

Assessment on the Camisea Pipeline Project in Peru

This document has been elaborated as an answer to an invitation of Senator Richard G. Lugar, Chairman of the Committee on Foreign Relations, issued to Mr. Carlos F. Herrera Descalzi to testify during the hearing on "Multilateral Development Banks: Development Effectiveness of Infrastructure Projects" to be hold on Washington, on Wednesday, July 12, 2006 at 9:30 a.m. in Dirksen 419.

1 Fundamentals

Since very early on in its history, Peru has been an oil producing country. In fact, the second oil well in the World to be drilled was in Peru in 1863.

In the first half of the 19th Century, Peru started to produce and export oil; being an oil producer, in middle of 20th century the Peruvian population was encouraged to consume oil rather than any other kind of fuel. At that time, Peru's energy supply was mainly composed by hydropower and oil. With regard to the power sector, even today Peru continues to have a very important hydro energy potential that is several times greater than its today's consumption.

As local oil consumption was increased and the depletion of oil production started, in 1968 the situation in Peru changed to become a net oil importer. Considerable effort was dedicated to finding new reserves, only succeeding at the end of the seventies; an oil pipeline was built, that conveyed oil from the northeastern Amazon forest to the Coastal Line where the two main refineries were located. At the beginning of the eighties, Peru recovered its condition as an oil exporter, and then, in the middle of that decade, the reservoir of Camisea, in the central region of the Amazon forest was found.

Shell was the company who found Camisea's reserves. As it was difficult to arrive at an agreement with the Peruvian Government, they decided to leave. Later on, they returned and agreed a program at the beginning of the nineties. Finally in 1998, Shell decided not to continue in Peru and to withdraw thereby, returning the gas fields with proven reserves to the Peruvian government.

Meanwhile, at the beginning of the nineties, once again Peru became a net oil importer, due to the decline in the production of the new fields in the Northeastern Amazon Forest, which were found at the end of the seventies. Efforts were made to carry out more exploration in the jungle and offshore; so wells were drilled, but unsuccessfully. Since then, every year the negative gap between oil production and consumption increased, in detriment to the Peruvian commercial balance and economy. The only hydrocarbon resource of significance was that of Camisea, where roughly 80% of the energy content was in gas and the other 20% were condensates; however, from an economical point of view, that 20% of condensates represented 50% of the economical value of the field.

Once Shell withdrew its operations from Peru, after a process, the government tendered Camisea project, dividing the project into three parts: (i) Field Exploitation;

(ii) Transport of Liquids and Gas; and (iii) Gas Distribution in Lima and Callao. The field winning bid was granted in February of 2000 and those of Transport and Distribution were granted in September of that year; however, government delayed its approval to the signature of the contracts. At this point in time, in November 2000, Peru's President resigned by fax, he himself being out of the country at the time. An interim government was charged to rule the country during a transition period until a new government was elected. After elections carried out in May of 2001, a new government, the current one, was elected for the period 2001-2006, and it will conclude its mandate at the end of July 2006. Now, recently, a new government has been elected for the 2006-2011 period.

In December of the year 2000, following the revision of Camisea Contracts and some modifications intended to fortify the social benefits of the project, the Transition Government authorized its signature. The Contracts were made public and published in internet; they are still available there.

Previously and along year 2000, Camisea had become a controversial project because of complaints from many sides, especially those received from the Cusco region, where the resources were located, due to the fact that they considered that they deserved more benefits and wanted that the pipeline will arrive to Cusco; also because of the fear of the environmental and social impacts on the native population of the area. In that period, Camisea's Contracts were kept nearly as a close to be a secret.

As economical strategy, Camisea was destined to modify the energy consumption matrix of Peru. The aim was to change the country's trend to oil in favor of a preference to natural gas, based on the proven reserves left by Shell.

Camisea natural gas was destined to replace the existing oil derivatives used in power generation, industrial field consumption, public transport and domestic consumption.

Camisea involves 4 contracts: (1) for the field (2) for the transport of liquids (3) for the transport of gas; and (4) for the gas distribution.

