



APPRAISAL REPORT

CAO Appraisal for Audit of IFC
CAO Compliance
C-I-R7-Y12-F158
April 18, 2012

Kosovo KEK
Pristina, Kosovo

Summary

Kosovo Energy Company (KEK) is Kosovo's publicly owned utility company. In 2009, the International Finance Corporation (IFC) approved an Advisory Services (AS) project to assist the Government of Kosovo (GoK) with possible privatization of KEK via private sector participation (PSP).

In August 2011, the CAO received a complaint regarding the IFC's Advisory Services project and its potential subsequent impact on the privatization of KEK. The complainants requested that their identities be kept confidential, and the complaint was supported (co-signed) by local Kosovar and international Non Governmental Organizations (NGOs). 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 client (GoK) followed relevant Performance Standards when privatizing.

Documentation reviewed by CAO show that the IFC followed the applicable procedures within what it defined as the scope of the Advisory Services project. However, it is unclear whether appropriate guidance exists to ensure that IFC delineates the scope of Advisory Services projects, and the scope of the due diligence review, so that the outcomes of Advisory Services are consistent with the desired effect of IFC policy provisions. Accordingly, the CAO finds that a compliance audit could yield information or findings that might better inform the IFC on the need for guidance to staff and application of policies to future IFC Advisory Services projects. Consistent with the CAO Operational Guidelines, the CAO will develop a Terms of Reference and conduct an investigation of IFC on the scope and mandate, and scope of the due diligence review, of IFC's Advisory Services project to the Government of Kosovo. The CAO does not audit IFC's client; thus the CAO will not pass any judgment on the performance of the IFC's client, but considers only issues related to IFC.

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



Contents

1. Overview of the CAO Appraisal Process and Compliance Audits
2. Background and Concerns that Led to the Appraisal
3. Scope of the Appraisal for a Compliance Audit of IFC
4. Findings of the CAO Appraisal
5. The CAO Decision

About the CAO

The 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.

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

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

1. Overview of the CAO Appraisal Process and Compliance Audits

When the CAO receives a complaint about an IFC or MIGA project, the complaint is first referred to the ombudsman role of the CAO, *CAO Ombudsman*, which works to respond quickly and effectively to complaints through facilitated settlements, if appropriate. If CAO Ombudsman concludes that the parties are not willing or able to reach a facilitated solution, the case will be transferred to the compliance role of the CAO, *CAO Compliance*, to appraise the concerns raised in the complaint, as the basis for a possible *compliance audit* of IFC or MIGA. Alternatively, a compliance audit can be initiated at the request of the President of the World Bank Group or the senior management of IFC or MIGA, or at the discretion of the CAO Vice President.

A *CAO compliance appraisal* is a preliminary investigation to determine whether the CAO should proceed to a compliance audit of IFC/MIGA. Through CAO compliance appraisals, the CAO ensures that compliance audits of IFC/MIGA are initiated only for those cases that may raise substantial concerns regarding social or environmental outcomes.

A compliance audit is concerned with assessing the application of relevant policy provisions and related guidelines and procedures to determine whether IFC/MIGA is/are in compliance. The primary focus of compliance auditing is on IFC/MIGA, but the role of the sponsor may also be considered.

A compliance audit appraisal, and any audit that ensues, must remain within the scope of the original complaint or request. It cannot go beyond the confines of the complaint or request to address other issues. In such cases, the complainant or requestor should consider a new complaint or request.

The CAO compliance appraisal will consider how IFC/MIGA assured itself/themselves of compliance with national law, including international legal commitments, and other appraisal criteria. The CAO has no authority with respect to judicial processes. The CAO is not an appeals court or a legal enforcement mechanism, nor is the CAO a substitute for international court systems or court systems in host countries.

The appraisal criteria are set forth in CAO's Operational Guidelines. The criteria are framed as a series of questions to test the value of undertaking a compliance audit of IFC or MIGA. The criteria are as follows:

- Is there evidence (or perceived risk) of adverse social and environmental outcomes that indicates that policy provisions (or other audit criteria) may not have been adhered to or properly applied?
- Is there evidence of risk of significant adverse social and environmental outcomes that indicates that policy provisions, whether or not complied with, have failed to provide an adequate level of protection?
- Is there evidence (or perceived risk) of significant adverse social and environmental outcomes where policy provisions, standards, or other audit criteria were not thought to be applicable but perhaps should have been applied?
- Is there evidence that the application of some aspect of a policy, standard, guideline, or procedure resulted in adverse social and environmental outcomes?



- Can the cause of adverse social and environmental outcomes not be readily identified and corrected through the intervention of the project team without a detailed investigation of the underlying causes or circumstances?
- Could a compliance audit yield information or findings that might better inform the application of policies (or other audit criteria) to future projects?

During appraisal, CAO Compliance holds discussions with the IFC/MIGA project team and other relevant parties to understand the validity of the concerns and to explore whether an audit would be warranted.

After a compliance appraisal has been completed, the CAO can choose only one of two options: to close the case, or to initiate a compliance audit of IFC/MIGA.

