

THE WORLD BANK/IFC/M.I.G.A.

OFFICE MEMORANDUM

DATE: March 15, 2013

TO: Ms. Meg Taylor, Compliance Advisor Ombudsman, CCAVP

FROM: Laurence Carter, Director, C3P

THROUGH: William Bulmer, Director, CESDR

EXTENSION: 38628

SUBJECT: Final IFC Management Response to CAO's Audit Report of IFC Advisory Services Project with the Korporata Energjetike e Kosovës (KEK), Kosovo

IFC Management thanks the Compliance Advisor Ombudsman (CAO) for its February 22, 2013 audit report of IFC Advisory Services project with the Government of Kosovo (GoK) for the privatization of the distribution and supply businesses (KEDS) of Korporata Energjetike e Kosovës (KEK), Kosovo, and is pleased to provide herewith its response.

IFC Management welcomes CAO's efforts to strengthen the environmental and social sustainability of IFC advisory services (AS) projects.

CAO's audit conclusions related to the project

IFC Management notes CAO's audit conclusion that IFC has been in material compliance with the policies and procedures applicable at the time the project was undertaken. IFC Management appreciates CAO's acknowledgment of the significant challenges that the IFC project team faced, and the skills and resources needed to complete this engagement.

IFC Management would also like to highlight that the project team exceeded the requirements of the policies and procedures in effect at the time of the mandate, in committing IFC to address future potential adverse environmental or social (E&S) consequences of the project, if any. More specifically, and as indicated in the CAO's conclusions, IFC leveraged its expertise in a *de facto* manner by guiding its client, the GoK, not only to abide by all relevant E&S policies, but to contractually require the selected future private owner of KEDS to abide by the same relevant E&S policies.

Throughout all project stages IFC staff assessed possible E&S risks, informed relevant parties of their existence, and guided the client in avoiding or minimizing adverse E&S consequences. The result of this approach is demonstrated by the fact that IFC's E&S requirements were incorporated in the tendering documents (via the Equator Principles) and in the final contract between the GoK and the winning bidder (a binding contract designed as a result of IFC's explicit guidance).

Finally, the project record demonstrates that IFC guided the client to adopt relevant E&S standards and, as such, followed its policy commitment to "do no harm".

Additional IFC Management comments with respect to the audit findings and conclusions can be found in Annex 1.

CAO's audit conclusions related to IFC's Sustainability Framework and Procedures

IFC Management notes CAO's audit conclusions that there is no structured approach for assessing the commitment of an AS client to adopt relevant aspects of IFC's sustainability agenda, and that it is ultimately the discretion of the client to take IFC's advice or to disregard it. Management further notes CAO's conclusion that, in the absence of IFC's formal leverage and absence of structured assessments of its "informal" leverage, when providing AS to a client, IFC is unable to assure itself beforehand of the degree to which the engagement will lead to improved E&S social outcomes, or will meet its policy commitment to "do no harm".

As noted in the CAO audit, when the mandate for this project was signed on November 13, 2009, there were few E&S requirements applicable to AS in the 2006 Sustainability Policy in effect at the time.¹

However, subsequent to the 2006 Sustainability Policy, IFC Management recognized the importance of adopting a more systematic approach to sustainability matters when evaluating AS projects, and the need to extend the Sustainability Policy to AS engagements with significant E&S issues, taking into account the nature of the relationship with AS clients, especially those in the public sector. In preparation for adopting the revised Sustainability Framework (comprising IFC's Policy and Performance Standards on Environmental and Social Sustainability and IFC's Access to Information Policy) which entered into effect as of January 1, 2012, IFC Management implemented organizational and procedural changes during 2010-2011 to facilitate application of these policies to all AS projects. These changes enabled IFC to integrate E&S sustainability considerations into the decision-making process for AS projects.

As part of a continual improvement process, IFC has amended its standard client engagement documentation for AS to provide for consistency with the 2012 Sustainability Framework. The revised Financial Advisory Services Agreement (FASA) template used for PPP advisory projects incorporates a clause stating that IFC will advise clients in a manner consistent with that Framework. The template includes a covenant giving IFC the right to terminate the FASA in the event the client breaches any of its obligations in such agreement or if IFC determines that it is not able to continue advising the Client in connection with the Project in a manner that is materially consistent with the Sustainability Policy.

It is in this manner that IFC Management is at present explicitly exercising formal leverage with its AS clients to encourage compliance with the Sustainability Policy. Notwithstanding this, there is no guarantee in an AS mandate of this nature that IFC's client will enforce the adoption of IFC's PS by the winning bidder over the life of the concession, as IFC's contractual relationship with a client government typically ends once the concession is awarded.

