MONITORING REPORT

CAO Audit of IFC

CAO Compliance

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January 16, 2015

Monitoring of IFC's Response to

CAO Audit of IFC Advisory Services Project with the

Korporata Energjetike e Kosovës, Kosovo

Office of the Compliance Advisor Ombudsman (CAO)
for the
International Finance Corporation (IFC)
Multilateral Investment Guarantee Agency (MIGA)
Members of the World Bank Group

About CAO

CAO's mission is to serve as a fair, trusted, and effective independent recourse mechanism and to improve the environmental and social accountability of IFC and MIGA.

CAO (the Office of the Compliance Advisor Ombudsman) is an independent post that reports directly to the President of the World Bank Group. CAO reviews complaints from communities affected by development projects undertaken by the two private sector arms of the World Bank Group, the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA).

For more information about CAO, please visit www.cao-ombudsman.org

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Abbreviations

Abbreviation	Definition
AS	Advisory Services (IFC)
CAO	Office of the Compliance Advisor Ombudsman (IFC and MIGA)
CES	Environmental, Social and Governance Department (IFC)
CESAS	Sustainability Advisory Services Division within CES (IFC)
CSO	civil society organization
E&S	environmental and social
ESRP	Environmental and Social Review Procedures
FASA	Financial Advisory Services Agreement
GoK	government of Kosovo
IFC	International Finance Corporation
ILO	International Labour Organization
KEDS	Kosovo Electicity Distribution and Supply
KEK	Korporata Energjetike e Kosovës
MIGA	Multilateral Investment Guarantee Agency
PS	Performance Standards
PSP	private sector participation
PPP (C3P)	Public Private Partnership Advisory (IFC)

Executive Summary

This report documents CAO's monitoring of IFC's response to a CAO audit (the audit) of an IFC Advisory Services project (the project) with Korporata Energjetike e Kosovës (KEK), Kosovo's publicly owned utility company. CAO finalized the audit in February 2013, and released an Audit Report to the public, along with IFC's Management response, in April 2013. Since then, CAO has been monitoring IFC's response to the audit.

In 2009, IFC approved an Advisory Services (AS) project to assist the government of Kosovo (GoK) with possible privatization of KEK. The project assisted the GoK with the separation of KEK's distribution activities and assets and with the design and implementation of the privatization of a separate electricity distribution and supply company.

The audit was triggered in response to a complaint received by CAO in August 2011. The complaint was co-signed by Kosovar civil society organizations (CSOs) and international CSOs, and raised concerns about the IFC Advisory Services project and its subsequent impact on the privatization of KEK.

The complaint raised several concerns, including:

- Job losses as a result of privatization
- Negative impacts on rights of association
- IFC's alleged lack of compliance with its Policy on Social and Environmental Sustainability and Policy on Disclosure of Information
- IFC's alleged failure to ensure that there was appropriate access to information concerning the privatization process and the client's ability to address the adverse impacts of the project, and
- IFC's alleged failure to ensure that the GoK followed relevant Performance Standards when privatizing.

The audit found IFC to be in material compliance with its environmental and social (E&S) procedures as applied to Advisory Services projects at the time. However, CAO also found that IFC's procedures were not prescriptive as to how IFC's sustainability agenda, or E&S requirements, should be applied to Advisory Services projects. CAO concluded that if IFC had assessed the context—and in particular, the E&S implications—of the project to a greater extent, it might have provided more clarity to external stakeholders regarding the scope of the IFC Advisory Services project.

The audit found that IFC did not have a structured approach to assessing the commitment or capacity of an AS client to meet IFC's E&S standards. The audit also found that due to IFC's lack of formal leverage, and in the absence of a structured assessment of its informal leverage, IFC was not in a position to assure itself that its Advisory Services engagement was likely to lead to improved E&S outcomes, or meet its policy commitment to "do no harm" principles.

IFC's response to the audit includes a number of revisions to its Advisory Services procedures that provide staff with greater guidance in assessing E&S risks. IFC's response also references updates to procedures and practices that will allow IFC staff to better determine a client's commitment and capacity to manage E&S risks, as well as changes to IFC's legal templates that will provide IFC with increased formal leverage in relation to its Advisory Services clients. These changes provide IFC the opportunity to assess E&S risks earlier in the Advisory Services project cycle.