The CAO will report and disclose the findings and decision of the CAO compliance appraisal in an appraisal report in order to inform the President of the World Bank Group, the Boards of the World Bank Group, senior management of IFC/MIGA, and the public in writing about its decision.

If the CAO decides to initiate a compliance audit as a result of the compliance appraisal, the CAO will draw up a Terms of Reference for the audit in accordance with CAO's Operational Guidelines.

2. Background and Concerns that Led to the Appraisal

On August 25, 2011, the CAO received correspondence from complainants who requested that their identities be kept confidential. The complaint was supported (co-signed) by local Kosovar nongovernmental organizations (NGOs) and international NGOs, and raised concerns about the IFC Advisory Services project and its subsequent impact on privatization of Kosovo's publicly owned utility company, Kosovo Energy Corporation (KEK). The complainants alleged that the privatization of KEK raised significant social and environmental 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 privatization; and IFC's alleged failure to ensure that the IFC's client (GoK) followed relevant Performance Standards in privatization.

The CAO deemed the complaint eligible for assessment in September 2011, and the CAO ombudsman began the assessment of opportunities for resolving the issues raised in the complaint. The CAO team made two trips to Kosovo in November 2011 to meet with local stakeholders. During these visits, the CAO team met with the complainants, IFC's project team, government officials, local and international NGOs, and other stakeholders.

The CAO Ombudsman concluded that the parties were not willing or able to reach a facilitated solution, and the case was transferred to the Compliance for appraisal.

Investment Background

This IFC Advisory Services (AS) project intended to assist the Government of Kosovo with possible privatization of KEK via private sector participation (PSP). The AS project had two phases. The first phase was a review of the feasibility of introducing private sector participation in KEK's distribution network and supply functions. Upon the determination that a PSP was viable from the market perspective and beneficial to the country, the second phase was to introduce a transparent 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 in particular to low collection rates).¹ In accordance with IFC procedures for classification, IFC classified the Advisory Services project as medium risk.

¹ International Finance Corporation (IFC), Kosovo KEK Summary of Advisory Services Project, <http://www.ifc.org/ifcext/spiwebsite1.nsf/b1e2a5a8fc40cd238525753d00658ca9/852568b10055270d852576b0007a3338?opendocument&Highlight=0,kosovo>

3. Scope of the Appraisal for a Compliance Audit of IFC

As discussed in Section 1, appraisals are limited to examining the issues related to the complaint and determining how they relate to the performance of IFC/MIGA and its obligations under the relevant standards, guidelines, procedures and policies. The scope of this compliance appraisal includes: IFC's due diligence and whether it was consistent with IFC's processes and policies; IFC's delineation of the scope of its due diligence, and whether that delineation is consistent with IFC policy provisions.

IFC Due Diligence

The complaints raised several social and environmental concerns with respect to the privatization process.

- Environmental and social due diligence: The complainants argued that the studies of the social and environmental impacts of IFC's advisory role and subsequent impact on the energy sector were inadequate. Specifically, complainants alleged that IFC's Advisory Services project is not in compliance with IFC's Performance Standards 1 (Social and Environmental Assessment and Management Systems) and 2 (Labor and Working Conditions), and that the social and environmental 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 sector, and that there have been inadequate plans for this retrenchment. They also indicated that rights of association might be impaired as a result of privatization.
- National and regional legislation: There are concerns that the IFC Advisory Services project and subsequent impact on the GoK's actions toward privatization may be in contradiction to national and international laws such as the International Labour Organization (ILO) conventions guaranteeing labor and associational rights, as well as the United Nations Human Rights Council's guidelines for business and human rights.²
- Disclosure of information and community consultation: The complainants argue that the disclosure of information about IFC's involvement in the privatization of KEK, and the privatization process, has been inadequate and has not been conducted in a timely fashion. They feel 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 contend that this is in noncompliance with IFC Policy on Disclosure of Information. The complainants also contend that the consultation for the entire AS privatization project was inadequate and should have been more inclusive and extensive. They argue that the consultation did not take place through the AS project assessment and selection phases.

² <http://www.business-humanrights.org/media/documents/ruggie/ruggie-guiding-principles-21-mar-2011.pdf>

IFC Scope

The CAO appraisal also looked at the extent to which IFC assured itself that the guidance it provides to its staff in defining the scope of its Advisory Service work was in line with its broader social and environmental policies. To that end, the appraisal also considered the following:

- Scope of IFC–Government of Kosovo Advisory Services: The CAO appraisal looked at the procedures and guidelines for defining the scope of an Advisory Service project, specifically, with the goal of understanding the extent to which the IFC policy framework was considered in the IFC’s definition of the project scope and considerations of the implications for associated facilities and the project’s outcomes. The CAO included these questions in the definition of the scope of the CAO’s appraisal, based on the CAO’s own Operational Guidelines. The CAO Operational Guidelines states that the issue at hand is whether:
 - The actual social or environmental outcomes are consistent with or contrary to the desired effect of the policy provisions
 - The failure to address social or environmental issues as part of the review process resulted in outcomes that are contrary to the desired effect of the policy provisions.

