ENERGY LAW IN LATVIA

RECENT DEVELOPMENTS IN LATVIAN ENERGY MARKET

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Energy Development Guidelines for 2006-2016

On 1 August 2006 the government of Latvia adopted the Energy Development Guidelines for 2007-2016 which is a policy document setting the national priorities and targets in the energy sector for the next decade. The guidelines state that the increase of Latvia's independence in energy supply and diversification of the availability of primary energy resources as one of the main targets to be achieved.

The guidelines provide for a series of resultative ratios set for the achivement of the targets. By way of example, the guidelines state that 80% of the consumed electricity must be generated locally in 2012, but by2016 it should be 100%. To achieve this target the generating capacity must be raised by at least 700 MW.

To achieve the set targets, the guidelines provide for several courses of action, such as fostering the developments in unifying the Baltic region's and Europe's energy systems, participating in research and supporting the TEN-E projects aimed at integrating the Baltic-European energy supply systems.

To improve the regulatory system in the energy sector, the guidelines envisage the creation of an Energy Agency. The deadline this is the end of 2006.

Green light for nuclear power plant

At the beginning of year 2006, the Prime Ministers of Latvia, Lithuania and Estonia agreed to conduct a feasibility study for construction of a joint nuclear power plant. Should the result of the study will be positive, the third block of Ignalina nuclear power plant may be set into motion in 10 years time. The total planned capacity could be 3200 MW. The life cycle of the new nuclear power plant is estimated to be 50 years. The total costs are calculated at about EUR 3 billion. It is expected that the safest, the so-called third generation technologies will be used in the project.

Infringement procedures against Latvia in the electricity sector

By notification letters of 10 April 2006 the EU Commission started two infringement procedures against Latvia in the electricity sector. The infringement procedures relate to an alleged noncompliance by Latvia with Directive 2001/77/EC on the promotion of electricity produced from renewable energy sources in the internal electricity market (hereinafter – "Directive 2001/77") and the Second Electricity Directive.

Regarding Directive 2001/77 the Commission has stated that:

1) Latvia has not been active enough to ensure that by 2010 at least 49,3% of the total electricity consumption in Latvia will be produced by use of renewable energy resources;
2) Latvia has not introduced system for issuing of certificates confirming origin of electricity produced by use of renewable energy resources;
3) in Latvia it is not ensured that TSOs and DSOs in their territory guarantee transmission and distribution of electricity produced by use of renewable energy resources.

To remedy the situation, the government is currently working on three regulations that will deal these issues.

Regarding the Second Electricity Directive the Commission stated that Latvia breached the directive as the price is regulated for both eligible and captive customers. The Commission also considered that the way the price is determined for the captive electricity users needs to be changed. Latvia's position is that allegations of the Commission are not well-founded because the Commission has relied on incorrect information. The government has provided the Commission with its explanations as to the actual circumstances in the Latvian electricity market.

Gas market closed until 2010 – approved by the Commission

In 1997 AS Latvijas Gaze was granted a monopoly position in relation to the distribution, transmission and storage of natural gas until 2017. This situation is contrary to the requirements of the Second Gas Directive. Negotiations between AS Latvijas Gaze and the government of Latvia on premature termination of the licence so far have not reached a satisfactory solution. Premature revocation of the exclusive licence for AS Latvijas Gaze could result in lengthy court proceedings in conjunction with claims for loss of profit.

The government of Latvia has informed the European Commission on derogation from the Second Gas Directive pursuant to Article 28(2) thereof which permits a Member State qualifying as an emergent market, which because of the implementation of the Directive would experience substantial problems, to derogate from a number of Articles of the Directive. It is scheduled that the gas market will remain closed until 1 January 2010.

The Commission has decided not to start any infringement proceedings against Latvia.

OVERVIEW OF THE LEGAL AND REGULATORY FRAMEWORK IN LATVIA

A. ELECTRICITY

A.1 INDUSTRY STRUCTURE

The overall supervision of the electricity industry is performed by the Ministry of Economics, while the objects and equipment of entities operating in the electricity market are under the technical control of the State Energy Inspection. The tariffs and market conditions in the electricity industry are regulated by the Public Utilities Commission, which is the institution in charge issuing of licences for the provision of public services in the electricity industry.

