

Liberalization of the Natural Gas Market in Latvia: Overview and Challenges

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Natural gas is a significant resource for Latvia's economy and a significant component in its energy balance, making both natural gas supply and cost a national security issue. Latvia sources all of its natural gas from Russia at a price that it cannot influence because, for the moment, Latvia has no technically feasible means of securing alternative supplies, nor does Lithuania or Estonia.* Latvia is also legally constricted in its ability to pursue alternative suppliers to Russia's Gazprom: the shareholders' agreement between Latvia and the energy company JSC *Latvijas Gāze* (LG) stipulates a privileged situation until 2017 for JSC *Latvijas Gāze* in transmission, distribution, storage and trade. Access to the natural gas transmission system by alternative suppliers is at the discretion of LG until April 2017. There is reason to believe that the March 2014 amendments to the Law on Energy did not simply move forward the deadline for liberalization of the natural gas market, but in fact closed this market until 3 April 2017, hampering efforts at improving energy security in Latvia and the Baltic States.

This has created an extremely unfortunate scenario, limiting access to opportunities offered to the Baltic States by the completion of the Klaipeda liquefied natural gas (LNG) terminal at the end of 2014. This terminal is the only realistic prospect for creating alternative natural gas supply routes for the Baltic States. As of May 2014 the Klaipeda LNG terminal operator *Klaipēdas nafta* had not yet signed agreements on LNG deliveries, but the geopolitical situation has created a favourable climate for conclusive negotiations with potential suppliers in Norway, the Middle East, North Africa or the United States.

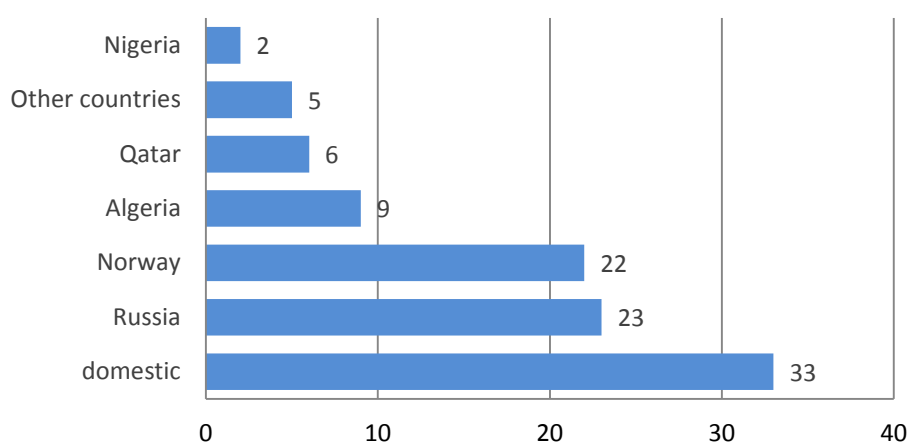
This policy paper aims to assess progress towards the liberalization of the natural gas market in Latvia in both a local and global context, to examine risks associated with the lack of alternative natural gas suppliers, and to offer policy proposals to lessen Latvia's energy dependence. The liberalization of the natural gas market in Latvia affects much more than simply the purchasing price for the consumer. The policy paper examines Latvia's energy supplies and Latvia's dependence on primary fossil energy resource imports, the natural gas transmission infrastructure of the European Union, and of the Baltic countries in particular, which creates a barrier to entry for alternative suppliers. Analysis of the role of natural gas in Latvia's energy portfolio and the legal framework, under which JSC *Latvijas Gāze* operates, highlights Latvia's dependence on Russian natural gas, a situation exacerbated by the de facto monopoly situation in which LG operates. The policy paper provides a detailed overview of the decision-making process leading to the delay of the liberalization of the natural gas market, which will keep alternative suppliers away until the spring of 2017. Finally, recommendations are made for actions that could ensure that Latvia will have alternative suppliers in 2017. Towards this end, the policy paper sets out conditions that should be taken into account if the Latvian government is to consider purchasing shares in JSC *Latvijas Gāze*.

**Situation as of November 2014 before the Klaipeda LNG terminal has begun operations, which will create the possibility of*

Regional Context

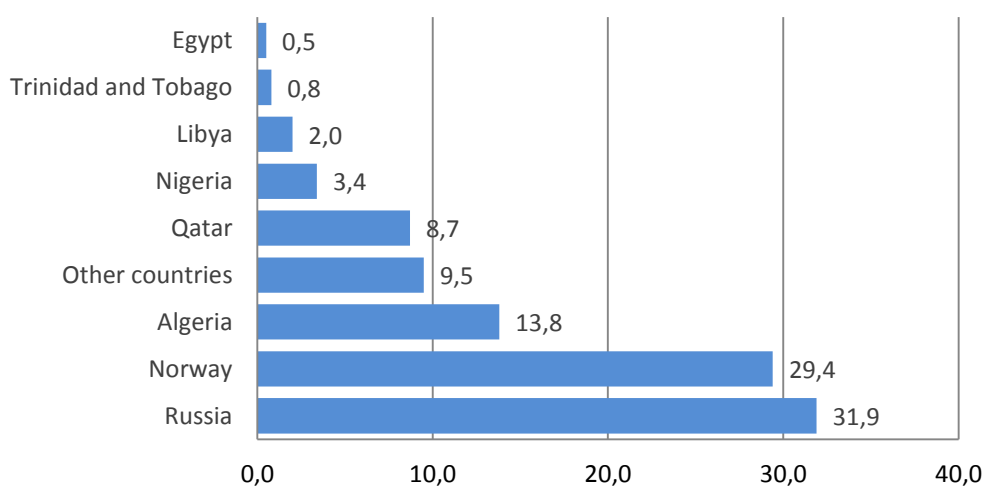
The Baltic States are not the only EU countries wholly dependent on Russian natural gas supplies. Over 80% of natural gas used in Finland, Bulgaria, Slovakia and the Czech Republic comes from Russia.¹ Great Britain and Romania produce approximately 75% of their own supplies, and Denmark and the Netherlands are net exporters of natural gas.² The European Union as a whole meets about 33% of its natural gas needs, 22% is imported from Norway and 23% from Russia.³ Russia is the largest third country supplier, with a market share of 32%, followed by Norway at 29%. The trend over the past several years points to a declining market share for Russia, while Norway's share is increasing, thus lessening EU dependency on Russian natural gas. However, the overall volume of natural gas supplies from Russia is still significant, and cannot easily be supplanted by other suppliers. For this reason, the European Union is pursuing a policy of improving energy infrastructure, connecting EU regions and creating a unified EU energy market that would be sheltered from the negative impact of energy supply interruptions or significant pricing differentials.

EU Natural Gas Supplies (%), 2012



Source: International Energy Agency

EU Natural Gas Supplies from Third Countries (%), 2012



Source: International Energy Agency

¹ „Member States' Energy Dependence: An Indicator-Based Assessment”, European Commission, April 2013, p.14.

