and taxes to the government. The GoP negotiated the highest share of the value of gas production with Pluspetrol, and TGP offered the lowest gas transportation fees.⁶⁷ This was intended to provide a financial advantage for the GoP, but it may have also resulted in a trade-off for less stringent environmental and social standards. (See “Social and environmental risks” below.)

The contracts between the GoP and consortium companies are pivotal to determining the royalties that Peru receives from Camisea gas and liquids. The formula used to calculate prices and the actual royalty percentage of the value of production is negotiated in the upstream contract with Pluspetrol. The downstream contract with TGP is of particular importance as well. Before the royalty is even calculated, a transportation tariff (fee)—agreed to during contract negotiations—is subtracted from the price of gas. Therefore, the amount of the downstream transportation tariff directly affects the price of gas, which in turn is used to calculate the royalty. Figure 2 illustrates the formula.

Figure 2. Camisea royalty calculation formula

Source: Camisea Upstream Contract,⁶⁸ compiled by authors.



The upstream contract was negotiated between Pluspetrol and Perupetro, a state-owned but independent government agency, and signed in December 2000. Under this 40-year license contract, ownership of gas is transferred from the GoP to Pluspetrol in exchange for royalty compensation, paid to the GoP through Perupetro.⁶⁹

In the downstream contract between GoP and TGP, signed at the same time as the upstream contract, the same companies overlap in two consortia by 78 percent. Like the upstream contract, the GoP awarded the downstream concession on a financial basis, since TGP offered the lowest transportation tariffs in its bid for the contract.⁷⁰ Per the 33-year concession agreement, the GoP required TGP to complete construction of the pipeline by August 2004 or the consortium would face hefty fines for violating contract terms. However, construction was slow until TGP secured financing; as discussed below, this was a challenge given the risks.

Investors

Financing the \$1.7 billion Camisea project was a challenge initially due to the environmental and social risks and questions about the Peruvian government's capacity and willingness to address them. The US Overseas Private Investment Corporation (OPIC) and Citigroup Inc. initially expressed an interest in the project but later declined because of the outstanding environmental and social risks.⁷¹ In August 2003, the Export-Import Bank of the United States (Ex-Im) denied a \$200 million loan guarantee for the project's upstream component,⁷² a gap filled by private funds from the consortium partners. Ex-Im, a government entity funded by US tax dollars, evaluated the project and found that there were risks of irreversible negative impacts (the project would "likely lead to landslides, destroy critical habitats, and spread diseases among indigenous peoples") and that mitigation measures were inadequate.⁷³ Citigroup withdrew from its role as financial advisor to the project after pressure from civil society groups called attention to the project's environmental risks.⁷⁴

Despite risks that were deemed unacceptable by other large financial institutions, the Inter-American Development Bank (IDB) chose to support the project. IDB approved a \$75 million loan in September 2003, shortly after Ex-Im withdrew support, but financed only the downstream consortium, TGP. This was a relatively small contribution compared to the total cost of \$811 million for the downstream pipeline, but IDB's backing was a catalyst to mobilize funding for the critical downstream component from other sources in Peru and abroad. The Andean Development Corporation (CAF) contributed \$50 million, the Brazilian National Development Bank (BNDES) contributed \$103 million, and Peru's Banco de Credito raised an unprecedented \$270 million from domestic capital markets through a domestic bond sale.⁷⁵ According to the IDB, its investment created "the necessary confidence to attract various sources of international project financing, but it also allowed the project to tap the local capital markets to raise a significant portion of the overall long-term debt."⁷⁶

IDB's decision to finance the project was controversial. The United States abstained from voting in support of IDB financing, partly because the project did not satisfy the conditions of the Pelosi Amendment to the US International Development and Finance Act of 1983.⁷⁷ The Pelosi Amendment prevents the United States from voting to support any project that has significant environmental impacts and whose Environmental Impact Assessment (EIA) is not made publicly available at least 120 days before voting on the project. Camisea had both of these attributes. A report by the US Agency for International Development (USAID) after a site visit to the affected areas in Peru made it clear that the EIA had several deficiencies (including planned mitigation efforts) and that many of the loan conditions between the GoP and the IDB had not been fulfilled as of mid-2004.⁷⁸ The USAID report encouraged that the United States not cast a supporting vote for the project.

Benefits and revenues

According to Peruvian law, the areas affected by the project—which includes some of Peru’s poorest communities—are intended to benefit directly from royalty payments. The rest of the country shares in the indirect benefits from widespread access to a domestic fuel source. A 2007 report commissioned by the IDB estimated that the Camisea project would generate \$4.5 billion in fiscal revenues over the life of the project, with the regional government of Cusco receiving approximately \$300 million annually in royalties.⁷⁹ In addition, the IDB estimated that the project would have a cumulative economic impact of \$14.2 billion.⁸⁰

The project began producing gas in August 2004, and revenues began flowing to local governments in the region in 2005. Between 2004 and 2009, approximately \$1.13 billion in revenue generated by the project was transferred to subnational governments (SNGs) in Camisea’s area of influence—including Cusco, Ayacucho, Huancavelica, Ica, Lima, and Ucayali.⁸¹ (See “3. Sharing the Wealth: Camisea Revenue Generation and Distribution.”)

In addition to generating revenues for SNGs, the Camisea project is intended to promote the domestic use of gas to facilitate a shift in the country’s energy matrix and eventually lead Peru to energy independence. It also is expected to contribute to reducing the existing deficit in Peru’s hydrocarbons trade balance by substituting for imports and allowing exports. As a result, other countries stand to benefit from Camisea’s gas resources. Its sister project, Peru LNG (or Camisea II), will transport and distribute LNG extracted from the Camisea fields to export markets in Mexico and the US⁸² (See Box 5).

Social and environmental risks

Camisea was a new type of extractive project for Peru, not only in its physical scale, but also in its significant logistical, social, and environmental challenges. The controversy surrounding the project focused largely on the social and environmental risks that would result from the project construction and operation, particularly in the vulnerable and remote Amazonian region, where law enforcement is largely absent and SNGs are weak. Nearly 75 percent of the “upstream” drilling component in Block 88 is located in the Nahua-Kugapakori (N-K) Reserve for indigenous peoples, home to populations living in voluntary isolation and an area of fragile ecosystems on which communities depend for subsistence⁸³ (see map in Annex 3). Peruvian law grants ownership over above-ground resources to those who own land, but resources that lie beneath the surface are property of the government.⁸⁴ Therefore, despite the reserve’s designation, drilling and mining are allowed to take place in legally-protected areas.⁸⁵ The export terminal on the coast is situated near the buffer zone of the Ramsar-listed Paracas Marine Reserve, home to a variety of endangered species.

As noted above, the emphasis on choosing consortia of companies that gave the GoP a larger share of royalties and lower transportation costs may have resulted in a trade-off for less stringent environmental and social standards. The project demanded particular skill sets because of its technical complexity, extreme topography and climate, critical needs to mitigate impacts on sensitive ecosystems, and the delicate nature of a development near indigenous communities. However, prior to this project, the pipeline operator TGP had never undertaken a project of this size and complexity. IDB acknowledged several of these risks in the project's Environmental and Social Impact Report (ESIR). For example, IDB noted in the ESIR that Camisea could open up the Nahua-Kugapakori Reserve to the "intensification of extractive activities" and that the pipeline right-of-way (ROW) could be a conduit for migration to the fragile Lower Urubamba valley.⁸⁶ A 2004 report from USAID on the potential risks existing before the pipeline was operational revealed several deficiencies in both TGP's and Pluspetrol's handling of environmental and social matters. It also mentioned the existence of "substantial adverse environmental and social impacts involving biodiversity and indigenous peoples that needed to be remedied."⁸⁷ The series of ruptures to the pipeline has been attributed in part to construction that was unusually hurried due to delays in financing coupled with a rigid timeframe.⁸⁸

As shown in Box 4, while IDB took steps to address some of these risks, challenges remain.

Box 4: The special role of the IDB

The Inter-American Development Bank (IDB) asserted that its involvement in the project resulted in better environmental and social safeguards than if the Camisea project had been financed by private sources and also that its involvement would contribute to "pioneering social and environmental investment programs that will enhance conservation and bring the economic benefits of the project to all sectors of Peruvian society."⁸⁹ As financier of the transport, or downstream, component, IDB pledged to ensure downstream impacts would be minimized through mitigation and monitoring requirements by the government of Peru (GoP) and the pipeline operator, Transportadora de Gas del Peru (TGP).⁹⁰

In an attempt to address social and environmental challenges, IDB also took a number of other steps. IDB initially encouraged the Export-Import Bank of the United States (Ex-Im) to impose environmental and social standards on Pluspetrol's upstream operation to lessen the disruption to communities and to more carefully consider the environmental risks involved with hydrocarbon exploitation in the Amazon.⁹¹ However, after Ex-Im declined to finance the project, the adherence to environmental and social standards were only formally required of the downstream consortium, as this was financed by IDB. IDB hoped that its efforts to provide institutional strengthening would help to address potential environmental and social impacts from the upstream operation.

As conditions for its approval, the IDB established various environmental and social requirements for the borrower, not only for TGP, but also for Pluspetrol, the upstream operator, and the GoP. The IDB has taken on a much greater

role than just mitigating the impact of the downstream portion of Camisea, which it is financing. In a precedent for the IDB—and unprecedented in project finance—the bank negotiated a special cross-default provision, whereby noncompliance by Pluspetrol and the other upstream consortium members with IDB’s environmental and social requirements will result in a default on the IDB loan at the downstream level; signed a legal agreement with the Upstream Consortium; and extended its requirements to the upstream portion.⁹²

IDB also saw future royalties as an integral factor in providing value-added activities to areas impacted by the project and conceived of a planned “Camisea Fund” specifically for community development and ecological projects. The IDB financed this initiative⁹³ and other governance capacity programs in 2003 as part of a \$5.16 million institutional strengthening loan⁹⁴ to the GoP (more detail on governance programs in the following section). In September 2003, the GoP and IDB signed a letter of commitment outlining 21 specific actions the GoP had to take to satisfy the loan conditions; this was a binding agreement to hold the GoP to its commitments related to institutional strengthening and environmental and social management.⁹⁵

Despite these measures, ongoing community concerns documented by Oxfam America on two 2008 trips to the region suggest that negative social impacts and environmental degradation persist. Oxfam recorded a number of community concerns:⁹⁶

- **Gas spills:** Six pipeline spills have occurred since operations began in 2004. A 2007 audit by E-Tech, a nonprofit engineering organization, asserts that the spills might have been avoided had the construction of the pipeline been undertaken with more caution.⁹⁷
- **Reduced fish populations:** Some community members reported declining fish populations as a result of gas spills and increased river traffic. A lack of baseline research on fish populations makes it difficult to assess competing claims on this issue.
- **Government relations:** Community members expressed frustration with inadequate consultation and engagement processes with district government entities and unreasonable delays in implementation of district projects, as well as disappointment that royalties have not resulted in more programs of direct benefit to affected communities.
- **Community engagement:** Community members complained that they had not had access to the right of free, prior, and informed consent; that company approaches to compensation agreements have not been transparent; and that technical expertise is not made available to them during negotiations. Some assert that companies have failed to comply with aspects of compensation agreements, such as reforestation of pipeline rights of way.

