

INFORMATIVE REPORT

19 December 2011

No 5.1-2-7/2011

Compliance of the Greenhouse Gas Emission Allowances Administration with Legal Requirements and Effectiveness of the System in Latvia

Legal Justification of the Audit#

1. According to the Section 2 of the State Audit Office Law and Audit Assignment No. 5.1-2-7/2011 of 2 May 2011 and Audit Sub-Assignment No. 5.1-2-7-1/2011 of 27 July 2011 of the Fourth Audit Department of the State Audit Office, the legality audit "Compliance of the Greenhouse Gas Emission Allowances Administration with Legal Requirements and Effectiveness of the System in Latvia" was conducted.
2. The audit was conducted by Senior State Auditor Jānis Salenieks (head of the team), State Auditor Linda Mikanovska, State Auditor Inese Priedīte and State Auditor Ineta Rancāne.

Objective of the Audit#

3. The objective of the audit is to gain assurance whether
 - 3.1. the Greenhouse gas emission allowances administration is organized in compliance with the requirements of the regulatory enactments; and
 - 3.2. the European Union emissions trading scheme has been implemented in Latvia in a way that motivates enterprises to lower emissions with minimum impact on the enterprises economic development.

Accountability of the State Audit Office #

4. The auditors of the State Audit Office are responsible for issuing an audit report that is based on appropriate, sufficient and credible audit evidence obtained during the audit.

Accountability of the Audited Entity#

5. The Ministry of Environmental Protection and Regional Development, the State Environmental Service, State Limited Liability Company Latvian Environment, Geology and Meteorology Centre (hereinafter: LEGMC) and the Public Utilities Commission are responsible for compliance with regulatory enactments and the truthfulness of the information provided to the auditors.

Scope of the Audit#

6. The audit was conducted in accordance with international auditing standards recognised in the Republic of Latvia. The audit was planned and conducted so as to obtain sufficient assurance regarding the compliance of the greenhouse emissions allowances administration with the regulatory enactments.
7. Due to the fact that the audit was conducted in the area involving a number of responsible institutions, two audit reports and an informative report have been prepared as a result of the audit:
 - 7.1. to the Ministry of Environmental Protection and Regional Development: on the implementation of climate change reduction policy and the compliance of the supervision over the operators with the regulatory enactments;

- 7.2. to the Public Utilities Commission: on the inclusion of GHG allowance purchasing expenses in the tariffs of the energy sector and the compliance of the use of revenues from the sale of emissions allowances with the regulatory enactments.
- 7.3. informative report on the compliance of the administration of greenhouse emission allowances with the requirements of regulatory enactments and the effectiveness of the system established.
8. The following inspections were included in the audit:
 - 8.1. at the Ministry of Environmental Protection and Regional Development; its subordinated institution, the State Environmental Service; State Limited Liability Company Latvian Environment, Geology and Meteorology Centre, for the period from 1 January 2008 to 31 May 2011;
 - 8.2. at the Public Utilities Commission, for the period from 1 January 2005 to 30 June 2011.
9. The following were carried out during the audit, selectively:
 - 9.1. checks on the issue of GHG emission permits:
 - 9.1.1. at the Lielrīga Regional Environmental Board: verification of the issue of 13 GHG emissions permits;
 - 9.1.2. at the Daugavpils Regional Environmental Board: verification of the issue of six GHG emissions permits;
 - 9.1.3. at the Liepāja Regional Environmental Board: verification of the issue of six GHG emissions permits;
 - 9.1.4. at the Jelgava Regional Environmental Board: verification of the issue of five GHG emissions permits;
 - 9.2. checks regarding the supervision of compliance with the rules of the GHG emissions permits:
 - 9.2.1. at the Lielrīga Regional Environmental Board, by examining 37 GHG emissions reports and 56 inspection protocols;
 - 9.2.2. at the Daugavpils Regional Environmental Board, by examining 15 GHG emissions reports and 19 inspection protocols;
 - 9.2.3. at the Liepāja Regional Environmental Board, by examining nine GHG emissions reports and nine inspection protocols;
 - 9.2.4. at the Jelgava Regional Environmental Board, by examining 16 GHG emissions reports and 21 inspection protocols;
 - 9.3. At the Ministry of Environmental Protection and Regional Development, regarding ten facilities for verification of the allocation of GHG emissions allowances that were allocated after the submission of the Emissions Allowance Allocation Plan ¹ to the European Commission;
 - 9.4. at the Public Utilities Commission: checks of 31 heat energy and co-generation tariffs approved for the producer.

¹ Emissions Allowance Allocation Plan 2008-2012 (approved by Cabinet Order No. 542 of 4 September 2008).

Brief Description of the Audited Area #

10. On 1 January, 2011 the Ministry of Regional Development and Local Government was integrated at the Ministry of Environment, and a new institution – the Ministry of Environmental Protection and Regional Development – was formed.²
11. In 1995, Latvia ratified the United Nations Framework Convention on Climate Change³ and, in 2002, the Kyoto Protocol of the said Convention⁴ (hereinafter: “Kyoto Protocol”). The Kyoto Protocol aims to reduce the quantity of emissions globally. In accordance with the Kyoto Protocol, Latvia had to achieve an emissions reduction of 8% in the period from 2008 to 2012 from the emissions levels in 1990.⁵
12. There are two parallel trading systems of GHG emission units currently in Latvia:
 - 12.1. international emissions trading,⁶ as part of which countries mutually trade in the GHG emission units allocated to them;
 - 12.2. the European Union emissions allowance trading scheme,⁷ as part of which enterprises mutually trade in the GHG emission units allocated to them.
13. The European Union emissions allowance trading scheme was introduced in the European Union and Latvia on 1 January 2005 in order to promote the reduction of GHG emissions in a cost-effective way.⁸
14. There are a total of six GHGs that are marked as carbon dioxide equivalents,⁹ of which only carbon dioxide has been included in the European Union emissions allowance trading scheme for 2008-2012.
15. Operators involved in the polluting activity of a specific kind¹⁰ must participate in the European Union emissions allowance trading scheme. See annex for a list of equipment whose operators are required to participate in the European Union emissions allowance trading scheme.
16. An operator is a private individual, a derived public person, a direct or mediated government institution which performs professional activities or is responsible for the performance of such activities or which has determinant economic power over the technical implementation of the relevant professional activity.¹¹

² Cabinet Order No. 676 of 22 November 2010 “On Ensuring the Liquidation of the Ministry of Regional Development and Local Government”.