Field contracts fixed wellhead gas prices, to be escalated according to a basket of residual oils formula. Transport and Distribution Contracts also contain formulas for escalating prices.

Gas exportation was allowed, conditioned to priority supply to internal market. It was agreed that to consider internal market supply as ensured, remaining reserves shall be able to supply local market requirements in next twenty years. This evaluation will be made on an annual basis, in order to allow the exportation in this year. This mechanism looked for to incentive the finding of new reserves for an exportation market, while ensuring the local market sufficiently in advance so as to when it arrive to be impossible, there will be a period of twenty years as to find and implement a new solution, before local reserves became completely depleted; the aim was energy independence.

Camisea Field Contract matters Block 88. Its proved reserves will allow the exportation since the beginning, but they cannot sustain it for a period of 20 years,

without finding new reserves. The finding of new reserves and the risk of none succeeding belonged to Field's Concessionaire.

A legal framework protected the compromises: Gas Law (Law 27133), Gas Law Ruling and Camisea Contracts. Gas Law and Gas Law Ruling were invoked by contracts.

During this current government, priorities were inverted, privileging Camisea natural gas exportation rather than local market satisfaction.

At the beginning there was an attempt to modify royalties, diminishing them for reserves dedicated to exportation. As former minister, I expressed my objection, due to the fact that the only bidding criterion to be the winner of Camisea tender was precisely the largest royalty percentage to be paid. Because of this the winning bid for the Field Contract was allocated to a consortium of small to medium sized companies who offered to pay a royalty of 37.24% rather than to a big and much more qualified bidder who offered 35.5% as Royalty. Moreover, the fact that most of the gas was going to be assigned to exportation, could left the suspect of an under-hand maneuver to grant the winning bid to one particular party with afterwards lower royalties.

Financing of the project was not an obligation of Peruvian Government; the companies were selected because they shall be able to finance the project by themselves. Economy and Energy Ministers dedicated their effort to finance Camisea and local consumer was forgotten. No effort was dedicated to local development; after the gas arrived to Lima in August of year 2004 and consumers asked how to benefit from it, just government realizes that there were as their duty.

Moreover, Government forced local consumers to finance companies. In order to make the construction of the Camisea Gas Pipeline feasible, faced with the lack of a sufficient initial gas demand as to ensure return on the investment, consumers shall pay within its electricity service monthly bill a contribution to pay the non used capacity of gas pipeline. This subsidy was justified by the benefits of lower power generating costs, as consequence of the availability of a cheaper fuel, as it will be the gas. This commitment presupposed that this payment would be effective once the service was available. However, in November of year 2002, government authorized a payment in advance, that resulted in a public contribution of nearly 100 MMUS\$ for pipeline construction, against a reduction on gas transport tariffs.

In case of none being possible to continue with Camisea Consortia, the other bidder (Total Fina) was available to take it over.

During the construction period of the Project, several other modifications were made to the contracts, which at the end operate against consumer's interests, as it was with modifications made to the Gas Distribution Contracts. Transport and Distribution projects were bided with a tariff fixed in advance and that in distribution shall last for 8 years; rules were changed against the consumers: residential tariffs were increased in more than 40% at the beginning of supply, with approval of General Bureau of Hydrocarbons (Ministry of Energy and Mines).

The Distribution contract established an obligatory minimum yearly goal of number of effective residence gas connections. The condition of effective supply was modified to potential supply, meaning that to fulfill the compromise it was not longer necessary that consumers were connected; but rather when distribution lines passed near to his residence.

Whilst the gas pipeline was still being constructed, news arrived appertaining to the non-compliance of regulations concerning the environmental conservation and the effects that the Project would have on native communities. It appeared that the press always kept quiet about or minimized the facts.

The final location of the liquids pipeline (now with 5 accepted leaks) was not Pisco/Paracas were a nature reserve is; final location was 70 km north from there and to be changed required the approval of Ministry of Energy and Mines.

