

**ENERGY CHARTER
SECRETARIAT**

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Related documents: CC 514, Mess 1214/15

DECISION OF THE ENERGY CHARTER CONFERENCE

Subject: Adoption by written procedure of the Policy Conclusions and Recommendations of the In-depth Review on Investment Climate and Market Structure (ICMS) in the Energy Sector of Latvia

By CC document 514, dated 27 April 2015, delegations were invited to approve the Policy Conclusions and Recommendations of the In-depth Review on Investment Climate and Market Structure (ICMS) in the Energy Sector of Latvia. As specified by Rule 20 of the Rules of Procedure (CC 53 corr. 2) concerning the adoption of decisions by correspondence, members of the Energy Charter Conference were informed that any delegation that wished to object to this proposal should notify the Secretariat of its position in writing not later than 15 May 2015. The executive summary of the In-depth ICMS Review of Latvia is attached.

Having received no objections within the specified time limit (as confirmed by Message 1214/15), on 15 May 2013 the Energy Charter Conference

Welcomed the In-depth ICMS Review of Latvia and

Endorsed the recommendations made to the Government of Latvia.

Keywords: In-depth review, Investment Climate, Market Structure, Investment Group, Latvia

In-depth ICMS Review of Latvia

Executive summary

Investment climate

Latvia has a favourable geographical position which is a strategic location for business operations targeting developed economies of the EU and emerging markets of eastern neighbours. Following a slowdown in 2014, Latvia's economic growth is expected¹ to pick up again in 2015 and 2016 despite a multitude of external shocks, which are rebalancing the country's growth towards domestic demand.

The country has consistently pursued liberal economic policies and reforms to improve business climate. The reforms in Latvia have strengthened the private sector, created macroeconomic conditions favourable for growth and helped to improve the business environment, thus attracting the attention of international investors. The stock of inward Foreign Direct Investments (FDI) reached almost 50% of the gross domestic product (GDP). However, the energy sector attracted only 4% of FDI in 2014 and the full investment potential yet to be realised in the context of ongoing liberalisation of electricity sector, opening of natural gas sector by 2017 and opportunities to utilise renewable energy potential of Latvia.

Latvia is ranked² 23rd among 189 countries and 9th among the EU member states in the ease of doing business. The World Bank has recognized Latvia to be one of the top 30 leaders that have implemented major reforms to improve the business environment in more than three areas over the past two years.

This review confirms that the investment climate in Latvia has considerably improved over the last years but some challenges needs to be addressed. According to the Global Competitiveness Index 2014³, efficiency of legal system to settle disputes of Latvia is poorly ranked as 116 out of 144 economies while the country general ranking is positive and ranked 42. It should be also noted that the government of Latvia experienced investment arbitration under the Energy Charter Treaty (ECT) in the past. Currently there are number of disputes that are filed by energy investors at local courts, one ongoing arbitration case under the ECT and potentially there could be more disputes especially in the renewable energy sector.

¹ The EC, Economic forecast Latvia, http://ec.europa.eu/economy_finance/publications/european_economy/forecasts/index_en.htm, Accessed on 24 February 2015

² World Bank, Doing Business 2015 report. More details available at <http://www.doingbusiness.org/data/exploreeconomies/latvia>

³ http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2014-15.pdf, Accessed on 25/02/2015

On a positive side it should be noted that the Latvian government established Investment and Development Agency of Latvia (LIAA) that implements the POLARIS process⁴ which is a national strategy enabling communication, cooperation and execution of tasks among stakeholders in the industry, as well as by government and academics. The Latvian government meets annually with the Foreign Investors Council in Latvia (FICIL), which represents large foreign companies and chambers of commerce, with an aim to improve the business environment and encourage foreign investment. In August 2010 the government also established the Coordination Council for Large and Strategically Important Investment Projects, chaired by the Prime Minister.