² Ibid.

³ See [Eurostat data](#).

The EU has set a goal of creating a single energy market and robust competition in that market and to this end has adopted the Third EU Energy package - a set of actions to strengthen the electricity and natural gas markets.⁴ This legislative package took effect September 2009, with three main directions:

- the creation of a single natural gas and electricity market by 2014,⁵
- the creation of a single energy regulatory agency,⁶
- the creation of a common regulatory framework enabling electricity producers to access distribution networks for cross-border trade,⁷ and the creation of a common regulatory framework for producers and traders to access the gas transmission system.⁸

The government of Latvia has in various policy documents affirmed intent to comply with these regulations, adopted by all EU member states. For example, in early 2014 the government adopted a work plan including the goal of reducing “Latvia’s energy dependence on third countries, diversifying energy suppliers, and contributing to the creation of a common EU energy market, developing interconnections with other EU member states.”⁹ In negotiations with other EU member states and institutions, Latvia has insisted on investments in energy infrastructure to make a single EU energy market technically feasible. As a result, the EU is focused not only on improving legislation, but also invests substantially into energy projects.

In order to overcome energy isolation of some EU member states, the EU invests in the creation of new interconnections and improvements in existing interconnections. Financing has been provided for electricity cables and overhead lines, for gas pipelines and LNG terminals. A special financial instrument - *Connecting Europe Facility* (CEF),¹⁰ has been created for financing energy infrastructure and transportation infrastructure improvements, which supports projects of common interest to the EU.¹¹ An example of one such project in the Baltic States is the Baltic regional liquefied natural gas (LNG) terminal.¹²

Competition and a free market are at the heart of the European Union. It ensures consumers the best possible position for purchasing goods and services. Competition and free market principles are key in the energy sector, contributing to a functioning economy by supplying electricity, heating, fossil fuel products and primary energy resources.

Suppliers of primary energy resources (for example, oil, gas and coal) usually offer long-term supply contracts to transformation sector companies – producers of electricity and heat. Transformation sector companies in turn contract directly with clients (consumers) for supply of electricity and heat. The EU pays particular attention to contracts between transformation sector companies and clients to ensure that these contracts are not too long-term, or do not contain provisions infringing on consumers’ rights to change suppliers. The EU supports long-term contracts between primary energy suppliers and transformation sector companies because this contributes to energy security.

⁴ [See EU homepage.](#)

⁵ The EU Parliament and Council directive 2009/73/EK and regulation (EK) Nr. 715/2009 provides the framework for the creation of a single natural gas market. The directive requires adoption by member states by March 3 2011. The regulation is to be applied as of September 3 2009 (paragraph 32).

⁶ The aim of the *Agency for the Cooperation of Energy Regulators (ACER)* is to support and coordinate the work of the energy regulatory bodies in EU member states, in order to create a single EU electricity and natural gas market. ACER oversees electricity and gas transmission systems operators (ENTSO-E and ENTSO-G), focusing on fulfilment of 10 year development goals. [European Parliament and Council regulation \(EC\) Nr. 713/2009](#) provided for the creation of this agency. [See also.](#)

⁷ See the [European Parliament and Council regulation \(EC\) Nr.714/2009.](#)

⁸ See [the European Parliament and Council 13 July 2009 regulation \(EC\) Nr.715/2009](#) regarding the conditions attached to access to natural gas transmission systems and the revocation of regulation (EC) Nr.1775/2005.

⁹ “[On the Government Action Plan for the Implementation of the Declaration on the intended work of the Cabinet of Ministers led by Laimdota Straujuma](#)” (in Latvian), April 7, 2014.

¹⁰ Under CEF, available financing for the energy sector will be 5,85 billion EUR for 2014-2020.

¹¹ *Projects of common interest.*

Alternative Supply Options in the Baltic States



Currently, Latvia and the other Baltic States are 100% dependent on one natural gas supplier and one supply route. These are energy islands: they are not currently connected to other EU transmission systems.¹³ Opportunities to negotiate pricing with the main supplier – the Russian energy company *Gazprom* – are, therefore, extremely limited as Latvia does not have any alternative suppliers, or technical feasibility for alternative supply channels. Latvia does, however, have strategic options to increase its energy security.

There are two possible avenues for alternative gas supplies for the Baltic States: creating a pipeline connection with another EU gas transmission system, or the creation of a liquefied natural gas (LNG) terminal in one

of the Baltic States. The first avenue could be pursued by creating a pipeline connection between Lithuania and Poland.¹⁴ There are several options for pursuing the second avenue:

- Create a LNG gasification terminal in Latvia, Lithuania or Estonia.¹⁵ The EU supports the creation of a regional terminal and is prepared to co-finance with CEF resources. The speediest solution would be to

¹² CEF is not financing the Klaipėda LNG terminal. Lithuania is financing this project on its own, despite the strategic importance of this project to the energy independence of all the Baltic States.

¹³ The Baltic States, Spain and Portugal are poorly connected to the energy infrastructure of the EU, which significantly hampers efforts to create a single EU energy market. „Energy islands in the EU – a challenge to a common EU energy policy”, R.Āboltiņš, Centre for Public Policy PROVIDUS, January, 2011.

¹⁴ The so called [GIPL project](#).

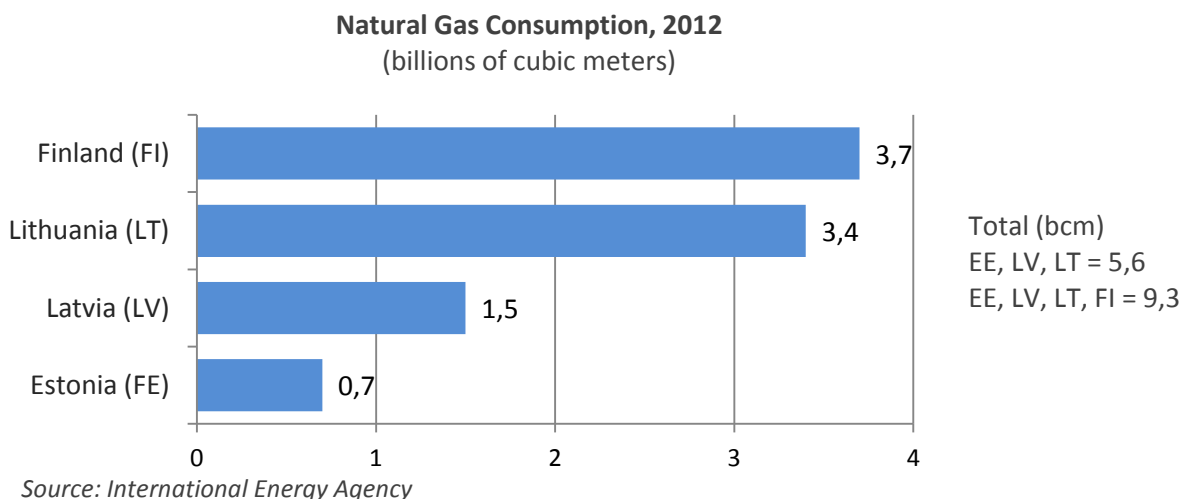
¹⁵ Here and elsewhere the author refers to a LNG gasification terminal that ensures the technical possibility of changing LNG from a liquid to a gaseous state.

develop the Klaipeda LNG terminal in order to create opportunities to transmit gas from Klaipeda to the Inčukalns underground gas storage facility if the gas supplies are not transmitted directly to consumers via the transmission and distribution systems in Lithuania, Latvia and Estonia. Even though the existing interconnections between the Baltic States transmission systems are good, increased volumes of gas flows between Lithuania and Latvia would require increased capacity.

