AUDIT REPORT

CAO Audit of IFC

CAO Compliance

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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 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.

CAO (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 lending 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
CAO	Office of the Compliance Advisor Ombudsman (IFC and MIGA)
CES	IFC's Environmental, Social and Governance Department
CO^2	carbon dioxide
CSO	civil society organization
E&S	environmental and social
EHS	environment, health and safety
ESRP	Environmental and Social Review Procedures
GoK	government of Kosovo
GIIP	good international industry practice
IFC	International Finance Corporation
IFI	international finance institution
ILO	International Labour Organization
KEDS	Kosovo Electricity Distribution and Supply
KEK	Korporata Energjetike e Kosovës (Kosovo Energy Corporation)
M&E	monitoring and evaluation
MIGA	Multilateral Investment Guarantee Agency
NGO	nongovernmental organization
PDS	Project Document Summary
PS	Performance Standards
PSES	Policy on Social and Environmental Sustainability
PSP	private sector participation
QAE	Quality Review at Entry
TL	transaction leader
ToR	terms of reference

Overview of the CAO Compliance Audit Process

When CAO receives a complaint about an IFC or MIGA project, it first refers it to the CAO Ombudsman, which works to respond to complaints through facilitated settlements, if appropriate. If the CAO Ombudsman concludes that the parties are not willing or able to reach a facilitated solution, the case is transferred to the compliance arm of CAO, CAO Compliance, to appraise the concerns raised in the complaint for a compliance audit of IFC or MIGA. A compliance audit may also be initiated by request from the President of the World Bank Group or senior management of IFC or MIGA.

CAO Compliance auditing focuses on IFC and MIGA, and how IFC/MIGA assured itself/themselves of project performance. The purpose of a CAO audit is to ensure compliance with policies, standards, guidelines, procedures, and conditions for IFC/MIGA involvement, and thereby improve the environmental and social performance of investments and activities backed by IFC/MIGA. In many cases, in assessing the performance of the project and implementation of measures to meet relevant requirements, it is necessary to review the actions of the project sponsor and verify outcomes in the field.

A compliance audit must remain within the scope of the original complaint or request. It cannot go beyond the confines of the complaint, or request that other issues be addressed. In such cases, the complainant or requestor may consider submission of a new complaint or request.

CAO Compliance appraisals and audits consider how IFC/MIGA assured itself/themselves of compliance with national law, reflecting international legal commitments, along with other audit criteria. CAO has no authority with respect to judicial processes. CAO is neither a court of appeal nor a legal enforcement mechanism, nor is CAO a substitute for international court systems or court systems in host countries.

In cases where IFC/MIGA is/are found to be out of compliance, CAO will keep the audit open and monitor the situation until actions taken by IFC/ MIGA assure CAO that IFC/ MIGA will move back in to compliance. CAO will then close the audit.

1. Background to the Audit

On August 25, 2011, the CAO received correspondence from complainants in Kosovo 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 an IFC Advisory Services project (# 29107) and its subsequent impact on privatization of Kosovo's publicly owned utility company, Korporata Energjetike e Kosovës (KEK). The complainants alleged that the privatization of KEK raised significant environmental and social 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 its 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 IFC's client (the government of Kosovo, GoK) followed relevant Performance Standards when privatizing.

This IFC Advisory Services (AS) project intended to assist the government of Kosovo 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 AS project had two phases. The first phase was a review of the feasibility of introducing private sector participation (PSP) 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 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 of the distribution business of KEK only. KEK received advice from other advisors on other aspects of KEK's operations.

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

- *Environmental and social due diligence*: The complainants argued that the studies of the environmental and social 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 Standard 1 (Social and Environmental Assessment and Management Systems) and Performance Standard 2 (Labor and Working Conditions), and that the environmental and social 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 the plans for retrenchment have been inadequate. They also indicated that rights of association might be impaired as a result of privatization.

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

- *National and International legislation*: The complainants raised 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.

- *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 was not conducted in a timely fashion. They claim 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 a noncompliance with IFC's 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 consultations did not take place through the AS project assessment and selection phases.