Governance challenges

The sheer geographic size of the project and the range of financial, environmental, and social challenges required an unprecedented level of capacity, coordination, and attention from a variety of Peruvian government agencies. The GoP and the IDB recognized these challenges in 2002 and agreed that existing institutions—despite the reforms mentioned in Section 1—lacked the capacity, budget, and coordination mechanisms to effectively manage and mitigate the risks involved.⁹⁸ As a result, in 2002 the Peruvian government created the Camisea Inter-Institutional Technical Coordination Group (GTIC), comprising all the agencies with jurisdiction over social and environmental aspects of the project. This group is managed by the GTIC Camisea Office, housed in the Ministry of Energy and Mines. The institutional strengthening loan in 2003 from IDB, mentioned previously, supported these initiatives and improvements to the regulatory capacities of the 13 governmental entities involved in the project's social and environmental aspects.⁹⁹

Results have been mixed. Improvements occurred in the regulatory capacity of OSINGERG, an independent agency tasked with supervising the project, and the loan supported the creation of a dedicated ombudsman to the project, the Camisea Ombudsman's Office, focused exclusively on preventing and mediating the project's social and environmental conflicts. However, at the 2007 Civil Society Camisea Public Meeting in Washington, DC, an IDB representative noted that skills-retention problems neutralized SNG capacity-building efforts through the GTIC loan. For instance, of approximately 500 government workers trained, half had left their jobs within a year. On this issue more generally, Peru's Vice Minister of the Economy and Finance noted at that meeting, "Local capacity building is a very big challenge. There are high levels of elected local government representative turnover—average person stays in a position for approximately one year—due in part to changes in political control."¹⁰⁰ The IDB's Project Completion Report for the GTIC loan noted that multiple reorganizations of the government agencies responsible for environmental and indigenous affairs, as well as the GoPs decision to employ short-term independent consultants to develop specific products associated with the loan, presented additional challenges for institutionalizing lessons learned. The report also pointed out that with increased SNG decision-making power as a result of decentralization, a risk has emerged that lessons learned on managing social and environmental impacts through the Camisea project will be diluted unless the national government makes a concerted effort to pass them on to SNGs.¹⁰¹ An October 2008 research study examining the implementation of the Peruvian government's commitments found that despite some progress, there were significant gaps in the implementation of these commitments and more action was critically needed to ensure that adequate governance mechanisms to address risks are in place.¹⁰²

Institutions created to support decentralization also face governance challenges. In January 2007, the government of President Alan Garcia dissolved the National Decentralization Council (CND) and created the Decentralization Secretariat to assume its primary responsibilities. Unlike the more independent CND, the Decentralization Secretariat was housed within the Presidential Council of Ministers. According to Garcia, the CND was inefficient and his actions were an attempt to streamline communication with SNGs. Civil society groups have raised concerns that the elimination of the CND sent mixed signals to SNGs regarding decentralization. There are also concerns that the transfer of control of the CND to the executive branch represents resistance by the national government to the primary goals of decentralization. According to Javier Azpur of Grupo Propuesta Ciudadana, “The impression that the government leaves with this type of announcement is that there is significant improvisation in this process, and that there is the desire that the Presidential Council of Ministers assume all of the responsibility, provoking a regression in the process of decentralization.”¹⁰³

The timing of interventions by international financial institutions (IFIs) that may have an impact on governance is critical. For example, IDB’s environmental and social due diligence and subsequent financial support came after the consortia of companies had already commenced construction both upstream and downstream. Therefore, IDB’s actions may have been too late to prevent or minimize impacts that had already occurred. Furthermore, the letter of commitment formalizing the Peruvian government’s responsibilities for environmental and social matters was not signed until March 2004, four years after the concession contracts were signed and after most of the construction was completed. The Camisea fund was stalled and eventually established as the Camisea Fund for Socioeconomic Development (FOCAM), described in the next section, in a form much different from its original intent. It did not begin to disburse transfers to impacted regions for nearly a year after the project came online.¹⁰⁴

In addition to IDB’s public-sector support programs designed specifically around the Camisea project, a number of other interventions played a role in improving governance of the sector at the time the project came online. To illustrate the challenge of timing governance capacity-building interventions so they can effectively address risks, Table 1 provides an overview of Camisea project milestones vis-à-vis IDB and World Bank’s lending programs that supported decentralization and energy sector governance improvements.

Table 1. Camisea Project: Chronology of milestones in context

	2001	2002	2003	2004
Camisea project	<ul style="list-style-type: none"> • Camisea contracts signed 			<ul style="list-style-type: none"> • Extraction operations begin
Peruvian Government		<ul style="list-style-type: none"> • Decentralization law passed • Creation of Camisea Inter-Institutional Technical Coordination Group 	<ul style="list-style-type: none"> • Letter of Commitment on governance & environmental and social management with IDB signed 	
Inter-American Development Bank		<ul style="list-style-type: none"> • Institutional Strengthening Loan for Camisea \$5 million • State Modernization & Decentralization Program ◊ \$28 million 	<ul style="list-style-type: none"> • TGP Camisea private-sector loan \$75 million • TGP Camisea private-sector syndicated loan \$60 million 	<ul style="list-style-type: none"> • Reform of Poverty Alleviation Programs & Human Capital Development ◊ \$300 million
World Bank			<ul style="list-style-type: none"> • Decentralization & Competitiveness I ◊ \$150 million 	<ul style="list-style-type: none"> • Decentralization & Competitiveness II ◊ \$100 million • Institutional Capacity for Sustainable Fiscal Decentralization • ‡ \$11 million • Programmatic Social Reform IV \$100 million • Accountability for Decentralization in the Social Sectors • \$7.8 million
Andean Development Corporation (CAF)			<ul style="list-style-type: none"> • TGP Camisea private-sector loan \$50 million 	
Brazil National Development Bank (BNDES)			<ul style="list-style-type: none"> • TGP Camisea private-sector loan \$105 million 	

2005	2006	2007	2008	2009
<ul style="list-style-type: none"> • Camisea revenue transfers to SNGs begin 			<ul style="list-style-type: none"> • Ministry of Environment created 	
<ul style="list-style-type: none"> • Public Expenditure Management Quality Loan I ◇ \$200 million 	<ul style="list-style-type: none"> • Decentralized Rural Transport \$50 million • Public Expenditure Management Quality Loan II ◇ \$200 million 	<ul style="list-style-type: none"> • Peru LNG private-sector loan \$400 million • Public Expenditure Management Quality Loan III ◇ \$75 million • Sustainable Development in the Bajo Urubamba × ‡ \$750,000 	<ul style="list-style-type: none"> • Strengthening Subnational Governments for Fiscal Management & Investment • ‡ \$300,000 • Management by Results & Public Expenditure Quality • ‡ \$1.5 million • Support for the Energy Strategy × \$500,000 • Institutional Support for Ministry of Environment× \$175,000 	<ul style="list-style-type: none"> • Development of New Sustainable Energy Matrix ‡ \$20 million
<ul style="list-style-type: none"> • Decentralization & Competitiveness III ◇ \$150 million 	<ul style="list-style-type: none"> • Fiscal Management & Competitiveness I ◇ \$200 million • Decentralized Rural Transport ◇ \$50 million 	<ul style="list-style-type: none"> • Results and Accountability ◇ \$150 million • Extractive Industries Transparency Initiative (EITI) × \$300,000 	<ul style="list-style-type: none"> • Fiscal Management & Competitiveness II ◇ \$370 million • Fiscal Management & Competitiveness III ◇ \$330 million • Peru LNG private sector loan via IFC \$300 million 	
			<div style="border: 1px solid black; padding: 5px;"> <p>bold Private sector loan</p> <p>◇ Policy-based loan</p> <ul style="list-style-type: none"> • Technical assistance loan × Technical assistance grant ‡ Includes components on building subnational government capacity for revenue management </div>	

Box 5: From Camisea project to Peru LNG

Sources: IFC; IDB, "Camisea Project Benefits"; Oxfam America.

The \$3.9 billion Peru Liquefied Natural Gas Project (Peru LNG, also known as Camisea II) is the largest foreign direct investment in Peru's history and the first LNG export project in Latin America. Peru LNG is expected to generate \$90 million in annual income tax revenue, as well as \$230 million in annual incremental taxes and royalties from upstream gas production, over the course of its operations.¹⁰⁵

In 2008, Peru LNG received financing from a consortium of lenders, including the International Finance Corporation (IFC), \$300 million; Inter-American Development Bank, \$400 million; Export-Import Bank of the United States, \$250 million; Export-Import Bank of Korea, \$300 million; and SACE S.p.A of Italy, \$250 million.¹⁰⁶ As with the Camisea natural gas project, the public financing component was controversial. At the time these banks were considering their decision, a number of Peruvian and international nongovernmental organizations (NGOs) publicly voiced significant concerns regarding the project's risks. In particular, these groups feared that because demand for gas from Peru LNG will expand production in the rainforest, the project will both generate additional threats to local communities and biodiversity and increase the risk of insufficient gas reserves to meet domestic demand.

Like the Camisea project, Peru LNG presents significant environmental and social risks, such as expanded upstream production operations by the Camisea consortium in sensitive rainforests in blocks 56 and 88 and their associated cumulative impacts, as well as the construction of the LNG terminal in Peru's only protected marine reserve. However, the IFC did not provide financing for Camisea and does not consider any components of the Camisea operations to meet its definition of an associated facility to the second phase, even though the Peru LNG project exists to export gas produced in the Camisea fields.¹⁰⁷ As a result, the IFC Performance Standards for Social and Environmental Sustainability cannot be applied to the production activities in the upstream portion of the project located in the fragile Urubamba Valley. This has raised concerns and protest from Peruvian and international NGOs since an increase in gas production by the Camisea project to feed demand from Peru LNG will lead to expansions in production areas in the Peruvian Amazon and an increased potential for direct and cumulative impacts.¹⁰⁸ These impacts would increase the environmental and social risk management responsibilities for subnational governments in the impact zone.¹⁰⁹ As a compromise, IFC has developed an Upstream Action Plan with the Camisea operating company, Pluspetrol, to help address additional risks posed by expansion of Camisea operations.¹¹⁰ One key product included in the Upstream Action Plan is an Indigenous Peoples Development Plan (IPDP). To date, however, the IPDP has not been made publicly available, and the IFC has no formal legal leverage over Pluspetrol.

3. Sharing the wealth: Camisea project revenue generation and distribution

Camisea gas is produced in the district of Echarate, in the rural Amazonian province of La Convención, in the region of Cusco. Of Cusco's districts, Echarate is the principal recipient of the revenues transferred from the central government. Neighboring subnational governments (SNGs) affected by the Camisea natural gas project pipelines also receive transfers, but to a lesser extent. This section describes how the revenue is distributed and which SNGs stand to benefit. The next section examines the performance of SNGs in managing these revenues.

Since gas production began in August 2004, the volumes of revenue transfers made to SNGs have been significant, in particular to some of the poorest SNGs in the nation. Cusco, the eighth poorest of the country's 24 regions (poverty rate of 58.4 percent)¹¹¹ and the principal regional-government recipient of Camisea project revenues, received a total of \$934 million in transfers between August 2004 and 2009¹¹²—\$233 million transferred to the regional government and \$701 million transferred to provincial and district governments.

Ayacucho (poverty rate of 64.8 percent) and Huancavelica (poverty rate of 82.1 percent), Peru's third poorest and poorest regions, also have benefited.¹¹³ Between 2004 and 2009, Ayacucho received approximately \$21.6 million in transfers of Camisea revenues, and Huancavelica received approximately \$13.5 million.¹¹⁴

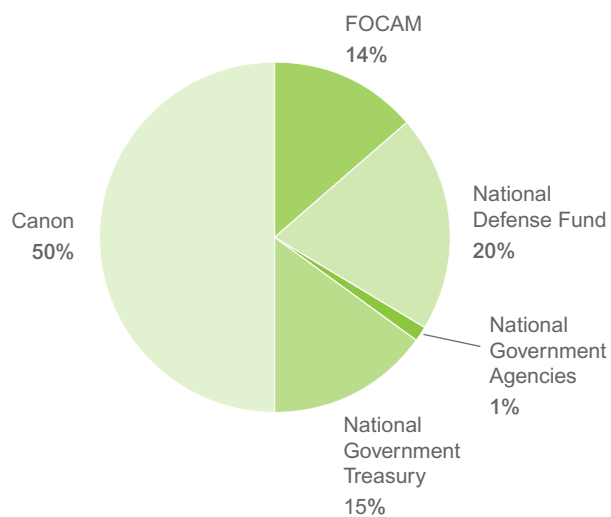
Revenue conduits

Revenues collected by the government of Peru (GoP) from Pluspetrol are divided between the central government and local governments through two inter-governmental transfers, the gas Canon and the Camisea Fund for Socioeconomic Development (FOCAM). Figure 3 provides an overview of the total allocation; additional detail on each transfer appears in the following sections.

Note: The equity of the distribution formulae for gas revenues has been debated in recent years in Peru, but a comprehensive analysis was beyond the scope of this paper.

Figure 3. Camisea project revenue allocation overview

Source: Canon Law, No. 27506 (2001).



Gas Canon

The gas Canon (*Canon Gasífero*)—composed of 50 percent of gas royalties and 50 percent of income tax received from the project—requires a transfer from the central government to SNGs where gas is extracted, in the region of Cusco.¹¹⁵

Distributed between regions, provinces, and districts in Cusco, the gas Canon was modified in 2004 to benefit the local governments more directly affected by the project. While Echarate, the producing district, and the Cusco regional government receive a set percentage by law, the distribution among the remaining districts and provinces varies. Before the 2004 modification, it was based solely on population density. Using annual household survey data, the Ministry of Economy and Finance now formulates a yearly distribution index that weights population, poverty levels, and unsatisfied basic needs (the NBI index¹¹⁶). Poorer district and province governments now receive a greater share per capita than governments that are wealthier.