- Create LNG terminals in each Baltic State. Three national terminals would solve energy supply diversification issues in each country, but such national terminals would not be considered a regional solution by the European Commission. It is, therefore, unclear if the EC would agree to participate in financing such terminals, despite the fact that strengthening energy security is considered a high priority. The importance of these types of projects in bolstering energy security has grown since the spring of 2014 due to the deterioration of the EU- Russia relationship over the crisis in Ukraine.
- Create a regional LNG terminal in Finland, providing a pipeline link between the Finnish and Estonian gas transmission systems. This solution would be preferable for Finland, whose natural gas consumption is the largest of the four countries. From the point of view of the Baltic States, however, this is the least acceptable solution because the construction of a pipeline between Finland and Estonia comes with high costs and a lengthy implementation timeline due to the need for a complex environmental impact assessment and technically challenging construction requirements.

In 2013 the European Commission produced a cost benefit analysis of potential LNG terminal sites¹⁶ and after evaluating possible sites in the Baltic States and Finland, concluded that the most cost effective (by a slight margin) solution was a regional LNG terminal in Paldiski, Estonia. Contrary to the expectations of the Baltic governments and other stakeholders, the cost benefit analysis did not come to definitive conclusions about where to locate the Baltic regional LNG terminal.

In March 2014 Estonia and Finland signed an agreement on the construction of LNG terminals in both Estonia and Finland, connecting them with the BALTICCONNECTOR gas pipeline. While this calmed speculations about the eventual sitting of a regional terminal, the double terminal solution cannot be considered as a regional solution addressing the common European interest, and as such will not qualify for EU co-financing.¹⁷



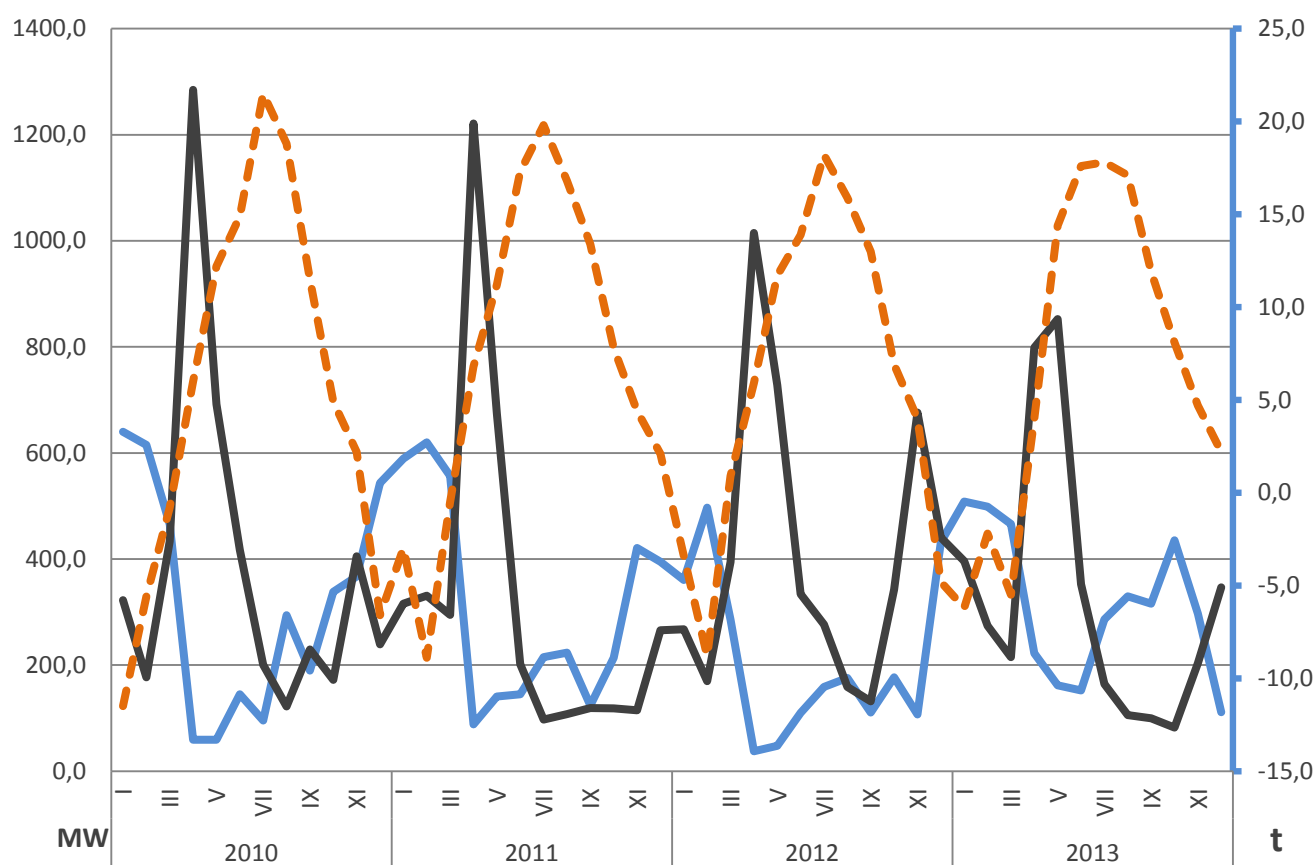
¹⁶ Analysis performed by the consulting company Booz&Co. „*Analysis of Costs and Benefits of Regional Liquefied Natural Gas Solution In The East-Baltic Area, Including Proposal for Location and Technical Options Under The Baltic Energy Market Interconnection Plan*”, report the EU DG for Energy, 20 November 2012.

¹⁷ It is estimated that the construction of two terminals would cost 690 million USD. Construction costs for the BALTICCONNECTOR are also high – approximately 130 million USD.