Conclusions and Recommendations on Investment Climate

- Latvia has undertaken substantive business reforms and significantly improved the investment climate over the last decade;
- The government is encouraged to continue the reforms in attracting FDIs and green field investments that contribute to economic development, job creation and technology transfer;
- The Foreign Investment Council of Latvia undertakes an important role in advising the government on how to strengthen the investment climate;
- The Latvian Investment and Development Agency plays an important role in facilitating investments and it is advisable to enlarge the POLARIS programme towards more investments in the energy sector;
- It is welcomed that the government has improved transparency, including stakeholders in decision making process in relation to major legislation;
- it is noted that Latvia provides national treatment (NT) regime to foreign investors but has one exception to the NT in terms of access to land.
- The government of Latvia should continue efforts to ensure a “level playing field” for energy sector investments with the aim of reducing to a minimum the non-commercial risks which is a fundamental objective of the Energy Charter Treaty;
- It is advised that efficiency in the domestic legal system for settling disputes be improved;
- In order to address current and potential disputes the government is advised to apply mediation and conciliation schemes in the energy sector which could be assisted by the Energy Charter Secretariat; and
- The level of required investments in the energy sector is significant thus the government should consider where possible more widespread use of a public-private partnership in improving the infrastructure.

⁴ More information available at <http://www.liaa.gov.lv> Accessed on 23/02/2015.

Energy Markets

The energy security of Latvia continues to be a key concern at a political level because the country remains largely isolated from EU energy networks and is highly dependent on Russian gas. Latvia has its Energy Strategy 2030, in force since March 2013, that sets long-term actions to ensure energy supply, competitiveness, energy efficiency and the use of renewable energy. Mid term energy priorities are described in the government's Energy Development Guidelines for 2007-2016. The main focus of the guidelines lies on hydropower which is the largest source of Latvia's domestic electricity generation. Currently the government is working on finalisation of new guidelines for the energy sector. The Public Utilities Commission (PUC) or the Regulator is institutionally and functionally independent and carries out regulation of public services including the energy sector.

Natural Gas

The Latvian natural gas supply system is not connected to the other EU Member States, with the exception of Lithuania and Estonia . Almost all natural gas in Latvia is supplied by Russia. Latvia received a derogation in the framework of the European Union's Third Energy Package under the criteria of being an “isolated market” in the gas sector. The gas market is dominated by one single vertically-integrated company - JSC “Latvijas Gāze”, which provides natural gas supply, storage, transmission, distribution and trading.

The new amendments to the Energy Law, adopted in March 2014, envisage a gradual opening of the natural gas market by April 2017. The government's ambition is to liberalise the natural gas market in Latvia, thereby encouraging alternative supplies and competition. The country already has access to an LNG terminal in Lithuania, which however is modest in terms of potential supply. Increasing competition on the supply side is in line with the EU's third energy package, which stipulates the effective separation of supply and production activities from network operations.

In 2015, the Regulator launched public consultation on the draft rules of access and use of the natural gas transmission system and the use of underground gas storage. The concept note on gas sector unbundling, which is currently under preparation by the government should provide the necessary information for investors regarding the upcoming changes.

Conclusions and Recommendations on Natural Gas Sector

- Latvia is mainly dependent on one gas supplier country however it has high security of supply due to good interconnections and UGS facility;
- Latvia has recently received access to an LNG terminal located in Lithuania and provides some gas storage services to it at the UGS facility.
- It is noted that privatization of state owned gas enterprise successfully attracted a significant number of foreign investments which resulted in improved reliability and safety of the gas system in Latvia;

- It is noted that the gas sector is partially liberalised and full unbundling will take place from 2017;
- The government is invited to ensure proper consultation and planning concerning the opening gas market from 2017. Adoption of the Gas Law would be an important step towards developing gas market legislation as well as improving competition;
- The existing Underground Gas Storage (UGS) facility plays a critical role in ensuring security of supply in Latvia, as well as the whole region, and is an integral part of the gas transportation system; and
- It is advisable to consider UGS and main gas transportation systems to be merged into one Transmission System operator (TSO) company after opening the gas markets in 2017.

Electricity

The electricity market liberalisation in Latvia has been fully implemented since 1 January 2015, introducing free competition in the electricity sector. In Latvia, supply of electricity can be divided into three main stages: electricity production and wholesale; electricity transmission and distribution and electricity retail trade. Generation of electricity is dominated by state owned JSC "Latvenergo" but there are also many local electricity production companies. In addition, electricity is imported from other countries.