CAO's compliance appraisal[2] found the following:

- *Environmental and social due diligence*: 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 International legislation*: The violation of national and international legislation was not specifically highlighted as a risk during IFC's initial assessments. However, in subsequent communication with local Kosovo NGOs, IFC did indicate that IFC had assured itself that the Advisory Services project was in compliance with international 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.

- *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.

[2] See CAO Appraisal Report for Kosovo KEK at http://www.cao-ombudsman.org/documents/CAO_Appraisal_Report_C-I-R7-Y12-F158_ENG.pdf (Accessed February 11, 2013)

CAO found that IFC's delineation of the scope of Advisory Services projects, and the underlying rationale for the scope of its due diligence review, was unclear. CAO also questioned how IFC assured itself that subsequent impact and outcomes of Advisory Services are consistent with the desired effect of IFC policy provisions.

CAO also looked at the procedures and guidelines for defining the scope of an Advisory Services project, specifically with the goal of understanding the extent to which the IFC policy framework was considered in IFC's definition of the project scope and considerations of the implications for associated facilities and the project's outcomes.

CAO concluded that an audit was merited. The CAO audits IFC, and how IFC assured itself of the environmental and social performance of its investments and activities. The audit focuses on IFC, and whether or not the processes and procedures IFC applied were aligned with, and in compliance with, IFC's broader policy provisions. CAO does not audit IFC's client; thus CAO does not pass any judgment on the performance of IFC's client.

The CAO Operational Guidelines states that the issue at hand is:

- Whether the actual social or environmental outcomes of these projects are consistent with or contrary to the desired effect of the policy provisions; and
- Whether there were any failures to address social or environmental issues as part of the review process—and if so, whether these failures resulted in outcomes that are contrary to the desired effect of the policy provisions.

Pursuing this line of inquiry involved answering the following questions:

- How did IFC determine which environmental and social provisions were applicable to a particular business activity?
- What was the primary purpose of applying these provisions to the particular business activity?
- To what extent did IFC assure itself that the selected provisions were implemented and had the desired effect?

2. An Overview of IFC's Policy Framework and Approach to E&S for Advisory Services Projects

2.1 *IFC's Mandate*

IFC's Articles of Association state that IFC is mandated to further economic development by encouraging the growth of productive private enterprise, particularly in less developed areas, by "assisting in financing productive private enterprises that would contribute to the development of its member countries by making investments."[3]

IFC's mandate, as specified in its Articles of Association, states that IFC shall not assume responsibility for managing any enterprise in which it has invested and shall not exercise voting rights for such purpose that is within the scope of managerial control, nor shall IFC interfere in the political affairs of any member or let anything but economic considerations be relevant to its decisions.

2.2 *IFC's Sustainability Framework*

IFC's Sustainability Framework articulates IFC's strategic commitment to sustainable development. The 2006 Framework consists of IFC's Policy on Social and Environmental Sustainability, IFC's Performance Standards, and IFC's Policy on Disclosure of Information. A summary of the recently adopted 2012 Sustainability Framework as it relates to Advisory Services is presented in section 2.5.

2.3 *IFC's Policy on Social and Environmental Sustainability and IFC Performance Standards*

IFC's Policy on Social and Environmental Sustainability (PSES), and the IFC Performance Standards (PS), require that clients be assessed for the potential environmental and/or social harm created by their activities on the basis of IFC's Environmental and Social Review Procedures (ESRP).[4,5]

The PSES, and the IFC Performance Standards, detail IFC's interpretation of an associated facility. An associated facility is defined as a facility that is "not funded as part of the project (funding may be provided separately by the client or by third parties including the

[3] IFC, 1993, "IFC Articles of Agreement." http://www1.ifc.org/wps/wcm/connect/1c95b500484cb68d9f3dbf5f4fc3f18b/articles.pdf?MOD=AJPERES. (Accessed May 3, 2012).