Latvia's Energy Portfolio

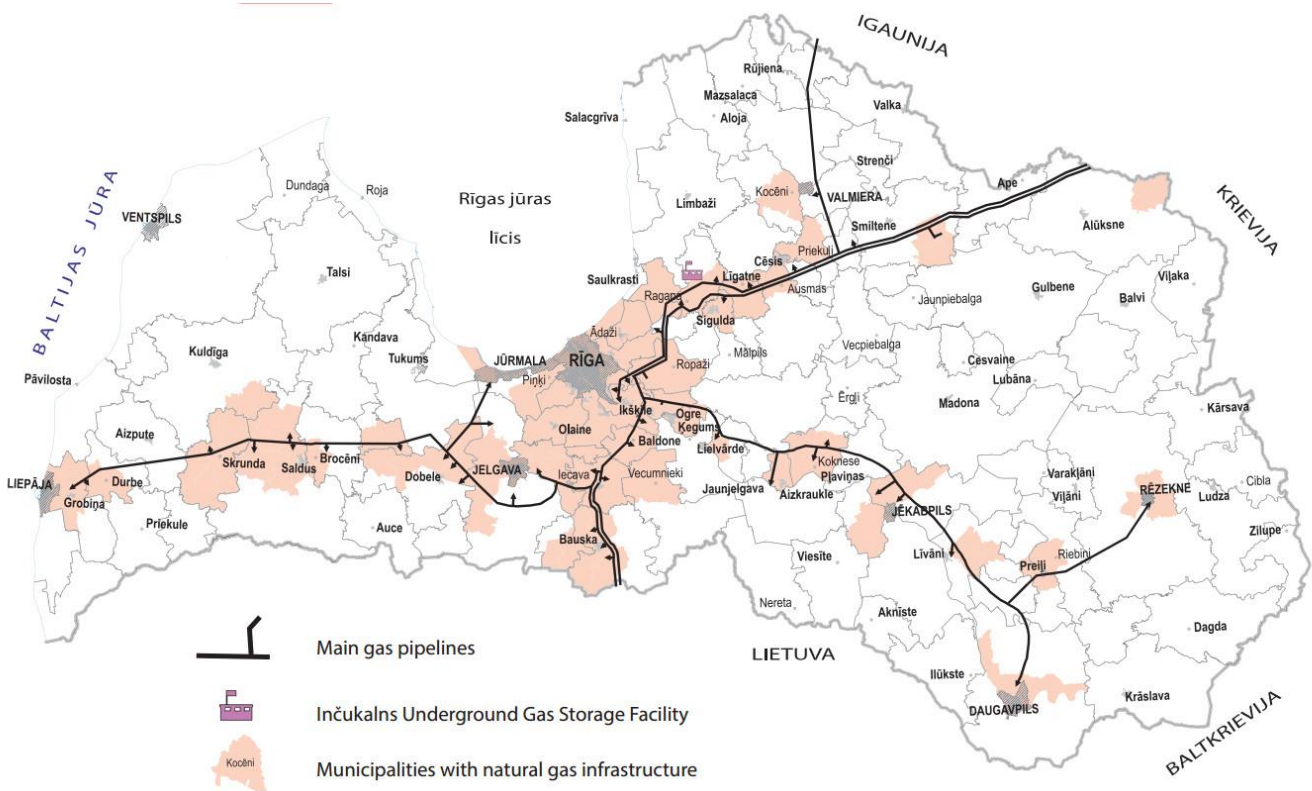
To draw conclusions about the significance of one particular energy source in the energy supply of a country, and its effect on the energy security of that country, one must take a close look at the country energy portfolio: what are the energy sources used to produce electricity and heat, what primary energy resources are produced locally, what are the production capabilities of the country's transformation sector. Given Latvia's climate, both the production of electricity and heat is crucial, and the production of both is seasonally determined.

Energy Generation Sources (MW, monthly average)
(1 January 2010 - 31 December 2013)



Source: Latvian electricity transmission system operator [AS Augstsprieguma tīkls webpage](#)

Latvia produces electricity domestically in the winter and spring, but imports electricity in the summer and fall. The production of energy in combined heat and power plants (CHP) is effective, if the plant is producing heat and electricity simultaneously. It is technologically possible for a CHP to produce only electricity (in condensation mode), but this is not economically effective and should be considered an exceptional or emergency measure. For the most part, CHPs produce electricity when there is demand for heating – in the cold months, when home heating is required and district heating systems supply heating to consumers.



The cyclical nature of natural gas consumption is not only due to the changing of the seasons. Natural gas delivery to consumers is also cyclical because natural gas for Baltic consumers is stored in the Inčukalns underground storage facility. In warm months, natural gas is transported from Russia to Latvia, and stored in the Inčukalns facility. In colder months the natural gas is delivered to consumers in Latvia, Lithuania, Estonia and Northwest Russia. The Inčukalns storage facility is a strategically important component of the security of energy supply for both the Baltic States and Russia:

- In the hypothetical case of a disruption of natural gas supplies, Latvia at current natural gas consumption levels would have enough gas in the Inčukalns facility to last approximately 18 months (depending on the outdoor temperature). But if the gas from Inčukalns was made available to all three Baltic States, there would be enough for five months, assuming that the Inčukalns storage facility is full to its maximum capacity.¹⁸
- As visualized in the graph below, during the heating season the Inčukalns storage facility provides a steady supply of natural gas to the northwest regions of Russia, where it is used for heating.¹⁹

Use of natural gas for the production of heat and electricity is only possible where gas can be physically delivered. Production and industrial facilities in Latvia that consume natural gas in large quantities are usually situated close to the natural gas transmission network. Natural gas pipelines belong to the transmission or distribution system depending on their function. High-pressure pipelines (equal to or higher than 1.6MPa) are used for transmission, while pressure in distribution pipelines is below 1.6MPa.