In 2013, Latvia started the operation of the power exchange by opening a new "Elsport" bidding area, which has connected Latvia to the Nordic electricity market. It is expected that greater integration with the Nordic electricity market will result in reduced wholesale electricity price in Latvia. It is not excluded that electricity prices might increase in response to market changes, and it is therefore important that the government approved a compensation mechanism for low-income households as well as households with three or more children, that will help to reduce energy poverty in the country.

Access by third parties to interconnected electricity transmission and distribution systems is ensured in Latvia. The small distribution network operators, a total of 11, are connected to both high-voltage grid and JSC "Sadales tīkls" grid. In 2013, the Regulator approved the updated Grid Code to coordinate cooperation of all market participants. The new Grid Code regulates activities and services of the transmission system and distribution system operators for stable operation of the electricity system, as well as obligations of all market participants⁵.

As a long term project, Latvia actively participates in the "Roadmap towards the Baltic States power system synchronisation with Continental Europe network" ("CEN") that was adopted in 2014. Furthermore, the "Declaration on Energy Security of Supply of the Baltic States" was recently signed by the Baltic Energy Ministers in January 2015.

⁵⁵ The Public Utilities Commission of Latvia. Annual report 2013.

Conclusions and Recommendations on Electricity Sector

- The government is encouraged to complete guidelines for the energy sector that will provide strategic orientation for the industry and investors;
- It is welcomed that the government completed liberalisation of the electricity sector and introduced a new support scheme for access to electricity by more vulnerable parts of the population and/such as families with three children;
- It is welcomed that the government introduced a system which allows large customers to construct required energy infrastructure and receive the investment back through reduced tariffs over a five-year period;
- It is noted that the electricity sector is fully unbundled from the beginning of 2015 and customers can now fully benefit on price and services by choosing preferred suppliers;
- It is recommended to improve procedures and reduce time to realise final customer electricity interconnection; and
- Further promote use of smart meters that would allow to take full advantage of day and night tariffs.

Renewable Energy

The share of renewable energy sources (RES) has traditionally been significant in Latvia's energy supply. Comparing EU member states, Latvia has the second highest share of renewable energy in its gross final energy consumption. In 2012, renewable energy accounted for 35.8% of the whole share of energy consumption in Latvia, approximately three times the EU-27 average. RES energy composed more than half of the total electricity consumption (52.3%) in 2013. It shall be noted that a significant share of renewable energy in the energy mix is owed to a high share of hydroelectric power for electricity generation. Latvia has great potential to further develop biomass, wind, solar and geothermal energy sources.

In order to promote RES and co-generation electricity productions Latvia adopted a mandatory procurement of electricity (feed-in tariff) and a guaranteed payment for installed capacity. The support scheme covered combined heat and power (CHP) plants of high efficiency and producers using renewable energy sources. The support schemes attracted many local and international investors. However, as of May 2011, the government introduced a moratorium on new power capacity until end of 2015 and such rights are no longer issued. It is reported that investors were not properly consulted prior to introduction of the moratorium and it is possible that the moratorium will be extended beyond the 2015. The confidence of investors in the Latvian investment environment was substantially affected, and it is reported that local financial institutions are limiting access to finance for renewable energy projects due to uncertainties of the support scheme.

Another grave problem that has been reported is the distribution of costs. The costs of grid connection currently rests on the plant operators, including the costs for the grid reinforcement. An exemption from this rule shall apply only if there is a specific agreement between the grid operator and the plant producer⁶.

Conclusions and Recommendations on RES

- Latvia has set clear goals in order to reach the 40 percent target by 2020 in renewable energy in the prime energy mix;
- It is noted that the government introduced a moratorium on mandatory purchases of new power capacity (until end of 2015) that could be extended. The government is advised to start consultation on adoption of a new support (capacity bidding) scheme that is more market oriented;
- The government is advised to balance interests of renewable and cogeneration heat and power (CHP) producers in relation to existing and future support schemes;
- Consider new regulation to provide for connection of RES projects to the power grid on a priority basis;
- It is advised to promote new and innovative financial schemes for the RES sector and promoting energy efficiency;
- It is advised to continue development of energy policy that would allow promotion of different technologies including biomass, wind, solar, geothermal which are the most important indigenous resources;
- Promote awareness and education about potential benefits of renewable energies among investors and the general population.

