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Position Paper No. 2

Position Paper on Energy Sector Policy

1. Executive Summary

Foreign Investors' Council in Latvia (FICIL), representing both energy users and producers and supporting improvements in the business environment and investment climate in Latvia, is closely following recent developments in the energy sector.

The energy sector provides the basic infrastructure and resources for the national economy and has attracted substantial investment in recent years. The sector currently faces a number of challenges, among these being policy planning for the next EU planning period, increasing risks of electricity price rise, the review of renewable energy support, and the debate over gas market liberalisation.

Taking into consideration plans to review support for renewable energy, FICIL encourages the government to follow best practices of setting public policy by conducting a thorough analysis of the future role of renewable energy in the country's energy mix, the investment cost of required renewable energy generation capacities, and appropriate support levels to promote this investment.

It is important to ensure that the competitiveness of Latvia's industrial investment is not endangered and that the environment for attracting future investment to the country's industrial base is not jeopardized. The cost of renewable energy subsidy to businesses and consumers needs to be properly assessed. Furthermore, subsidies should either be reduced or redistributed in order to effectively balance the economic burden and to guarantee that there is no disproportionate impact on a particular sector.

The energy sector policy should be linked to the objectives of the National Development Plan and support the achievement of these goals.

More attention should be paid to the quality of service and the effectiveness of natural monopolies. Clear benchmarks measuring effectiveness of the natural monopolies should be introduced.

Recognising the complexity of the tasks associated with the changes in the energy sector, it is important to take a fixed amount of time to conduct the analysis needed, evaluate different options, and enter into an open dialogue with the relevant stakeholder groups representing both energy producers and energy consumers. The government should use a fixed amount of time as it is also vital to implement policy changes since on-going uncertainty is harmful to the investment climate of the country.

2. Recommendations

2.1. General energy sector policy-related topics (long-term development)

The first set of FICIL's recommendations relate to long-term policy development issues. In this position paper, FICIL draws attention to the most salient topics that should be addressed – the need for a energy strategy based on rigorous analysis, the need for a more active Public Utility Commission, as well as the necessity of addressing effectiveness and other issues pertaining to natural monopolies.

2.1.1. Strategy planning and key challenges

The latest version of the Energy Strategy, “*Latvijas Enerģētikas ilgtermiņa stratēģija 2030 – konkurētspējīga enerģētika sabiedrībai (27.09.2012)*”, (the Energy Strategy) provides an overview of the Energy Strategy for the sector. However, a more comprehensive discussion and justification is needed in order to support the aims and activities described in the Energy Strategy.

In order to ensure that the Energy Strategy tackles the most relevant issues as effectively as possible, FICIL proposes the following improvements in the Energy Strategy:

- To assess the priority aims of the Energy Strategy, and evaluate the feasibility of achieving these aims;
- To include aims and activities related to all energy sub-sectors (i.e. market considerations, production, transmission and distribution of electricity, gas and heat);
- To align with the target of reaching a 50% share of energy production from renewable energy sources (RES) in terms of gross final consumption of energy, in agreement with the EU strategy ‘Europe 2020’. i.e. the Energy Strategy should set this target at the EU specified level of 40%.
- To link the aims of the Energy Strategy with the National Development Plan (NAP);
- To set transparency as one of the main principles of the Energy Strategy;
- To provide comprehensive justification for the aims and key performance indicators (KPIs) of the Energy Strategy, as well as to link the aims with specific financial resources and a concrete timeframe;
- To take into account the obligations pertaining to the Energy Efficiency Directive and integrate these obligations into the Energy Strategy.
- Regarding the use of RES in transport industry, to focus not only on the production of biofuels, but also to promote consumption of biofuels. It would be possible to increase the biofuel addition to fossil fuel and comply with the RED in traffic in Latvia by 2020 if other alternative renewable fuels besides RME (Rapeseed Methyl Ester) would be evaluated.

2.1.2. Role of the Public Utility Commission (PUC)

The PUC should take a more proactive role in driving progress within the regulated markets

and industries that it is responsible for. The PUC should not only focus on tariff calculation methodologies, but should also take active participation in regulatory policy development.