The basic legislative framework of the electricity industry consists of the Energy Law, the Electricity Market Law, the Law on Regulators of Public Services as well as a series of subordinated regulations of the Cabinet of Ministers and the Public Utilities Commission. The Electricity Market Law implements the Second Electricity Directive.

The generation, transmission, distribution and supply of electricity are regulated activities and are therefore subject to licences which are issued by the Public Utilities Commission where the volume of the relevant activities exceeds the thresholds stipulated by the Regulations on Types of Regulated Public Services issued by the Cabinet of Ministers. Electricity generation, transmission and distribution licences are issued for the period of 20 years, while electricity supply licences are issued for the period of five years.

While approximately 70 licences have been issued by the Public Utilities Commission for entities to operate in the Latvian electricity market, the dominant role in that market undoubtedly belongs to the state owned AS Latvenergo which is the major electricity producer, distribution system operator and supplier in Latvia. The transmission system is operated by AS Augstsprieguma Tikls which is a fully owned subsidiary of AS Latvenergo.

According to the Energy Law, AS Latvenergo as well as the shares of AS Latvenergo must remain the property of the state and therefore may not be privatised or otherwise distributed. Furthermore, the power plants and the electricity transmission and distribution grid and equipment may not be used as collateral or transferred to any entities other than those fully owned by the state or AS Latvenergo.

Even though the Electricity Market Law has provided the general legal framework for liberalisation of the electricity market, the market participants have not yet been activated so as to benefit from it. Thus, while all electricity users except households have been allowed to choose alternative electricity suppliers, none as yet have done so (households will be permitted to choose alternative electricity suppliers as from 1 July 2007). Several companies which do not own distribution networks have been licenced to supply electricity, however to date there have been no actual sales.

A.2 ELECTRICITY TRADING

Electricity trading is regulated in Latvia by the Grid Code which provides for various trading mechanisms including pooling. Electricity trading is however considerably encumbered in Latvia by the inadequate of generation capacities and the insufficient number of market participants.

Ensuring the system of balance is the responsibility of the TSO. The TSO provides the balancing services to the users, electricity generators and distribution system operators connected directly to the transmission system. The users, electricity generators and other distribution system operators connected to the distribution system receive the balancing service from the.

Generally, electricity can be traded in the balancing market. By way of exception from a general prohibition to engage in electricity trading, the TSO is entitled to engage in electricity trading for the purposes of balancing.

The supply of electricity to customers is regulated by the Electricity Supply and Usage Regulations issued by the Cabinet of Ministers, providing for a detailed regulation of the relationship between the electricity suppliers and customers. The supply of electricity to captive customers (ie, those electricity users which have not exercised their right to freely select the electricity supplier) is subject to the tariffs approved by the Public Utilities Commission. The tariffs are calculated in accordance with the methodologies approved by the Public Utilities Commission.

The Electricity Market Law imposes certain obligations on the so-called public trader which is to be established by the entity having the distribution licence with the largest area of operation and the largest number of users switched to its networks (ie, AS Latvenergo). Among other things, the public trader is under an obligation to supply electricity to all captive customers in the entire territory of Latvia, as well as to purchase electricity generated in the cogeneration process and by using the renewable energy resources.

A.3 THIRD PARTY ACCESS REGIME

The Electricity Market Law generally provides for the right of the market participants to use the transmission and distribution systems at the tariffs approved by the Public Utilities Commission. The access to the transmission and distribution systems is subject to compliance by the market participants with the technical requirements of the system operator. The system operator may refuse the access where it lacks the necessary capacity, giving a duly substantiated reasons to the market participant within 30 days of receipt of its application.

A.4 USE OF SYSTEM

The use of electricity transmission and distribution networks are subject to the tariffs approved by the Public Utilities Commission. The tariffs are calculated in accordance with the methodologies approved by the Public Utilities Commission.