Heating sector

In Latvia the average length of the heating season is up to 200-210 days in the year. About 70% of households are connected to the heating grid, consuming 39% of prime energy resources. Municipalities are main shareholders of the district heating companies. In most cases the heating companies are vertically integrated with responsibilities to produce, transmit and sale heat to customers. JSC Rigas Siltums is the main heat supplier of Riga, which is engaged in production, distribution and sale of thermal energy, and also ensures technical maintenance of inner heat supply systems in buildings.

In Latvia, the CHP that utilise natural gas and heating boilers based on wood chips play an increasing important role in the heating sector of Latvia. Operation of CHP plants have been affected by the moratorium that was described above. In addition, it should be noted that in 2012, the Cabinet of Ministers shortened the mandatory procurement term for existing producers. Currently mandatory procurement for CHP plants, with installed

⁶ Keep on truck project. National Report Latvia, Prepared by eclareon 2014.

capacity of up to 4 MW, is available for a period of 10 years, and for CHP above 4 MW for a period of 15 years.

Conclusions and Recommendation on Heating Sector

- The heating sector plays an important role in the energy sector of Latvia;
- The heating sector is largely owned by local municipalities. It is recommended to investigate how the private sector could contribute more strongly in developing and upgrading the massive infrastructure of the heating sector;
- Consider how small scale CHP and local heat boilers that utilise wood chips and other RES could be supported in the framework of new support scheme to be developed;
- It is noted that biomass and wood chips in particular play an important role as local fuel in heating boilers. It is important to facilitate the use of modern technologies that have high standards in terms of emissions from heat boilers;
- Introduction of individual heat meters could be considered in direction of cost control for end-users; and
- There is a need to promote energy efficiency investments, in order to reduce losses in the distribution and to upgrade production, the government is encouraged to carry out with the Energy Charter Secretariat a comprehensive review of its energy efficiency policies.

Regional cooperation

The energy markets of Latvia, Estonia and Lithuania lack adequate connections, both between themselves and to other parts of the EU. This lack of integration drives up energy prices for consumers and lowers energy security in the region. The Baltic Energy Market Interconnection Plan (BEMIP) aims to solve this by creating a fully functioning and integrated energy market in the region, supported by the necessary infrastructure. BEMIP projects are part of the European Economic Recovery Plan (EERP) which means that they have been eligible for over half a billion euros in funding. Projects can further be funded through the European Regional Development Fund, the EU's Cohesion Fund, and, as projects of common interest, through the Connecting Europe Facility⁷.

In order to achieve the goal of secure, competitive and sustainable energy the Baltic states should cooperate with developed and developing countries, be they producers, transit countries or consumers. The Energy Charter Treaty establishes a framework for international cooperation between European countries and other industrialised countries with the aim of developing the energy potential of central and Eastern European countries and of ensuring security of energy supply for the European Union. The multilateral platform of the Energy Charter may be actively used by Latvia and other Baltic states to promote regional and international cooperation in promoting global energy security.

⁷ <http://ec.europa.eu/energy/en/topics/infrastructure/baltic-energy-market-interconnection-plan>. Accessed on 25 February 2015

Conclusions and Recommendation on Regional Cooperation

- Implementation of the EU projects of common interest in electricity and gas interconnections in the region will further increase the security of supply to Latvia and the entire region; and
- Latvia shall actively participate in and benefit from various support schemes provided by the European Union to improve the regional infrastructure and energy interconnectivity in the Baltic region; and
- Latvia has already achieved greater security of electricity supply through participation in the Nord Pool spot electricity market;
- More considerations and planning shall be undertaken towards the synchronous interconnection of the Baltic States with the European network as a long term regional project; and
- It is advised to continue and strengthen beneficial regional cooperation in the framework of the Energy Charter, BEMIP and other appropriate fora.