2.1.3. Natural monopolies

In order to improve the quality of service and the effectiveness of natural monopolies:

- Effectiveness targets for performance should be defined in a way that offsets tariff increases (for example - every year the distribution system operators' (DSO) and transmission system operators' (TSO) tariffs both in electricity and gas should decrease by 3%);
- The improvements measured by the System Average Interruption Duration Index (SAIDI) and the System Average Interruption Frequency Index (SAIFI) should be set as a targets for the DSO;
- In addition to the losses measured by district heating distribution operators, electricity TSO network losses should also be benchmarked and goals should be set for diminishing these losses.

Governmental decisions aimed at full implementation of the Third Energy Package for an internal EU gas market should be based on the following principles:

- Political and administrative decisions should ensure the effective functioning of the natural gas market in Latvia, thus benefitting the end consumers of natural gas;
- The implementation of the Third Energy Package should be based on reliable estimates of the effects of natural gas tariffs for end consumers in the future;
- Liberalisation of the gas market and increased competition is, in the long-term, the only recourse to the increasing prices on the Latvian gas market, when there is no leverage for negotiating prices with suppliers.

2.2. Energy sector issues requiring short-term actions

- A level playing field must be ensured;
- The Government must provide a reliable and thorough calculation of the actual cost effects on the final electricity price of any restrictive measures to be imposed on support for renewable energy projects under different stages of the project cycle;
- In the context of Latvia and its current economic situation, an assessment should be made as to what level of green energy production is currently subsidized and what level of future investment should be supported. Latvia should aim to comply with the EU Renewable Energy Directive but not to surpass it, unless there is a solid commercial case for doing so;
- The weight of the mandatory procurement component (OIK) in the consumer's electricity bill needs to be assessed in order to ensure that the interests of existing investors are protected, and that electricity is cost competitive for industrial electricity consumers and for households. This is especially relevant considering the lower electricity prices for industrial consumers in the Baltic Sea region.

2.2.1. Approach to electricity support allocation and potential changes

Renewable energy projects are on different stages of implementation, and restrictive regulations, if and when they are adopted, should consider the status or progress of implementation of each project.

(A) With respect to executed projects (both constructed and in operation):

- Further price increases due to formulas that have gas price as a variable should be avoided;
- Gas price ceilings in legislative acts should be set either in a fixed way or by applying a floating average for a time period that includes the most recent years.;
- All restrictive measures if adopted, should be well-balanced, and should take into account actual investments made, in order to ensure a reasonable level of return on investments in case of termination of support;
- The PUC should set/revise tariffs (similar to the municipal heating structure) thus ensuring a reasonable return for investors and reasonable tariffs for consumers.

(B) With respect to projects which have been granted a licence but are not yet in operation:

- A thorough review of the current status of the projects and their compliance with licensing regulations needs to be conducted, to ensure that projects with questionable eligibility for support are not supported; utilisation of heat and generating capacity are the main issues of concern.

(C) With respect to possible support schemes starting from 2016:

- Any future support should be clearly justified by providing clear examples of the reasoning behind it, and it should be clearly communicated to both society and potential investors;
- Any future support should be provided via EU funds, tax reliefs, or through extra CO2 emission allocations, thus having little or no impact on end-user electricity costs;
- No duplication of support should occur during the implementation of projects;
- Strict monitoring and control of the time limits for project implementation should be undertaken by the responsible state authorities.

(D) With respect to the state-owned enterprises that receive support from both OIK and power-generating capacity payments:

- The support should be reviewed in the context of receiving double support. This takes the form of a mandatory electricity purchase (OIK), which is a support payment by all electricity consumers, and payments for installed power-generating capacity, which is a support payment by the State. Assessment should be made of the feasibility of opting for just one type of support and restructuring its origin (capacity payments should normally be handled by the TSO);
- Currently the State-owned energy producer's profits from both consumer and support. Since dividends from the State owned energy producer are paid into the state budget the consumer OIK subsidies resemble a form of undeclared tax on consumers. It is important to allow the State owned energy producer to develop capital expenditure budgets in order to allow the producer to invest in infrastructure and to dedicate retained earnings to this rather than distributing the profit to shareholders to subsidise the State budget.

2.2.2. Financing OIK support

In order to finance OIK support:

- Alternative sources of financing should be used to partly cover the financial burden on consumers;
- Stronger government control over the utilisation of licenses should be implemented;
- The Ministry of Economics shall be urged to prepare and make public a report on

electricity production from fossil fuels, which would allow the evaluation of energy support mechanisms in a more precise way;

- The Ministry of Economics should look for examples of experiences from other EU countries that can be used by Latvia. Advanced electricity tariff schemes from other countries can help to spread the weight of OIK amortization and protect the least favoured economic segments of the population.