[4] IFC's Sustainability Policy (2006) and the IFC Performance Standards (2006) were applicable to this project. See applicable IFC Policy on Social and Environmental Sustainability and Performance Standards at http://www1.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+Sustainability/Sustainability+Framework/Sustainability+Framework+-+2006/ (Accessed February 5, 2013).

[5] Version 4.0 of the ESRP (August 2009) were the procedures applicable for this project. They can be found at http://www1.ifc.org/wps/wcm/connect/1fcd4880488559908374d36a6515bb18/ESRP2009.pdf?MOD=AJPERES&attachment=true&id=1322807821599 (Accessed February 5, 2013).

government), and whose viability and existence depend exclusively on the project and whose goods or services are essential for the successful operation of the project."[6]

The ESRP required IFC to review the overall reputational risks with a client, as well as the potential E&S risk associated with the Advisory Services project. An assessment typically includes a review of information in the public domain, a determination as to whether the impacts and outcomes have potential E&S risks, and an examination of mitigation measures for such risks.

The framework of IFC's due diligence for Advisory Services projects that are not linked to an IFC investment, as per the ESRP, is governed by the Procedure for Stand-alone Advisory Services Projects.[7]

2.4 *IFC E&S Processes as Related to Advisory Services*

When IFC commenced the Advisory Services project with the GoK, it was operating under the 2006 Policy on Social and Environmental Sustainability (PSES). This policy is not explicit as to the applicability of the Performance Standards for IFC Advisory Services projects. "The Purpose of this Policy" section states that "IFC seeks to ensure that the projects it finances are operated in a manner consistent with the requirements of the Performance Standards."

The "IFC Roles and Responsibility" section outlines the roles of IFC and the client. With respect to the client, the section states: "In its operations, IFC expects clients to manage the social and environmental risks and impacts of their projects. This entails the client's assessment of these risks and impacts, and implementation of measures to meet the requirements of the Performance Standards." With respect to IFC, the section states that IFC's role "is to review the client's assessment; to assist the client in developing measures to avoid, minimize, mitigate or compensate for social and environmental impacts consistent with the Performance Standards."[8]

Under the Advisory Services section, other wording is utilized: "When IFC is providing advice for large-scale investment projects, the Performance Standards are used as a reference in addition to national laws."

At the time the Advisory Services project was initiated, no explicit project governance procedures existed for Advisory Services.[9] CAO understands that procedure-like guidance was usually provided by the Vice President or Director in charge. This guidance, the *Technical Assistance and Advisory Services Approval Process*, was provided in 2005 and updated in 2006.

[6] See IFC Performance Standards (2006), Performance Standard 1, page 2
http://www1.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+Sustainability/Sustainability+Framework/Sustainability+Framework+-+2006/Performance+Standards+and+Guidance+Notes/
(Accessed February 5, 2013).

[7] See IFC ESRP 2009 (Version 4) for further details.
http://www1.ifc.org/wps/wcm/connect/1fcd4880488559908374d36a6515bb18/ESRP2009.pdf?MOD=AJPERES&attachment=true&id=1322807821599

[8] IFC Policy on Social and Environmental Sustainability (2006), p. 2.

[9] The Advisory Service Project Governance Procedure was first formalized into a policy and procedure document in May 2011.

For an Advisory Services project to be approved, it must be processed through the following stages:

- Quality Review at Entry (QAE)
- Project Document Summary (PDS) Early Review
- PDS Approval
- Legal documents drafted and signed.

IFC's Environmental and Social Review Procedures (ESRP)[10] stipulate that IFC's Transaction Leader (TL) on the proposed project will include IFC's Environmental and Social department (CES) specialist and an Advisory Services sustainability champion as a peer reviewer[11] at the PDS Approval stage if the TL determines that there are potential E&S risks associated with the project or environmental and social (E&S) reputation risk associated with the AS client.

2.5 *Revisions to the Sustainability Framework in 2012*

Following extensive internal and external consultation, IFC issued a revised Sustainability Framework, including revised versions of the Performance Standards and Access to Information Policy, that are effective for activities[12] processed after January 2012.[13] The most significant change for AS projects is the change from the requirement that "When IFC is providing advice for large-scale investment projects, the Performance Standards are used as a reference in addition to national laws" to the following: "Should the review result in the identification of environmental and/or social risks, the advice provided to clients shall be consistent with the Performance Standards as a framework of good international industry practice (GIIP)."

