

AUDIT REPORT

Riga

02.12.2011

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 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 Janis Salenieks (head of the audit group), State Auditor Linda Mikanovska, State Auditor Inese Priedite and State Auditor Ineta Rancane.

Objective of the Audit

3. The objective of the audit is to gain assurance whether
 - 3.1. the administration of the emission of greenhouse gases (hereinafter: "GHG") is realized in compliance with the requirements of regulatory enactments; and
 - 3.2. the European Union emissions trading scheme has been implemented in Latvia in a way that motivates enterprises to lower emission with the minimum impact on the enterprises economical development.

Accountability of the State Audit Office

4. The State Audit Office is 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 and the State Limited Liability Company *Latvian Environment, Geology and Meteorology Centre* (hereinafter: LEGMC) are responsible for compliance with regulatory enactments and the truthfulness of the information provided to the auditors.

Scope of the Audit

6. The audit has been 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 administration of greenhouse emission allowances with the regulatory enactments.
7. Due to the fact that the audit was conducted in an area involving a number of responsible institutions, two audit reports 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 monitoring of operators to regulatory enactments;

- 7.2. to the *Public Utilities Commission*: on the compliance with regulatory enactments of the inclusion of expenses of purchase GHG allowances in the tariffs of the operators in the energy sector and the use of revenues from the sale of emission allowances.
8. This audit report has been prepared for the Ministry of Environmental Protection and Regional Development regarding the implementation of climate change reduction policy and the compliance of the monitoring of operators with regulatory enactments.
9. The audit involved inspections at the Ministry of Environmental Protection and Regional Development, the State Environmental Service and State Ltd *Latvian Environment, Geology and Meteorology Centre*.
10. The audit was conducted on the period from 1 January 2008 to 31 May 2011.
11. The following were carried out, selectively, during the audit:
 - 11.1. checks on the issue of GHG emission allowances:
 - 11.1.1. at the Lielriga Regional Environmental Board: verification of the issue of 13 GHG emission permits;
 - 11.1.2. at the Daugavpils Regional Environmental Board: verification of the issue of six GHG emission permits;
 - 11.1.3. at the Liepāja Regional Environmental Board: verification of the issue of six GHG emission permits;
 - 11.1.4. at the Jelgava Regional Environmental Board: verification of the issue of five GHG emission permits;
 - 11.2. checks regarding the supervision of compliance with the terms of the GHG emission permits:
 - 11.2.1. at the Lielriga Regional Environmental Board, by examining 37 GHG emission reports and 56 inspection protocols;
 - 11.2.2. at the Daugavpils Regional Environmental Board, by examining 15 GHG emission reports and 19 inspection protocols;
 - 11.2.3. at the Liepāja Regional Environmental Board, by examining nine GHG emission reports and nine inspection protocols;
 - 11.2.4. at the Jelgava Regional Environmental Board, by examining 16 GHG emission reports and 21 inspection protocols;
 - 11.3. at the Ministry of Environmental Protection and Regional Development, controls over the ten facilities for the verification of the allocation of GHG emission allowances that were allocated after the submission of the Emissions Allowance Allocation Plan¹ to the European Commission.

Summary

12. The European Union emissions trading system in Latvia does not sufficiently ensure the achievement of the goal, “to reduce greenhouse gas emission with the

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

least possible diminution of the economic development of enterprises”, established in the European Union directive², for the following reasons:

- 12.1. the State has failed to use the Emissions Allowance Allocation Plan as an instrument to reduce GHG emission by operators: the Emissions Allowance Allocation Plan³ applies a 5% emissions allowance reduction for all sectors without evaluating the potential of the operators’ facilities in reducing GHG emission;
- 12.2. already at the time of drafting of the Climate Change Reduction Programme for 2005-2010,⁴ it was known that Latvia would be able to meet its international emission reduction obligations assigned by the Kyoto Protocol of the United Nations Framework Convention on Climate Change, even if no additional State measures towards the reduction of GHG emissions were implemented, thus failing to set focused and operators motivated steps in the emission reduction;
- 12.3. the policy planning documents and regulatory enactments regulating the emissions allowance trading scheme do not provide for the obligation of enterprises (operators) to invest the revenues from the sale of emission allowances in the reduction of GHG emissions, as a result of which, for instance, in 2006 Joint Stock Company *Latvenergo* was required to contribute part from the sale of emission 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 emission;
- 12.4. the Natural Resource Tax rate for the emission of carbon dioxide has been set six times lower than the average market prices of emissions allowances, taking into account a 20% deficit of emissions allowances for operators, thus facilitating use of low-capacity (up to 20 megawatts) devices that are not subject to European Union requirements for the reduction of GHG emission, and the transfer of carbon dioxide emission out of the European Union emission trading scheme;
- 12.5. the basic regulations for the allocation of emissions allowances – not to allocate more emissions allowances than the facilities require – were ignored. 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;
- 12.6. enterprises have no access to actual information on the real reserve of emissions allowances still available to enterprises (operators) in the available information sources – the actual volume of the emission allowance reserve in the European Union GHG Emission Register and in the recent resolution