3. Rationale

3.1.1. Strategy planning and key challenges

FICIL recognises the progress achieved in the latest version of the Energy Strategy. However, there are several considerations necessary to further improve the Energy Strategy:

1. The energy sector provides basic infrastructure and resources for the national economy. For this reason, the Energy Strategy should be closely connected with the aims and activities of the NAP.
2. Lack of transparency within the energy sector, including in policy planning, is detrimental not only to sector stakeholders (including consumers), but also to the competitiveness of Latvia's economy. A more transparent energy sector would benefit policy planning and would reduce the risk of conflicting interests.
3. The effectiveness of any strategy depends on clearly stated KPIs, against which it is possible to evaluate progress toward identified aims. The Energy Strategy 2030 does not provide a well-substantiated justification for the chosen aims and KPIs. Furthermore, the Energy Strategy does not clearly link these aims with concrete timeframe and financial resources. In order to justify the choice of these aims, FICIL suggests conducting a cost-benefit analysis for the whole economy, as well as for various stakeholder groups within energy sector.
4. Although the Energy Strategy covers Latvia's position regarding neighbouring countries and Scandinavia in regard to the integration of the electricity grid and market, it does not sufficiently discuss Latvia's views on EU-level energy policy decisions, as well as its position towards third countries.

The recently adopted EU Energy Efficiency Directive 2012/27/EU (Directive) provides binding measures for the promotion of energy efficiency in all parts of the energy supply chain. Therefore, the Energy Strategy should take into account the obligations pertaining to the Directive and integrate these obligations into the Energy Strategy. Particular attention should be devoted to those parts of the Directive that are related to cost-effectiveness:

- The responsibility of Member States to set up an energy-efficiency obligation scheme, under which a cumulative end-use energy savings target of 1,5 % of annual energy sales should be reached by energy distributors and/or retail energy sales companies;
- The exemplary role of public bodies, which entails ensuring an annual renovation of 3 % of the total floor area of heated and/or cooled buildings owned and occupied by the government, installing an energy management systems;
- The need to ensure (in so far as it is technically possible) that the end consumers of electricity, natural gas, district heating, district cooling, and domestic hot water are provided with competitively-priced individual meters that accurately reflect their actual energy consumption;
- The development and deployment of smart grids.

Regarding the use of RES in the transport industry, the Energy Strategy focuses on the production of biofuels while neglecting the need to promote the consumption of biofuels. It would be possible to increase the biofuel addition to fossil fuel (especially diesel), if Latvia allowed imports of not only RME (Rapeseed Methyl Ester) biodiesel, but also other alternatives.

In relation to the share of energy from the RES in gross final consumption of energy, the Energy Strategy sets higher target (50%) than the EU Strategy Europe 2020 (40%). These aims should be balanced. National energy priorities are best served by using Latvia's scarce financial resources to meet but not to exceed the EU's mandated 40%.

In general, there are a number of issues that need to be clarified. The government should set a foreseeable medium and long-term energy strategy that helps to:

- Identify priority areas in the sector in the future;
- Allow investors to plan their investment and revenue to a reasonable extent;
- Allow consumers a degree of price stability or, at least predictability.

Once there is agreement about long-term goals, it will become possible to plan short and medium-term policies and activities. The effects of the support policy on the economy will become more clear and predictable, thus minimising the business risks stemming from energy price volatility.

3.1.2. Role of the Public Utility Commission (PUC)

The PUC's activities could be described as being rather reactive, by not utilising all the opportunities that have been provided to it by the law.

Article 9 of the Law On Public Utility Regulators (*likums "Par sabiedrisko pakalpojumu regulatoriem"*) stipulates that the PUC's functions are to:

- Protect the interests of consumers and promote development of providers of regulated services;
- Devise the methodology for tariff calculation;
- Define tariffs, if sector-specific regulations do not determine the way that tariffs should be calculated;
- Issue licences to service providers in the relevant sectors;
- Perform dispute settlement;
- Promote competition in regulated sectors and supervise the compliance of public service providers with regulatory requirements;
- After receiving a request from the relevant Ministry, to provide information and proposals regarding issues of public services;
- Inform society about the activities of the regulator and the providers of regulated services.