2.6 *IFC's Legal Context and Disclosure*

IFC's Policy on Disclosure of Information, which is part of the 2006 Sustainability Framework, states that "IFC makes available information concerning its activities that would enable its clients, partners, and stakeholders (including affected communities), and other interested members of the public to understand better, and to engage in informed discussion about, IFC's business activities, the overall development and other impacts of its activities, and its contribution to development" (paragraph 8).

Paragraph 9 of the Policy states that "there is a presumption in favor of disclosure," but that "consistent with the practice of commercial banks and of most public sector financial institutions (for their private sector investments), IFC does not disclose to the public financial, business, proprietary or other nonpublic information provided to IFC by its clients or other

[10] Version 4.0, August 2009.

[11] Peer reviewers are required to provide clearance for a project to proceed within seven days; otherwise, clearance is automatic.

[12] As per the IFC Sustainability Framework (2012), p.3 "activities include (i) investments financed directly by IFC; (ii) investments implemented through financial intermediaries (FIs) or managed by IFC's Asset Management Company or any other IFC subsidiary, as well as investments funded in part or in whole by donors; and (iii) advisory services".

[13] IFC, 2012, IFC Sustainability Framework–Effective January 1, 2012. http://www1.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+sustainability/publications/publications_handbook_sustainabilityframework (Accessed May 9, 2012).

third parties. To do so would be contrary to the legitimate expectations of its clients, who need to be able to disclose to IFC detailed information without fear of compromising the confidentiality of their projects or other proprietary information in a highly competitive marketplace."

While IFC's Policy on Disclosure of Information (2006) encourages disclosure of information, there was no clear requirement for public disclosure of information concerning any IFC Advisory Services project. Disclosure requirements are binding on the establishment and funding of new Technical Assistance and Advisory Services programs or facilities 30 days after IFC approval.

3. An Overview of IFC's KEK Advisory Services Project

3.1 Overview of IFC's Processing of Advisory Projects

Historically, KEK was a publicly owned and operated company with three major business lines: mining; power generation; and power distribution and supply services throughout Kosovo. Following several earlier attempts at privatization, Kosovo Electricity Distribution and Supply (KEDS) was incorporated in August 2009 with the objective of transferring KEKS distribution and supply services into a new company. However, in May 2011, IFC acknowledged that it did not expect the actual unbundling of assets relevant for distribution services from KEK to KEDS to be undertaken until the selected buyer was known. KEDS was offered to the private market as a stand-alone entity, with transaction advice from IFC.

IFC commenced the pre implementation phase of this project on October 29, 2009. The QAE meeting was held on November 9, 2009. At this meeting, it was decided that E&S issues, as per the ESRP, were to be considered in the PDS Early Review and not at the PDS approval stage, which the CAO understands to be the practice at the time. As CAO understands it, the legal agreement ("Advisory Services Agreement") was signed with the client on November 13, 2009. The PDS Early Review was completed on November 11, 2009 and approved on November 17, 2009. The first documented contact with IFC's CES department was on November 12, 2009. The PDS Approval was completed and approved on December 14, 2009. IFC disclosed the project publicly on January 28, 2010.

3.2 IFC's E&S Due Diligence and Follow-up

The IFC Project Document Summary (PDS) Early Review of the KEK Advisory Services project and the Advisory Services PDS Approval (November 17, 2009, and December 14, 2009, respectively), identified several environmental and social (E&S) risks associated with the AS project:

- Environmental and Social reputational risks were identified with respect to the client. Specifically, weak environmental monitoring mechanisms in Kosovo were identified as a potential risk associated with the client. IFC stated it would work with other international finance institutions (IFIs) present in Kosovo to promote the development and application of environmental monitoring mechanisms.
- Environmental risks, as 80 percent of the electricity was generated from lignite (brown coal). However, as a positive impact of the privatization, IFC believed that the PSP would contribute to reducing the distribution losses and hence partly reduce the overall level of CO^2 emissions.
- KEK's distribution and supply services were identified as having high overstaffing. As layoffs were unavoidable for profitable operations to be achieved, the recommendations of the "Retrenchment Good Practice Guide" were to be utilized as mitigating measures.