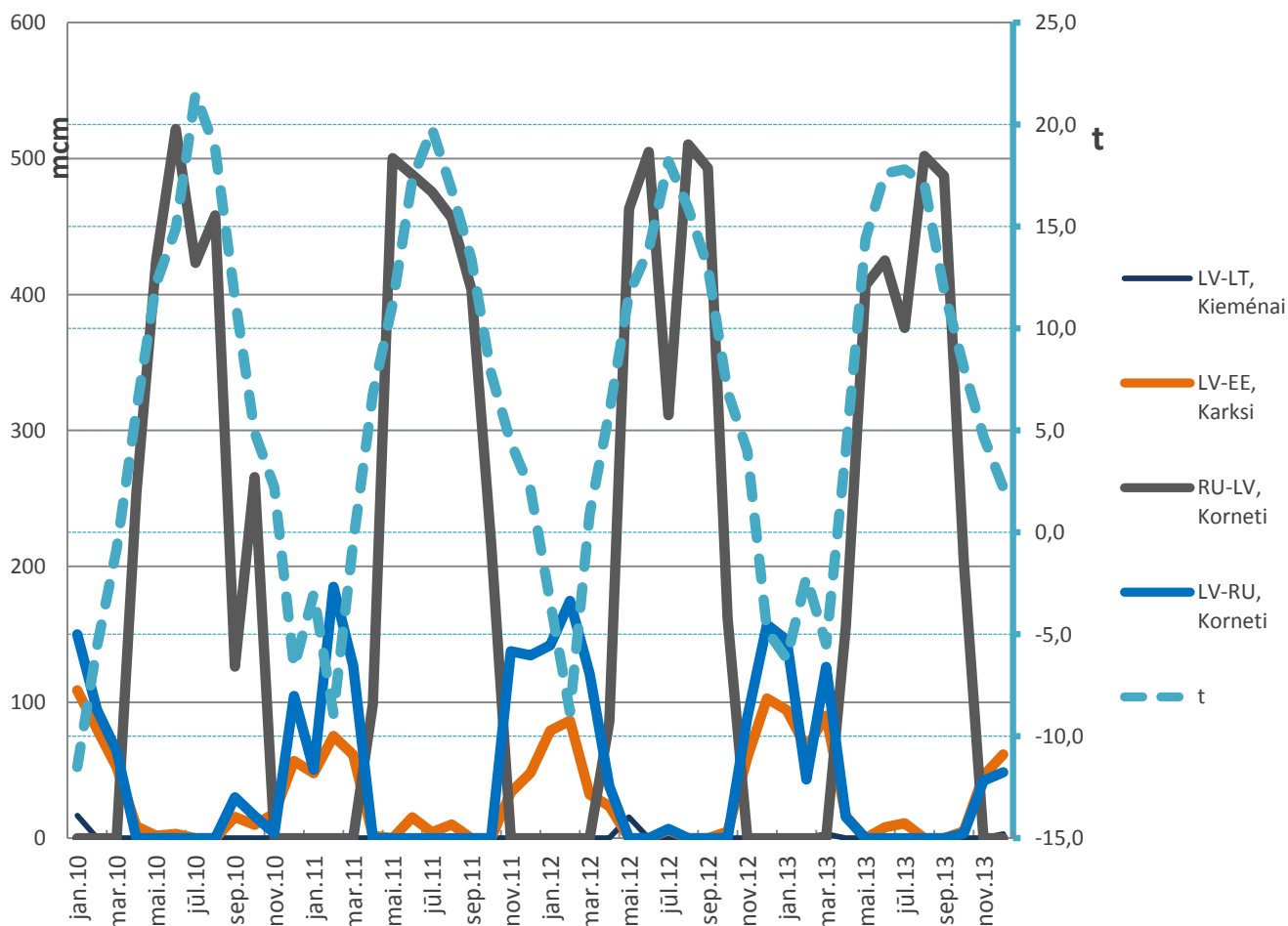
It is important to note that the Inčukalns natural gas storage facility does not belong to the Latvian state. It belongs to the shareholders of *JSC Latvijas Gāze*, but the land is leased from private landholders. Without the infrastructure, the geological formations at Inčukalns still hold potential for natural gas storage.

¹⁸ Annual consumption in Latvia is approximately 1,5 bcm, in the Baltic states – 5,6 bcm..

¹⁹ Mostly for district heating needs.

However, it is precisely the infrastructure (pipelines, compression stations and other equipment) that enables the current use of the Inčukalns geological formations for natural gas storage. Therefore, the Inčukalns facility is strategically important infrastructure, used to store a strategically important energy source – natural gas, yet decisions about the use and development of the Inčukalns facility are the prerogative of the owners, rather than the Latvian state. One can even say that the Latvian state has precious little to do with this facility;²⁰ there is only a geographical connection.

Natural Gas Flows between Latvia and Russia, Latvia and Estonia, Latvia and Lithuania, in Correlation to the Air Temperature
(millions of cubic meters (mcm), January 2010 - December 2013)



Data: International Energy Agency and the Latvian Environment, Geology and Meteorology Centre, 2014

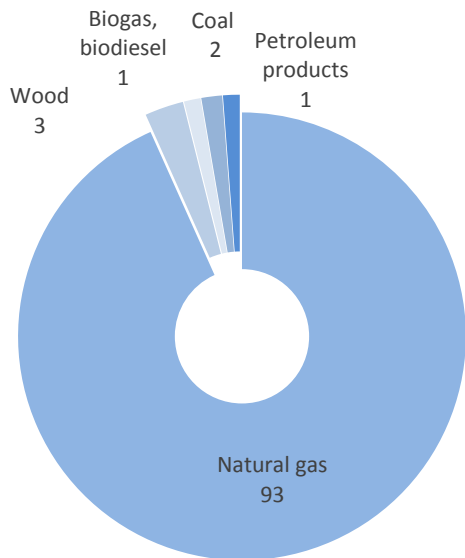
The Role of Natural Gas in District Heating and Electricity Generation

Natural gas remains vital to the transformation sector in producing heat and electricity. The largest consumer of natural gas in Latvia is the energy producer *JSC Latvenergo*, which uses gas for heat and electricity cogeneration. Overall, the share of natural gas as fuel in²¹ cogeneration plants is 93% and in heating plants, over 62%. The share of domestic fuel sources used in heating plants is still small, despite the potential for expanded use of wood, straw, biogas and peat.

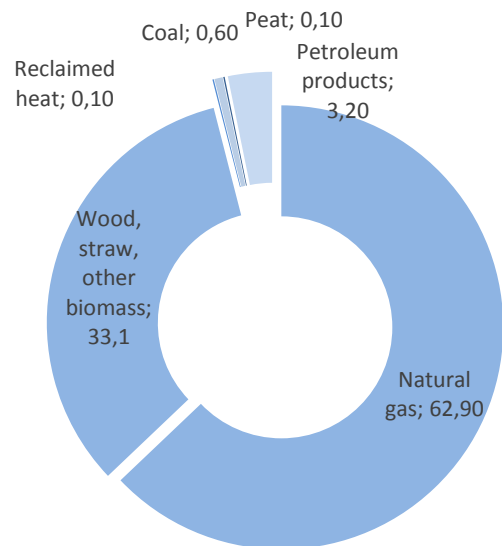
²⁰ Situation as of 6 October 2014.

²¹ *Latvia's Energy in Figures (Latvijas enerģētika skaitļos)*, Ministry of Economy, 2013, pp., 34-35.