All of these functions are essential, and PUC has, to a certain extent, covered all of them. However, efforts should be increased regarding functions that require a more proactive approach. This includes issuing licences and approving proposed tariffs, spending more resources on efforts to seek opportunities to protect consumer interests and promoting the development of the providers of regulated services.

An important role of the PUC is to develop the market environment in regulated industries. The PUC should be a more active regulator and it should push, proactively, for changes that would improve market conditions, transparency, and accountability, thus improving the quality of services.

The PUC should strive to surpass the experiences of other EU countries, in which regulators have triggered significant changes not only by improving the state of a given industry or sector (for example, Ofgem (the Office of the Gas and Electricity Markets) in the UK has driven change in the British electricity retail market by making it clearer and fairer), but also by assisting the overall development of regulated industries and promoting innovation (for example, Italian and Spanish regulators have introduced measures promoting the use of smart metering).

Case study:

Ofgem in the UK, after extensive stakeholder consultations, has come up with a package of proposals for gas and electricity retail market reforms that will make it easier for customers to understand the market and to choose the best offer. The prospective changes include a requirement:

- To offer only a limited number of tariffs;
- To remove two-tier tariffs in order to offer more transparency;
- To clearly indicate which offer is the cheapest;
- To show a tariff comparison rate for all tariffs, to allow customers to compare their offers with those from other suppliers;
- To provide a summary on the electricity or gas bill covering basic and easily understandable information on the status of a customer's account and the current tariff and energy usage;
- To provide an annual statement that includes information about the costs and terms of the tariff, and the energy consumption and potential savings of switching to another tariff;
- To provide a price increase notification which informs customers in advance about tariff changes and the impact of the increase on individual energy bills;
- To discontinue the practice of automatically rolling customers into another fixed-term offer without their consent.

The case study above illustrates how a national regulator can assume ownership of fresh initiatives aimed at improving the conditions for both market players and end consumers. Consequently, FICIL encourages the PUC to adopt the best practices in regulation. The PUC should, for example,

- Promote long-term planning, as well as the profitable and sustainable development of energy sector companies;
- Introduce innovative regulatory measures which are aimed at developing a fair and dynamic market, always considering the interests of consumers;
- Consistently adopt the best practices of other national regulators.

3.1.3. Natural monopolies

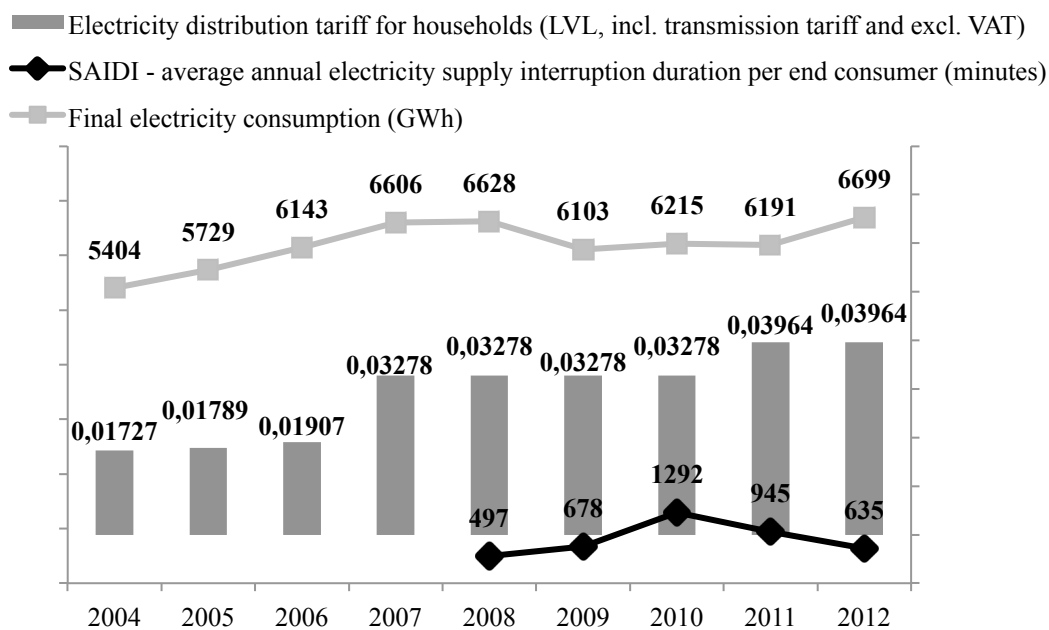
Transmission and distribution systems play an important role in both the electricity and gas sectors. TSO and DSO are natural monopolies and operate in regulated environments. In this context, it is essential to introduce measures that are aimed at promoting the effectiveness and

efficiency of the natural monopolies in order to ensure that their customers receive secure and reliable service for a fair price. For the electricity DSO:

- Exact SAIDI and SAIFI targets should be set;
- Performance should be regularly monitored and benchmarked;
- A balanced reward/penalty mechanism should be put in place in order to ensure compliance with efficiency targets.