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. The CES specialist's input was incorporated at the PDS Approval stage.

As part of IFC's due diligence, IFC contracted an external third party to carry out a review of environmental issues related to the distribution and supply services business of KEK. The report (February 2011) identified the following priority areas where it was believed that further surveys would be 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 (IFC AS E&S Memo dated September 7, 2011). The E&S Memo noted that the due diligence for this project commenced in February 2010, and also noted that, at the time, there were no formal procedures designed to carry out E&S risk assessments for AS. The process of designing formal procedures for AS started in October 2010, when a dedicated unit for AS projects was created by CES.

The E&S Memo reiterated concerns that had been highlighted in the PDS 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, identified the following risks/issues: needed reforms in the tariff methodology, a new market model, and investor feedback. In the fourth quarter of 2011, the AS supervision report noted the growing engagement by local Kosovar civil society organizations (CSOs) and NGOs that wished to be involved in evaluating the strategy for the privatization of KEK and the effect of this privatization on Kosovo.

3.3 Legal Agreement for IFC's Advisory Services Project

The legal agreement between IFC and the GoK required IFC to perform the following tasks:

Phase 1

- *Due Diligence*

Specifically, carry out due diligence on the legal/regulatory, technical/environmental, and financial/accounting issues related to the unbundling and the sale or concession of the electricity distribution and supply company.[14] Based on the findings and issues identified during the due diligence phase, IFC would make recommendations as to the separation of KEK distribution and supply activities; the transfer of assets, liabilities and employees; the organization and functions of the newly created company; the optimal transaction structure; and any other subjects, such as regulation, legal or competition, that could have a possible impact on the transaction structure and success. The agreement specifically mentioned that IFC would provide assistance in designing the best approach as to how to deal with surplus staff in order to mitigate social consequences that may arise as a result of any envisaged retrenchment plans.

Phase 2

- *Separation and incorporation of the distribution activities*

Specifically, IFC would evaluate the technical, financial, and legal feasibility of the new distribution company as an autonomous company and would recommend the optimal structure of the electricity distribution and supply sector in Kosovo; and the most suitable and timely allocation of assets and liabilities and transfer of contracts, agreements, obligations, and licenses to the newly created company

- *Preparation and structuring of the PSP transaction*

IFC would present and discuss with the GoK the main issues that needed to be addressed to ensure the optimal transaction structure that would fulfill GoK's privatization goals and attract a strategic investor in the electricity distribution and supply sector.

3.4 Overview of the Implementation of the AS Project

IFC completed the Key Issues Report in February 2010. It identified six issues important to the future of KEDS: Financial and Economic Balance of the electricity systems; Mitigating the Regulatory Risk; Special Customers; Distribution Losses and Revenue issues; Public Supply Obligations; and Legislative Issues. The risks associated with the allocation of personal and possible downsizing were included as part of other risks under the context of issues that needed attention and that were of a more procedural nature and/or whose implications would not require structural policy directions.

[14] The term distribution and supply does not refer to the generation of electricity, but to the activities that KEDS would undertake.

In June 2011 the government issued a call for Expressions of Interest in purchasing and operating KEDS. Five companies responded. In January 2011, prequalification documentation for tenders were published. Four companies responded in March 2011. Simultaneously, civil society groups in Kosovo first contacted IFC, raising their concerns with regard to the transparency of the privatization process. IFC engaged frequently with civil society over the following months, facilitating further disclosure of information on the project.

As noted, IFC retained a reputable international consultancy firm to prepare an Environment, Health and Safety Assessment of KEDS. This was completed in February 2011. At the time, KEK recognized that the practices of the distribution business were not in accordance with international standards.