A.5 MARKET ENTRY

As mentioned above, electricity generation, transmission, distribution and supply are all subject to obtaining a licence issued by the Public Utilities Commission unless the applicable thresholds are not exceeded. The issuance of the licence is normally decided within one month, however that period may be extended to four months in exceptional cases.

Where the entrant intends to use the existing transmission and/or distribution system for transportation of the electricity, an agreement needs to be entered with the operator of the relevant system(s). While the system operators are generally under an obligation to grant access to the systems, the exercise by the market participants of such right has not yet been tested in practice.

Entities intending to engage in electricity supply are subject additional requirements relating to the relationship with the electricity users stipulated by the Electricity Supply and Usage Regulations issued by the Cabinet of Ministers. New regulations are currently under preparation and are intended to provide a more detailed and up to date legal framework for electricity supply.

A.6 CROSS-BORDER INTERCONNECTORS

Similarly to Estonia and Lithuania, Latvia is not yet linked to the European grid but is still connected to the Russian/CIS electricity system only.

B. OIL & GAS

B.1 INDUSTRY STRUCTURE

The Latvian natural gas market is purely monopolistic, the only entity licenced to transport, distribute, store and supply natural gas being AS Latvijas Gaze. the Second Electricity Directive. is owned by E.ON Ruhrgas International AG (47,15%), AAS Gazprom (25%), SIA Itera-Latvija (25%) and a collection of minority shareholders (2,85%). The transportation, distribution and storage licences of AS Latvijas Gaze are valid throughout the period until 10 February 2017 while the supply licence is valid until 10 February 2007.

Since currently natural gas is imported only from two external suppliers, AAS Gazprom and SIA Itera-Latvija, liberalization of the natural gas market is unlikely in the near future. In the light of this, Latvia has exercised its rights under Article 28(2) of The Second Gas Directive permitting Member States qualifying as emergent markets, which because of the implementation of the The Second Gas Directive would experience substantial problems, to derogate from a series of Articles of the The Second Gas Directive until the Member State no longer qualifies as an emergent market. According to the transitory provisions of the Energy Law, the natural gas market will remain closed until 1 January 2010.

Non-exclusive licences for supply, distribution, storage and refilling of liquid natural gas have been issued to around 50 entities.

Similarly to the electricity market, the overall supervision of the gas industry is performed by the Ministry of Economics, while the objects and equipment of entities operating in the gas market are under the technical control of the State Energy

Inspection. The tariffs and market conditions in the gas industry are regulated by the Public Utilities Commission, which is the institution in charge of issuance of licences for the provision of public services in the gas industry.

The basic legislative framework of the gas industry consists of Energy Law, the Law on Regulators of Public Services as well as a series of subordinated regulations of the Cabinet of Ministers and the Public Utilities Commission. Subject to the derogation referred to above, the Energy Law implements the Second Gas Directive.

The transportation, distribution, storage and supply of natural gas as well as the supply, distribution, storage and refilling of liquid natural gas are regulated activities and are therefore subject to obtaining a licence issued by the Public Utilities Commission. The transportation, distribution and storage licences are issued for the period of 20 years, while supply licences are issued for the period of five years.

Since the Latvian natural gas market is monopolistic, no product sharing regime currently exists.

B.2 GAS TRADING

Natural gas is supplied to customers only by AS Latvijas Gaze and is regulated by the Gas Supply and Usage Regulations issued by the Cabinet of Ministers.These rovide for a detailed regulation of the relationship between the gas supplier and customers. Supply tariffs of natural gas are established by the Public Utilities Commission and are calculated in accordance with the methodologies approved by the Public Utilities Commission.

Liquid natural gas is supplied by around 50 licenced entities which are not bound by any tariffs approved by the Public Utilities Commission.

B.3 THIRD PARTY ACCESS REGIME TO GAS TRANSPORTATION NETWORKS

The natural gas transportation and distribution networks are operated by AS Latvijas Gaze. Due to the monopolistic character of the Latvian natural gas market, no third party access to the gas transportation and distribution networks is guaranteed by Latvian law.

