PN-ACE-598
100648

Kazakhstan: Power Sector Reform

Comments of Legal Working Group on Energy Efficiency on the Use of a Russian Draft Energy Efficiency Law as a Basis for Developing an Energy Law for the Government of Kazakhstan

Prepared for

United States Agency for International Development
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Washington, DC 20004-3002

Under

Contract No CCN-Q-00-93-00152-00
Delivery Order 5

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April 24, 1995

COMMENTS OF LEGAL WORKING GROUP ON ENERGY EFFICIENCY ON USE OF A RUSSIAN DRAFT ENERGY EFFICIENCY LAW AS A BASIS FOR DEVELOPING AN ENERGY EFFICIENCY LAW FOR THE GOVERNMENT OF KAZAKHSTAN

Critique prepared by Latham & Watkins
for Consideration by the Working Sub-Group
on the Energy Efficiency Law

April 24, 1995

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COMMENTS OF LEGAL WORKING GROUP ON ENERGY EFFICIENCY ON THE USE OF A RUSSIAN DRAFT ENERGY EFFICIENCY LAW AS A BASIS FOR DEVELOPING AN ENERGY EFFICIENCY LAW FOR THE GOVERNMENT OF KAZAKHSTAN

--Prepared by Latham & Watkins

At the request of the Kazakhstan Ministry of Energy and Coal Industry (MOE&CI), the Legal Working Group on Energy Efficiency (LWG) has reviewed and is providing its comments on a Russian draft energy efficiency law, which was presented to the Russian Council of Ministers in 1993

The MOE&CI has expressed an interest in using this Russian draft energy efficiency law as a basis for developing an energy efficiency law for Kazakhstan We have undertaken a detailed review of this draft law and consulted with experts involved in the development of energy efficiency measures in other countries Based upon these efforts, we have concluded that the Russian draft law has substantial deficiencies and should not be used as a model for an energy efficiency law for Kazakhstan

The Russian Draft Energy Efficiency Law <u>Should Not Be Used As A Model For Kazakhstan</u>

The most critical problem with the Russian draft law is that it relies upon regulation and enforcement instead of market mechanisms to increase energy savings We believe this is the wrong approach We recommend that the Government of Kazakhstan ("GOK") rely upon the competitive market whenever possible, instead of government regulation, to promote energy efficiency To increase economic efficiency, the focus should be on making the market more competitive, not increasing the role of the government to develop and enforce regulations to restrict energy use This is consistent with the terms of the European Energy Charter Treaty (to which Kazakhstan is a signatory), which provides that the signatories shall work to "alleviate market distortions and barriers to competition" (Article 6, para 1)

C

The most important step necessary to achieve energy efficiency is through energy price reforms Permitting energy prices to rise to market-levels (or at least to marginal cost-levels) would give proper incentives to customers and producers to act efficiently The Russian draft law is severely deficient since it ignores price reforms

We have substantial concerns about many other aspects of the Russian draft law, and recommend against using the Russian draft energy efficiency law as a model We recommend that the GOK avoid the imposition of penalties and avoid the granting of subsidies in the development of Kazakhstan's energy efficiency law Instead, the GOK should seek to eliminate existing barriers to competition that would otherwise stagnate Kazakhstan's evolution to a market-based energy sector Our more specific concerns are set forth in the attached Appendix

We hope that we can work together with the GOK from May 2 through May 8, 1995 to develop a new concept paper for the development of an energy efficiency law for the GOK, based upon the following market principles (a) energy prices should reflect market value (or at least marginal cost), (b) energy consumption needs to be metered, and (c) energy efficiency measures/technologies need to be supplied by multiple and diverse sources

d

APPENDIX
DETAILED COMMENTS ON RUSSIAN DRAFT ENERGY EFFICIENCY LAW

1. The Draft Russian Energy Efficiency Law is outdated.

As a preliminary matter, we have recently determined that the draft energy efficiency law that the Kazakhstan MOE&CI presented to the LWG for its review is not the most recent law on energy savings that has been introduced in the Russian Duma This draft law has since been replaced by a different energy savings law that is in Committee in the Russian Duma, but has not yet been read to the Duma [1/]

2 The Russian Draft Law adds substantial regulatory burdens without addressing the primary method of increasing energy efficiency -- competition.