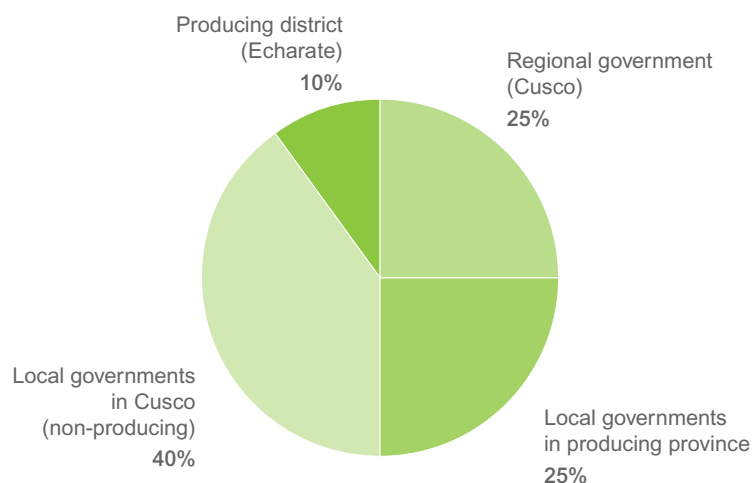


Figure 4. Gas Canon allocation

Source: Canon Law, No. 28322 (2004).

FOCAM (Camisea Fund for Socioeconomic Development)

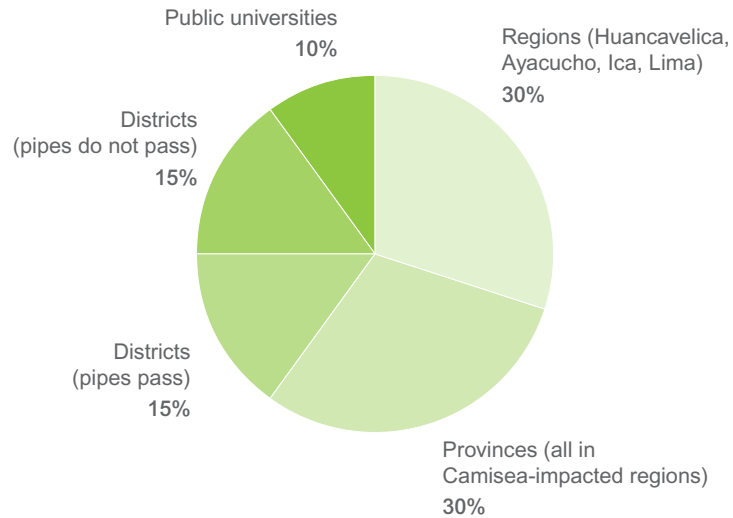
The inter-governmental transfer FOCAM allocates revenues to SNGs in other regions directly impacted by the Camisea pipeline (Huancavelica, Ayacucho, Ica, and Lima). It also includes the region of Ucayali, which was granted access to Camisea revenues because of the use of Ucayali’s rivers for logistical and transport support for the project. FOCAM consists of 25 percent of the total royalties received by the government from gas production for Camisea in blocks 88 and 56, after the deductions for the gas Canon are made.¹¹⁷

The purpose of FOCAM is to allow all regions impacted by the Camisea Project to receive compensation, not just those containing gas reserves. Meant as a complement to the gas Canon, it was conceived by the Inter-American Development Bank (IDB) as part of the public sector support the bank provided to the GoP for the management of the Camisea project, specifically the *Program for Institutional Strengthening and Environmental and Social Management Support*.¹¹⁸

FOCAM’s current distribution structure to regional and local governments mirrors the Canon. While the Canon favors districts and provinces where gas is produced (upstream), FOCAM directs compensation to regions through which the gas transport pipeline passes. As illustrated in Figure 5, 10 percent of FOCAM revenues is granted to public universities, with the remainder allocated to different levels of government: 30 percent allocated to the regional governments of Huancavelica, Ayacucho, Ica and Lima¹¹⁹; 30 percent allocated to the provincial governments within those regions; 15 percent divided among the governments in districts within these regions where pipelines do not pass; and 15 percent divided among governments representing the districts in which pipelines do pass. The central government then uses a poverty/population index¹²⁰ to allocate resources to the SNGs within each distribution category.

Figure 5. Allocation of FOCAM between different levels of government

Source: Law No. 28451 (2005).



This distribution scheme applies in the regions where the pipelines pass, which include Huancavelica, Ayacucho, Ica, and Lima (but not including metropolitan Lima). These four regions and their local governments began to receive FOCAM transfers in May 2005.

The region of Ucayali was later added to the beneficiaries of the FOCAM transfer¹²¹ and began receiving transfers in January 2006. The inclusion of Ucayali was not originally anticipated when FOCAM was established, since it is not directly crossed by the pipeline. Its inclusion was prompted by nearly week-long protests in September and October 2005 by indigenous groups that blocked the transportation routes for Camisea’s upstream consortium on the Urubamba and Ucayali rivers. The groups demanded a portion of Camisea royalties for alleged contamination to the rivers caused by boat traffic related to the project.¹²² After negotiation with the national government, Ucayali was granted 2.5 percent of the central government share of royalties as a FOCAM transfer. The FOCAM funds are allocated largely to Ucayali’s provinces and districts, with the regional government receiving 13 percent and universities 4 percent. Districts in Atalaya province, where protests were held, receive the largest share, 60 percent of Ucayali’s total transfer.¹²³

Managing revenues

As shown in Figure 6, the volume of transfers to regional and local governments between 2004 and 2009 has grown dramatically.

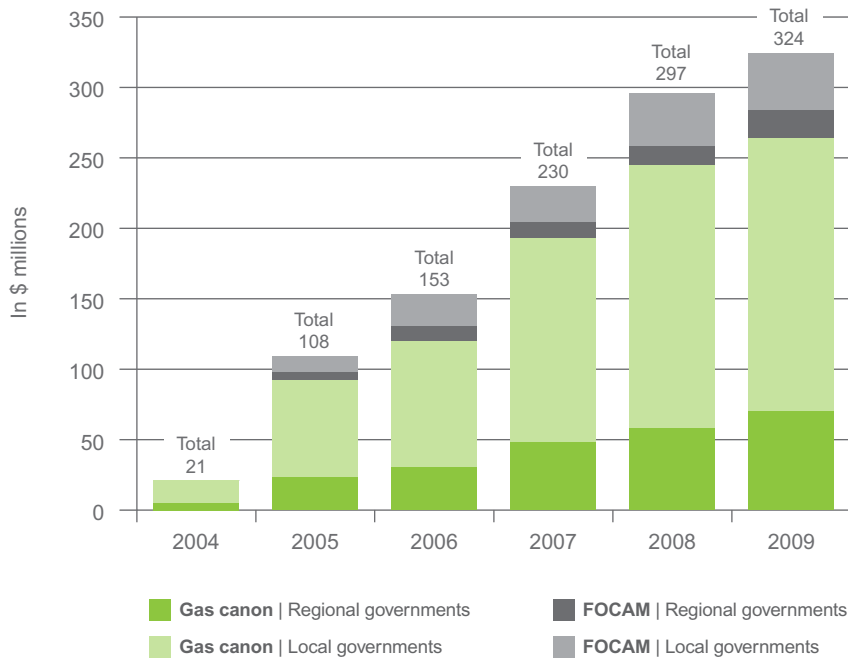


Figure 6: Distributions to regional and local governments by year

Source: Peru Ministry of Economy and Finance.¹²⁴

Managing this huge influx of funding has created both challenges and opportunities for the new regional governments and the lower-tier provincial and district governments. Public international financial institutions (IFIs) supporting Peru’s decentralization process and extractive industries sector growth have recognized these challenges and have initiated programs to address them. For example, the IDB approved a technical cooperation of \$750,000 to the GoP entitled “Sustainable Development of the Lower Urubamba” as a precursor to a possible larger loan to ensure that benefits of the Camisea project reach the impacted zone. This technical cooperation includes a component entitled “support to local governments,” which is intended to evaluate the institutional and investment capacity of select SNGs. A capacity-building plan will be developed as a result of the assessment.

As noted above, the IDB also approved a policy-based loan to Peru to support the development of a sustainable energy matrix for Peru, which includes some support to SNGs to increase the effectiveness of their revenue management. Finally, the International Finance Corporation is adapting its Improving Municipal Investment/Independent Monitoring Mechanism (MIM) initiative to provide assistance to municipalities in the impoverished Ayacucho and Huancavelica regions to more efficiently and effectively manage the revenues they receive through FOCAM. (See Annex 4 for detail on these IFI efforts.)

These revenue management capacity-building programs have not yet translated into SNG spending with a significant impact on poverty, however, as Box 6 discusses. National poverty statistics from 2009 from Peru's Instituto Nacional de Estadísticas e Información (INEI) suggest that the massive influx in funds has not yet led to a significant decrease in poverty levels (see Map 2). The next section provides insight into some of the factors affecting the impact of Camisea revenue distributions on poverty and the challenges confronted by SNGs as they manage and distribute these revenues. The findings are meant to be particularly relevant to public IFIs developing and implementing programs to provide support to build SNG revenue management capacity.

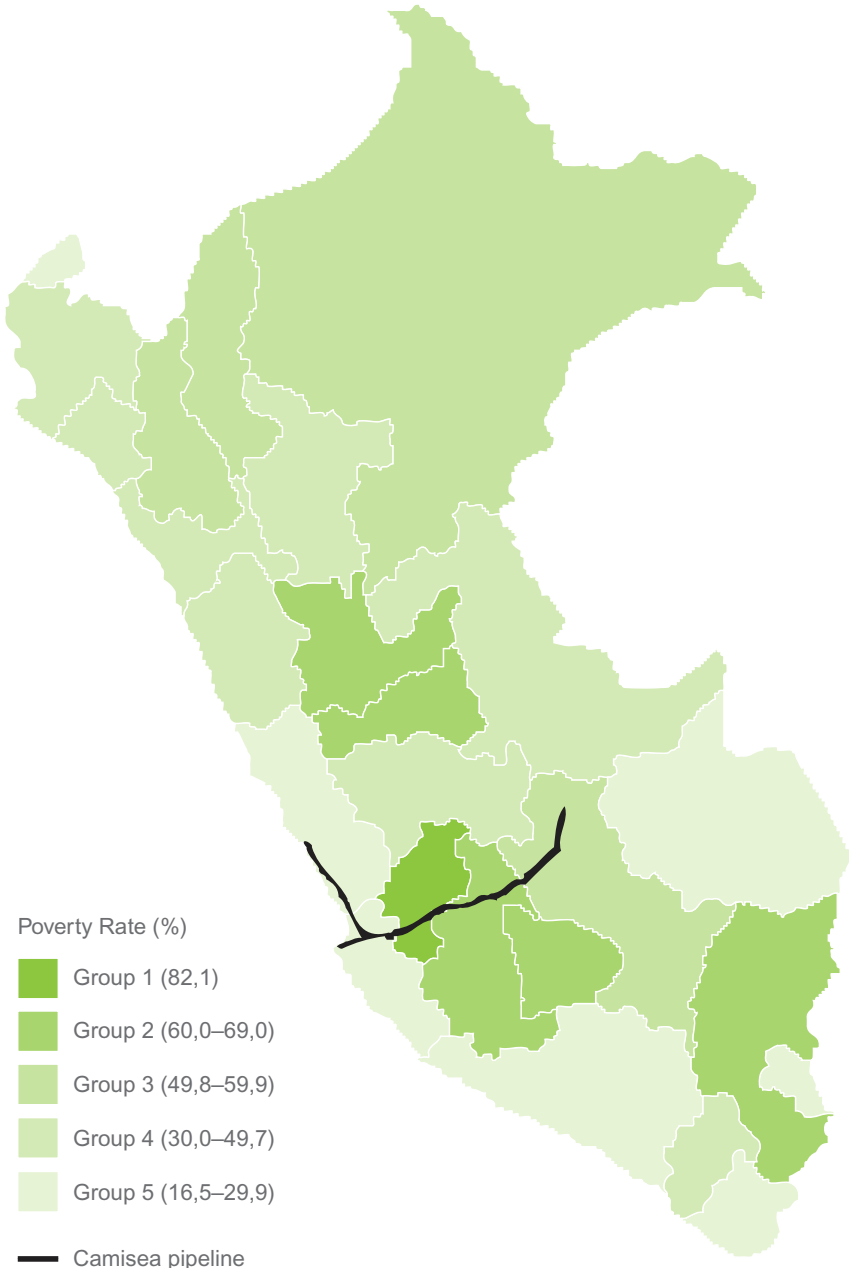
Box 6: Revenues fail to reverse poverty

In 2005, as Camisea revenues began to flow, poverty levels were high in many of the regions meant to benefit. Although there are limitations to what can be achieved over a period of five years, with \$934 million transferred to regional and local governments in Cusco between August 2004 and 2009, greater change was expected. More than five years after the start of gas operations, critical gaps in meeting the basic needs of Cusco's citizens remain.