Fuel Shares in District Heating Produced by Cogeneration Power Plants 2011 (%)



Fuel Shares in District Heating Produced by Boiler Houses 2011 (%)



Avots: Ekonomikas ministrija, „Latvijas enerģētika skaitļos 2013”

The Daugava Cascade hydroelectric power plants produce approximately one-third of Latvia’s electricity. Another third is produced by the large central heating plants (CHP) Riga TEC-1 and TEC-2, which use natural gas as their primary fuel. The remaining third is imported. The proportion of electricity supplied by these three sources shifts over the course of the year, depending on the flow of water in the Daugava and the outside temperature during the heating season. If water volume in the Daugava is high, the share of electricity generated by hydropower grows. For example, in April and May of 2013 the Daugava Cascade power plants produced over 1000MW, which is more than twice the average amount for summer months.²² Similar volumes were observed in 2012. When Daugava water volumes are high, and the hydroelectric plants are producing high volumes of electricity, the cogeneration stations using natural gas are producing at a lower capacity. Similarly, if the heating season begins relatively early (for example, in the latter half of October) and lasts until at least the end of March, then the Riga TEC-1 and TEC-2 plants are operating at capacity, and they are generating electricity along with heat, in high volumes for extended periods. In this case, electricity imports drop, because domestic electricity generation has risen.

Natural gas consumption in Latvia has fallen significantly since the metallurgical enterprise *Liepājas metalurģs*, which was one of the largest natural gas consumers, retooled its smelting process switching from gas-fuelled equipment to electric-operated equipment. Energy efficiency measures in households, state and local governments and energy sector enterprises have also served to reduce natural gas consumption. For example, renovations in the district heating system have led to a substantial drop in technical losses from the distribution system during winter months, peak heating season. Improvements in the energy efficiency of district heating systems lead to fuel savings, and that in turn reduces natural gas consumption.²³

JSC Latvijas Gāze

Latvia’s dependence on Russian natural gas is connected to the monopoly situation enjoyed by the enterprise *JSC Latvijas Gāze* (LG), which came about as a result of the privatization of this enterprise, and the legal framework governing its operations. Initially LG was a part of Soviet era state-owned Gazprom. Following the reestablishment of Latvia’s independence, LG was owned by the Latvian state, which decided

²² Daugava HES production average in summer (May-October) is 423MW.

²³ According to Eurostat, Latvia has reduced its heating consumption – in 2004 consumption was at 432 toe, but in 2010 – 384 toe.

in favour of privatization.²⁴ In 1997 LG was sold to private shareholders – AAS Gazprom and a consortium of energy companies created by the German companies Ruhrgas AG and PreussenElektra AG, currently – E.On Ruhrgas International AG.²⁵ The proportions of shares held by each shareholder has changed multiple times,²⁶ but since the end of 2002 the Latvian state no longer holds shares.²⁷

In light of the fact that the state no longer has any influence²⁸ over decision-making about strategically important infrastructure, discussions have emerged about the possibility of gaining state control over the Inčukalns underground natural gas storage facility. Decisions about the Inčukalns facility and its development are taken by the owners - LG. Therefore, if the Latvian state wishes to participate in decisions about the Inčukalns facility, it must become a shareholder in *JSC Latvijas Gāze*. There are two possible scenarios for securing Latvian energy independence:

- 1. Taking a majority stakeholder position in *JSC Latvijas Gāze*.** Acquisition of a large minority stake would require the Latvian state to participate in the operations and development of the enterprise, but would not ensure control. Therefore, if the Latvian government decides to purchase shares held by E.On Ruhrgas (47,32%), the government needs to have the next steps in place, i.e. plans to purchase shares from other shareholders to gain a majority stake. An additional 3% share would be necessary to reach majority shareholder status. It would be short-sighted to rely only on the promises of other shareholders to cooperate with the Latvian government in taking major decisions. This type of a situation would make the Latvian state as a shareholder extremely vulnerable and dependent on other shareholders' support or lack of support in decisions crucial to the operation and development of the enterprise.²⁹ These same issues must be taken under consideration by any future buyer of shares in *JSC Latvijas Gāze*, if they wish to gain control of the Inčukalns facility, not simply gain a stake in *JSC Latvijas Gāze*.³⁰
- 2. Purchasing shares in gas transmission or storage companies.** An alternative, and preferable, approach would be to consider taking shares in the strategically important gas transmission and gas storage enterprises after the breakup of *JSC Latvijas Gāze* and the liberalization of the natural gas market (the Third EU Energy package requires liberalization of the gas market and the breakup of vertically integrated monopolies into separate entities for transmission, distribution, storage and trade). A window of opportunity could appear for the government to improve energy security for a lesser investment amount than taking a majority share in *JSC Latvijas Gāze* would require. The government could take shares in only one of the four enterprises resulting from the breakup of *JSC Latvijas Gāze*.³¹

²⁴ LG privatization was managed by the non-profit state-owned *Privatisation Agency*.

²⁵ In 1997 in the privatization process of LG the government of Latvia chose a consortium of two German companies: PreussenElektra Aktiengesellschaft (PreussenElektra) and Ruhrgas Aktiengesellschaft (Ruhrgas). After a number of restructurings and purchases, the shares originally belonging to the consortium now belong to the enterprise E.ON Ruhrgas International AG.

²⁶ There were two major shifts in the proportions of shares held by shareholders. In 1998 the state sold its shares (24,62%) for privatization certificates. In 2000 the remaining Latvian state shares – 29% - were sold at two public auctions conducted by the Riga Stock Exchange. Data from [JSC Latvijas Gāze website](#) (in Latvian).

²⁷ On 1 February 2002, the last 3% of state owned shares were sold via privatization. In December 2003, after the merger of Ruhrgas Energie Beteiligungs AG and E.ON Energie AG, all of E.ON Energie AG shares were transferred to Ruhrgas Energie Beteiligungs AG, which changed its name in June 2004 to E.ON Ruhrgas International AG. Data from [JSC Latvijas Gāze website](#) (in Latvian).

²⁸ *JSC Latvijas Gāze*, as the owner of the Inčukalns storage facility, is licensed to conduct the business of gas storage, and as such must comply with all requirements stipulated by the license. Therefore, one can say that the only entity able to influence decisions about the Inčukalns facility is the public utilities commission.

²⁹ One of *JSC Latvijas Gāze* shareholders – Itera Latvija director Juris Savickis [has in a short time span reversed his position](#) (in Latvian) on the possibility of a government purchase of *JSC Latvijas Gāze* shares.

³⁰ It is important to note that the rights and responsibilities of the four different commercial operations are defined not by the privatization of the enterprise itself, but by the commercial licences issues for operations.

³¹ Transmission, distribution, storage, trade.

Legislative changes made to the Law on Energy in March of 2014 strengthen the monopoly position of *JSC Latvijas Gāze* as a vertically integrated company, which in turn significantly complicates any attempt by the government or other potential shareholders to acquire shares in *JSC Latvijas Gāze*.

The Liberalization of Latvia's Natural Gas Market

It is in the Latvian national interest to have an open and free gas market, where more than one natural gas supplier can operate on a level playing field, free from discrimination. Competition, alternative suppliers and supply lines improve energy independence. Recent parliamentary decisions, however, have weakened Latvia's energy independence by limiting entry of alternative suppliers to Latvia's market until 2017. This situation also makes it impossible to negotiate prices with Latvia's only supplier, thus placing Latvia at risk for significant external economic and political pressure.