¹ See paragraph 30 of IFC's *Policy on Social and Environmental Sustainability* dated April 30, 2006.

Additional IFC Management comments on CAO Audit Findings and Conclusions

1. CAO findings on applicable IFC Procedures

IFC Management notes the CAO's audit conclusion that shortcomings on how IFC addressed various issues do not constitute a breach of the applicable IFC procedures, mainly because the procedures applicable at the time were not prescriptive.

It is true that when the mandate for this project was signed on November 13, 2009, there were very few E&S requirements applicable to AS in the 2006 Sustainability Policy in effect at the time; the 2006 Policy only required that the IFC Performance Standards (PS) be used as reference in AS projects, in addition to national laws. Despite not being required to do so, however, the project team incorporated the 2012 Sustainability Policy into the project; as a result, the future private owner of KEDS is contractually obliged to comply with the Equator Principles.

This outcome demonstrates how IFC used its informal leverage to guide its client and other relevant parties in a manner consistent with the Sustainability Framework. As noted above, there is no guarantee that IFC's client will enforce the adoption of IFC's PS with the winning bidder given that IFC's contractual relationship with a client government typically ends once the concession is awarded.

The AS situation is fundamentally different from an IFC investment project, where IFC has a direct and ongoing contractual relationship with the project developer during the life of the investment and has various contractual remedies that can be exercised to ensure compliance with E&S requirements, including defining the borrower's failure to comply with E&S covenants as an event of default.

2. CAO findings related to the E&S implications of power generation facilities in the scope of an AS project

The audit findings note that "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 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 E&S review".

IFC Management would like to clarify that IFC was hired by the GoK only to assist with the privatization of KEK's distribution network, one of the three business units of KEK that include: (i) mining; (ii) power generation; and (iii) supply and distribution. IFC was not hired to assist with the privatization of KEK as a whole, i.e. all three units. Thus all issues pertaining to the mining and power generation business units of KEK fell outside of IFC's AS mandate.

Furthermore, matters related to power generation, within the context of the sale of the electricity distribution business, were not material to the mandate for several reasons, including:

- (i) The power generation was operational at the time of the mandate and as such the type of ownership of KEDS (public or private) had no influence on the type and source of electricity or any matters related to the power generation business unit; and

- (ii) The objective of the privatization of the electricity distribution network was primarily to address under-performance and failures of operational and commercial nature. The achievement of such objectives is independent of how the electricity is generated.

3. CAO findings related to the dependence of the power generation and distribution businesses

IFC Management notes but respectfully differs with CAO's audit findings that the power generation and the distribution network are dependent on each other, for the following reasons:

- (i) The electricity distribution network and organization of the operations of such network, which links the grid's dwellings and businesses, are not dependent on the type of electricity source.
- (ii) The power generation already existed at the time of the privatization. The sale of the distribution network thus had no impact on the type of the existing generation.

IFC Management notes but also differs with the CAO's audit finding that the new generation project is dependent on the privatization of KEDS as there is no demonstrated economic rationale for the KEDS privatization to be successful as a condition for the success of the new generation project.

As further evidence of the above, we note that when IFC was mandated to privatize KEDS in November 2009, the GoK had already engaged a transaction advisor (PWC) to complete the new generation project (GenCo). At the end of 2010, when IFC was still in the process of identifying the pre-requisites for a successful privatization of KEDS, the GenCo tender had been launched and four companies had been pre-qualified. The reasons why this project was not completed prior to the KEDS privatization was related to funding, processes and transaction structure issues wholly unrelated to KEDS.

(i) CAO findings related to overstaffing

IFC Management notes CAO's comments related to the labor force and stresses that IFC applied policies and procedures beyond the requirements then in effect, in a commitment to address any future potential adverse effects of the privatization.

IFC Management also stresses that the issue of overstaffing may have pertained to KEK as a whole and not specifically to the distribution business. Moreover, there was little indication to substantiate the claim that the KEDS business unit was overstaffed. Irrespective of this, IFC nonetheless advised the GoK on mitigation measures to manage potential future retrenchment, in the event such issues arose in the future as a result of the privatization. Specifically, the privatization includes a mechanism to secure the positions of the employees for at least three years. Despite the absence of evidence of specific retrenchment matters within KEDS, IFC recommended to the GoK the inclusion of a commitment to be met by the future private owner of KEDS to follow IFC Performance Standard 2 dealing with the workforce.