At the time the privatization project commenced, beyond the overarching Sustainability Framework relating to all IFC business activities, there were no formal IFC procedures to carry out an E&S risk assessment for AS projects. A unit dedicated to AS projects was created in CES in October 2010. The Environmental, Health and Safety Assessment was presented to the CES AS unit on August 30, 2011 in their preparation of the due diligence E&S memo, which was completed on September 7, 2011. The E&S memo recommended that the project operate in accordance with IFC's general Environmental, Health and Safety Guidelines; implement a formal documented environmental, health, safety, and social management system for the project in accordance with the Performance Standard 1 requirement; and adopt and implement IFC's retrenchment guidance. Furthermore, the E&S memo recommended that an E&S baseline study be completed by the winning bidder, and that if any Performance Standards were triggered in the E&S study, the bidder should identify the specific issues and propose mitigation measures.

The draft Implementation Agreement was completed in January 2012. The agreement contained the requirements for the winning bidder to comply with IFC's Performance Standards and EHS Guidelines; undertake an E&S baseline study and at the date of completion of the bid to provide employment to all employees for a minimum period of three years. The final bids were received in May 2012. The winning bidder was announced in June 2012. During the final negotiations between the winning bidder and the GoK, the requirement in the legal agreement to explicitly comply with IFC's Performance Standards was changed to comply with the Equator Principles. The final legal agreement was signed on October 17, 2012.

4. CAO Audit Findings

CAO acknowledges the significant challenges related to this IFC advisory project, and the skill and effort that the IFC team has exercised in guiding its client when seeking to privatize the power distribution grid of the KEK.

IFC's Sustainability Framework, as outlined in the PSES, requires IFC to ensure "that the projects it finances are operated in a manner consistent with the requirements of the Performance Standards." However, the applicable ESRPs did not provide clear guidance as to how to incorporate the Performance Standards in an Advisory Service project. Furthermore, there were no formal procedures to carry out E&S risk assessments for AS projects. CAO finds that IFC's procedures were not prescriptive as to how IFC's sustainability agenda, or E&S requirements, should be applied when providing advice.

As pointed out in the CAO's compliance appraisal of this case, IFC's due diligence identified concerns related to the generation of power being distributed through the network and anticipated a significant decrease in the workforce. In addition, the IFC team responded during the execution of their project to the concerns regarding perceived lack of transparency on behalf of their client. Specifically, IFC engaged proactively with civil society organizations and NGOs in Kosovo.

IFC's definition of the scope of the project in terms of the privatization of the electricity distribution network supported the team in their decision to not let the power generation part of KEK overly influence their engagement and approach to the project. Hence, these broader potential impacts of the project were not considered in relation to the environmental and social review.

The power generation and the distribution network in this instance are exclusively and mutually dependent on each other. Further, the privatization of the distribution company has been argued to be a condition for new power generation to proceed.[15] In this context, the CAO finds that a more expansive consideration of the project's risks and impacts would have been appropriate particularly in consideration of the World Bank's involvement in power generation projects in Kosovo. Such an approach would have led IFC to engage with the otherwise unanalyzed reputational risk that existed due to the association of the project with the nature of power generation in Kosovo.

IFC's ToR for this project specified that IFC was tasked with identifying surplus staff and designing the best approach on how to deal with such staff in order to mitigate social consequences that may arise as a result of any envisaged retrenchment plans. As the project developed, KEDS was established as a shell in August 2009, to be populated by assets, including the workforce, once the selected buyer was known. The ToR specified that IFC guidance was needed to ensure that the process of dealing with surplus staff and unbundling staff was consistent with the social policy directives of the World Bank. However, this process was guided by another advisor. Consequently, IFC perceived the scope of its advice in terms

[15] CAO notes a June 28, 2010 presentation by the U.S. Agency for International Development (USAID), where it was highlighted "Without the Distribution Company privatization new power generation project might be more expensive … and may not proceed at all."

of labor issues as limited to matters concerning KEK staff who were previously identified as working on distribution and supply services that would be unbundled to KEDS.[16]

This removed IFC's involvement in providing guidance for the earlier identified challenges related to dealing with high overstaffing as regards the distribution company. The CAO's audit did not disclose any evidence of IFC going beyond normal communication in assuring itself that the management of staff within the distribution company was, or will be, consistent with IFC's requirements and guidelines.