The primary problem with the Russian draft law is that it relies upon institutional and bureaucratic means to resolve competitive problems In other words, the Russian draft law approaches energy efficiency as something that can be increased through increases in governmental regulation and control (e g , by setting energy efficiency standards and imposing penalties for noncompliance), while ignoring the most effective method of increasing energy efficiency -- strengthening the competitive markets for energy producers and consumers

We do not believe that the approach in the Russian draft law is the most effective way for the GOK to increase energy efficiency in Kazakhstan The creation and enforcement of government-imposed standards for energy efficiency would

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1/ Notwithstanding the differences between the two draft Russian laws, this critique remains a worthwhile exercise, as the GOK has expressed an intention to rely as much as possible on this Russian draft law and has asked us to prepare this critique

undoubtedly add significant bureaucratic costs to the GOK and may not significantly or effectively alter the behavior of energy producers and consumers to act efficiently Rather, imposing standards and penalties such as the ones included in the Russian draft law motivates energy producers and consumers to circumvent those standards and penalties whenever possible If such a scheme were adopted in Kazakhstan, this could, in turn, increase the potential for abuse of authority, and could impair (instead of enhance) the efforts of the GOK to increase competition

The most effective way to change the behavior of energy producers and consumers is by increasing competition through the introduction of competition in energy production and consumption Increasing competition requires privatizing major energy producers and consumers and opening markets, increasing energy prices to levels that represent the cost of energy plus a reasonable profit, and attracting foreign capital investment However, the Russian draft law does not address these goals [2/]

a An energy efficiency law should establish standards for measuring energy consumption, but should not mandate other standards

The Russian draft energy efficiency law includes numerous provisions that develop and implement standards for energy use and energy efficient technology that we believe should be modified and/or clarified

Section IV provides that energy efficiency standards would be established for virtually all devices that consume electricity and other forms of energy There are a number of aspects of

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2/ The Russian draft law states in Section I that it would combine "regulation with market mechanisms" to effect improvements in energy efficiency However, the LWG views the draft law as virtually exclusively utilizing regulatory means to change the behavior of energy producers and consumers

the standardization procedure in the draft law that we believe are inappropriate and/or that need clarification

First, the law does not clearly distinguish between different types of standards (a) standards for measuring energy use (i e , through metering), (b) standards for measuring energy efficiency (i e , through creation of indices that measure energy efficiency for different products), and (c) standards of behavior (i e , restrictions/prohibitions on the use of certain technologies that are determined to operate below designated levels) The Russian draft law employs all three standards

We agree that it would be useful to have a government agency work with industry groups to determine standards for the measurement of energy consumption, primarily through the installation of meters Metering that accurately reflects energy use is consistent with the competitive principles described above and sends the right price signals (i e , incentives) to energy consumers and producers

However, we disagree with the Russian draft law's establishment of standards for measuring energy efficiency and standards for behaving efficiently As to measuring energy efficiency levels, it is difficult to gauge the energy efficiency levels of different technologies/products Most energy efficiency measures have numerous variables and are not conducive to the establishment of generally applicable standards of energy efficiency measurement

As to changing the behavior of consumers and producers, we disagree with a legislative approach that attempts to adopt and enforce standards for behaving efficiently Such an approach would require value judgments to be made about different energy uses and technologies (e g , that the standards would apply for the life of the product and that certain technologies would be determined to be the "leading" technologies against which all others would be measured) Contrary to the provisions in the Russian draft law, we believe that the market (and not the government) should

provide incentives for consumers and producers to act efficiently

Second, the standards of measurement in the Russian draft law are determined unilaterally by governmental authorities, and do not provide mention the need to obtain input from industry and consumer groups We believe that industry and consumer groups should be consulted before any standards are established

Third, the governmental agency should not be charged with the sole implementation and enforcement of these standards Instead, we believe that the governmental agency should, whenever possible, leave the enforcement and implementation of standards of measurement to industry and consumer groups (which will themselves have incentives to prevent misrepresentation of energy efficiency information) Government involvement in implementation and enforcement would be limited to circumstances such as those involving safety considerations

Fourth, there are certain aspects of the standardization provisions of Section IV that are unclear and terms that are undefined Articles 16 and 17 provide that certain standards would be "binding" and certain other standards "recommended", but do not explain how such a determination would be made or the effect of such a distinction It remains unclear whether "binding" standards would restrict the manufacturer's ability to produce and sell products that are below certain standards, but this would have to be clarified Nor does the draft law specify which products are intended to have "binding" standards and which products are intended to have "recommended" standards

b An energy efficiency law should not impose penalties or sanctions based upon levels of energy consumption