While this Monitoring Report acknowledges CAO's and IFC's different views on the finding related to the assessment of E&S risks based on the definition of scope employed in this project, CAO notes IFC has taken actions to provide guidance on what constitutes the scope of an Advisory Services project and related implications for E&S risk assessment and management. CAO acknowledges these steps, but is of the view that there is a need for a broader consideration of the project's E&S risks and impacts. Although CAO remains concerned that the existing guidance may be overly narrow as it relates to this project, CAO does not view this as a rationale to keep the audit open.

Overall, CAO finds that IFC's commitments and actions constitute a constructive approach to address the conclusions reached in the Audit Report. CAO determines that it has sufficient basis to close the audit at this stage.

1. Introduction

CAO's Compliance function oversees compliance investigations and audits of IFC and MIGA with a view to improving the environmental and social (E&S) performance of the institutions.

Following a CAO compliance investigation or audit, CAO may determine that it is necessary to monitor actions taken by IFC of MIGA until such actions assure CAO that its compliance findings are being addressed. When its monitoring function is complete, CAO closes its compliance process.

This report documents CAO's monitoring of IFC's response to its audit of an IFC Advisory Services project with the Korporata Energjetike e Kosovës, Kosovo, which IFC completed in February 2013.

2. Background and Complaint

The IFC Advisory Services Project

This IFC Advisory Services (AS) project intended to assist the government of Kosovo with the separation of the distribution activities and assets of Kosovo's publically owned utility, Korporata Energjetike e Kosovës (KEK), and with the design and implementation of the privatization of a separate electricity distribution and supply company. The AS project had two phases. The first phase was a review of the feasibility of introducing private sector participation (PSP) to KEK's distribution network and supply functions. Upon the determination that PSP was viable from the market perspective and beneficial to the country, the second phase was to introduce a tender process to attract a private investor with the necessary funds and expertise to correct KEK's operational failures (high overstaffing, inadequate management, outdated equipment) and financial problems (due to low collection rates, in particular).[1] IFC's scope of work was to focus on the privatization only of KEK's distribution business. KEK received advice from other advisors on other aspects of its operations.

The Complaint

In August 2011, CAO received a complaint in relation to the project. The complainants requested that their identities be kept confidential. The complaint was supported (co-signed) by Kosovar civil society organizations (CSOs) and international CSOs, and raised concerns about the IFC AS project and its subsequent impact on the privatization of KEK. The complainants alleged that the privatization of KEK raised significant E&S concerns, including:

- *E&S due diligence*: The complainants argued that the studies of the E&S impacts of IFC's advisory role and subsequent impact on the energy sector were inadequate. Specifically, complainants alleged that IFC's AS project was not in compliance with IFC's Performance Standard 1 (PS1) (Social and Environmental Assessment and Management Systems) and PS2 (Labor and Working Conditions), and that the E&S implications of associated facilities (particularly a lignite coal mine and coal combustion plant) affecting the privatization of KEK had not been considered.
- *Retrenchment and rights of association*: The complainants expressed concerns that privatization would lead to job losses (retrenchment) in both the utility and broader energy

[1] IFC Disclosure. See http://www.ifc.org/ifcext/spiwebsite1.nsf/b1e2a5a8fc40cd238525753d00658ca9/852568b10055270d852576b0007a3338?opendocument

sector, and that the plans for retrenchment had been inadequate. They also indicated that rights of association might be impaired as a result of privatization.

- *National law and international obligations*: The complainants raised concerns that the IFC AS project and subsequent impact on the GoK's actions toward privatization might be contrary to national law and international obligations, such as the International Labor Organization (ILO) conventions guaranteeing labor and associational rights, as well as the United Nations Guiding Principles on Business and Human Rights.
- *Disclosure of information and community consultation*: The complainants argued that the disclosure of information about IFC's involvement in the privatization of KEK, and the privatization process was inadequate and was not conducted in a timely fashion. They claimed that interested stakeholders were not given appropriate information about the economic, environmental, and social risks associated with the privatization of KEK, or the potential options to mitigate these risks. They contended that this represents noncompliance with IFC's Policy on Disclosure of Information. The complainants also contended that the consultation around the AS project was inadequate and should have been more inclusive and extensive. They argued that consultations were not conducted through the AS project assessment and selection phases.