While the national levels of poverty presented in Figure 1 in Section 1 show gradual declines over the past four years in each geographic region, data from Cusco demonstrate that this picture can be quite different at the regional level. The latest official figures show that poverty levels in Cusco have increased since 2007, rising from 54.7 percent to 58.4 percent in 2008.¹²⁵ While there was a slight decrease in 2006 to 49.9 percent, the numbers show little change from 2004 and 2005, which had poverty rates ranging between 53 percent and 55 percent. According to official figures, in 2007 one third of Cusco's population still lacked water, sewage, and electricity services, while a fifth of women were illiterate and one in three children under 12 suffered from malnutrition. New figures show some progress in Huancavelica and Ayacucho, yet poverty in these areas still remains severe.

Map 2. Camisea pipeline path and poverty (2008)

Sources: IDB; Instituto Nacional de Estadísticas e Información (INEI).



4. SNG experience in managing the Camisea project revenue boom

In this section, the authors examine how well subnational governments (SNGs) at the regional and district level have coped with the new management authorities that have been devolved to them by national government and have adapted to the added responsibility of managing the new influx of Camisea natural gas project revenues. Reflecting SNG experience managing Camisea project revenues in Cusco, this discussion should inform programs designed to improve SNG capacity to manage extractive industries revenues more broadly.

Methodology

Regional-level and district-level analyses were conducted by Grupo Propuesta Ciudadana (GPC) in 2008 as part of a study supported by Oxfam America, Bank Information Center, and the World Resources Institute.¹²⁶ The regional-level analysis examined the importance of the gas Canon in financing investment within the region of Cusco between 2005 and 2007 and examined whether investment priorities aligned with the regional government's existing strategic development plans.

At the district level, the analysis examined three Cusco districts that receive Camisea revenues (in varying degrees), Echarate, Santa Ana, and Urubamba. As the district in which the gas from Camisea is produced, Echarate receives the largest share of revenues. Santa Ana is also within the producing province and receives significant revenues, but these are substantially less than Echarate. Urubamba is not located within the producing province and receives the least in direct revenue transfers, but Urubamba still stands to benefit from improvements in regional-level development initiatives and programs.

The district-level analysis examined municipal capacity for strategic planning, developing and managing public-investment projects, operations and budget management, and natural resource management. The study also examined local capacities and processes to ensure citizen participation, transparency, and information access, and gauged the extent of local citizen awareness of the gas Canon and its contribution to development projects in their vicinity. Researchers used government websites and interviews with government staff in the selected municipalities to gather information on local participatory budgeting processes, public audiences, and other transparency and accountability mechanisms that enable citizens to exercise control over municipal spending. To gauge citizen awareness of the Canon and perceptions of municipal spending, researchers conducted a survey in each of the three districts selected.

The study also examined 10 local development projects that have been completed or are underway in the selected districts. Projects selected were intended to improve the quality of life of local populations and increase productivity and economic competitiveness. The analysis identified areas for needed improvements in project design and implementation based on focal group studies with project beneficiaries and attempted to identify if citizens perceived any benefits from these projects.

Given the remote locations of the areas targeted—such as in the district of Echarate—some information gathering proved difficult and beyond the scope of our resources. Therefore, GPC focused citizen surveys on urban areas and, where possible, traveled to more remote locations to gather data.

In April 2009, the study results were published in Spanish by GPC in the report *Gasto Público y Canon en el Perú*. Unless noted otherwise, all data on SNGs in this report are drawn from that study.¹²⁷

Each of the three Cusco districts studied by Grupo Propuesta Ciudadana—Echarate, Santa Ana, and Urubamba—faces considerable development challenges. The district of Echarate is located in the province of La Convención within the Peruvian Amazon rainforest. Its capital, Echarate, has a population of 3,000; the remaining population of about 40,000 is largely dispersed throughout the district's remote territory, a significant portion of which are indigenous communities. The district has high rates of poverty according to Peru's Social Development Fund (FONCODES). Seventy-eight percent of the population does not have potable water, and most district residents depend on rivers and springs. Nineteen percent of the population lacks basic sanitation for sewage treatment, and 73 percent lacks electricity. Twenty-four percent of women are illiterate, and 41 percent of children are malnourished.¹²⁸

The district of Santa Ana has a population of approximately 33,000, with about 30,000 residing in its capital, Quillabamba. Its climate and landscape are typical of areas along the edge of the rainforest in the Western Andes mountain range. FONCODES characterizes the district as poor, noting that 23 percent of the population lacks access to potable water, six percent lacks access to basic sanitation for sewage treatment, and 10 percent lacks electricity. Illiteracy rates for women reach 12 percent.¹²⁹

Box 7: District characteristics

Urubamba, the capital of the province of the same name, is located around 50 miles from the city of Cusco. Urubamba's climate is typical of valleys within the Andes—temperate in low altitude areas and cold in higher altitude mountainous areas. Its population of approximately 18,000 represents around 32 percent of the province. Seventy-three percent of the district's population resides in the city, with the remaining 27 percent in rural areas. According to FONCODES, poverty levels in the district are not as high as those in Echarate but higher than those in Santa Ana.¹³⁰ The 2005 census found that 30 percent of the population lacks access to potable water, 17 percent lacks access to basic sanitation and sewage, and 10 percent lacks access to electricity. The rate of illiteracy for women in the district is 19 percent.¹³¹

Findings

The regional-level and district-level analyses of Camisea revenue management produced four major findings:

1. SNG expenditures have increased substantially, with the majority of investment spending in infrastructure. SNGs are carrying over significant surplus revenues from year to year, however, and are missing opportunities to address risks of oil price volatility and to prepare for the eventual decrease in gas revenues.
2. SNGs have made progress in establishing institutions and procedures for fiscal management, as evidenced by the existence of almost all of the legally mandated operational documents and units and by new models to manage projects in more remote locations. However, interviews with municipal officials suggest that these documents are rarely used in day to day administration.
3. A lack of planning documents at the municipal level suggests that SNG strategic planning and implementation capacity at that level remains weak and that investment choices are not based on a medium-to-long-term view or on a coherent strategy. SNGs may be ill-prepared to assess and mitigate the potential impacts of infrastructure expansion in environmentally and socially sensitive regions or to ensure an equitable distribution of costs and benefits.
4. SNGs have made progress in designing mechanisms for providing public access to information, but these mechanisms still fall short of what is required by Peruvian law and what is necessary to enable citizens to hold SNGs accountable.

These findings—discussed below—are intended to inform programs designed to support SNG capacity building, particularly those supported by public international financial institutions (IFIs). In addition to addressing SNG capacities for strategic planning, fiscal administration, and operational management, the findings provide insight into SNG mechanisms for transparency and public accountability and local citizen awareness of Camisea revenue transfers.

Finding 1

SNG expenditures have increased substantially, with the majority of investment spending in infrastructure. SNGs are carrying over significant surplus revenues from year to year, however, and are missing opportunities to address risks of oil price volatility and to prepare for the eventual decrease in gas revenues.

Between 2005 and 2007, public investment in the Cusco region grew by 50 percent. Local governments—provincial and district—accounted for almost 60 percent of the total. During that period, regional government spending rose to represent 18 percent of total spending, while national government investment in the region diminished, contributing only 25 percent in 2007.

In two of the three districts studied, investment spending also grew. In Echarate, public investment grew from \$6.1 million in 2005 to \$22.7 million in 2007, an increase of 272 percent; in Santa Ana, spending rose 33 percent, from \$3.6 million to \$4.8 million. These spending increases were enabled by improvements in capacity after the Echarate and Santa Ana municipal governments took measures to become incorporated into the National Public Investment System (SNIP).¹³² In Urubamba, however, investment spending declined, due in part to the requirements the municipality had to meet to incorporate itself into the SNIP.¹³³ As shown in Box 8, challenges with the SNIP were among several challenges faced by districts as they sought to implement their investment spending.

The objective of the National Public Investment System (SNIP), which is managed by the Ministry of Economy and Finance, is to ensure that public revenues allocated for investments are put to their optimal use for development through a process of planning, quality control, and monitoring. Investment projects at both the regional and local levels are subject to the SNIP. For subnational governments located in remote areas and lacking in management capacity, conforming to SNIP requirements can present significant challenges.

The districts studied by Grupo Propuesta Ciudadana face the following general challenges:

- Failure to meet SNIP eligibility criteria¹³⁴
- Delays in developing technical terms of reference for projects
- Delays in public contracts and acquisitions due to extensive bureaucratic processes
- Scarcity of human resources for project development and for work needed in remote areas

Box 8. Spending challenges for districts

Source: Grupo Propuesta Ciudadana.

Investment priorities

Infrastructure development for transport, electricity, water, and sanitation plays a key role in the government of Peru (GoP) strategy to accelerate growth and widen the economic base of the various regions.¹³⁵ Accordingly, the majority of public investment in Cusco by the three levels of government prioritizes the construction of infrastructure.

More than half of central government investment in Cusco between 2005 and 2007 focused on transport infrastructure—mainly highways—in line with Peru’s Rural Infrastructure Strategy, which had been developed in 2003 in partnership with the World Bank. Likewise, more than half of the Cusco regional government investment in this period prioritized infrastructure for irrigation, highways, and school buildings, in line with its Regional Development Plan. In the municipalities studied, more than half their investments in 2006 and 2007 were on highways, urban streets, school buildings, and sports centers.

While the focus on infrastructure appears to be aligned with national and regional priorities, it is important to note that the analysis by GPC recorded little investment in projects to support improvements in other key areas, including health, education, and agriculture.

Regional-level and district-level surpluses

Both regional and local governments have focused on increasing their spending capacity, but neither have been able to meet the investment targets projected in annual budgets and consequently are carrying over significant surplus revenues from year to year. Surpluses are accumulating in savings accounts, with no financial management strategy, leading to missed opportunities for returns.

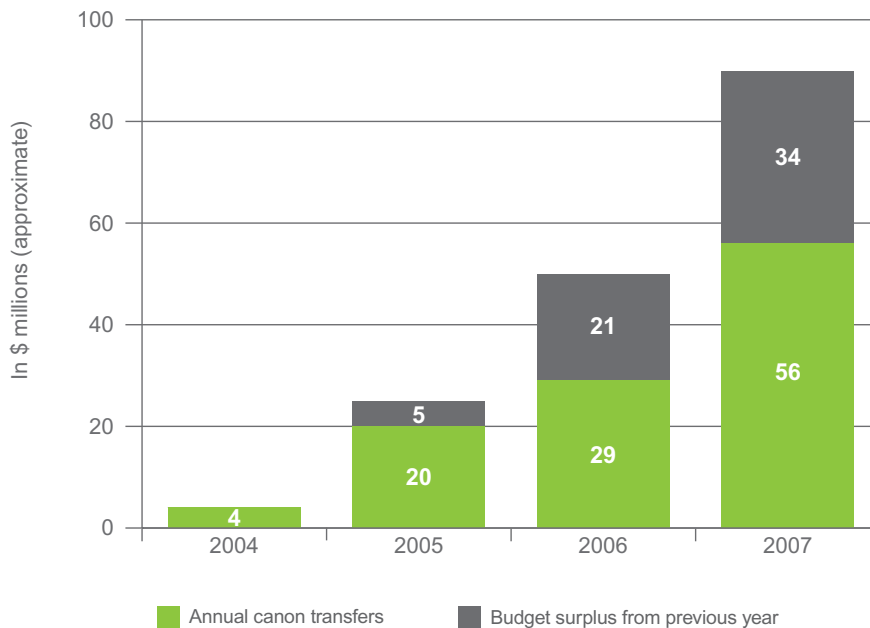


Figure 7. Canon funds available in the Cusco regional government budget, 2004–2007

Source: Grupo Propuesta Ciudadana.

Between 2004 and 2007, Canon transfers to the regional government increased by 14 times, from approximately \$5 million to \$70.3 million. Balances grew from approximately \$4.6 million in 2005 to \$95.2 million in 2007 (see Figure 7). The Cusco regional government has created a savings fund for the surplus.

District-level spending patterns mirror those of the regional government. Despite efforts by the municipality of Echarate to increase spending, the rapid growth of revenues generated from the gas Canon has exceeded its capacity, resulting in rising budget surpluses. As noted previously, Echarate increased its budget by 272 percent between 2005 and 2007. However, in 2005 it disbursed only 38 percent of its total budget, and in 2006 and 2007 only about half. A savings fund has been created in the Banco de la Nación, but without the financial management that might produce greater profitability.¹³⁶ Similar spending trends are apparent in Santa Ana and Urubamba.

The oil price boom and financial crisis has called attention to the need to save for future uncertainty. The eventual drop-off in gas production will also significantly impact SNG incomes. Furthermore, SNGs that initiate multi-year projects in flush times, prior to completing adequate strategic planning processes, risk running out of resources down the road and leaving projects incomplete. Nevertheless, no stabilization or investment fund for the surplus revenues has been established by these governments. Given that Canon funds constitute a large proportion of their budgets, this finding suggests the critical need for SNGs to reorient investments with a view to the long term.