³ Ratified by the Law on the United Nations Framework Convention on Climate Change.

⁴ Ratified by the Law on the Kyoto Protocol of the United Nations Framework Convention on Climate Change.

⁵ Article 3(7) of the Kyoto Protocol of the United Nations Framework Convention on Climate Change of 11 December 1997.

⁶ Article 17 of the Kyoto Protocol of the United Nations Framework Convention on Climate Change of 11 December 1997.

⁷ Article 1 of Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC.

⁸ Article 1 of Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC.

⁹ Section 1, Clause 10.¹ of the Law on Pollution.

¹⁰ Annex 2 to the Law on Pollution, “Polluting Activities (Installations) Requiring a Greenhouse Gas Emission Permit”.

¹¹ Section 1, Clause 5 of the Law on Pollution.

17. As part of the European Union emissions allowance trading scheme,¹² operators mutually trade in the emissions allowances, emission reduction units and certified emission reduction units allocated to them.
18. Thirty states are currently involved in the European Union emissions allowance trading scheme, including the 27 Member States of the European Union and Iceland, Liechtenstein and Norway.
19. A GHG emission unit is a unit equivalent to one tonne of carbon dioxide or marked amount of another greenhouse gas expressed in equivalents of carbon dioxide, taking into account the global heating potential of the particular greenhouse gas.¹³
20. In 2004, the emissions of the installations (facilities) included in the European Union emissions allowance trading scheme constituted 27% of the overall volume of carbon dioxide emissions of the Republic of Latvia.¹⁴
21. The Directive¹⁵ prescribes the following emissions allowance trading periods in the European Union:
 - 21.1. first period, from 2005 to 2007;
 - 21.2. second period, from 2008 to 2012;
 - 21.3. third and subsequent periods: eight calendar years starting 1 January 2013.
22. The total amount of the emissions allowance to be allocated within a particular period to operators performing the polluting activities referred to in the regulatory enactment,¹⁶ as well as the distribution of the proposed emissions allowances among the operators of the installations (facilities), is specified in the Emissions Allowance Allocation Plan.¹⁷
23. In Latvia, the Emissions Allowance Allocation Plan for the first and second European Union emissions allowance trading period is developed by the Ministry of Environmental Protection and Regional Development and approved by the Cabinet of Ministers.¹⁸ The Emissions Allowance Allocation Plan approved by the Cabinet has to be submitted to the European Commission for a decision to be taken.
24. GHG emissions allowances in the 2008-2012 European Union allowance trading period are allocated to the operators of installations free of charge¹⁹
25. Starting from 2013, the Member States will auction all the quotas not allocated free of charge to operators.²⁰

¹² Article 1 of Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC.

¹³ Section 1, Clause 3 of the Law on Participation of the Republic of Latvia in the Flexible Mechanisms of the Kyoto Protocol.

¹⁴ Emissions Allowance Allocation Plan 2008-2012, approved by Cabinet Order No. 348 of 1 August 2011 "On the Emissions Allowance Allocation Plan 2008-2012", Sub-Chapter 1.1.

¹⁵ Article 11(1) and (2) (edition until 24 June 2009), Article 13(1) (edition since 25 June 2009) of Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC.

¹⁶ Annex 2 to the Law on Pollution, "Polluting Activities (Installations) Requiring a Greenhouse Gas Emission Permit".

¹⁷ Section 32.¹, Paragraph two of the Law on Pollution.

¹⁸ Section 32.¹, Paragraph four of the Law on Pollution.

¹⁹ Section 32.², Paragraph three of the Law on Pollution.

²⁰ Article 10(1) of Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC; Section 32.², Paragraph three of the Law on Pollution (edition since 4 August 2011).

26. The following institutions are involved in the administering of GHG emissions allowances:
- 26.1. Ministry of Environmental Protection and Regional Development: ensures the development of the planning documents for the Latvian climate change reduction policy, draft regulations and emissions allowance allocation plans, ensures the allocation of emissions allowances to current and new participants of the scheme;
 - 26.2. State Environmental Service: issues GHG emission permits, supervises the activities of operators, approves the annual GHG emissions reports;
 - 26.3. verifiers: juridical persons that are accredited to verify the GHG emissions reports submitted by operators; they verify the annual GHG emissions reports and prepare papers;
 - 26.4. LEGMC: performs the supervision of the transfer of emissions allowances by maintaining a register of GHG emissions units; prepares Latvian national reports on GHG emissions; and provides public information;
 - 26.5. Public Utilities Commission: approves tariffs that include the cost of purchasing emissions allowances.