3. CAO Audit Findings

CAO's audit of IFC's KEK Advisory Services project found IFC to be in material compliance with the E&S procedures that applied at the time of investment and project supervision, and acknowledged the skill and effort that the IFC team exercised in guiding its client when seeking to privatize KEK's power distribution grid. At the same time, CAO found that the IFC's E&S assurance processes and operational requirements for this project in particular, and Advisory Services projects in general, were not appropriately aligned with IFC's broader policy commitments to E&S sustainability.

Finding 1– Lack of specific Advisory Services requirements: CAO found that IFC's procedures were not prescriptive as to how IFC's sustainability agenda, or E&S requirements, should be applied to AS projects. In this context, CAO noted that IFC's Sustainability Framework[2] and applicable Environmental and Social Review Procedures (ESRP)[3] did not provide clear guidance as to how to incorporate the Performance Standards (PS) into an AS project.

Finding 2– Project definition: CAO found that a more expansive consideration of the project's risks and impacts would have been appropriate**.** CAO found that such an approach would have led IFC to more fully consider the otherwise unanalyzed reputational risk that existed due to the association of the project with the nature of power generation in Kosovo. CAO noted that IFC's definition of the scope of the project in terms of the privatization of the electricity distribution network supported the IFC team in its decision to not let the power generation part of KEK overly influence their engagement and approach to the project. CAO also noted that the power generation and the distribution network in this instance are exclusively and mutually dependent on each other and that the privatization of the distribution company has been argued to be a condition for new power generation to proceed.

[2] IFC's Sustainability Policy (2006) and the IFC Performance Standards (2006) were applicable to this project.
[3] Version 4.0 of the ESRP (August 2009) were the procedures applicable for this project.

Finding 3– Assessment of client commitment and capacity: CAO found that IFC did not have a structured approach to assessing the commitment or capacity of the client to meet IFC's E&S standards.

Finding 4– Lack of formal leverage: CAO found that the Financial Advisory Services Agreement (FASA) contained no requirement that the AS client adopt IFC's E&S standards. This resulted in a scenario where the client would be free to disregard advice IFC provided in relation to E&S issues while advancing the privatization process. Due to IFC's lack of formal leverage, and in the absence of a structured assessment of its informal leverage, CAO found that IFC was not in a position to assure itself that its Advisory Services project was likely to lead to improved E&S outcomes, or meet its policy commitment to "do no harm" principles.

4. Methodology

This report is based on a review of documents available to CAO as of November 2014. These include:

- Final IFC Management Response to CAO's Audit Report (March 2013)
- Report of the follow-up meeting with IFC Team (April 2014)
- Updates provided to CAO by IFC as of November 2014.

5. Assessment of IFC's Action in Response to the CAO Audit

In its official response to the CAO audit dated March 15, 2013, IFC Management acknowledged CAO findings that E&S sustainability requirements as applied to Advisory Services projects required strengthening.

Finding 1– Lack of specific Advisory Services requirements

IFC's Response to the CAO Audit

With regard to CAO's findings on IFC procedures, IFC acknowledged that there were very few E&S requirements applicable to Advisory Services at the time the project was committed (November 2009). IFC noted that though the 2006 Sustainability Policy required only that the IFC Performance Standards be used as reference in Advisory Services projects, the project team applied the requirements from the 2012 Sustainability Policy to the project.[4] As a result, the future private owner of Kosovo Electricity Distribution and Supply (KEDS) was to be contractually bound to comply with the Equator Principles.[5] IFC explained that this outcome demonstrated how IFC used its informal leverage to guide its client and other relevant parties in a manner consistent with the Sustainability Framework.

The IFC response also notes that IFC has put in place procedures to support the implementation of the 2012 Sustainability Policy in relation to AS projects. These procedures, which include a new section of the ESRP (Section 11), contain guidance and specify relevant

[4] The 2012 Sustainability Framework requires IFC to provide advice to its clients that is consistent with the Performance Standards. IFC's E&S due diligence is integrated into IFC's overall due diligence of the advisory activity under consideration, including the review of financial and reputational risks. IFC also monitors implementation progress of its advisory activities on an ongoing basis, with formal supervision reporting undertaken semi-annually.