Box 9. Spending trends, 2008–2009

This report draws lessons from the Grupo Propuesta Ciudadana examination of Camisea revenue distribution between 2004 and 2007 at regional and local levels. Although the analysis of data from 2008 and 2009 was beyond the scope of this report, a preliminary review of that data—coincidentally the beginning of the global financial crisis—signals trends that require study.

During 2008–2009, the budgets of district governments of Echarate, Santa Ana, and Urubamba grew in absolute terms. Also, these governments appear to have spent a greater proportion of their total budgets during that period than in the 2004–2007 period. This suggests several trends that require more study in the field to draw lessons and strengthen recommendations. For example, these governments may be improving their ability to develop technical project proposals, to organize and implement project bidding rounds, and to execute contracting and procurement processes. Such improvements would decrease delays and increase rates of spending. However, strategic development plans are not yet available online to the public, which prevents analysis of the projects being financed and their alignment with long-term development planning. Fieldwork to identify whether these plans exist and their strategic alignment with the development objectives of the district and the region would be useful, as would analysis of the influence of citizen project requests and project requests that emerge from the participatory budgeting process on budgeting and spending patterns.

In addition, the growth in budgets in absolute terms must be compared to population growth and the relative need to increase per capita spending versus the need to save for the future. As mentioned in this report, in the early years of Camisea project revenue distribution, neither the district governments studied nor the regional government of Cusco appeared to be maximizing the investment potential of the surplus revenues that were being carried over from year to year. Funds sitting in savings accounts could have been gaining interest over the years and could have been funneled into trust funds or other special funds to prepare these governments for the eventuality of an end to Camisea revenue transfers. Although a preliminary analysis of 2008–2009 numbers suggests that these governments are now increasing the proportion of their budgets that are being spent, it remains unclear whether they have chosen to invest the surpluses in ways that would be profitable.

Additional fieldwork is needed to support a comprehensive analysis of the spending trends between 2004 and 2009. We hope that this report and its recommendations provide a framework on which to build this future analysis and provide a basis on which to evaluate learning and progress by subnational governments. (For a list of additional suggested areas for future research, see Annex 6).

Finding 2

SNGs have made progress in establishing institutions and procedures for fiscal management, as evidenced by the existence of almost all of the legally mandated operational documents and units and by new models to manage projects in more remote locations. However, interviews with municipal officials suggest that these documents are rarely used in day to day administration.

The first phase of Peru’s decentralization reforms focused on implementing financial and control measures to ensure fiscal discipline in the delivery of services and in the execution of new functions. Given the rapid increase of large volumes of Camisea revenue transfers to local governments, the public administration capacities of local governments must be strengthened. The analysis of municipal governments shows that almost all of the operational documents and units mandated by law are in place (see Tables 2 and 3).¹³⁷

	Echarate	Santa Ana	Urubamba
Annual Operations Plan	X	X	
Annual Acquisitions and Contracts Plan	X	X	X
Regulation of Organization and Function	X	X	X
Organization and Functions Manual	X	X	X
Personnel Assignment Chart	X	X	X
Personnel Budget	X	X	X
Administrative Procedures Unique Text	X	X	X

Table 2. Operational management documents, 2009

Source: Municipalities of Echarate, Santa Ana and Urubamba (accessed September 2009).

	Echarate	Santa Ana	Urubamba
Municipal Management	X	X	X
Office of the Legal Counsel	X	X	X
Planning and Budget Office	X	X	X
Internal Control Body	X	X	X
General Attorney’s Office	X	X	X
Project Formulation Office	X	X	X
Project Evaluation Office	X	X	X
Acquisitions and Contracts Area	X	X	X
Economic Development Management	X	X	X
Environment Division	X	X	X
Citizen Participation Division		X	X

Table 3. Administrative units, 2009

Source: Municipalities of Echarate, Santa Ana and Urubamba (accessed September 2009).

The decision of each municipality to incorporate itself into the SNIP is one factor that led them to establish project evaluation and formulation offices, that is, to meet the SNIP project viability requirements. Echarate joined the SNIP in 2005, enabling increased investment spending and a greater portfolio of projects. In contrast, Santa Ana and Urubamba joined in 2007 and 2008, respectively, reflecting the slow advance of their spending.

Further investigation revealed, however, that even though operational documents are in place, they are not yet applied fully to operational management. According to interviews of officials from each of the three municipalities conducted by GPC, operational documents serve a more formal than practical purpose and are rarely used in day-to-day administration. A more systematic assessment of the quality or performance of these SNG management functions is needed.

Finding 3

A lack of planning documents at the municipal level suggests that SNG strategic planning and implementation capacity at that level remains weak and that investment choices are not based on a medium-to-long-term view or on a coherent strategy. SNGs may be ill-prepared to assess and mitigate the potential impacts of infrastructure expansion in environmentally and socially sensitive regions or to ensure an equitable distribution of costs and benefits.

Strategic planning and implementation capacity at the local level is critical given the type of coordinated development activities mandated by the national government, including investments in infrastructure and efforts to reduce poverty. While municipal governments have primary responsibility for funding and implementing development projects and public infrastructure at the local level, regional governments draft the development plans that include regional infrastructure. To ensure efficient resource use and complementary efforts, local governments need to conduct analyses of local needs with extensive public input and identify means to coordinate these with both national-level and regional-level priorities.

To be effective, these combined priorities must be reflected in municipal-level strategic plans. The GPC study revealed, however, that the districts studied generally lacked these five key strategic planning documents, as shown in Table 4:

- Local Development Plan
- Institutional Development Plan
- Capacity Development Plan
- Land Use Plan
- Urban Development Plan and Cadastre

	Echarate	Santa Ana	Urubamba
Local Development Plan	X		X
Municipal Strategic Plan			X
Capacity Development Plan			
Land Use Plan			
Urban Development Plan and Cadastre	X		X

Table 4. Strategic management documents, 2009

Source: Municipalities of Echarate, Santa Ana and Urubamba (accessed September 2009).

Even when plans did exist, some local governments surveyed in 2008 in this study indicated that they were not using them. The Echarate government, for instance, had not updated its Local Development Plan since 2001 and therefore no longer found it useful. In Urubamba, the government’s Municipal Strategic Plan had been prepared by the previous administration and the government chose not to use it.

The lack of strategic planning tools among the governments surveyed suggests that spending has been increasing without long-term strategic planning. This situation exposes SNGs to a number of risks and could also contribute to suboptimal project planning decisions and missed opportunities. For example, the risk exists that local development efforts will focus on implementing individual projects, without considering long-term, cumulative impacts. In addition, municipalities could miss opportunities to achieve economies of scale, and SNG interventions might not meet citizens’ most basic needs as a priority. (A 2007 financial review of gas Canon and the Camisea Fund for Socioeconomic Development, FOCAM, financed by the Inter-American Development Bank, IDB, found that SNGs would benefit from developing strategic investment plans whose priorities are guided by analysis of the basic needs index, NBI, within that jurisdiction.)¹³⁸

Without a strategic planning process, the public misses an opportunity to participate in setting goals and contributing citizen knowledge that can be useful in identifying the risks and opportunities posed by proposed investment plans. Without documented plans and strategies, citizens are prevented from holding local governments accountable for strategic leadership. Even though citizens in these districts take part in local participatory budgeting processes, their requests cannot be weighed against long-term plans, which can prevent adequate prioritization and can lead to environments where political interests (rather than strategic priorities) may have greater influence in determining the projects that are selected for financing.

Furthermore, strategic planning exercises can provide the basis on which local governments can learn the views of the public and explain development choices to their citizens, while managing expectations. Surveys of citizen perceptions in areas benefiting from local development projects can provide useful information for understanding the extent to which local governments are making strategic choices. Box 10 describes the results from a citizen survey on municipal projects conducted by GPC as part of its research for this report.

Box 10. Results from citizen surveys of municipal projects

Source: Grupo Propuesta Ciudadana.

This study included a citizen-centered analysis of the implementation of 10 municipal projects in the three focus districts—four in Echarate and three each in Santa Ana and Urubamba. Implemented between 2004 and 2008, the projects were supported with funds from the gas Canon, were chosen with local government input, and primarily focus on infrastructure development. The Peruvian nongovernmental organization Centro Bartolomé de las Casas¹³⁹ conducted field research based on focus groups with representatives of local communities to determine if projects responded to community priorities, the impact of projects on the living conditions of families, and beneficiary participation in project selection and implementation.¹⁴⁰

Research results indicated that, in general, projects underway did respond to local needs and were selected through participatory budgeting processes. However, community members expressed concern over the absence of productive projects to support agricultural and forestry activities, particularly in Echarate and Santa Ana. Participants also identified notable technical failures in the design or implementation of six of the projects. For example, in the indigenous community of Sensa, located in Lower Urubamba, researchers examined a school construction project consisting of two classrooms, a kitchen area, and bathrooms with showers and toilets. While focus group participants expressed general satisfaction with the completed project, they complained that the project took three years, far beyond the nine months originally scheduled. In addition, the new bathroom facilities were nonfunctioning, since the community did not have the necessary water and sewage system to accommodate these facilities.

While this limited review does not reflect a representative sample of municipal projects, it suggests that weaknesses in strategic planning are having an adverse impact at the local project level.

As IFIs and others design programs to support SNG capacity, an examination of specific cases can help illustrate the type of obstacles that may arise at the local level. Box 11 presents an example of the project development challenges faced by Echarate in the absence of strategic planning around land use.

Box 11. Echarate: Governance challenges in Camisea's producing district

Sources: Grupo Propuesta Ciudadana, Oxfam America, World Wildlife Fund.

The risks posed by a lack of strategic planning are encapsulated in the district of Echarate. In addition to housing the Camisea natural gas project, the district faces a multitude of challenges as it engineers its development. As noted above, 78 percent of residents lack potable water (they depend on rivers and springs) and 73 percent lack electricity. Four children out of 10 are malnourished, and the infant mortality rate in 1997 was 126 deaths for every 1,000 births. The principal livelihoods among the district's 24 indigenous groups are agriculture, ranching, commerce, and transport, and some remote communities subsist on hunting and fishing.¹⁴¹ The wider region is also a biodiversity hotspot, home to a high number of endemic plant and animal species and to several protected areas.¹⁴²

To date, Camisea project activities have presented a variety of threats to cultural and biological diversity in the Lower Urubamba region, which includes Echarate. Six spills in the gas liquids pipeline have caused conservation repercussions for local communities, including declining fish catches. Communities also have expressed frustration over inadequate government support for project consultation, inadequate compensation for areas cleared for seismic exploring, company noncompliance with commitments to local development projects, and disturbance of fauna due to helicopter noise, making subsistence hunting more difficult.¹⁴³

The district government has responded by establishing six “decentralized offices” to manage public works financed by Canon revenues. Previously, project management was centralized in the town of Echarate, far from project sites. Project beneficiaries from remote areas had been forced to travel up to three days to see government staff. This resulted in insufficient monitoring and tracking of revenue investments and inadequate or weak government responses to problems with project construction.

While these new offices have allowed the district government to improve its capacity to oversee projects, major strategic planning gaps remain. As of January 2010, the district government had not developed a Capacity Development Plan or a Municipal Strategic Plan. There are “zoning plans for populated centers” (Planos de Zonificación de Centros Poblados), but no Land Use Plan covering the entirety of the district, including indigenous communities.¹⁴⁴

The lack of a Land Use Plan is of particular concern because the district government is initiating plans to build a road between the town of Chinguriato and the remote Lower Urubamba communities. While the communities support the road as a means of addressing delays in government projects, the plan poses significant environmental and social risks. Completion of the road could lead to encroachment by illegal loggers and drug traffickers, biodiversity degradation, depletion of natural resources the communities depend on for subsistence, and health risks to vulnerable populations with limited exposure to disease. The proposed road would cross through Megantoni National Sanctuary, a protected area of great biodiversity which spans between Manu National Park and the Machiguenga Communal Reserve, creating an uninterrupted stretch of protected land which facilitates plant and animal migration.¹⁴⁵

As of mid 2009, the government of Echarate had not released detailed information on the road’s planned construction, although construction was already well underway. According to a representative of the national agency responsible for natural resource protection in Peru, the local government has also failed to conduct an Environmental Impact Assessment of the road’s impact on the protected Megantoni National Sanctuary, as required by law.¹⁴⁶ The Regional Government of Cusco and national Ministry of Transportation have also received limited information regarding construction of the road.¹⁴⁷

This case illustrates the issues that can arise when revenue-rich SNGs fail to produce strategic and transparent planning processes. A participatory and transparent land-use planning process could help to address some of these issues by fostering structured dialogue among citizens and government and by providing a platform for the strategic collaboration needed among levels of government tasked with coordinating development strategies.