B.4 THIRD PARTY ACCESS TO LNG TERMINALS AND STORAGE FACILITIES

Natural gas in Latvia is stored in Incukalns Underground Gas Storage Facility with capacity of 4,400 billion cubic metres of natural gas (of which 2,145 billion cubic metres is cushion gas and 2,255 billion cubic metres of active gas). The Incukalns Underground Gas Storage Facility is operated by AS Latvijas Gaze. Due to the monopolistic character of the Latvian natural gas market, no third party access to the storage facilities is guaranteed by Latvian law.

B.5 USE OF SYSTEM

As noted above, no third party access to the gas transportation and distribution networks is guaranteed by Latvian law.

B.6 MARKET ENTRY

Since the transitory provisions of the Energy Law provide for the Latvian natural gas market to remain closed until 1 January 2010, entry in the Latvian natural gas market is not possible until that time. The government of Latvia is currently holding negotiations with AS Latvijas Gaze regarding the limitation of operation of the exclusive licences issued to AS Latvijas Gaze for the period until 1 January 2010.

Any entities willing to deal with liquid natural gas are required to obtain a licence issued by the Public Utilities Commission. The issuance of the licence is normally decided within one month, however that period may be extended in exceptional cases to four months.

B.7 CROSS-BORDER INTERCONNECTORS

Latvia's gas transportation system is connected with the transportation systems of Lithuania, Estonia and Russia. However, this is of little importance as both Estonia and Lithuania are, in turn, only connected to the Russian system.

C. ENVIRONMENTAL ISSUES

C.1 EMISSION TRADING

The legislative framework of emission trading is provided by the Law on Pollution and the Regulations on Activities with Emission Allowances and Organisation of Pools of Installations issued by the Cabinet of Ministers which both basically repeat the relevant provisions of the Directive 2003/87/EC. The emission allowances are allocated by the Ministry of Environment, while the Latvian Environment, Geology and Meteorology Agency of operate and maintain the issuing and the register of allowances. . Despite of initial difficulties in launching the registry, it is now fully operational. No emission trading schemes are available in Latvia that would operate nationally in addition to the European Union Emission Trading Scheme.

C.2 CARBON CAPTURE AND STORAGE

Currently there are no existing carbon capture and storage projects in Latvia. Neither laws, nor guidelines issued by the State are regulated this issue. Taking into account the costs and complexity of this new technology, the private sector will need economic incentives to apply it. If the costs of this technology is not be reduced, most probably these kind of projects will not be used in Latvia in the immediate future. At the moment Latvia is more concentrating on carbon sinks projects.

C.3 RENEWABLE ENERGY

The Energy Law generally defines renewable energy resources as wind, sun, geothermal, tidal, and water energy, waste landfill site and sewage treatment plant gas and biogas as well as biomass (biologically degradable fraction in products, industrial and household waste, agricultural, as well as forestry and similar sector production residual materials). In practice, the two of the most exploited renewable energy resources are wood-pulp and hydroresources, wind energy and biogas being used in considerably smaller volumes.

The Electricity Market Law provides that a definite part of the total consumption of the electricity by end users shall be the electricity produced from renewable energy resources. In 2005, the electricity produced from renewable energy resources constituted 46% of the total electricity consumption. The Electricity Market Law requires this part to be gradually increased so that by 31 December 2010 it is not less than 49,3% of the total electricity consumption.

The Electricity Market Law also requires the public trader (ie, AS Latvenergo) to purchase a certain amount of the electricity produced by using renewable energy resources. The price of such electricity and the amount to be purchased by the public trader are determined by the Cabinet of Ministers for each year. Entities producing electricity by using renewable energy resources may acquire the right to sell the produced electricity to the public trader provided that they have received a special permit from the Ministry of Economy. Such permit also confirms that the electricity has been produced using renewable energy resources.

D. NUCLEAR ENERY

D.1 NUCLEAR ENERGY

No nuclear energy is generated in Latvia. The only Latvian research reactor, a pool-type IRT-2000 research reactor with a 5000 kVt capacity, was shut down in 1998.

At the beginning of year 2006 the Prime Ministers of Latvia, Lithuania and Estonia agreed to conduct a feasibility study for construction of a joint nuclear power plant. Should the result of the study be positive, the third block of Ignalina nuclear power plant may become operational in 10 years.