[5] The Equator Principles are a risk management framework, adopted by financial institutions, for determining, assessing, and managing environmental and social risk in projects, and are primarily intended to provide a minimum standard for due diligence to support responsible decision making about risk.

tools to ensure that AS projects are implemented within the framework of the Sustainability Policy.

Assessment of IFC's Action

CAO notes a number of changes in IFC's procedures that are designed to better address E&S risk management.

Specifically, IFC has updated both its ESRP (June 2011) for project due diligence and supervision and the AS Project Governance Manual (August 2011). Further, IFC has issued a number of internal guidance notes, process tools, and tip sheets to assist staff in assessing and managing E&S risk in their projects. For high-risk E&S projects, IFC also now prepares an AS E&S Memo[6] analyzing project E&S risks in light of the requirements of the IFC Sustainability Framework and outlining specific measures to close observed gaps.

Further, in accordance with the 2012 Sustainability Framework, IFC is required to provide advice to its clients that is consistent with the Performance Standards. IFC advises its clients to incorporate the PS into concession agreements.[7] IFC has also incorporated provisions in its AS agreements that allow it to terminate the AS project if it determines that its client is not implementing IFC's advice in a manner consistent with the Performance Standards.

As per IFC's AS Project Governance Procedures (February 2014), for a project to be approved, two key documents must be prepared—an AS Concept Note, and an AS Implementation Plan—both of which are subject to review. In contrast to the practice at the time the Kosovo KEK project was approved, the updated procedures require an IFC E&S specialist or a Sustainability Champion to be included as a reviewer during project appraisal. Specifically, an E&S specialist or a Sustainability Champion is required to review the project AS Concept Note and the AS Implementation Plan against the Performance Standards and to participate in the Concept Review Meeting.

In relation to Finding 1, CAO is of the view that IFC has developed procedures that, if well implemented, would provide the opportunity for E&S risk assessment and management earlier in the project cycle. CAO finds that IFC's commitments and actions constitute a substantive response to these findings.

This item is closed.

Finding 2– Project definition

IFC's Response to the CAO Audit

Regarding the scope of an AS project with respect to E&S issues, IFC clarified that it was hired by the GoK to assist with the privatization of KEK's supply and distribution network, one of three units in KEK.[8] Since IFC was not hired to assist with the privatization of KEK as a whole (that is, all three units), IFC considered that issues pertaining to the mining and power generation

[6] The E&S memo for the KEK project was prepared in September 2011. The E&S memo recorded the list of: potential sector- and project-specific E&S issues; project-relevant PS and World Bank Group environmental, health, and safety (EHS) guidelines; advice that IFC's Environmental, Social and Governance Department (CES) had provided at the time of the project E&S due diligence; and actions required to translate requirements of the relevant PS into actionable tasks, assigned to the appropriate party in the concession agreement. At the time of project appraisal, there were no formal procedures for recording outcomes of E&S due diligence.

[7] In some cases, as in KEK, clients suggest that the Equator Principles be used instead of the Performance Standards.

[8] The other two are mining and power generation.

business units of KEK remained outside IFC's mandate for this AS project.[9] IFC further noted that matters directly related to power generation were not material to the mandate. IFC reasoned that as the power generation was already operational at the time of this AS project, the type of ownership (public or private) of the future distribution unit (KEDS) did not relate to the power generation business unit. Moreover, IFC emphasized that the objective of the privatization of the electricity distribution network was primarily to address underperformance and failures of an operational and commercial nature. Thus IFC considered that the sale of the distribution network had no impact on the type of the existing power generation.

Assessment of IFC's Action

Regarding the need for a more expansive consideration of the project's risks and impacts, CAO notes that IFC has provided internal guidance notes to staff detailing criteria for determining associated facilities in IFC projects. The detailed internal guidance on associated facilities is summarized in a tip sheet developed in October 2012. The tip sheet provides guidance to staff on how to identify associated facilities and assess their risk management practices in both AS and investment projects. It is meant to clarify what is within the scope of the IFC due diligence analysis, and it defines nonassociated facilities to which the risk assessment would not necessarily apply. However, when the project involves issues of significant reputational risk, the tip sheet requires inclusion of third-party nonassociated facilities in the E&S risk assessment of the project. Further, IFC has recently developed detailed stakeholder engagement and management tools, which aim at providing IFC staff with the good practice essentials for managing stakeholder relationships to capture different stakeholder aspirations and needs, and balance and manage the interlinked elements of environmental and social performance. These tools are expected to increase attention to a wider array of risks and concerns, and help project teams identify what actions need to be taken during due diligence.