In 2005 the Latvian parliament decided to liberalize the natural gas market by 4 April 2014.³² For nine years Latvia had a clear deadline for liberalization. However, two weeks before this deadline, on 13 March 2014, parliamentarians approved changes to legislation withdrawing the deadline.³³ There is reason to believe that the changes to the Law on Energy will be interpreted in a way that not only withdraws the deadline, but significantly hampers ongoing efforts to move towards market liberalization by legally underpinning the discretionary rights of *JSC Latvijas Gāze* to allow or deny third party access to the transmission system until 3 April 2017.³⁴ The regulator does, however, have oversight over LG decisions on access for third parties, as this is included in the licensing conditions.

These conclusions can be drawn upon close examination of all licences issued to *JSC Latvijas Gāze* on 11 February 1997³⁵ – for natural gas transmission, distribution, storage and trade.³⁶ These licences grant exclusive rights to natural gas transmission, distribution, storage and trade in Latvia,³⁷ however, exclusivity means the rights to undertake these commercial activities either in the absence of competition or under conditions of limited competition. Analysis of laws in force at the time of issuance leads to the conclusion that exclusivity includes conditions of limited competition. The laws state that:

- an exclusive licence for the transmission and distribution of energy creates a responsibility to provide transmission and distribution services,
- the holder of an exclusive licence may not limit access to the transmission and distribution system for other license holders, if it is technically feasible to provide access.³⁸

Therefore, the legislative framework at time of issuance and licensing conditions lead to the conclusion that *JSC Latvijas Gāze* – prior to the March 2014 legislative changes in the Law on Energy - had obligations related to the liberalization of the gas market. The licence expiration date for all four licences is 10

³² The liberalization of the natural gas market in Latvia is regulated by the Law on Energy and a separate law on the entry into force of certain paragraphs of the Law on Energy, adopted 30 June 2005.

³³ Changes to the Law on Energy were adopted 13 March 2014, with all present members of parliament voting for the bill. It came into force 26 March 2014, only one week before the market liberalization deadline. With the adoption of these changes, the previous legislation setting the market liberalization deadline of 4 April 2014 ceased to apply.

³⁴ The previous legal framework did not give the monopolist broad discretionary powers over such strategically important issues as third party access to the gas transmission network or storage facility. The new legislative changes legally underpinned substantial discretionary powers for *JSC Latvijas Gāze* for a three year period.

³⁵ [See the Public Utilities Commission website](#) (in Latvian).

³⁶ [Council for the Regulation of Energy Supply](#) (in Latvian), 12 November 1996 ruling refers to "sales".

³⁷ Conditions for licensing were approved in November 1994 by the Council for the Regulation of Energy Supply (ERP), whose functions were taken over by the Public Utilities Commission in October 21001. The conditions are outlined in three documents: ERP 12 November 1996 ruling Nr. 11 On the licensing of energy companies, the Council of Ministers 7 May 1996 Regulation Nr. 163 The foundation document of the Council for the Regulation of Energy Supply, the 6 September 1995 [Law On regulation of commercial activities in energy](#) (in Latvian).

³⁸ Reference to the limits of exclusivity is made in the [ERP 12 November 1996 regulation paragraph 4.1.](#) (in Latvian) this addresses the zone of operations, and paragraph 4.2.3. which indicates that the holder of an exclusive licence may not limit access to the transmission and distribution system for other license holders, if it is technically feasible.

February 2017³⁹ not 3 April 2017, as would be logical if the exclusivity arrangement was directly tied to the original conditions of the privatization agreement. It is possible that the exclusivity is not an outcome of the agreement between the government of Latvia and the shareholders of *JSC Latvijas Gāze*, but rather a consequence of the fact that, at the time of privatization, *JSC Latvijas Gāze* was the only natural gas company in Latvia.

Delaying Liberalization of the Natural Gas Market

February 2013: *JSC Latvijas Gāze* proposes indefinite postponement of liberalization of the gas market. Serious discussion of changes to the Law on Energy aimed at postponing liberalization began one year before the legislated deadline. On 26 February 2013 the parliamentary Committee on Economy, Environment and Agrarian Policy considered two issues of importance to the energy sector: the report by the Ministry of Economy on the draft *Latvia Energy Strategy 2030*⁴⁰ and the report by Chairman of the Board of *JSC Latvijas Gāze* Adrians Dāvis⁴¹ on natural gas prices.⁴² Dāvis' report marked a turning point in public discussion on the liberalization of the natural gas market. He proposed changes to the Law on Energy, which, if adopted, would postpone indefinitely the liberalization of the gas market.⁴³

To create the impression that failure to amend the Law on Energy and respecting the market liberalization deadline would create serious financial and economic consequences, Chairman of the Board Dāvis referenced confidential information contained in the privatization agreement between the shareholders of *JSC Latvijas Gāze* and the government of Latvia. Dāvis argued that failure to amend the law would result in increased operating costs for LG⁴⁴ and would provoke a rise in natural gas prices because liberalization would create a rift in the relationship between the Russian energy company *Gazprom* and Latvia. At the 26 February meeting of the Commission on Economy, the members of parliament chose not to make public confidential information, so they called a closed meeting one day later, with one agenda item – natural gas prices.⁴⁵

December 2013: The government proposes creating competition in the natural gas market. Until November 2013 the *JSC Latvijas Gāze* proposal to postpone liberalization went nowhere, creating the impression that parliament does not have any intention of making changes to the Law on Energy. However, on 3 December 2013, the Council of Ministers submitted to parliament legislative amendments concerning liquefied natural gas supply, transmission, distribution and storage.⁴⁶ This draft legislation was approved by parliament in its first reading on 12 December 2013.⁴⁷

The main intention of this draft legislation was to harmonize legislation with the EU natural gas market liberalization and regulate particular issues: third party access to the natural gas transmission system, unbundling of the distribution systems operator, separation of accounts,⁴⁸ creating a framework for the

³⁹ Licence texts available at the [Public Utilities Commission website](#) (in Latvian).

⁴⁰ The Minister of Economy Daniel Pavļuts report to the Commission was largely of an informative nature.

⁴¹ Formally – upon the request of Ivars Zariņš, MP (represents “Harmony Centre” party).

⁴² [The agenda of the Saeima Commission on the economy](#) (in Latvian) for 26 February 2013.

⁴³ As per the legislative proposals submitted by *JSC Latvijas Gāze*.

⁴⁴ Contrary to public statements by *JSC Latvijas Gāze*, that a separation of accounts will significantly increase operating costs, which would have to be passed on to the consumer, it must be noted that a requirement to separate accounts is contained in the licensing conditions from date of issuance, therefore, a lack of separation of accounts is a violation of the [licensing conditions](#) (in Latvian). The law „On the licensing of companies in energy supply” paragraph 5 requires a vertically integrated company to keep separate accounts for each of the licence commercial activities. [The Law on regulation of commercial activities in energy](#) (in Latvian), paragraph 21.1 requires an energy company to operate in accordance with conditions set out in the licence and in the public interest according to law.