Contractually the discharge of the condensates pipeline was to terminate in a point on the coast close to the fractioning plant. This was Pampa de Clarita, in the Province of Cañete, Department of Lima, located approximately 70 km North of Pisco (Contract mentioned as geographical coordinates 13.15466° South and 76.36996° West). This location could be changed by mutual agreement between the companies but always with the consent of the Ministry of Energy and Mines. Companies asked to move that point to the Buffer Zone of Paracas Bay only natural reserve in Peru's Coastline. It was accepted by the authorities. Organizations of citizens and NGO's, which were fighting to preserve nature, protested and a period of discussions was commenced. These discussions concerned the offshore installations but not the ones onshore. Authorities then accepted construction in the onshore zone, whilst they continued to discuss the offshore zone, until they were faced with the fact whereby to modify the marine location would oblige them to move the onshore installations, which meant that the project would not be built within the pre-established timeframe. This was how it was accomplished to install the terminal near to the Paracas Reserve zone, completely ignoring all of the protests. On the other hand, a program to muffle this situation was defined with the credit support from the international development banking institutions.

During the construction phase and with the object of distracting the public opinion from the difficulties and focusing it on the benefits involved, it was continually announced that the arrival of Camisea would benefit everybody by reducing the price of gas and electricity; promises continued even when they became unsustainable. Just a few days after the construction was completed and a new reduction of electricity tariffs was promised, the electric tariffs were raised and the LPG – which was the only gas known to the population in Lima – went up.

On the other hand, the industrial companies that accepted to purchase gas since the beginning of the project were more benefited than they expected, because the international prices of the fuel had risen considerably, which made using gas more advantageous. However, this benefit was not enjoyed by the public in general. The application in the electric generation could not be initiated immediately to full capacity in the plants which had been converted to gas. The restriction was due to the

fact that the distribution tubing was built with less capacity than it was necessary. This resulted in Electroperu as prejudiced party. Electroperu is a state ruled company that formally belongs to state pensioners. As ruled by State, they fear to initiate a reclaim against gas supplier.

Within this climate, failures in the pipeline that transported the liquids began to occur, causing spillage of said liquids and damage to the environment, and in particular to the water currents that provide the fish that are part of the diet of the native inhabitants of this area. When the first failure took place, whilst initially being surprising, there was a generally comprehensive attitude, accepting that eventualities could occur. However, the failures continued, even though an effort was made by authorities and companies to convince the public that this was a normal situation.

Under these circumstances, in year 2006, in a Public Hearing of the IDB in Washington, it was claimed that the tubing had been constructed without sufficient quality and with negligence as far as the materials and specialized workmanship were concerned; that the hurry to catch up on deadlines and the lack of economical resources had brought about these consequences. The accusation indicated that throughout the extent of the tubing there had been many susceptible zones which could be likely to suffer further failures. This latter comment coincided with a rather ignored similar appraisal carried out some weeks before by OSINERG, the regulating organism and supervisor of the investment in energy.

The potentiality for new failures and the accusations of lack of quality were denied by the companies and by the authorities; this took place whilst the political campaign for the election of a new President of the Republic was in full swing. Under these circumstances, a new failure of a larger dimension than the previous ones occurred. Without obtaining more information, the Prime Minister attributed it to an act of sabotage, an explanation which was difficult to accept. On this occasion the press was overly generous when dealing with the subject; the television transmitted images of a hut and domestic animals burned, indicating that also two children had been severely wounded by to the explosion that followed the gas leak. This occurrence was heard of far and wide. The political candidates from all the tendencies condemned the event and demanded investigations considering even the renegotiation of the gas contracts. This situation was followed by open requests of renegotiation to other sectors, mainly the mining.

In the Congress, an Investigative Committee was constituted; the Executive designated a Committee in charge of hiring an Audit; the Association of Engineers indicated that, without a doubt, faults in the engineering or in the construction existed that were undoubtedly the responsibility of the company that owned the tubing. The discussions on this subject led to accusations that members of the Government, including the Prime Minister, were alternating between working for the State and for the Company, which led to a request for impeachment in the Congress.