Finding 4

SNGs have made progress in designing mechanisms for providing public access to information, but these mechanisms still fall short of what is required by Peruvian law and what is necessary to enable citizens to hold SNGs accountable.

Transparency and access to information are critical to enable the citizen participation necessary to ensure that extractive industries revenues are applied to develop projects that meet local development priorities. They are also critical for communicating progress to address existing expectations and prevent social conflict.¹⁴⁸

Nevertheless, a 2008 study found that despite the efforts to build SNG capacity throughout Peru to manage extractive industry revenues via the decentralization reforms, “there is still widespread public perception that money is not being well spent.”¹⁴⁹

Peru’s Transparency and Access to Information Law mandates all district governments, including Echarate, Santa Ana, and Urubamba, to implement practical mechanisms to make public information on local management. Minimum requirements include a process to respond to public solicitations and an electronic transparency portal to disseminate information.¹⁵⁰ However, despite the scale of revenues flowing to these SNGs, none of the three municipalities has either established a formal process or formally designated someone to manage information requests. Instead, information requests are being handled by clerical workers, external relations officers, municipal managers, or even the mayor (if the topic is sensitive). This lack of dedicated capacity can create obstacles to holding local government accountable. For example, despite working directly with municipal authorities, local nongovernmental organizations Centro Bartolome de las Casas and Asociación Arariwa¹⁵¹ met with unresponsiveness and significant delays when soliciting information for the study. Some of the information requested did not exist, and information finally provided was unorganized.

The Transparency and Access to Information Law also requires that local governments provide electronic transparency portals with specific information, complete and current¹⁵²:

- Local budgets: Investment program, budget execution, and both the preliminary and operational budgets
- Contracts and acquisitions: Annual Plan of Contracts and Acquisitions, scheduling, and results of contract bidding rounds
- Municipal councils: Decrees, ordinances, and agreements
- Salaries of principal officials

Echarate, Santa Ana, and Urubamba have established their transparency portals, but all require significant and urgent work (see Table 5). Echarate, which began receiving revenues from Camisea in 2005 and tripled its

spending between 2005 and 2007, has a web page (www.muniecharate.gob.pe/) but it is incomplete. No information is available on preliminary and operational budgets, budget execution or contracts, acquisitions, or bidding rounds. A list of projects in execution is provided, but the project start dates and levels of completion remain unclear. Santa Ana’s portal does not yet contain essential, legally required elements on contracting plans and bidding rounds, municipal decrees and agreements, and the salaries of municipal officials. Urubamba has made the most progress but lacks information on contracting plans and bidding rounds.

	Echarate	Santa Ana	Urubamba
Transparency Portal	X	X	X
Local budgets			
Investment program	X	X	X
Budget execution		X	X
Preliminary budgets		X	X
Operational budgets		X	X
Contracts and acquisitions			
Annual Plan of Contracts and Acquisitions			
Scheduling and results of contract bidding rounds			
Municipal councils			
Decrees, ordinances, and agreements	X		X
Salaries of principal officials	X		

Table 5. Transparency and access to information, 2009

Source: Municipalities of Echarate, Santa Ana and Urubamba (accessed September 2009).

While it is urgent that these local governments meet their legal requirements, efforts at transparency using only the internet are not sufficient to meet the needs of rural populations, many of whom lack electricity and other basic services—let alone internet access. Given that about 75 percent of Peru’s district capitals do not provide fixed telephone service to their inhabitants,¹⁵³ internet access is unlikely to be provided as a service for most households in our focus districts. Therefore, local governments might explore additional means of communicating this information, perhaps through print media or radio.

Generally, public requests for any type of SNG action to improve information access or dissemination are lacking. The field researchers found that neither local organizations nor local citizens make frequent use of their right to solicit information, perhaps because citizens are ignorant of their rights, perhaps because they do not think that the information requested will be delivered. While the cause is unclear, this absence of citizen requests or demands for information or improvements in transparency results in a lack of public pressure for municipalities to establish the mechanisms required by law.

Finally, public knowledge of the gas Canon in the urban populations of the municipalities benefiting from Camisea revenue is limited, decreasing the ability of citizens to monitor public spending and to hold local governments to account. Surveys of urban populations in the three districts showed a lack of awareness of the gas Canon or its origin. More than half those surveyed in Echarate, for instance, were unaware of the Canon, while 75 percent were unaware in Santa Ana and Urubamba. Given the significant increases in municipal spending using gas Canon resources, particularly in Echarate and Santa Ana, it is critical that citizens have information with which to hold government accountable on spending.

5. Recommendations

International financial institutions (IFIs) have played an important catalytic role in creating the enabling investment environment for extractive industries and by investing in specific projects. Therefore, IFIs bear a shared responsibility with the government of Peru (GoP) to ensure that benefits are captured and distributed fairly in a manner that supports their mission of poverty reduction. As IFIs develop programs and policies to increase the potential of extractive industries to lead to sustainable local development, we recommend that IFIs consider the following recommendations (discussed below).

1. Ensure adequate governance conditions prior to financing
2. Build SNG capacity for long-term strategic planning
3. Support increased revenue transparency and public education
4. Support SNG internal learning and preservation of institutional memory
5. Evaluate and share lessons across IFI programs and projects

Recommendation 1

Ensure adequate governance conditions prior to financing

IFIs should withhold project support to commercial extractive industry companies until in-country governance conditions and government capacity is sufficient to manage the financial windfall associated with these projects for development and poverty-reduction purposes. (This recommendation is in line with the recommendations of the World Bank's independent Extractive Industries Review.) IFIs should determine minimum threshold governance indicators to guide the sequencing of investments and disclose their assessment prior to project financing. When IFIs do choose to finance extractive industry projects, they should consistently include in their loans accountability performance indicators focused on local outcomes.

As shown in this report, the devolution of revenue management authority to subnational governments (SNGs) via decentralization occurred in parallel with investments in the Camisea natural gas project and the subsequent transfer of Camisea project revenues to local governments. Four years after revenue transfers were initiated, local governments receiving

these funds did not have strategic plans in place, nor had they fully complied with Peruvian laws on transparency, laws that protect citizen rights to hold their governments accountable. Thus, local governments lacked the capacity to effectively and strategically use these revenues to address the needs of their citizens.

Going forward, public IFIs should develop a set of indicators for identifying aspects of governance capacity that must be in place before making investments in commercial extractive industry projects. If IFIs choose to support projects where SNG governance gaps exist to encourage “learning by doing,” the risks of this approach should be assessed and communicated publicly prior to project financing. Also, the measures to be applied to address and monitor these risks throughout the project cycle should be disclosed. Financing decisions in these cases should be guided by a set of criteria regarding the acceptable scale and complexity of the project. (For example, SNGs may be better served by building their governance capacities in the context of a smaller-scale project, unlike the Camisea megaproject.) These criteria should be complemented by an exclusion list. (For example, this list could exclude investments in projects with operations on indigenous lands if indigenous customary land rights are not being effectively recognized and protected by the government.) Indicators of governance capacity could be used to publicly report the justifications for investment choices as well as inform the timing of investment decisions and the priority areas for lending and technical support for governance capacity-building programs at the national and local levels.

Further, IFI investment loans should include explicit and measurable SNG accountability performance indicators. As highlighted in a 2008 report from the World Bank’s Internal Evaluation Group on 20 World Bank decentralization projects, including Peru, IFIs should “encourage the adoption of a more results-based approach to decentralization by helping develop in-country and Bank capacity for monitoring and evaluation that focuses on local outcomes (such as enhanced accountability, greater citizen participation, and improved service delivery) rather than only on the process of decentralization.”¹⁵⁴ While a strong legal framework is critical, monitoring and evaluation of results and outcomes should also be central elements of IFI support for extractive industry projects.

Given the experience of public IFIs in supporting decentralization and the extractive industries sector, they should use or develop their capacity to determine whether governance and environmental and social risk management at the national and local levels are sufficiently mature to handle risks posed by their commercial extractive industries investments. Central to this effort is policy coherence and coordination between public-sector and private-sector divisions.

Recommendation 2

Build SNG capacity for long-term strategic planning

Building capacity for long-term strategic planning could include the development of investment and savings plans and the development of land-use and infrastructure plans designed to address poverty alleviation, while minimizing the environmental and social tradeoffs of infrastructure investments.

With local governments in Cusco making the majority of public investments financed principally by the gas Canon revenue, it is critical that they have the capacity to plan and implement projects with the long-term potential of alleviating poverty at the local level. These governments must also have the capacity to evaluate the cumulative impacts and benefits of their investment choices when coupled with development associated with the Camisea project. Governments must prioritize the development and, importantly, the implementation of both strategic and operational plans. As noted above, even when plans exist, often government officials fail to use them. Effective plan development and implementation will be necessary to ensure that investment choices effectively mitigate negative environmental and social impacts and maximize local benefit.

Strategic planning capacity must include the ability to develop and evaluate the menu of options for maximizing surplus revenues. Support is needed to help SNGs identify and evaluate options for investing budget surplus revenues wisely to protect themselves against price volatility and address the eventual reduction in Camisea revenues as gas resources are depleted. Given significant increases in Canon revenues, Cusco's regional and local governments should encourage a national-level, participatory dialogue regarding the establishment of stabilization or savings funds.¹⁵⁵ IFIs and donors (governments providing bilateral aid and technical assistance) can support this dialogue by providing lessons learned from other regions and access to international research regarding options for the identification, establishment, and management of these funds. (See Annex 5 for a discussion of stabilization and savings funds.)

Recommendation 3

Support increased revenue transparency and public education

IFIs should increase their support for programs that strengthen transparency and accountability mechanisms, as well as educate and raise awareness, to promote and facilitate public oversight at the local level in areas with extractive industries.

IFIs can do this by supporting programs aimed at helping SNGs comply with legal requirements around transparency and access to information—such as the design and implementation of information systems that allow local governments to disseminate information about the gas Canon and its use and to hold SNGs accountable to their legal requirements.

Civil society organizations and institutions in urban and rural areas can help to address gaps in public awareness of the existence and use of the gas Canon identified in this report by providing basic information through civic education programs and public communications campaigns. IFIs should seek to support efforts that build such capacity within various organizations, such as local churches, cooperatives, political parties, associations, and youth groups.

To hold SNGs accountable, civil society organizations also need support to inform citizens of local government responsibilities as required by law and of the grievance mechanisms available to them.

In areas with extractive industries, a growing number of local-level institutions exist with the capacity to deliver information and analysis on Canon revenues distribution and use, as well as municipal management quality and transparency. IFIs should support efforts that strengthen the capacity of these groups to deliver high-quality, accurate, and reliable information to complement government monitoring and evaluation efforts.

Recommendation 4

Support SNG internal learning and preservation of institutional memory

IFIs should support initiatives that help SNGs review their progress, document lessons, and exchange this information with peer institutions and the public. The Camisea project and the Peru Liquefied Natural Gas Project (Peru LNG), as with other hydrocarbon projects, are expected to operate for 30 years or more. Also, the pipeline infrastructure has served as a catalyst for further hydrocarbon exploration of the Urubamba valley region of the Peruvian Amazon. While there should be some level of continuity of technocrats at the municipal level, it is reasonable to assume that each successive local government administration that is elected over that timeframe will require some degree of training. In particular, they will need training in using the strategic, fiscal, and operational tools available to them to manage the revenues effectively. To replicate

successes and avoid repeating mistakes, it is critical that lessons and experiences are documented and passed on, not only to the leadership, but also to citizens. In this way, such initiatives can help to protect institutional memory and establish a baseline on which citizens can measure progress and potentially hold new governments accountable for outperforming their predecessors.

Recommendation 5

Evaluate and share lessons across IFI programs and projects

IFIs should evaluate and share lessons across their programs and projects that are aimed at building SNG capacity for extractive industries revenue management in Peru and more widely, and should generate multi-stakeholder dialogue to replicate successful approaches.

As identified earlier in this report, several IFIs and development agencies are working on parallel or joint initiatives to support SNG capacity with a number of techniques. To maximize the impacts of their combined investments, they should coordinate approaches to SNG revenue expenditure capacity building. Specifically we recommend that the Inter-American Development Bank (IDB) and the World Bank International Finance Corporation (IFC) collaborate and share lessons from their experiences in Peru and globally. Experiences from the IDB public sector support of SNG capacity in the district of Echarate can be shared and lessons can be exchanged with the IFC's Improving Municipal Investment/Independent Monitoring Mechanism (MIM) initiative to be applied in cooperation with Peru LNG to build local government capacity in the districts of Ayacucho and Huancavelica. (See Annex 4 for MIM initiative information.)