IFC's formal leverage with its client is limited in all instances where specific requirements or conditions have not been built into agreements before signing the legal documentation. When providing Advisory Services under the current IFC approach, the client is free to take on board IFC's advice or discard it. In this case, there was no requirement of the client to accept IFC's advice, and no evidence in the Advisory Services legal documentation between IFC and the client to incorporate more substantiated covenants in the final sale purchase/implementation agreements regarding incorporation of IFC's sustainability agenda. Accordingly, the CAO finds that IFC was mainly leaning on informal leverage when advising the client on issues like transparency and sustainability.

The outcomes on the ground as regard environmental and social issues related to IFC's advisory project are that the client has ensured that the entity operating the grid will not lay off staff from KEDS for a period of three years, and that the client required the entity to adhere to the Equator Principles and the related technical guidance. The reason the client referred to the Equator Principles and not the IFC PS was, according to IFC, the concern that referring to provisions owned by one specific potential financier would send a message that the client was biased toward accepting financing from IFC, compared to other potential financiers.

CAO finds that IFC did not have any structured approach to assess the commitment or capacity of the client to implement IFC's sustainability agenda, and thus had no way of assessing the likelihood that the informal leverage would be sufficient in ensuring adoption of IFC's Performance Standards.

CAO finds that no formal conditions were applied in order to enforce adoption of IFC's sustainability agenda by IFC's AS client.

[16] However, CAO notes the USAID *Assessment of KEK Progress Towards Privatization* (April 2009), which highlighted that identifying staff for KEDS business support units had yet to be decided.

5. CAO Audit Conclusions

Conclusions related to Project # 29107

With an exception regarding the sequencing of some internal IFC documentation, CAO finds IFC to be in material compliance with the procedures applicable at the time. CAO acknowledges the significant challenges that faced the IFC team, and the skills and resources needed and allocated to complete the engagement.

Whether or not the specific task turned out to be more limited in scope than first anticipated, CAO considers that IFC did not address the issues related to labor force in KEDS as spelled out in its initial scope.

CAO considers that if IFC had to a greater extent contextual assessed the environmental and social implications of power generation facilities in the scope of the Advisory Services project, it might have provided greater clarity to external stakeholders regarding IFC's scope.

These shortcomings do not constitute a breach of the applicable IFC procedures, mainly because the procedures applicable at the time were not prescriptive. However, it leads CAO to raise concerns of the effectiveness of IFC's E&S requirements and IFC Sustainability Framework when applied to IFC's Advisory Services.

Conclusions related to IFC's Sustainability Framework and Procedures

IFC's 2012 Sustainability Framework states that all advice given by IFC will be consistent with the Performance Standards, and that the Performance Standards help IFC's advisory clients manage and improve their environmental and social performance.

The 2006 & 2012 Sustainability Framework commits IFC to seek positive development outcomes in its activities. However, there is no structured approach on how to assess the commitment of an Advisory Services client and the likelihood that they will take on IFC's sustainability agenda. It is ultimately at the discretion of the client to take on board IFC's advice or to disregard it.

CAO concludes that due to IFC's lack of formal leverage, and absence of structured assessments of its "informal" leverage, when providing Advisory Services to a client, IFC is unable to assure itself beforehand to what degree it is likely that its engagement will lead to improved environmental and social outcomes, or meet its policy commitment to "do no harm."[17]

[17] Specifically; "Central to IFC's development mission are its efforts to carry out investment and advisory activities with the intent to "do no harm" to people and the environment, to enhance the sustainability of private sector operations and the markets they work in, and to achieve positive development outcomes". IFC (2012) *Policy on Environmental and Social Sustainability*.
http://www1.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+Sustainability/Sustainability+Framework/Sustainability+Framework+-+2012/#SustainabilityPolicy (Accessed February 12, 2013)