⁴⁵ [Parliamentary Commission on Economy 26 February 2013 agenda](#) (in Latvian).

⁴⁶ The draft law of the amendments was reviewed at the Cabinet of Ministers on November 26, 2013 ([minutes of the meeting Nr.63, 30.§, TA-3452](#) in Latvian). The draft law was elaborated by the Ministry of Economy. The annotation and [the initial text of the draft law](#) on the Parliament's website.

⁴⁷ On 5 December the draft legislation (Nr. 1017/Lp11) was submitted to the Commission on Economy, which considered it during their 11 December meeting.

⁴⁸ The requirement to keep separate accounts according to licensed activities is contained in [the Law on Energy](#) (in Latvian), which provides that „An energy company, that is either horizontally or vertically integrated, needs to keep internal accounts with a balance sheet, profit and

functioning of a liquefied natural gas system.⁴⁹ The first three of these tasks are directly connected to creating a favourable legal environment for competition in the natural gas market.

March 2014: Parliament postpones liberalization of the gas market until 2017. In the second and third readings of the proposed legislative changes, *JSC Latvijas Gāze* representatives offered their own amendments, which indefinitely postponed market liberalization, requiring that two criteria be met before market liberalization could move forward:

- Latvia's gas transmission system must be directly connected to other EU natural gas transmission systems, not counting the system connecting Lithuania, Estonia and Finland,
- The dominant natural gas supplier (Russia's *Gazprom*) has a market share of less than 75% in Latvia, without creating any deadlines or benchmarks for opening the market.

These requirements cannot be quickly met given the current situation in the natural gas market in Latvia, which would mean an indefinite postponement for liberalization of the gas market. This proposal was rejected, but in its place members of parliament supported postponement of the liberalization deadline until 3 April 2017.

Taking a closer look at the substance of the discussions in the Commission on Economy, one can conclude that a more thorough analysis of the commercial licensing conditions and their application would have offered an opportunity to let the original liberalization deadline stand. The legislative amendments seem poorly considered, because there is no answer to the question – who will ensure natural gas transmission from 11 February to 3 April 2017⁵⁰ Parliament has voted⁵¹ to close the market for these two months to other operators. In order to manage this gap, the Public Utilities Commission will have to take a decision to issue new licences to *JSC Latvijas Gāze*⁵² so that they would have the right to operate in Latvia during these two months.

Action Items

It is important to take advantage of the time until April 2017, when *JSC Latvijas Gāze* monopoly situation expires and unbundling of the gas transmission system occurs, establishing an independent transmission operator. Taking into account the decisions taken and not taken, the general market situation, the economic and political risks surrounding the decision to liberalize the natural gas market, the following issues demand immediate resolution:

- A decision needs to be taken on the model for creating an independent transmission system operator, as per the EU natural gas internal market directive⁵³, and the conditions outlined therein⁵⁴. This decision would clearly and unequivocally show Latvia's resolve to open the natural

loss statement and cash flow report separately for each type of energy supply activity – as if each activity were performed by a separate commercial entity.” (paragraph 12.2.)

⁴⁹ [Transcript of the 12 December 2013 plenary session of parliament](#) (in Latvian).

⁵⁰ See, for example, paragraph 2 of the gas transmission and distribution licences.

⁵¹ 13 March 2014 plenary session.

⁵² Under the conditions that the gas market does not undergo liberalization earlier and there are no other traders or distribution companies operating in the market.

⁵³ [13 July 2009 European Parliament and Council directive 2009/73/EK](#) on common rules for the natural gas internal market and on the repeal of Directive 2003/55/EK.

⁵⁴ The directive sets out detailed conditions, which must be met in order to create an independent systems operator as foreseen in paragraph 14, which does not necessitate separation of assets (assets remain with the producer), but requires supervision of independence of the operator by the competition regulator. The directive also sets out detailed conditions to enable independence for the transmission systems operator, free from influence of the parent company (paragraph 18.4), if a subsidiary model is employed. In this case, a strong and competent regulator is needed, who can closely monitor implementation of the directive as regards independence of the operator, and the operator's ability to fulfil the conditions set out in chapter VIII of the directive, especially with regard to paragraphs 39, 40 and 41. If compliance can be ensured, the state should not care which of the two models is employed. Business logic and development interests would dictate a preference for the subsidiary model, which is outlined in detail by the directive.

gas market, thus contributing to the creation of a single EU electricity and natural gas market⁵⁵ and coordinating actions with Lithuania and Estonia;

- Amendments to the Law on Energy need to be adopted, which would separate the gas transmission system from *JSC Latvijas Gāze*, creating an opening for the entry of other suppliers into the Latvian market;
- A legal framework is needed to protect consumers from a possible extreme hike in tariffs when the independent systems operator is created;
- A decision needs to be taken on the construction of either a regional or national liquefied natural gas terminal;
- Support should be given to Lithuania in its negotiations with potential LNG suppliers after the Klaipeda LNG gasification terminal has begun operations;
- Latvia needs to take a clear supportive position on the conclusion of the EU and USA Transatlantic Trade and Investment Partnership, with special focus on US LNG exports to Europe, especially to the Baltic States as soon as it is technically feasible for the Baltic States to import LNG;
- In evaluating the need for and possibility of the Latvian state acquiring shares in *JSC Latvijas Gāze*, quality discussions and consultations are needed in order to ensure that Latvia meets its goal of improved energy security, which is possible only by gaining a majority share. Simultaneously an alternative approach should be considered – acquiring shares of an already unbundled *JSC Latvijas Gāze* after liberalization of the market. This could create an opportunity for improved energy independence at a lower investment cost.

In decision-making and policy implementation one should not lose sight of the ultimate goals – to create the possibility for alternative energy supplies, to create incentives for price negotiations with Latvia's existing natural gas supplier, to bolster Latvia's energy independence. Policy makers and decision makers need to recognize that options that may seem complex and expensive today, can lead to significant savings in the future. These options may in fact present the only opportunity for Latvia to retain its independence in political decision-making.⁵⁶

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⁵⁵ The aim of the Third EU Energy package is to create a single EU electricity and natural gas market, with robust competition, where no entity dominates in relationships with clients, and all entities have equal access to the energy transmission infrastructure. More on EU policies on the [European Commission website](#).

⁵⁶ Italy has traditionally had close cooperation with Russia, including in the energy sector. In commenting on the rift in the Ukraine and Russia relationship and its effect on gas supplies to Europe, the director of Italy's largest energy company ENI Paolo Skaroni said to the BBC: „If a country is not energy independent, it is not independent at all.”