Responsibility of the Ministry of Environmental Protection and Regional Development

27. Latvia has developed two Emissions Allowance Allocation Plans: for the first (2005-2007)²¹ and the second (2008-2012)²² European Union emissions allowance trading period, as well as a list of facilities for the third (2013-2020)²³ European Union emissions allowance trading period.
28. For the second European Union emissions allowance trading period, the Cabinet has approved five²⁴ Emissions Allowance Allocation Plans for 2008-2012 submitted by the Ministry of Environmental Protection and Regional Development. Adjustments for the Emissions Allowance Allocation Plan 2008-2012 approved by the Cabinet were made in accordance with European Commission decisions on changes in the overall amount of emissions allowances to be allocated to Latvia with respect to the Emissions Allowance Allocation Plans for 2008-2012 submitted by Latvia.
29. Until 31 July 2011, emissions allowances were allocated to operators according to the Emissions Allowance Allocation Plan 2008-2102 approved by the Cabinet on 4 September 2008,²⁵ establishing that, in the period 2008-2012, an average of 3,398,483 emission allowances are allocated to Latvia annually.

²¹ Emissions Allowance Allocation Plan 2005-2007, approved by Cabinet Order No. 270 of 27 April 2004 "On the Emissions Allowance Allocation Plan 2005-2007".

²² Emissions Allowance Allocation Plan 2008-2012, approved by Cabinet Order No. 348 of 1 August 2011 "On the Emissions Allowance Allocation Plan 2008-2012".

²³ Cabinet Order No. 499 of 29 September 2011 "On the List of Installations for the Allocation of Emissions Quotas in 2013-2020".

²⁴ Cabinet Order No. 608 of 9 August 2006 "On the Emissions Allowance Allocation Plan 2008-2012" (no longer in effect by Cabinet Order No. 1010 of 28 December 2006); Cabinet Order No. 1010 of 28 December 2006 "On the Emissions Allowance Allocation Plan 2008-2012" (no longer in effect by Cabinet Order No. 809 of 17 December 2007); Cabinet Order No. 809 of 17 December 2007 "On the Emissions Allowance Allocation Plan 2008-2012"; Cabinet Order No. 542 of 4 September 2008 "On the Emissions Allowance Allocation Plan 2008-2012"; Cabinet Order No. 348 of 1 August 2011 "On the Emissions Allowance Allocation Plan 2008-2012".

²⁵ Emissions Allowance Allocation Plan 2008-2012 (approved by Cabinet Order No. 542 of 4 September 2008).

30. Total 73 facilities have been included in the Emissions Allowance Allocation Plan 2008-2012,²⁶ of which 67 facilities operators are mandatory and six are voluntary participants of the European Union emissions allowance trading scheme.
31. Comparing the total number of emissions allowances established by the first Emissions Allowance Allocation Plan 2008-2012 produced by the Republic of Latvia²⁷ with the total number of emissions allowances established in the Emissions Allowance Allocation Plan 2008-2012 approved by the Cabinet on 4 September 2008,²⁸ the planned total annual amount of emission allowances was reduced by 44%, in accordance with the decisions of the European Commission.
32. On 26 September 2007, the Republic of Latvia submitted a claim to the Court of the First Instance of the European Communities²⁹ to recall the European Commission Decision³⁰ on the reduction of the number of emission allowances for the Republic of Latvia.
33. On 22 March 2011, the Court of Justice of the European Union recalled³¹ the European Commission Decision,³² and the Cabinet approved the fifth Emissions Allowance Allocation Plan 2008-2012 on 1 August 2011,³³ establishing that, in the period 2008-2012, an average of 6,253,146 emission allowances are allocated to Latvia annually.
34. Overall, the actual emissions of the facilities included in the European Union emissions allowance trading scheme are lower than the emissions allowances allocated (see Figure 1).

²⁶ Section 5 “List of Installations” of the Emissions Allowance Allocation Plan 2008-2012 (approved by Cabinet Order No. 542 of 4 September 2008).

²⁷ Cabinet Order No. 608 of 9 August 2006 “On the Emissions Allowance Allocation Plan 2008-2012” (no longer in effect by Cabinet Order No. 1010 of 28 December 2006).

²⁸ Section 5 “List of Installations” of the Emissions Allowance Allocation Plan 2008-2012 (approved by Cabinet Order No. 542 of 4 September 2008).

²⁹ As of 1 December 2009, the Court of Justice of the European Union.

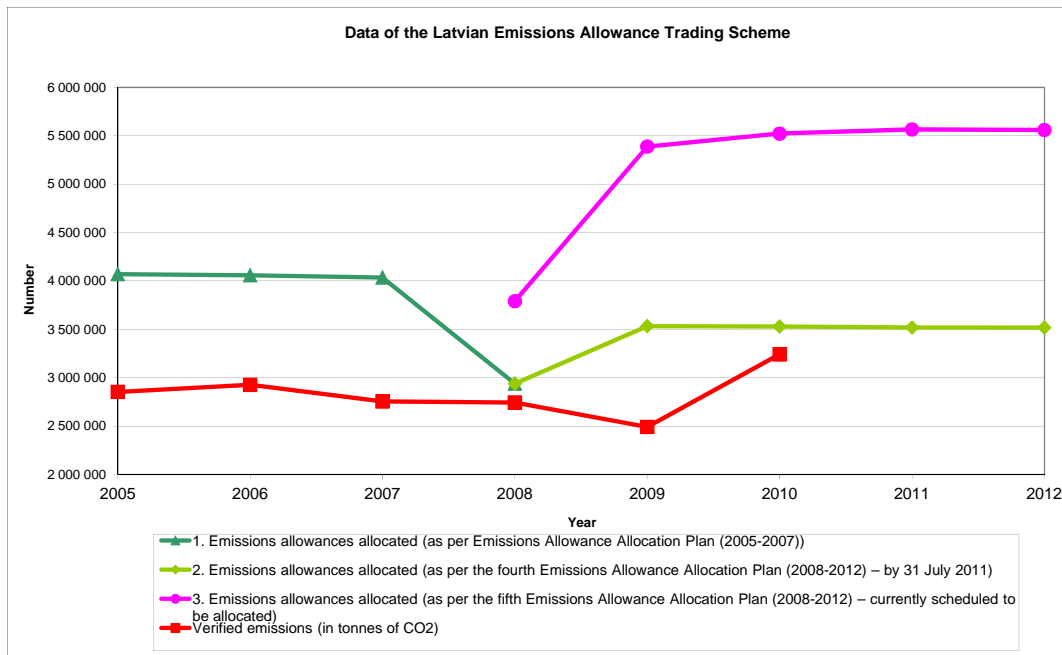
³⁰ European Commission Decision C(2007) 3409 of 13 July 2007 on the amendment of the national plan for the allocation of greenhouse gas emission allowances announced by the Republic of Latvia under Article 3(3) of Commission Decision C/2006/5612 (final) on the national plan for the allocation of greenhouse gas emission allowances announced by Latvia under European Parliament and Council Directive 2003/87/EC.