In the time passed until now, the Investigative Committee of the Congress has issued a report indicating that a presumption of guilt exists that should be investigated by the District Attorney. The Association of Engineers, in their quality as representative of

the Civil Society in the committee in charge of hiring the tubing audit, has manifested their discrepancy; as in reality, this audit is only being carried out by the State as it excludes all environmental and community aspects, as well as all the phases up until the construction and also for being in disagreement with the Terms of Reference, for which reasons they have preferred to withdraw their participation.

The primary rationale for the project – shifting the country towards cheap natural gas – was energetic independence, a cleaner and cheaper fuel was an upside: Peru's dependence on oil in commercial energy is strong and one third of the consumed oil is imported. The exportation project is against the objectives of the project; in the first 20 years 4 TCF will be dedicated to local market while 4.2 TCF were dedicated to exportation.

Changes to Camisea I means to embark Peru into a new source of energy that after initial stage to win the market (around 10 years), as adult will not have the strength to sustain the next 15 years, not being that new important reserves will be found. Does it have a strategic meaning for a country?

Camisea II is the mutation of a national effort for a shift from oil to natural gas into an exportation project to favor a company.

To move from one condition to the other (Old to new Camisea), it was necessary to produce significant changes to the legal frame; those changes has been made systematically, along the time, hiding the real aims and negating in front of the people the real intentions; it has been supported by people inserted in key positions of the government; all of this turns the process into illegitimate.

Camisea's Contracts and the legal framework were systematically modified in order to benefit and prioritize the exportation without the obligation to find new reserves. So it was that the Gas Law Ruling, the Gas Law itself and finally the Camisea Contract were successively modified.

As an example of how it proceeded, to modify the Gas Law, it was figured out a situation to change its Article N° 4; this situation was one of sending gas to atmosphere in Peru's Northern Coast Fields. In order to correct that situation, it was proposed to add two sub-points "c" and "d", to Article No. 4. It was accepted by Congressmen and like it was proposed, it was innocuous for Camisea's contract. But without reporting, the new writing also deleted part of sub-point "a", which resulted in an insurmountable obstacle to modify Camisea Gas Field Contract as to allow exportation without finding new reserves. None of the debates included the issue of sub-point "a", which was the real objective of this modification. Months later, dated as November 30, 2005 and invoking this change in sub-point "a", modification of Camisea Field Contract was dictated by Supreme Decree N° 050-2005-EM, allowing the company involved to dispose for exportation part of the reserves that were contractually destined for the internal market.

The Block 56 contract (Pagoreni, with proven reserves found by Shell and returned in last nineties to State) is so uneven and harmful in royalties and tax benefits that will bring resistance in future, when more people arrives to understand its meaning.

The forgetfulness to local market and initial objective of the project shall also be a responsibility of Banks.

The way in which the resources to the inhabitants of the forest had been supplied is also a big mistake; poor effort was made in obtaining something positive; just to provide money, no matter what they will do.

Pleasing attitudes of Peruvian authorities in front of poor construction or operation created social mistrust on all authorities, companies and institutions; this feeling is now extending to other sectors (mining, energy, communications,) and to the privatization process of the '90s. After fifth leak, Prime Minister accepted in Congress that he was linked to Camisea's companies.

The atmosphere created about the non legitimacy and even illegality of the process that converted Camisea I in Camisea II (modification of contracts and laws, special laws for Hunt Oil, participation of Prime Minister, way in which Gas Law was modified via a Trojan Horse asking to add something to one article and without permission deleting key words of the same article) will certainly bring problems for the future; indeed, it has already caused problems: credibility of government (and also of institutions like IDB) is in question; voices has risen asking the revision of Camisea's contracts, with risk of extending to all mining and energy companies.