While acknowledging actions that IFC has undertaken in developing the detailed guidance notes and tip sheet on associated facilities, as well as the related stakeholder engagement and management tools, CAO is of the view that there is a need for a broader consideration of the project's E&S risks and impacts. CAO notes that the focus of the tip sheet on associated facilities could be too narrow. IFC is now applying its new guidance note, which intends to help IFC staff define and manage E&S risks in Advisory Services and investment projects. CAO notes actions taken by IFC so far and encourages IFC to increase these efforts to enhance its analysis of broader potential impacts of the projects during the E&S review. CAO leaves the option open to address this issue comprehensively under a more systemic review through its Advisory function, not directly relating to the IFC Advisory Services project with the KEK.

In relation to Finding 2, CAO views these initiatives as positive steps and encourages IFC to continue enhancing its analysis of broader potential impacts of the projects during the E&S review.

This item is closed.

[9] IFC considered that providing advice relative to the overall energy sector strategy would far exceed the relatively focused scope of the IFC's mandate for this AS project. In addition, the involvement of the International Bank for Reconstruction and Development (IBRD) in advising the government in the power production sector provided some control/reassurance to IFC that the principles and objectives of the World Bank Group /IFC would be considered in the advice to the government concerning the development of its energy sector.

Finding 3– Assessment of client commitment and capacity

IFC's Response to the CAO Audit

IFC noted CAO's findings in relation to the assessment of client commitment and capacity. IFC recognized the importance of adopting a more systematic approach to sustainability matters when evaluating Advisory Service projects. Thus in 2010–11, before adopting the revised 2012 Sustainability Framework (comprising IFC's Policy and Performance Standards on E&S Sustainability and IFC's Access to Information Policy), IFC implemented organizational and procedural changes to facilitate application of these draft polices to all Advisory Services projects. Specifically, the Sustainability Advisory Services Division (CESAS)[10] was created in October 2010 as part of CES (Environment, Social and Governance Department). Dedicated to E&S risk management for Advisory Services, the division supports AS staff on issues related to E&S risk assessment. The Sustainability Champion global network was officially established at the end of 2010 to support CESAS in ensuring that all newly approved AS projects apply a sound E&S risk management system. IFC affirmed that these changes enabled IFC to integrate E&S sustainability considerations into the decision-making process for AS projects, including the assessment of client commitment and capacity.

Assessment of IFC's Action

Regarding IFC's approach to the assessment of client commitment and capacity, CAO notes the following actions.

First, CAO notes that a new practice of IFC Public Private Partnership Advisory unit (C3P) is to have detailed discussions with its clients on E&S issues before signing the mandate letter. The C3P Operational Manual includes additional guidance that, before signing the FASA, IFC point out to the client that IFC's advice will be consistent with the Performance Standards. In addition, the Operational Manual includes a set of templates, procedures, and process tools that have been developed specifically for the C3P business line, to ensure that E&S risks are reviewed throughout the C3P project cycle. A new system for E&S risk management specific to C3P projects has been effective since August 2014. This system provides new directions and process, including:

- The classification of C3P projects as High and Medium, signaling both to CES staff and C3P teams the likely level of effort that will be required
- Assignment of one or two E&S specialists as part of the team for all C3P projects, enabling the team to have an E&S viewpoint over the entire project cycle
- Review and approval of texts for public disclosure by the primary CES specialist assigned to the project
- Opportunity for CES staff to comment on standard project documentation, such as Concept Notes and AS Implementation Plans.

CAO notes the new process could lead to a closer involvement of CES staff and thus enhance E&S risk management of C3P projects.

Second, CAO notes that where IFC determines that a client requires assistance with capacity building during implementation, IFC has a new product to offer a client in the form of post-transaction support.[11] As it relates specifically to the IFC's role in KEK, IFC approved a one-year

[10] The CESAS mandate consists of provision of: advice on high risk projects; tools for E&S risk management in Advisory Services; and capacity building to help clients comply with the Environmental and Social Review Procedures and the IFC Sustainability Framework.