³¹ Judgment of the General Court of 22 March 2011 (Case T-369/07).

³² European Commission Decision C(2007) 3409 of 13 July 2007 on the amendment of the national plan for the allocation of greenhouse gas emission allowances announced by the Republic of Latvia under Article 3(3) of Commission Decision C/2006/5612 (final) on the national plan for the allocation of greenhouse gas emission allowances announced by Latvia under European Parliament and Council Directive 2003/87/EC.

³³ Emissions Allowance Allocation Plan 2008-2012 (approved by Cabinet Order No 348 of 4 September 2008).

Figure 1



35. By 30 April of each year, operators devolve emissions allowances to LEGMC corresponding to the quantity of GHG emitted by the facility in the previous calendar year.³⁴

Responsibility of the Public Utilities Commission

36. The regulatory enactment³⁵ states that a person who owns allowances may without restriction transfer such allowances to other persons.
37. The operator of facility may:
- 37.1. sell the unused emissions allowances if the amount of the emissions allowances allocated to the operator exceed the actual quantity of emissions;
 - 37.2. purchase emissions allowances if the amount of the emissions allowances allocated to the operator does not cover the actual quantity of emissions.
38. The State regulates the provision of public utilities as a commercial activity in the energy sector.³⁶
39. Public utilities in the regulated sectors are regulated by a State public utilities regulatory institution:³⁷ the Public Utilities Commission, whose functions are as follows:
- 39.1. to protect the interests of users and promote the development of providers of public utilities;
 - 39.2. to set the method for the calculation of tariffs;
 - 39.3. to determine tariffs if special laws concerning sectors do not provide for other procedures for determining tariffs, etc.³⁸

³⁴ Section 32.³, Paragraph one of the Law on Pollution.

Paragraph 16.1 of Cabinet Regulation No. 661 of 3 March 2004 “Procedures for the Performance of Activities with Emission Allowances and for the Establishment of Installation Pools”.

³⁵ Section 32.³, Paragraph five of the Law on Pollution.

³⁶ Section 2, Paragraph two, Clause 1 of the Law on Regulators of Public Utilities.

³⁷ Section 6, Paragraph one of the Law on Regulators of Public Utilities.

40. Until 31 October 2009, there existed two levels of regulation of public utilities in Latvia: at the State and local government level:
- 40.1. the State regulated the provision of public utilities as a commercial activity in the energy sector, except heat supply where no electrical power is generated in the production process;³⁹
- 40.2. within their administrative territory, local governments regulated the provision of public utilities as a commercial activity that was heat supply where no electrical power is generated in the production process.⁴⁰
41. Following a reform of local government regulators, as of 1 November 2009, the provision of public utilities as a commercial activity is regulated only at the State level.⁴¹
42. The regulatory enactment⁴² states that the Public Utilities Commission shall, by 1 November 2009, take over the regulation functions from local government regulators or local government city councils (county or parish councils) in the relevant local government-regulated sectors.
43. Free GHG emissions allowances were allocated
- 43.1. in the 2005-2007 European Union emissions allowance trading period: to 25 operators of heat and co-generation installations;
- 43.2. in the 2008-2012 European Union emissions allowance trading period: to 27 operators of heat and co-generation installations.
44. United principles for the allocation of free emissions allowances have been established for the 2013-2020 European Union emissions allowance trading period.
- 44.1. in 2013, 80% of the amount of emissions allowances required by the facilities will be allocated free of charge for heat generation and to the sectors of the industry that have not been classified as sectors subject to the risk of carbon redirection. The number of the emissions allowances allocated will have to be reduced annually by a certain amount so that the volume of free emissions allowances to be allocated in 2020 constitutes 30% of the number of allowances required by a facility, whereas, in 2027 no emissions allowances would be allocated to operators free of charge. In turn, the sectors of the industry that have been classified as sectors subject to the risk of carbon redirection, as well as the quantity of heat supplied to enterprises in such sectors, the volume of the emissions allowances to be allocated free of charge in 2013-2020 will be 100%;⁴³
- 44.2. no free emissions allowances are allocated for electricity generation facilities.⁴⁴
45. The cost of purchase of GHG emissions allowances by merchants is included in the heat and co-generation tariffs,⁴⁵ and, as the volume of the allowances to be purchased

³⁸ Section 9, Paragraph one, Clauses 1, 2 and 3 of the Law on Regulators of Public Utilities.

³⁹ Section 2, Paragraph two of the Law on Regulators of Public Utilities (edition until 13 July 2009).

⁴⁰ Section 2, Paragraph three of the Law on Regulators of Public Utilities (edition until 13 July 2009).

⁴¹ Section 2, Paragraph two of the Law on Regulators of Public Utilities (edition since 14 July 2009).

⁴² Paragraph 12 of the Transitional Provisions of the Law on Regulators of Public Utilities.

⁴³ Article 10A(11) and (12) of Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC.