Furthermore, IFIs should support a national, multi-stakeholder dialogue in Peru to share the results of such a collaboration to identify and propose best practices in SNG revenue management and expenditure performance, as well as best practices in SNG performance monitoring. As the largest investments in Peru's history, the Camisea and Peru LNG projects have the potential to establish precedents for SNG management performance that could be replicated around the country in areas receiving extractive industry revenues. A significant opportunity exists to provide leadership in the assessment and communication of lessons learned and to support government, civil society, and private-sector efforts to ensure that extractive industry revenues are put to their best use at the local level.

6. Next steps

International financial institutions (IFIs) can address the recommendations in this report (many of which can be applied beyond Peru) through a number of mechanisms, including country strategies, loans, grants, and technical cooperation.

As an example, in Peru existing Inter-American Development Bank (IDB) and World Bank instruments could address recommendations as follows:

- **Country strategies.** Both banks are implementing strategies covering 2007 to 2011. New strategies will be developed in partnership with the new Peruvian administration, to be elected in 2011. Performance assessments, such as this report, can be used to set expectations for improvements; the results could then be used as the basis for discussion with the new government on programs that identify measurable indicators of success to include in the subsequent five-year strategy.
- **Policy-based loans for improved fiscal management.** The World Bank and IDB are supporting a series of programmatic loans focused on public-sector reform for improved fiscal management and competitiveness. Opportunities exist to address these recommendations in future loan operations within the series. However, to promote effectiveness and accountability, any new development-policy loans should be contingent upon external evaluation of prior development-policy loans and the creation of a more robust monitoring and evaluation framework.
- **Policy-based loans for energy-sector development.** Since 2009, the IDB has been supporting a policy-based loan intended to support the design and development of a sustainable energy matrix in Peru. The loan comprises a series of operations to support the reform of regulatory and institutional frameworks for conventional and renewable energy sectors, addressing policies and mechanisms for environmental and social risk management and public participation mechanisms, as well as SNG capacities for management of hydrocarbon revenues. These energy-sector policy-based loans are envisioned as a series of loans that will extend past the end of the Country Strategy period and into the next Peruvian presidency. The IDB should consider this report's recommendations in the design of these loans.

- **Project-specific investment loans.** Both the IFC and the IDB have invested in private-sector loans for the Peru LNG project, and IDB made similar loans for the Camisea project. According to their country strategies, future support for growth in the hydrocarbon sector is also envisioned. This type of financing will catalyze the generation of a vast amount of revenues for the SNGs in the project's area of influence. While steps have been taken to address local government revenue management capacity, there are opportunities to build in components that can measure the extent to which these lending operations will address gaps identified in this report.
- **Technical cooperation or advisory services.** Systematic analysis of SNG experience in strategic development planning, managing surplus revenues, and developing and implementing public accountability mechanisms is needed. This work could provide the basis for negotiations around country strategies and loan programs with the incoming Peruvian administration, while providing a practical basis on which to convene stakeholder dialogues on lessons learned at the national, regional, and local levels.
- **Elite-level engagement.** High-level representatives of IFIs should take advantage of visits to Peru (as well as other opportunities for engagement with Peru's political leadership) to underscore the need to ramp up SNG capacity to manage extractive industry revenues, particularly in the areas highlighted in this report.

7. Conclusion

As the Peruvian government expands the development of its hydrocarbon and mineral resources, international financial institutions (IFIs) working in Peru have the opportunity to play a key role in supporting subnational government (SNG) management of extractive industry risks and revenues. In the case of the Camisea natural gas project, the Peruvian government and IFIs clearly underestimated the SNG need for capacity building prior to the massive revenue transfers that began to flow just a few years after the start of the project. Increased IFI commitment to ensuring adequate country governance capacity prior to investment, supporting SNG capacity-building programs, promoting revenue transparency and public education, and sharing lessons learned across their own programs would help to ensure that those most impacted by extractive industries receive a fair share of the benefits generated by these industries. IFIs should consider applying key lessons learned from the Camisea experience in Peru to their extractive industry projects globally.

Annex 1

Overview of Peru's decentralization reforms

Peru's political and fiscal decentralization reforms attempted to address the core problem of delivering the benefits of economic growth directly to citizens by strengthening subnational government (SNG) capacities to meet the needs of their citizens. In 2002, Peru initiated these reforms with a Constitutional amendment that established the legal framework for decentralization.

The decentralization agenda was designed to achieve a number of laudable objectives: enable economic development and competitiveness, modernize and simplify administrative systems and processes, devolve responsibilities for public services to government levels closest to citizens, and enable citizen participation in governance by expanding mechanisms for transparency and public participation.

New national and subnational institutions

The decentralization reforms created new institutions at the national and subnational levels to serve citizens. The political reforms created a new level of government—regional government—and divided the country into regions, provinces, and districts. The three levels of government have different regulatory, planning, and budget responsibilities, some the exclusive responsibility of that level and others shared with the other levels of government. Table A-1 reviews the responsibilities assigned to each level of government.

To offer support to local governments, the National Decentralization Council (CND—Consejo Nacional de Descentralización) was created in 2002 to facilitate the decentralization process. CND supported SNGs in the creation and implementation of development plans and maintained a transparency portal for transfers, laws, and budget execution. The CND consisted of 10 representatives—four regional leaders, two representatives of the Presidential Council of Ministers (the Presidential Cabinet of Peru),

two representatives of the Ministry of Economy and Finance, the President of the Republic, and the Technical Secretary. As noted above, in early 2007 President Garcia dissolved the CND and replaced it with a Decentralization Secretariat, housed within the Presidential Council of Ministers.

Table A-1. Responsibilities by level of government

The table below outlines the chief responsibilities of each level of government, as set forth in the Framework Decentralization Law of 2002.

Source: Framework Decentralization Law of 2002 (Law 27783).

	Central Government (GoP)	Regional Government	Municipal Government (provinces and districts)
Exclusive Responsibility	<ul style="list-style-type: none"> Defense and national security Foreign relations Justice Banking Taxation Public services and public infrastructure regulation 	<ul style="list-style-type: none"> Regional development plan development and approval Regional infrastructure Agriculture, forestry, and artisans promotion 	<ul style="list-style-type: none"> Urban and rural municipal development Local public infrastructure and services implementation, management, monitoring, and regulation
Shared Responsibility	<ul style="list-style-type: none"> Defined by the Law of Executive Power or by sector-based legislation 	<ul style="list-style-type: none"> Education sector management Public health Economic activities regulation (industry, agriculture, tourism, energy, etc.) Environment Culture and arts 	<ul style="list-style-type: none"> Education Public health Culture, tourism, sports Local police Public transportation Housing Social programs Waste management

Support tools

The Peruvian government created a number of tools to support the decentralization process by improving coordination among varying levels of government, building SNG capacities for fiscal administration, and increasing fiscal transparency and accountability. These tools, which must be adapted and applied by SNGs to manage their budgets, investments, and projects—include:

- **Financial management tools:** *Integrated Financial Management System (SIAF)*. SIAF is a financial information system managed by the Ministry of the Economy and Finance (MEF) that provides access to public budgets as required by law. Currently all regional governments are represented in the system. Coverage of provinces and districts is

incomplete; although some provinces and districts have created and submitted development plans and budgets to MEF, thus far SIAF does not systematically include local budgets.

- **Investment project management tools:** *National Public Investment System (SNIP)*. As described above, SNIP is managed by MEF, with the objective of ensuring that public revenues allocated for investments are put to their optimal use for development through a process of planning, quality control, and monitoring.
- **Citizen participation tools:** *Participatory budgets*. The system of participatory budgets was established to allow citizens to participate in identifying and prioritizing investment projects that meet local needs.
- **Outcomes-based management tools:** *Results-based budgeting*. In 2008, Peru initiated a results-based budgeting system pilot in its health and education sectors. The pilot is expected to generate draft performance indicators as part of a comprehensive reform to gradually move public-sector accounts to performance-based budgeting by 2010.¹⁵⁶

SNGs apply these tools to funds transferred from the central government, such as those derived from the development of natural resources. Box A-1 reviews the main intergovernmental transfers received by SNGs.

The Canon is one of four major intergovernmental transfer mechanisms that allocate resources among SNGs according to unique formulas that give different weights to poverty, population, and/or production (in the case of natural resources). Several natural resources—natural gas, oil, mining extracts, forestry products, hydroelectricity, and fisheries products—produce revenues (royalties and corporate income tax) that are paid to the national government and then shared with SNGs. The Canon transfers for each resource are known as Canon Gasífero, Canon y Sobrecanon Petrolero, Canon Minero, Canon Forestal, Canon Hidroenergético, and Canon Pesquero, respectively. Canon revenues—30 percent of SNG revenues in 2006—are earmarked for investment projects, including project design and maintenance. In terms of their contributions to SNG budgets, the gas and mining Canons are the most important.

In addition to revenues from the various Canon funds, SNGs also receive three other types of transfers, which are shares of the general revenues collected by the Government of Peru from taxes and tariffs: Fondo de Compensación Regional (FONCOR, or Regional Compensation Fund), Fondo de Compensación Municipal (FONCOMUN, Municipal Compensation Fund), and Vaso de Leche (“Glass of Milk”). FONCOR and FONCOMUN are distributed among regional and municipal governments (respectively). Intended to fill in the gap between the spending responsibilities devolved to SNGs and the funds that SNGs are not yet able to raise on their own from levied taxes, FONCOR and FONCOMUN in many cases make up the largest share of SNGs’ income. Vaso de Leche, a food subsidy program, helps poor families meet their nutritional needs.

Box A-1. Intergovernmental transfers

Source: Grupo Propuesta Ciudadana.

Annex 2

Progress on extractive industries transparency at the national level

At the national level, the Peruvian government has signed onto the Extractive Industries Transparency Initiative to promote the transparency of extractive industries revenues. In 2007, Peru was admitted by the Board of the Extractive Industries Transparency Initiative (EITI) as a candidate country and given until March 2010 to become validated.¹⁵⁷ To date, Peru is the only country in Latin America to join.

In September 2007, the World Bank provided a Technical Assistance Loan of \$300,000 to support Peru's EITI implementation activities.¹⁵⁸ However, since its admittance Peru has faced difficulties in making the initiative work. It struggled to get leading companies to participate and to convince participating companies to generate information that adds value to what already exists in the public domain.

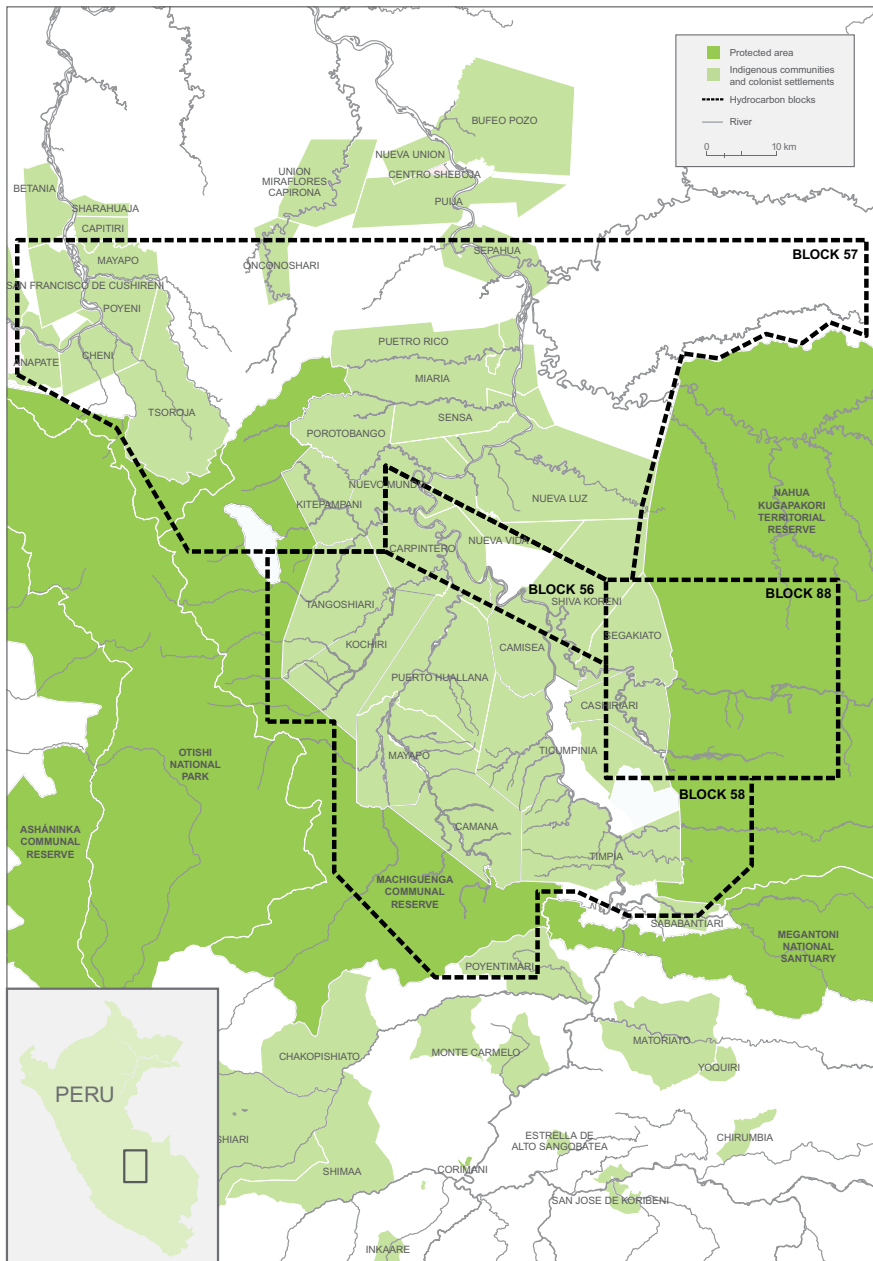
Unfortunately, several major hydrocarbon and mining companies opted out of disaggregated or company-by-company reporting of their payments to the government, including Pluspetrol, the operator of the Camisea natural gas project and the largest producer in Peru's hydrocarbons sector. Aggregated information on the volume of revenues being generated by the extractive industries sectors in Peru is already publicly available, unlike in many EITI candidate countries. For the EITI to provide value in the Peruvian context, the information produced by the initiative needs to provide disaggregated figures on payments made to the government by individual companies.