²Paragraph 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.

³Cabinet 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).

⁴Climate 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.

of the Ministry of Environmental Protection and Regional Development⁵ differs by approximately 125 times.

13. Upon inspection of the actions of the state institutions involved in the European Union emissions allowance trading scheme during the audit, violations of regulatory enactments were also detected, as the following:

13.1. the Regional Environmental Boards of the State Environmental Service are failing to observe the requirements of the regulatory enactment⁶ by exceeding the period for decisions regarding the issue of GHG emission permits to enterprises (operators) by five to 53 days;

13.2. the Jelgava and Liepaja Regional Environmental Boards are failing to observe the requirements of the regulatory enactment⁷ by failing to ensure the inspection of facilities prior to the granting of a GHG emission permit;

13.3. the Regional Environmental Boards of the State Environmental Service are failing to observe the requirements of the regulatory enactment⁸ regarding the control over the emissions quantity and the harmonization of the conditions of GHG emission permits with the conditions of category A or B permits of the respective facility, as a result of which the fuel quantity planned in GHG permits exceeds the maximum permissible volume of fuel consumption by approximately 20 million m³, or 29%.

14. During the audit, deficiencies were detected in the effective regulatory enactments regulating the operation of the European Union emissions allowance trading scheme, including the following:

14.1. the period for the taking decision on granting emissions allowances prescribed in the regulatory enactment⁹ – i.e., within two weeks of the issue of the GHG emission permit or amendment thereof –

14.1.1. contradicts the requirement specified by the Law on Pollution¹⁰ that the Ministry of Environmental Protection and Regional Development has to ensure considering of the public opinion regarding a draft decision on allocating emissions allowances, by giving the opportunity to submit persons proposals for at least 30 days;

14.1.2. is not proportional, 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).

⁵Ministry 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””.

⁶Section 64 of the Administrative Procedure Law.

⁷Paragraph 11¹ of Cabinet Regulation No. 400 of 22 April 2004 “Procedures for Applying for and the Issuance of a Greenhouse Gas Emissions Permit”.

⁸Section 24¹, Paragraph six of the Law on Pollution; Section 10, Paragraph four of the Law on Pollution

⁹Paragraph 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”

¹⁰Section 32⁷, Paragraph two of the Law on Pollution”

- 14.2. if an enterprise (operator) has not used a facility long time and has not submitted an application to cancel the GHG emission permit, the provisions of the regulatory enactment¹¹ do not enable the State Environmental Service to cancel a GHG emission permit issued to an enterprise (operator) and to reallocate permit to other enterprises (operators);
 - 14.3. the regulatory enactment¹² 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 emission 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 lower by 19,910 tonnes than by applying the other method, thus reducing the number of emissions allowances subject to submission and allowing for an average savings of LVL 45,710 per operator that could be invested in measures towards the reduction of GHG emission;
 - 14.4. the terms established in the regulatory enactments¹³ for the performance of category A and B polluting activities and the terms for the issue 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 emission permit, or in cases where the permit of category A or B polluting activity needs to be amended.
15. 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 Ltd *Latvian Environment, Geology and Meteorology Centre*, which, if implemented, will ensure the following:
- 15.1. improvement of the European Union emission trading scheme in Latvia, ensuring the achievement of the goal: to reduce GHG emission in a cost-effective and economically efficient way;
 - 15.2. improvement of the internal control systems in order to prevent the violations of regulatory enactments detected in the activities of the state institutions while administering GHG emissions allowances;
 - 15.3. elimination of deficiencies of the regulatory enactments governing the operation of the European Union emissions allowance scheme.

¹¹Paragraph 16 of Cabinet Regulation No. 400 of 22 April 2004 “Procedures for Applying for and the Issuance of a Greenhouse Gas Emissions Permit”.

¹²Sub-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”

¹³Paragraph 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.