⁴⁴ Article 10A(3) of Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC; Minutes No. 50, §73, Paragraph 2 of the Cabinet meeting of 30 August 2011.

⁴⁵ Sub-Paragraph 32.2 of the Methodology for the Calculation of Tariffs for Heat Supply Services (approved by Decision No. 1/7 of 14 April 2010 of the Council of the Public Utilities Commission, in effect as of 21 April 2010); Sub-Paragraph 23.6 of the Methodology for the Calculation of Co-Generation Tariffs (approved by

increases, this may serve as the basis for an increase in the tariffs. According to the price projections for emissions allowances published by the European Commission, the price of emissions allowances is expected to grow from EUR 14.5 in 2013 to EUR 30 in 2020.⁴⁶

46. By 30 June 2011, the cost of purchasing GHG emissions allowances was included in nine heat and co-generation tariffs.
47. On average, the cost of purchasing GHG emissions allowances constitutes 2% of the total costs included in the tariffs.
48. Two methodologies for the calculation of tariffs in the energy sector have been developed at the Public Utilities Commission:
 - 48.1. a methodology for the calculation of tariffs for heat supply services which prescribes the procedure according to which merchants shall calculate the tariff for heat supply services: heat generation, heat transmission and distribution, and heat sales;⁴⁷
 - 48.2. a methodology for the calculation of co-generation tariffs that prescribes the procedure for the calculation of the draft tariff for heat generated at co-generation stations with the heat capacity exceeding one megawatt and the calculation of the draft tariff for electrical power generated in the co-generation mode for co-generation stations whose installed gross electrical capacity exceeds four megawatts, where the energy supply merchant has acquired the right to sell the electrical power generated as part of the compulsory procurement.⁴⁸

Audit Summary#

49. The European Union emissions trading system in Latvia does not sufficiently ensure the achievement of the aim, *“to reduce greenhouse gas emissions with the minimum impact on the economic development of enterprises”*, established in the European Union directive⁴⁹, for the following reasons:
 - 49.1. the State has failed to use the Emissions Allowance Allocation Plan as an instrument to reduce GHG emissions by operators: the Emissions Allowance Allocation Plan⁵⁰ applies a 5% emissions allowance reduction for all sectors without evaluating the potential of the operators’ facilities in reducing GHG emissions;

Decision No. 1/10 of 11 June 2010 of the Council of the Public Utilities Commission, the edition in effect as of 23 June 2011).

⁴⁶ “Discussion paper on market value of free allocation” and “Analysis of options to move beyond 20% greenhouse gas emission reductions and assessing the risk of carbon leakage”, Brussels, 26 May 2010.

⁴⁷ Cabinet Regulation No. 281 of 26 June 2001 “Methodology for the Calculation of Public Utility Tariffs in Local Government-Regulated Sectors” (in effect from 16 August 2008 to 15 March 2011, applicable until 20 April 2010); Methodology for the Calculation of Tariffs for Heat Supply Services (approved by Decision No. 15.03.2011 of 14 April 2010 of the Council of the Public Utilities Commission, in effect as of 21 April 2010).

⁴⁸ Methodology for the Calculation of Tariffs for Heat Generated in a Co-Generation Station and for Electrical Power Generated in a Co-Generation Station with the Capacity Exceeding Four Megawatts (approved by Decision No. 58 of 26 February 2003 of the Council of the Public Utilities Commission, in effect until 20 December 2005); Methodology for the Calculation of Tariffs for Heat Generated in a Co-Generation Station and for Electrical Power Generated in a Co-Generation Station with the Capacity Exceeding Four Megawatts (approved by Decision No. 311 of 21 December 2005 of the Council of the Public Utilities Commission, in effect from 21 December 2005 to 17 June 2010); Methodology for the Calculation of Co-Generation Tariffs (approved by Decision No. 1/10 of 11 June 2010 of the Council of the Public Utilities Commission, in effect as of 18 June 2011).

⁴⁹ Paragraph 5 of the Preamble, Article 1 of Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC.

⁵⁰ Cabinet Order No. 608 of 9 August 2006 “On the Emissions Allowance Allocation Plan for 2008-2012” (no longer in effect as per Cabinet Order No. 1010 of 28 December 2006); Emissions Allowance Allocation Plan for 2008-2012 (approved by Cabinet order No. 348 of 1 August 2011).

- 49.2. already at the time of drafting of the Climate Change Reduction Programme for 2005-2010,⁵¹ it was known that Latvia would be able to meet its international emissions reduction commitments imposed by the Kyoto Protocol of the United Nations Framework Convention on Climate Change, even if no additional State-prescribed measures towards the reduction of GHG emissions were implemented, thus failing to specify targeted steps towards emissions reduction that would motivate operators;
 - 49.3. the policy planning documents and legislation regulating the emissions allowance trading scheme do not provide for the obligation of enterprises (operators) to invest the revenues earned from the sale of emissions allowances in the reduction of GHG emissions, as a result of which, e.g., in 2006 Joint Stock Company *Latvenergo* was required to contribute a part of the revenues from emissions allowances (LVL 3.5 million) to the State budget as payments for the use of State capital (dividends) rather than to promote the reduction of GHG emissions;
 - 49.4. in the 2005-2007 European Union emission allowance trading period, the funds obtained from the sale of emissions allowances were not sufficiently used for the reduction of GHG emissions, as 17% of the energy sector operators inspected during the audit used revenues from the sale of GHG emissions allowances to cover expenses unrelated to the reduction of GHG emissions;
 - 49.5. the rate of natural resource tax for the emissions of carbon dioxide has been set six times lower than the average market prices of emissions allowances, taking into account a 20% shortfall of emissions allowances for operators, thus promoting the use of low-capacity (up to 20 megawatts) facilities that are not subject to European Union requirements for the reduction of GHG emissions, and the transfer of carbon dioxide emissions out of the European Union emissions trading scheme;
 - 49.6. the prerequisite for the allocation of emissions allowances – to not allocate greater emissions allowances than the facilities require – is not being met. In selective inspections during the audit it was established that, in the period from 2008 to 2012, enterprises were allocated emissions allowances that were at least 69% more than actually required, as the Ministry of Environmental Protection and Regional Development had not obtained information from the Public Utilities Commission regarding the proposed activities specified in the draft tariffs of the operators and has thus not observed the requirements of the methodology;⁵²
 - 49.7. enterprises have no access to current information on the effective reserve of emissions allowances still available to enterprises (operators) in the available information sources – the actual amount of the emissions allowance reserves in the European Union GHG Emissions Register and the latest, most current decision of the Ministry of Environmental Protection and Regional Development⁵³ differs by approximately 125 times.
50. Upon inspection of the actions of the State administration institutions involved in the European Union emissions allowance trading scheme during the audit, violations of regulatory enactments were also detected, including the following:

⁵¹Climate Change Reduction Programme for 2005-2010 (approved by Cabinet Order No. 220 of 6 April 2005 and by amendments to Cabinet Order No. 659 of 30 August 2006), Chapter 7.2.

⁵²Sub-Chapter 3.1.3 “Methodology in the event of construction of a condensation station of the Emissions Allowance Allocation Plan 2008-2012 (approved by Cabinet Order No. 542 of 4 September 2008).

⁵³Ministry of Environmental Protection and Regional Development Decision No. 38 of 2 February 2011 “On clarifying the volume of the emissions allowance reserves and amending Ministry of Environment Decision No. 2 of 5 December 2008 “On the allocation of emissions allowances to operators in 2008-2012””.

- 50.1. the regional environmental boards of the State Environmental Service are failing to meet the requirements of the regulatory enactment⁵⁴ by exceeding the period for decisions regarding the issuance of GHG emissions permits to enterprises (operators) by five to 53 days;
- 50.2. the Jelgava and Liepāja Regional Environmental Boards are failing to meet the requirements of the regulatory enactment⁵⁵ by not ensuring the inspection of facilities prior to the granting of a GHG emissions permit;
- 50.3. The regional environment boards of the State Environmental Service are failing to meet the requirements of the regulatory enactment⁵⁶ regarding the control of the emissions volume and the matching of the conditions of GHG emissions permits with the conditions of category A or B permits of the respective facility, as a result of which the fuel volume planned in GHG permits exceeds the maximum permissible volume of fuel consumption by approximately 20 million m³, or 29%;
- 50.4. by failing to conduct checks of operators on the site, the requirement stipulated by the internal regulation⁵⁷ – to verify whether the amount of resources and auxiliary materials correspond to the amount recorded in registration logs for the reporting period – is not controlled;
- 50.5. in 60% cases the data provided in the *GHG Emissions Reports* do not match the data provided in the *Air Forms*,⁵⁸ thus failing to comply with the requirement specified in the internal regulation,⁵⁹ to verify whether the types and volumes of fuel correspond to the data provided in the *Air Form*, whereas in 7% of the cases, the State Environmental Service was unable to perform data comparison for the *GHG Emissions Reports* submitted overall, as the operators had not submitted the *Air Forms*;
- 50.6. by not implementing the OneSystems record-keeping software, procured as part of the project,⁶⁰ and by paying the licence maintenance fees for two years, the State Environmental Service has failed to comply with the requirements of the regulatory enactment⁶¹ and has not effectively used funds in the amount of LVL 16,852, thus failing to ensure that the aim has been achieved with the least spending of financial resources;
- 50.7. LEGMC does not ensure the timely transfer of emissions allowances to operators, because:
 - 50.7.1. of the 178 transfers of emissions allowances performed by LEGMC in 2008 and 2009, in 33 cases, or 19%, the emissions allowances were transferred without complying with the periods prescribed in the regulatory

⁵⁴Section 64 of the Administrative Procedure Law.

⁵⁵Paragraph 11¹ of Cabinet Regulation No. 400 of 22 April 2004 “Procedures for Applying for and the Issuance of a Greenhouse Gas Emissions Permit”.

⁵⁶Section 24¹, Paragraph six of the Law on Pollution; Section 10, Paragraph four of the Law on Pollution.

⁵⁷“Guidelines for the issuance of greenhouse gas emission permits, the control of conditions and compliance with reporting requirements” of the Ministry of Environment (2007), Chapter 2.

⁵⁸Cabinet Regulation No. 1075 of 28 December 2009 “Regulations Regarding the State Environmental Protection Statistical Statement Forms”, Annex 2, Form No. 2 “Air. Statement on Air Protection”.

⁵⁹“Guidelines for the issuance of greenhouse gas emission permits, the control of conditions and compliance with reporting requirements” of the Ministry of Environment (2007), Chapter 2.

⁶⁰Minutes No. 14 of the meeting of 2 December 2006 of the Council of the Latvian Environmental Protection Fund regarding the project “Implementation of a uniform document management system at the central structural unit of the State Environmental Service and the Greater Riga Regional Environmental Board”, project registration No. 1-08/529/2006.