One of the main concerns is royalties indicated in Contract for Block 56. The exportation project was analyzed and considered economically feasible for an international (Henry Hub) price of US\$ 3.2/MMBTU; it was announced with royalties of 38%, more than Camisea (37.24%). But it was not mentioned that royalties will not be paid on international price, but roughly on one seventh of international price (according to a table of clause), meaning that real royalty was 5% - 6%; in addition, for prices over US\$ 10/MMBTU Royalties will be paid as for US\$ 10/MMBTU.

2 Answer to questions

2.1 Question 1: Is Camisea bringing development benefits to Peru and, in particular, to affected communities?

Camisea is bringing benefits to Peru as a total and under a macro economical view.

But it is not at the level it should have been done nor the right time to do it. There is a two-year delay regarding activities that should have been initiated before the project came to an end, as to arrive together with the gas. The State forgot to give enough time and effort to prepare a consumption market in order to accelerate this substitution.

As the communities are concerned, it is not clear that damage is smaller than the benefits received. It was of importance not only to give money, but to ensure that that money was useful to them or that if it was being used adequately.

2.2 Question 2: How, if at all, should the Project design been changed to maximize benefits for the people of Peru and minimize impacts on the indigenous peoples and the environment?

Mainly, by an effort to respect the contracts like there were agreed; especially regarding the application of International Standards.

It is important that financing institutions care to the achievement of strategic goals and not only to reduce approval to acceptance of a checklist. It is important to preserve the vision of the project.

The banks assumed the environmental commitment counting with the highest standards, allowing that the financing count with the environmental and social guarantee. However, what it is clear to see is that practice is not always successful.

It is advisable to reformulate the objectives, asking whether Camisea contract has been treated as a checking list or it has taking into account the results. In opinion of Peruvian experts dealing directly with those matters, the Bank should supervise the compliments of these objectives that will be mentioned here below:

- Camisea Fond (FOCAM): It was original conceived as an instrument to help that the financing could reach the local communities for their development. The State before complying with these objectives gave the Camisea Fond a meaning of royalties. The Bank only verified the creation of this fond but failed to verify if this financing reached the said benefits for the development of the said local communities.
- Environmental Strategic Evaluations (ESE): Up to this date, it has not been possible to implement this instrument, originally conceived to identify policies and develop programs for projects. The Bank should supervise the comply of this instrument, taking into account that further hydrocarbon projects in the Urubamba area shall be put into consideration that further projects will be presented to the Bank.
- Commission for the Camisea Defend (CCD): The objective to create CCD was to be used it as a mechanism to give more transparency to the whole process and to benefit the communities involved. However, to create other parallel institutions (To Ombudsman) with these same objectives seems not to be adequate. Another important issue is that this Institution does not count with the trust of the indigenous communities. In Ombudsman Report N° 103, titled “Camisea Project And Its Effect on Persons”
- Plans of Right of Way: Even though there is a commitment with the Bank, for the reforestation of the involved areas, planned for the access control, and a plan for the migration control, none of these have been observed.

After the five failures of the tubing, it can be observed that the project has technical problems, situation that gives uncertainty with respect to the way

that the social and environmental policies want to be implemented in the Camisea Project.

2.3 Question 3: *If there have been negative impacts in Peru from this Project, how could they have been avoided?*

Most of problems arise from the lack of supervision and political willing to sanctions. Most of finings of OSINERG were not effective.

Asking to persons involved in Camisea Project, following proposals were mentioned:

- a) Selecting companies that are willing and able to invest upfront to avoid, mitigate, repair and/or compensate the direct and indirect social and environmental impacts.

Main criterion for the selection process was the amount of royalties to be paid. Companies did not have to prove their environmental and social performance.

- b) A proper legal framework is necessary as well strengthening of institutions in charge of supervision and control.

It could be observed that each productive sector has its own small environmental office in charge of approving the Environmental Impact Assessments, to be coordinated by the CONAM which has the mandate to coordinate among the different sectors.

As a result of structural reform during the 90's, government was radically downsized in part due to recommendations of multilateral banks. This downsizing also included institutions regulating and supervising productive activities. The structural reform also made it very difficult to create new permanent positions in any government institution, a good policy to avoid senseless hiring but it backfires now when the need for a stronger supervision is apparent.