[11] Post-transaction support can be provided to selected clients to help them monitor their public-private partnership (PPP) contracts for the first 12 to 24 months.

project to support the GoK in implementing its agreement with the concessionaire.[12] As part of this project, IFC agreed to assist the government of Kosovo in dealing with matters of disagreement if and when they arise, and assisting the GoK to monitor the fulfillment of the contractual obligation by the concessionaire. As the concessionaire is required to abide by the Equator Principles, IFC's mandate for this post-transaction support[13] includes E&S technical assistance.

In relation to Finding 3, CAO views these initiatives as positive steps toward developing a more robust approach to assess the commitment or capacity of the client to implement IFC's sustainability agenda.

This item is closed.

Finding 4– Lack of formal leverage

IFC's Response to the CAO Audit

IFC disagreed with CAO's findings in relation to the lack of a formal requirement that the AS client adopt IFC's E&S standards, noting that IFC's advice in this project included a requirement by the concessionaire to meet the IFC Performance Standards through a contractual obligation.

IFC further noted that as part of a continual improvement process, it had amended its standard FASA to incorporate a clause stating that IFC will advise clients in a manner consistent with the Sustainability Framework. IFC also notes that it has the right to terminate the FASA in the event the client breaches any of its obligations or if IFC determines that it is not able to continue advising the client in a manner that is materially consistent with the 2012 Sustainability Framework. A formal commitment of the client to consider E&S risks in accordance with IFC requirements is therefore now included in the FASA terms.

IFC further noted that its contractual leverage with a client typically ends when the AS mandate concludes and that there is no guarantee that IFC's client will require the winning bidder of a concession to comply with the IFC's Performance Standards.

Assessment of IFC's Action

Regarding the lack of formal conditions to require IFC's AS client to adopt IFC's E&S standards, CAO notes that IFC amended its FASA template to include formal conditions and provide consistency with the 2012 Sustainability Framework. The FASA now incorporates a clause stating that IFC may terminate the engagement should IFC determine that it is not able to continue advising the client in a manner that is materially consistent with the 2012 Sustainability Framework.[14] To ensure a mutual understanding of the terms and conditions of the agreement, the FASA points to the Sustainability Framework, records the client's acknowledgment that its operations will be guided by IFC Sustainability Framework, and that IFC will advise the client in a manner that is consistent with this Framework.

In relation to Finding 4, CAO views these initiatives as positive steps toward incorporating formal conditions into the legal documents requiring adherence to E&S standards.

This item is closed.

[12] IFC Advisory Service Project No. 599771. See https://ifcndd.ifc.org/ifcext/spiwebsite1.nsf/d011bd56046289dc85257b6000260169/436b678b89cea7e085257c6f005fa19e?opendocument

[13] The technical support component is composed of support in the area of regulatory issues; and consultation on E&S issues and interpretation of Equator Principle standards, local standards, and best practice.

[14] Section 8 "Termination", b, 11, A. of the FASA.

6. CAO Monitoring Conclusion

IFC's response to the audit includes a number of revisions to its Advisory Services procedures that provide staff with greater guidance in assessing E&S risks. It also references updates to procedures and practices that will allow IFC staff to better determine a client's commitment and capacity to manage E&S risks, as well as changes to IFC's legal templates that will provide IFC with increased formal leverage in relation to Advisory Services clients. These changes, if they are implemented, provide the opportunity for IFC to assess E&S risks earlier in the Advisory Services project cycle.

While this Monitoring Report acknowledges CAO's and IFC's different views on the finding related to the assessment of E&S risks based on the definition of scope employed in this project, CAO notes that IFC has taken actions to provide guidance on what constitutes the scope of an Advisory Services project and related implications for E&S risk assessment and management. CAO acknowledges these steps, but is of the view that there is a need for a broader consideration of the project's E&S risks and impacts. Although CAO remains concerned that the existing guidance may be overly narrow as it relates to this project, CAO does not view this as a rationale to keep the audit open.

Overall, CAO finds that IFC's commitments and actions constitute a constructive approach to address the conclusions reached in the Audit Report. CAO determines that it has sufficient basis to close the audit at this stage.