IFC Standards, Guidelines, and Procedures

The Environmental and Social Review Procedures require IFC to review projects against the Performance Standards and good international practice standards, as set out in the Environmental, Health and Safety (EHS) Guidelines. In addition, an assessment typically includes a review of the track record, technical capacity, corporate and project-specific management systems of the client/operator, and mitigation measures for business and technical risk and associated risks.

The framework of IFC’s due diligence for Advisory Services projects is governed by the Social and Environmental Requirements for Standalone Advisory Services.

IFC’s Due Diligence and Follow-up

In 2009, the IFC Project Document Summary (PDS) Early Review of the KEK AS project and the Advisory Services PDS Approval identified several environmental and social (E&S) risks associated with the AS project:

- Weak environmental monitoring mechanisms in Kosovo. IFC stated it would work with other international financial institutions (IFIs) present in Kosovo to promote the development and application of environmental monitoring mechanisms;
- That there were environmental risks as 80% of the electricity is generated from lignite (brown coal). However, as a positive impact of the privatization, IFC believed that the PSP would contribute to reduce the distribution losses and hence partly reduce the overall level of CO₂ emissions;
- That KEK’s overstaffing meant that layoffs were unavoidable for profitable operations to be achieved. Hence, IFC recommended that the IFC guidelines on retrenchment should be followed.



IFC's Environment, Social, and Governance department (CES) specialists were consulted in identifying the risks and establishing monitoring and evaluation (M&E) indicators that would track the progress toward mitigating the risks associated with the Advisory Services.

In February 2011, as part of IFC's due diligence, IFC contracted an external third party to carry out a review of environmental issues. The report identified the following priority areas where it was believed that further surveys were required to understand the nature of environmental, health, and safety risks associated with the performance in KEK's distribution business:

- Fluid filled cables
- Discharges to water
- Contaminated land
- PCB management
- Waste management (including asbestos management)
- Flood risk

These findings were included in IFC appraisal documentation, which also reiterated the concerns that had been highlighted in the Early Review and PDS Approval assessments. IFC concluded in its AS project E&S Memo that the assessments provided adequate information to ensure that the potential bidder for the KEK project knew what the E&S risks were. IFC recommended that the bidder operate the project in accordance with IFC's Environmental Health and Safety guidelines; implement a formal documented environmental, health, safety, and social management system; and adopt and implement IFC's retrenchment guidelines.

The initial IFC AS supervision reports, which started in the fourth quarter of 2010, indicate that IFC focused on the risks to tariff reforms, market models, and investor feedback. In the fourth quarter of 2011, the AS supervision report notes the growing engagement by local Kosovar civil society organizations (CSOs) and NGOs that wish to be involved in evaluating the strategy for the privatization of KEK and the effect of this privatization on Kosovo.

4. Findings of the CAO Appraisal

- Environmental and social due diligence: The IFC documentation demonstrates that the environmental and social risks subsequently raised by the complainants were identified in IFC's reviews of the AS project.
- Retrenchment and rights of association: IFC documentation demonstrates that reviews of the AS project identified retrenchment risks. Initial reviews did not specifically highlight the right to association as a potential risk associated with the AS project or privatization.
- National and regional legislation: The violation of national and regional legislation was not specifically highlighted as a risk during IFC's initial assessments. However, in subsequent communication with local Kosovo NGOs, IFC does indicate that the IFC has assured itself that the Advisory Services project was in compliance with regional legislation.
- Disclosure of information and community consultation: The disclosure of information and community consultation were not highlighted as issues of concern in the initial reviews of the

AS project. However, subsequent communication between local Kosovo NGOs and IFC indicates that the IFC endeavored to foster communication between the Government of Kosovo and the public by encouraging the GoK to share the business model for privatization with the public via NGOs.

- Scope of IFC's GoK's Advisory Services project. The CAO appraisal found potentially insufficient guidance to staff to inform their decision on how to define the scope of an Advisory Services project, and the extent to which the guidelines for the definition of this scope are in compliance with broader IFC policies on sustainability.

5. The CAO Decision

It is unclear whether appropriate guidance exists to ensure that IFC delineates the scope of Advisory Services projects, and the scope of its due diligence review, so that the subsequent impacts and outcomes of Advisory Services are consistent with the desired effect of IFC policy provisions. Accordingly, the CAO concludes that a compliance audit could yield information or findings that might better inform the IFC on the need for guidance to staff and application of policies to future IFC Advisory Services projects. Consistent with the CAO Operational Guidelines, the CAO will develop a Terms of Reference and conduct an investigation of IFC on the scope and mandate, and scope of the due diligence review, of IFC's Advisory Services project to the Government of Kosovo.

The CAO audits IFC, and how IFC assured itself of the environmental and social performance of its investments and activities. This audit will focus on IFC, and whether or not the processes and procedures IFC applied are aligned with, and in compliance with, IFC broader policy provisions. The CAO does not audit IFC's client; thus the CAO will not pass any judgment on the performance of IFC's client.