⁶¹Section 3, Clause 1 of the Law on the Prevention of Squandering of the Financial Resources and Property of State and Local Governments.

enactments,⁶² and the due dates in these cases have been exceeded by an average of 58 days, which prevented the operators from performing timely actions with the emissions allowances; such situation existed until the end of 2009, as the European Commission adopted its internal decisions on the uploading of the plans for the allocation of emissions allowances and amendments thereto to the European Union GHG emissions registers to enable LEGMC to perform the transfers of emissions allowances;

- 50.7.2. in nine of the 33 cases, the emissions allowances were transferred to the accounts of the operators after 30 April, although the decisions by the Ministry of Environmental Protection and Regional Development had been adopted by 3 April 2009, thus the ability of the operators to submit the free emissions allowances to LEGMC by 30 April could be affected;
 - 50.7.3. in two cases, LEGMC transferred emissions allowances to operators whose emissions allowances had already been cancelled by decisions of the Ministry of Environmental Protection and Regional Development.
- 50.8. As of 1 November 2011, the GHG emissions permits for 17 (or 20%) of the 87 operator facilities have not been published on the LEGMC website; and for four of the 11 facilities that have left the European Union emissions allowance trading scheme, i.e., in 36% of the cases, the decisions on the cancellation of the GHG emission permit have not been published; the requirements of the regulatory enactments⁶³ have not been complied with, as a result of which the general public is not being informed regarding the operators' activities.
51. During the audit, deficiencies were detected in the effective regulatory enactments governing the operation of the European Union emissions allowance trading scheme, including the following:
- 51.1. the period for the decision granting emissions allowances prescribed in the regulatory enactment,⁶⁴ i.e., within two weeks of the issuance of the GHG emissions permit or amendment thereof,
 - 51.1.1. contradicts the requirement specified by the Law on Pollution⁶⁵ that the Ministry of Environmental Protection and Regional Development has to ensure that public opinion is considered regarding a draft decision of allocating emissions allowances, providing an opportunity for the submission of proposals for at least 30 days;
 - 51.1.2. is not proportionate, because, in order to adopt a decision to allocate emissions allowances, the Ministry of Environmental Protection and Regional Development needs to request additional information from the enterprises (operators);
 - 51.2. if an enterprise (operator) has not used a facility for a long period and has not, by itself, made an application to cancel the GHG emissions permit, the provisions of the

⁶² Section 32.², Paragraphs five and six of the Law on Pollution; Paragraph 13 of Cabinet Regulation No. 661 of 3 March 2004 "Procedures for the Performance of Activities with Emission Allowances and for the Establishment of Installation Pools".

⁶³ Section 32.⁷, Paragraph three of the Law on Pollution; Paragraph 20 of Cabinet Regulation No. 400 of 22 April 2004 "Procedures for Applying for and the Issuance of a Greenhouse Gas Emissions Permit".

⁶⁴ Paragraph 3 of Cabinet Regulation No. 661 of 3 March 2004 "Procedures for the Performance of Activities with Emission Allowances and for the Establishment of Installation Pools".

⁶⁵ Section 32⁷, Paragraph two of the Law on Pollution".

regulatory enactment⁶⁶ do not enable the State Environmental Service to cancel a GHG emissions permit issued to an enterprise (operator) and to reallocate this to other enterprises (operators); thus, in the period from 2008 to 2010, four operators that had stopped the operation of the facilities did not use 85,291 emissions allowances, or 90% of the emissions allowances allocated, which, if cancelled, could have been allocated to other operators;

- 51.3. the regulatory enactment⁶⁷ provides for a possibility for enterprises (operators) to use two different approaches for calculating GHG emissions, and, depending on the approach selected, enterprises (operators) are able to increase or decrease the number of emissions allowances to be submitted. Using an approach that is favourable to them, the enterprises (operators) included in the audit sample have calculated actual GHG emissions that are by 19,910 tonnes lower than by applying the other method, thus reducing the number of emissions allowances subject to submission and allowing for average savings of LV 45,710 per operator that could be invested in activities towards the reduction of GHG emissions;
- 51.4. the regulatory enactment⁶⁸ does not provide the criteria according to which a regional environmental board should evaluate the *GHG Emissions Report* and what information the board has to collect, since the controls of the *GHG Emissions Report* is performed by a verifier;
- 51.5. by requesting operators to provide information on the carbon dioxide emissions and fuel consumption by the type of fuel on the *Air Form*,⁶⁹ the administrative weight is increased without reason, as this information is not collected for statistical purposes, for its part the regional environmental boards of the State Environmental Service do not use the *Air Forms* to perform controls of operators, as prescribed by the regulatory enactment;⁷⁰
- 51.6. the regional environmental boards of the State Environmental Service are unable to assess the correspondence of the information provided in the *Air Form* to actual data, as the submission date of the *Air Form* is 31 January of the current year, whereas verified data on the operations of an facility are submitted 1.5 months later, by 15 March of the current year; accordingly, the State Environmental Service only formally fulfils the requirement prescribed by the regulatory enactment⁷¹ – to control the conformity of the information included in the *Air Form* with the stated requirements by evaluating the information provided in the form; which is also indicative of the discrepancies between data of the same type in *Air Forms* and *GHG Emissions Reports* in 146 cases, or 60% of all cases found during the audit;

⁶⁶ Paragraph 16 of Cabinet Regulation No. 400 of 22 April 2004 “Procedures for Applying for and the Issuance of a Greenhouse Gas Emissions Permit”.

⁶⁷ Sub-Paragraph 8.1 of Cabinet Regulation No. 778 of 7 September 2004 “Procedures for Monitoring Greenhouse Gas Emissions and the Verification and Approval of Annual Reports Regarding Greenhouse Gas Emissions”.

⁶⁸ Paragraph 21 of Cabinet Regulation No. 778 of 7 September 2004 “Procedures for Monitoring Greenhouse Gas Emissions and the Verification and Approval of Annual Reports Regarding Greenhouse Gas Emissions”.

⁶⁹ Cabinet Regulation No. 1075 of 28 December 2009 “Regulations Regarding the State Environmental Protection Statistical Statement Forms”, Annex 2, Form No. 2 “Air. Statement on Air Protection”, Tables 2 and 4.