The Inter-American Development Bank (IDB) endorsement of EITI in 2009, and its stated intention of participation in dialogues around the initiative,¹⁵⁹ may provide the basis for discussions on requirements for borrowers to publish their payments.

Sources: EITI, Oxfam America, Grupo Propuesta Ciudadana, IDB.

Annex 3

Map of overlap of Camisea blocks



Map A-1: Overlap of Camisea blocks with communities, territorial reserves for indigenous communities in isolation, and natural protected areas

Source: Shinai.

Annex 4

SNG revenue management capacity- building programs funded by IFIs

A number of loans by international financial institutions (IFIs) for transport and other sectors include components to support subnational government (SNG) capacity building. The programs discussed below relate to the Camisea natural gas project and Peru Liquefied Natural Gas Project (Peru LNG, also known as Camisea II).

Inter-American Development Bank

Technical cooperation: Sustainable development of the Lower Urubamba (PE-T1053)

In September 2007, the Inter-American Development Bank (IDB) approved this \$750,000 technical cooperation project for the Peruvian government to support the preparation and rapid implementation of a larger and more comprehensive loan in support of sustainable development activities in the Lower Urubamba (PE-L1021). This IDB technical cooperation specifically focused on ensuring that the development benefits of the Camisea project accrue directly in the project's impact zone.

In addition to financing activities—such as participatory community assessments, community development plans, local pilot projects, and monitoring activities—PE-T1053 contains a component pertaining to local financial management entitled “support to local governments.” This component supports the preparation of a capacity-building plan for SNGs based on an evaluation of “regional and municipal government capacity to identify and implement investment projects and increase civic participation in investments within the participatory budgeting framework established by law.”¹⁶⁰

According to the IDB, PE-T1053 finances specific initiatives:

- **An assessment of the institutional and investment capacity of at least two regional governments (likely Cusco and Ucayali), two provincial municipalities (likely La Convención and Atalaya), and two district governments (likely Echarate and Sepahua).** The assessment will address, for example, issues such as organizational capacity, budget expenditures, planning and implementation capacity, and local participation in setting budget priorities and monitoring government activities.
- **An assessment of the Lower Urubamba Management Committee.** This assessment will determine whether the committee could take on responsibilities associated with implementation of the planned PE-L1021 loan.
- **Viability assessments of potential investments to improve the well-being of inhabitants of the Lower Urubamba.** Issues reviewed will include electrification of the area using gas produced in the zone and sustainable alternative technologies, improving river transportation, access to financial services, improving connectivity opportunities, evaluating environmental impact of the program, and updating the plan to defend the Nahua Kugapakori National Reserve.
- **An evaluation of potential ways to update and adapt SNIP implementation to the particular context of the Lower Urubamba.** Since production costs may be particularly high in Lower Urubamba, the National Public Investment System (SNIP) may need to be refined. Specific proposals will be developed and selected by the Ministry of Economy and Finance and relevant local governments (IDB 2008).

After initial approval of the technical cooperation project by the IDB, many months of delay by the Peruvian government raised concerns from nongovernmental organization watchdog groups. However, the Peruvian government renewed its commitment to the loan in November 2008 by signing an agreement with the IDB. If implemented and managed effectively, the IDB's program could represent an important precedent for programs directed at improving local government revenue management.

Policy-based loan: Development of a new sustainable energy matrix

IDB's 2009 policy-based loan to support the development of a Sustainable Energy Matrix for Peru includes triggers related to public revenue expenditures. Totalling \$150 million, this loan provides support for the development of public policies and reforms in the energy sector to "promote diversified energy transformation and transportation, taking into account environmental and social considerations." The program intends to set a course for sustainable energy development in Peru by coordinating energy policies and strategies across a number of energy-related sectors, including hydrocarbons, renewable energy, energy efficiency, and biofuels. The forward-looking loan description includes implementing a Strategic Environmental Assessment, developing a strategy for climate change adaptation and mitigation, establishing mechanisms for public participation in energy-sector decision-making processes, and improving environmental and social standards in energy projects.

In terms of its support to local governments, the program supports "the strengthening of control and management of the use of energy project royalties so that municipios [municipalities], particularly those that receive royalties for hydrocarbon-producing activities, can evaluate execution effectiveness." The loan documentation cites that 24 regional "Technical Assistance Coordination Committees" have been established to help local governments prepare projects that are relevant to the region and meet local needs. To trigger the second operation, or lending program, the Peruvian government must demonstrate that they are implementing a system of indicators to rank the performance of local governments, as well as a system to assess the quality of public investment by local governments.

International Finance Corporation

MIM initiative – Peru LNG/Camisea II

Since gas production in the Camisea fields will increase to meet demands by Peru LNG, more revenues will flow to SNGs. The International Finance Corporation (IFC) has developed a partnership with the Peru LNG consortium on a joint program to assist municipalities in Ayacucho and Huancavelica, two of Peru's poorest regions, to more efficiently and effectively manage the extractive revenues they receive via the Camisea Fund for Socioeconomic Development (FOCAM).

IFC adapted a program developed by its Enhancing Local Benefits initiative (ELB), which worked with the Yanacocha Mine Project in Cajamarca, Peru, to improve the quality of mining royalties spending in the Baños del Inca district. The program, Improving Municipal Investment/Independent Monitoring Mechanism (MIM), uses parallel strategies to "increase local government use of mining royalties for public investment and empower civil society to help local governments become socially accountable."

One component of the MIM initiative involves direct engagement with municipal governments on investment management strategies, organizational structures and internal coordination mechanisms, and the use of public financial management systems as well as mechanisms for coordination with national agencies. A second focuses on working with civil society groups to create an independent monitoring mechanism to monitor the performance of local governments, which involves applying a monitoring methodology developed in Cajamarca to monitor government investment activities. Monitoring results are then disseminated to the public with the objective of increasing public debate and increasing government accountability.

The project is currently being implemented in Cajamarca, Ancash, Tacna, Moquegua, and Puno, which receive 80 percent of the total royalties paid by the mining sector in Peru. In late 2008, the IFC launched a two-year project in the Peru LNG impact zone to provide technical assistance to the municipalities of Huaytará in Huancavelica and La Mar and Huamanga in Ayacucho. The IFC allocated approximately \$300,000 to the project, which attempts both to improve the investment capacity of these municipalities and to support civil society monitoring of public investment.¹⁶¹

Annex 5

Options for investing wisely: Stabilization or savings funds

Countries around the world have experimented with various types of natural resource funds (NRFs)—including budget-stabilization funds, savings funds (such as “Future Generation Funds”), and earmarked funds/regional development funds—with varying degrees of success. Often governments see these funds as a panacea or substitute for strong public financial management systems and policy frameworks. Objectives of NRFs include:

- Save money beyond what the budget system can absorb
- Respond to weak budget and procurement systems and limited political accountability
- Protect the economy from overheating
- Protect the government budget from excessive volatility
- Provide for “intergenerational equity”
- Enhance transparency
- Direct revenues to specific regions

Norway’s Government Pension Fund–Global (formerly known as the Government Petroleum Fund), a successful example of an NRF, had grown to \$373 billion by the end of 2007 according to the Norwegian Ministry of Finance. Other NRFs include Chile’s Copper Stabilization Fund, Canada’s Alberta Heritage Savings Trust Fund, and Kuwait’s General Reserve Fund and Reserve Fund for Future Generations.

Grupo Propuesta Ciudadana’s report, “Investment and Intergenerational Funds: Alternatives for optimizing Canon Resources,” takes a closer look at these NRFs and begins to contemplate what a local NRF might look like in the Peruvian context. The report also examines relevant legislation and

the specific policy changes that would need to occur to create a fund in Peru and presents selected scenarios for establishing funds in Echarate and Cusco.¹⁶²

Increased dialogue around the possibility of creating local NRFs would help flush out potential opportunities and risks within the context of local political and economic factors. Clearly the success of savings or stabilization funds in Cusco will be dependent on the government's ability to institute adequate governance mechanisms and sound legislation. Based on research of experiences of unsuccessful attempts from multiple oil-producing countries, Oxfam America recommends that future funds used to save oil and gas revenues adopt the following principles:

- Combine all oil revenues into a single fund.
- Adopt clear rules for moving money into and out of the fund. Clear rules for withdrawals are particularly important. Equatorial Guinea has a “worst practice” experience with overseas banks holding oil funds that can be withdrawn with only the president’s signature. Sao Tome and Principe has adopted a system of maximum annual withdrawals, and these withdrawals require four government signatures from different parts of government.
- Integrate funds into the national budget. Spending should not come directly from the fund, but rather money from the fund should flow to the budget using one yearly transfer based on an agreed-upon system or formula.
- Conduct regular independent auditing of the fund.
- Ensure fund transparency. The fund operations should be fully transparent, including disclosure of funds flowing in and out, the investment strategy and management system, and fund audits.
- Formalize civil society oversight. Government should include a space for formal civil society oversight of the fund, as in East Timor, Sao Tome and Principe, Chad, and other countries.
- Avoid conflicts of interest.
- Prohibit oil-backed loans. The law should prohibit loans that use money in the oil fund as collateral and loans that mortgage future production.

Sources: Oxfam America, Grupo Propuesta Ciudadana.

Annex 6

Recommended areas for further research

This study provides only a limited review of the experiences of subnational governments (SNGs) in Cusco at an early stage in their management of gas revenues from the Camisea natural gas project. Given the long-term nature of the Camisea project, the Peru Liquefied Natural Gas Project, and other hydrocarbon projects, there is a need to establish a systematic methodology for periodic evaluations of SNG progress to inform mid-course corrections and inform public debate on decentralization and the use of extractive industries revenues.

In addition, several other topics that emerged over the course of this study would benefit from additional research:

- Comparative analysis of international financial institution (IFI) methodologies for evaluating development impact of extractive industries projects.
- SNG spending on infrastructure and the extent to which it leads to poverty alleviation.
- Changes in decentralization processes and institutions and the extent to which they impact SNGs and their capacity to manage revenues effectively.
- The National Public Investment System (SNIP) project approval process and the extent to which it could strengthen environmental and social risk management by SNGs.
- SNG best practices in balancing citizen requests through the participatory budgeting process and priorities outlined in strategic plans.
- Indicators of governance readiness to guide sequencing of IFI investments.

Endnotes

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- 133 If a project meets certain criteria, regional and local governments formulate plans for the project, conduct feasibility studies, and create a project profile. The profile is submitted to the SNIP Office of Programming and Investment (OPI)—an office at the regional or local level—which can accept the project, reject it, or require further studies. Acceptable projects are then passed on to Ministry of Economy and Finance (MEF) for final approval; MEF also can require further study or reject the project. Projects declared "viable" by MEF can be implemented. The SNIP process is complicated and has faced criticism regarding the capacity of local governments to adhere to the procedures due to staffing and funding constraints. For a thorough overview of SNIP requirements and processes, see www.ocimed.gob.pe/observatorio/documentos_obs/asist_doc/presentacion_snip.ppt.
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Aerial view of the Camisea gas installations located near the Urubamba River in the Cusco region of Peru. *Luis Julian / Caretas Magazine*



COVER: Marianella Mata, a Shivankoreni resident, speaks at a community meeting held in 2006 to discuss the impact of the Camisea gas project on her village. "Since the December 22, 2004 spill we've had very few fish to catch. We've been greatly affected—everything has changed since the spill," she says.
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