Figure 1, below, illustrates the need for linking tariffs with efficiency mechanisms, as the DSO (incl. TSO) tariff in 2011 has noticeably increased since the previous increase in 2007, the demand of electricity is on par with 2007, while the SAIDI indicator has not improved as compared to 2008.

Figure 1. Selected indicators of electricity distribution efficiency in Latvia



Source: Eurostat, AS „Sadales tīkls”, www.likumi.lv

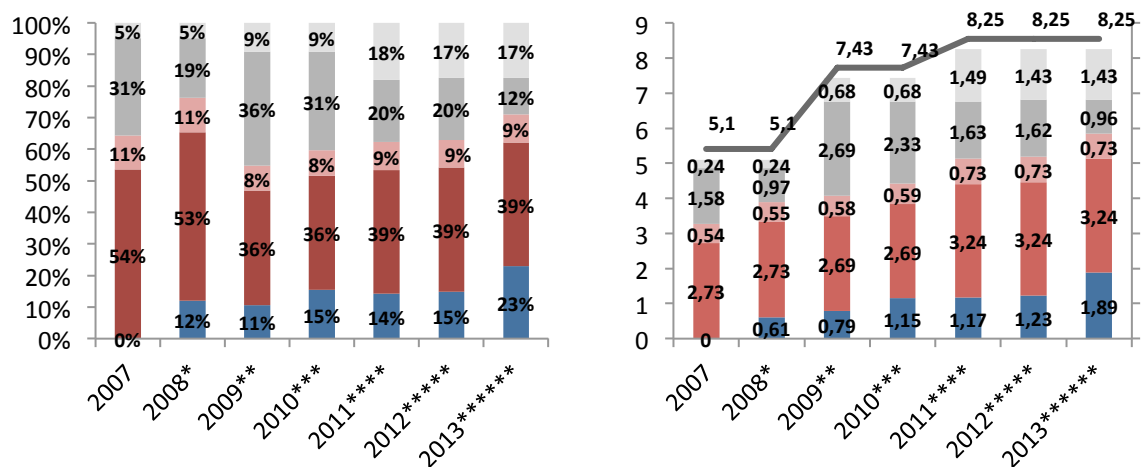
*Final consumption estimate based on AS „Sadales tīkls” information that electricity consumption in 2012 was 8,2 % higher than in 2011.

In addition, Latvia’s SAIFI results are among the weakest, if compared to other EU member states. In 2010, it was about 3.4, which was slightly better than in Poland, but considerably higher than that of the other two Baltic States (whose SAIFI scores were approximately 2) and the Nordic countries (SAIFI in Finland and Sweden was around 1,3).

Figure 2, below, illustrates the structure of an electricity tariff for a household. Although this tariff is currently regulated, some of its components are similar to other specific tariffs pertaining to other groups of electricity consumers. These components are the feed-in tariff (or OIK).

The main issue illustrated by Figure 2 is the tendency for OIK and system service costs (mostly distribution) to increase relative to other parts of the tariff, thus exerting significant pressure for further increase in the tariff.

Figure 2. Cost breakdown of regulated electricity end-user tariff for households, sant./kWh



- OIK (for electricity produced both using CHP and RES)
- System service - distribution^^
- System service - transmission^^^
- Electricity price (including trading costs)^^^^
- VAT^^^^^
- Total electricity end-user tariff for households, sant./kWh

*OIK as of 1.04.2008.
 **OIK and end tariff as of 1.04.2009.; VAT change from 5% to 10% as of 1.01.2009.
 ***OIK as of 1.04.2010.
 ****OIK and end tariff as of 01.04.2011.; VAT 22% as of 01.02.2011.
 ***** OIK as of 01.04.2012.; VAT 21% as of 1.07.2012.
 *****System service costs assumed to stay unchanged; as of 2013. - "Starta tarifs", which is applied to consumed electricity of up to 1200 kWh