Lack of funds implied that OSINERG staff had to rely on consortium logistic to get to the areas to supervise.

Even with such difficulties, OSINERG imposed two fines during construction amounting US\$ 1,700,000. Fines are not a deterrent because companies can always sue the government and keep the litigation for years.

- c) Companies should have been forced to use Shell's standards in terms of transparency of information, participation of civil society, involvement in local development, care for the environment etc. Banks should have really enforce its loan conditions.
- d) Government and Bank should have supported communities to negotiate with companies.

Based on opinions of involved parties, it was received information that companies used their own criteria, their sheer strength and intimidation tactics

to negotiate compensation and reparations with communities during construction and operation. Dismal differences among communities increase the feeling of unfair negotiation conditions.

- e) Time goals set should have been more realistic and production start should have been postponed to allow for a more careful construction.

The completion of the project on time was the only important consideration for government, without regarding consequences. Five reported large leakages, breakages or spills in the first 18 months of operation, this point to severe deficiencies in the design and/or execution of the project. There were reports (URS and Knight Piesold) that repeatedly point out that construction (opening the right of way and installing the pipes) went far too fast for the revegetation and erosion control; crews to keep up the pace, they were severely understaffed.

- f) Soil study should have been conducted to guide the design and soil stabilization needs.

From the onset it was clear that the project was to have a lot of problems related to steepness of the terrain, soil instability, extreme rainfalls, and isolation, among others. According to the conclusions of the Commission of the Peruvian Congress the path of the pipeline was designed without a proper soil study. Periodical reports from URS stated again and again the need to take soil stabilization and erosion control seriously

- g) Government should have been taken the right approach to strengthening its institutions, as perhaps giving CONAM a stronger mandate.

Camisea Defense Committee (CDD) was perceived as a trick to get Ombudsman out of the way. In spite of this maneuver, Ombudsman published a long report with all the instances where the project violated people's rights, holding the companies and the government itself responsible for these violations.

CONAM states in a report that the Camisea project with its ad-hoc solutions to favor the projects implementation has undermined the ability of the government to fill out its role of environmental advocacy.

The Organism for Paracas bay was created right before the approval of the loan, but funds to implement its activities only were available 10 months later.

- h) Government should have heeded civil society's advice or demands for an audit to the construction process and the environmental and social impacts to reestablish confidence in the government and companies' intention.

Problems with the selection of the plant in Paracas, change of use, partial EIA, etc. brings the impression that everything was possible to keep the time schedule. 5 spills had to occur until audits were commissioned by the Government and the Bank.

- i) A proper strategy to deal with vulnerable groups should have been put in place to protect the people.

2.4 Question 4: Have the Government of Peru and the Inter-American Development Bank implemented adequate safeguards to ensure that the revenues and royalties generated from the pipeline are used correctly, that poverty reduction and development benefits are maximized, that compensation is distributed fairly, and that environmental, social and health impacts are prevented or mitigated?

Regarding these issues, the testimony that I can give should be considered as indirect as though I have not directly participate on these process. I have had the opportunity to get in touch with formal related organizations like Asociación Civil Labor, Derecho Ambiente y Recursos Naturales (DAR-Peru), Escuela para el Desarrollo, World Wildlife Fund – WWF (WWF-Perú), Sociedad Peruana de Derecho Ambiental (SPDA) and Oxfam America.

Through their statements, arguments and after verifying the solidity of their answers, which have appeared to me that they are consistent, it can be deduced that the Peruvian Government and the Bank have not been able to reach too much success over the items that covered this question. The results that have been reached are far away of what they should have been obtained. What it has been done mainly is a checking list with items that have been taken as objectives, to only say that the activity had been complied, but without previously verify its true compliance. All the expenses that were made, just upon a checking list filled out in a routinely way, just gave a result that the goals were not reached.

3 Annex

Publication made by Press and others