⁷⁰ Paragraph 5 of Cabinet Regulation No. 1075 of 28 December 2009 “Regulations Regarding the State Environmental Protection Statistical Statement Forms”.

⁷¹ Paragraph 5 of Cabinet Regulation No. 1075 of 28 December 2009 “Regulations Regarding the State Environmental Protection Statistical Statement Forms”.

- 51.7. the periods established in the regulatory enactments⁷² for the performance of category A and B polluting activities and the periods for the issuance of GHG emission permits are not coordinated in cases where an enterprise (operator) applies for a permit to perform category A or B polluting activities simultaneously with an application to be granted a GHG emissions permit, or in cases where a permit of category A or B polluting activity needs to be amended.
52. Neither local government regulators⁷³ nor the Public Utilities Commission have undertaken sufficient actions to ensure that the tariff payments made by heat energy users cover only economically justified costs of public utilities,⁷⁴ thus raising the tariffs, and they have failed to supervise the spending of the revenues from the sale of GHG emission quotas, as the following is found:
- 52.1. failing to comply with the requirements of the regulatory enactments, the inclusion of the cost for purchase of GHG emissions allowances in the tariffs of the energy sector merchants, thus causing a situation where, of the nine tariffs in which the cost of purchase of emission allowances has been included, the emissions allowance expenses included in two tariffs approved by local government regulators and one tariff approved by the Public Utilities Commission, or 33% of the tariffs of the operators inspected, were unjustified, and the heat tariffs per megawatt hour have been raised from LVL 0.08 to LVL 0.42;
- 52.2. the possibility to initiate tariff revisions for five public utility providers whose heat tariffs include the cost of GHG emission allowances but which had no expenses associated with GHG emissions allowances in 2011 was not used, thus:
- 52.2.1. in one case, the heat tariff was increased by 0.7%, or LVL 0.19 per megawatt hour, as of 1 January 2011;
- 52.2.2. in four cases, the heat tariffs have been increased by LVL 0.34 to LVL 1.03 per megawatt hour as of 1 August 2011.
- 52.3. by not observing the requirements of the regulatory enactments, no assurance was gained that the revenues from the sale of GHG emission allowances are used towards activities to reduce GHG emissions, as a result of which,
- 52.3.1. in two cases, a risk of double funding exists; i.e., the expenses included in the tariff may have been paid for from the revenues from the sale of GHG emissions allowances in the amount of up to LVL 492,781;
- 52.3.2. the tariff includes depreciation of LVL 3,475 for fixed assets purchased from revenues for the sale of emissions allowances, thus increasing the tariff by LVL 0.02.
53. As part of the audit, 12 recommendations were issued to the Ministry of Environmental Protection and Regional Development, one recommendation to the State Environmental Service, and one recommendation to State Limited Liability Company LEGMC, which, if implemented, will ensure the following:
- 53.1. improvement of the European Union emissions trading scheme in Latvia, ensuring the achievement of the aim: to reduce GHG emissions in a cost-effective and economically efficient way;

⁷²Paragraph 49 of Cabinet Regulation No. 1082 of 30 November 2010 "Procedures by which Polluting Activities of Category A, B and C shall be Declared and Permits for the Performance of Category A and B Polluting Activities shall be Issued"; Section 64 of the Administrative Procedure Law.

⁷³By 31 October 2009.

⁷⁴Section 20 of the Law on Regulators of Public Utilities.

- 53.2. improvement of the internal control systems in order to prevent the violations of regulatory enactments detected in the activities of the State administration institutions while administering GHG emissions allowances;
 - 53.3. elimination of deficiencies of the regulatory enactments governing the operation of the European Union emissions allowance scheme.
54. Following the audit, four recommendations were issued to the Public Utilities Commission, which, if implemented, would ensure the following:
- 54.1. inclusion of the cost for purchase of GHG emissions allowances in the heat and co-generation tariffs in the economically justified way;
 - 54.2. use of revenues from the sale of GHG emissions allowances by public utility providers towards the reduction of GHG emissions, and the non-inclusion of such costs in the tariffs.

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**Facilities of Polluting Activities Required to Participate in the
European Union Emissions Allowance Trading Scheme⁷⁵**

1. In the energy sector:

- 1.1. incineration facilities whose nominal thermal input exceeds 20 megawatts, except facilities for the incineration of hazardous waste or household waste;
- 1.2. mineral oil treatment and refining installations;
- 1.3. coke ovens.

2. In the production and processing of ferrous metals:

- 2.1. facilities for the roasting and sintering of metal ores, including sulphide ores;
- 2.2. facilities for the primary or secondary fusion of crude iron or steel, including continuous casting, with a capacity exceeding 2.5 tonnes per hour.

3. In the production of mineral products:

- 3.1. facilities for the production of cement clinker in rotary kilns with a production capacity exceeding 500 tonnes per day or facilities for production of lime in rotary kilns with a production capacity exceeding 50 tonnes per day or other furnaces for lime production with a production capacity exceeding 50 tonnes per day;
- 3.2. facilities for the manufacture of glass, including glass fibre, with a melting capacity exceeding 20 tonnes per day;
- 3.3. installations for the manufacture of ceramic products by firing, including roofing tiles, bricks, refractory bricks, tiles, stove tiles or porcelain, with a production capacity exceeding 75 tonnes of finished products per day or with a kiln capacity exceeding 4 cubic metres and with a setting density per kiln exceeding 300 kg/m³.

4. In other sectors:

- 4.1. facilities for the production of pulp from timber or other fibrous materials;
- 4.2. facilities for the production of paper or board whose production capacity exceeds 20 tonnes per day.

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⁷⁵ Annex 2 to the Law on Pollution, "Polluting Activities (Installations) Requiring a Greenhouse Gas Emission Permit".