Source: AS "Latvenergo", AS "Sadales Tīkls", PUC, www.likumi.lv, household survey

^^Electricity distribution tariff for households - tariff plan S1, excluding transmission costs
 ^^Transmission service cost (sant./kWh) derived from the regulated distribution tariff: dividing electricity distribution services received from AS "Augstsprieguma tīkls" with the total amount of electricity distributed by AS "Sadales tīkls"
 ^^^Electricity price calculated by subtracting all the other components from the end-user tariff for households
 ^^^^^Calculated based on the end-user tariff for households and the respective VAT applicable to electricity

The implementation of the Third Energy Package for an internal EU gas market should be carried out, involving the relevant stakeholders in the gas infrastructure. This is essential in order to transpose the respective EU directive into national legislation in a way that guarantees the security of the gas supply and also ensures cost-effective implementation. A transparent, reasonable, and predictable gas policy in Latvia is in the interest of both consumers and investors.

As of 4 April 2014, Latvia will no longer have the status of ‘emergent market’ under the Directive 2009/73/EC, which stipulates the liberalisation of the gas market. This is one of the two derogations that allow Latvia to postpone the implementation of gas TSO unbundling. The other derogation – being an isolated market – will automatically end once an alternative gas supplier can potentially cover more than 25% of the demand.

Latvia should indicate the plans of the government in regard to the liberalisation of the natural

gas market, given that Estonia and Lithuania are already set to complete TSO unbundling by the beginning of 2015. A clear indication of what principles will be used to make the decision, as well as a timely decision on which TSO unbundling model Latvia is going to choose would minimise uncertainty and increase the potential for attracting foreign direct investment.

A clear roadmap for liberalising the gas market is equally important for consumers and existing players in the gas sector. FICIL encourages the government of Latvia to ensure that gas market liberalisation is conducted based on a thorough analysis of legal, political, and economic factors that might be affected by choices related to the transposition of the Third Energy Package.

3.2. Energy sector issues requiring short-term actions

3.2.1. Approach to support allocation and potential changes

Effect on end consumers: Any planning in the energy sector should be done with the end energy consumers in mind, acknowledging the fact that energy is produced for the social and economic benefit of private and business users. In order to guarantee that a fair balance is kept, energy, and specifically electricity tariff surcharges, should be scrutinized for their economic effect on final consumers. These effects, in the form of GDP reduction, loss of market competitiveness, and possible loss of employment, should be immediately and correctively acted upon.

One immediate and relatively simple way to manage electricity price escalation for large industrial consumers is to deploy a step-down tariff system -a system that re-distributes the amount of specific surcharges in tariffs among different consumer groups. This causes energy-intensive industries to pay less of the specific tariff, while smaller consumers pay a relatively larger part of the tariff surcharge (due to the lower consumption levels of private consumers, the relatively larger surcharge for them would be negligible in absolute terms).

A good example of such step-down tariff system in an electricity tariff is being used by the Austrian regulator E-Control as follows:

Austrian electricity consumer group division as per grid voltage levels							
	7	6	5	4	3	2	1
Voltage level	400 V	Transf.: 10-30 kV to 400 V	10-30 kV	Transf.: 110 to 10-30 kV	110 kV	Transf.: 380-220 to 110 kV	380-220 kV
Min. power	n/a	100 kW	400 kW	5000 kW	n/a	n/a	n/a
User group	Household	Business	Large business	Industry	Large industry		
Number of users (2010)	5 723 470	26 745	4 877	164	98		

Allocation of financing (collections) among 7 consumer groups in Austria							
Austrian grid levels	7	6	5	4	3	2	1
Allocation of total RES support costs according to grid level (%)	66%	11%	16%	4%	3%		

A similar tariff system may be considered in Latvia and may be relatively easy to implement, considering the existing legal framework.

There are other instruments that the Latvian regulators may opt to adopt, such as:

1. Regulating the burden on final consumers through tax regulation;
2. The development of specialised financial instruments using State guarantees (revolving and/or leveraged funds), and;
3. Using Latvia's CO2 allowances to finance RES-E support.
4. Adopting economic instruments of other countries that have demonstrably helped with the goal of balancing the burden of energy prices for final consumers.