The Russian draft law included numerous provisions for monitoring industries and other energy consumers for efficiency Article 24 provides that governmental

organizations are empowered to monitor and enforce the "rational and efficient use of fuel and energy resources" and compliance with federal and regional standards for energy use Article 6 contemplates that regional energy efficiency agencies would have the authority to impose economic sanctions "and administrative liability for irrational use of energy resources " Article 25 gives the government the right to impose economic sanctions on entities that fail to abide by energy efficiency standards Articles 34 and 35 provide for criminal and civil liability for violations of particular energy efficiency policies This approach is inconsistent with a market-oriented approach to encouraging energy efficiency We recommend that the GOK exclude from an energy efficiency law provisions that mention "irrational use" or call for sanctions or other penalties

c Governmental functions in energy efficiency should be limited to recommending policy and providing/collecting information

Section II of the draft Russian energy efficiency law establishes federal and regional energy efficiency bodies to develop energy efficiency policy, approve energy efficiency programs, implement energy efficiency measures, and impose sanctions for irrational energy use Almost all of these functions can and should be performed by nongovernmental entities without governmental intervention

Based on our experience with energy efficiency programs in other countries, it is our opinion that federal and regional energy efficiency agencies should be limited to two major functions (1) recommending policy modifications, and (2) providing/collecting information

First, agencies should recommend modifications to policy that would increase energy efficiency through competitive means Based on input from industry and consumer groups, these agencies should make recommendations for changes to laws and regulations to facilitate the ability of industry/consumers to take advantage of energy efficient technologies

Second, as stated in Section 2 b above, government agencies could provide a transitional role of accumulating and disseminating information about energy efficiency (i e , information about energy efficiency methods, standards and products) The agencies should assist non-governmental entities to establish industry and consumer groups that would ultimately take over this role

d. The marketplace (and not the Government) should determine energy efficiency priorities

The Russian draft energy efficiency law provides that the federal and regional energy efficiency authorities shall develop and implement energy efficiency programs However, the draft law does not describe what these programs would entail To the extent that such programs involve the implementation and enforcement of energy efficiency policy, we believe that such decisions should be given to individuals and businesses (i e , the marketplace) whenever possible

3 An energy efficiency law should not rely upon government-controlled dedicated energy savings funds to support the government's energy efficiency policies

Article 7 of the Russian draft energy efficiency law proposes the creation of one federal-level and many regional-level dedicated energy savings funds to finance governmental energy efficiency policies and programs The existence of a dedicated energy efficiency fund implies that a value judgment has been made that energy efficiency is more important than other uses of capital, and should somehow receive specialized treatment If, in fact energy efficiency is a good investment (and there are many indications that it is), this should be a function that the market assumes, through both financial institutions, electric utilities and suppliers of energy efficiency technology Energy users will be encouraged to invest in energy projects as energy prices rise to economic (i e , market or marginal cost) levels

Based on the experience of energy efficiency funds in other countries, we have found that these funds tend to drain the government and the private sector of valuable capital resources (through taxation on energy consumers) and tend to be inefficient, compared with alternative forms of financing that are available through the private sector Furthermore, the creation of a number of new agencies with overlapping jurisdictions would promote the growth of bureaucracy and create the potential for abuse of governmental authority

For these reasons, we do not recommend that the GOK develop dedicated funds to finance energy efficiency projects/programs on either a federal or regional level Below are some of the specific deficiencies of the energy savings fund provisions in Section III and suggested alternative mechanisms

a The Russian draft law does not include proper restrictions on the authority of the funds

Nowhere in Article 7 of the Russian draft law is there any indication of the function of the energy savings funds or what government entities, if any, the funds must report to on the federal or regional level Although the purpose of the funds is nominally to implement federal and regional energy savings programs and projects, this stated purpose does not establish an obligation on the part of the funds to follow the directions of any government authority As this draft law is written, each of these funds could formulate its own strategy to promote federal and regional objectives without virtually any governmental oversight With a substantial budget and no oversight, substantial portions of the funds would likely be expended in bureaucratic costs, and the funds could increase the potential for abuse of governmental authority

Legislation that creates and empowers new agencies should also provide for their supervision and control This is not a matter that is properly left to the future resolution of undetermined authorities Without proper supervision or restriction, the administration of the funds have the potential of multiplying in size and consuming an ever-greater

proportion of their fixed revenues to pay their own increasing expenses

b. The establishment of the funds in the Russian draft law would be burdensome and the funds are not "non-budget"

The draft law refers to the funds as "non-budget" agencies This term highlights the fact that the funds would not rely on annual appropriations from the federal budget for funding The justification for this intended non-budget status is unclear from the text of the draft law What is clear is that (a) the draft law does, in fact, rely on government appropriations and a series of new taxes that would burden both the energy sector and consumers at large, and (b) the fund is not, in fact, "non-budget"

The funds in the draft law would rely primarily on three different methods of taxation/penalty (i) a three percent tax on fuel and energy resources, (ii) penalties for "wasteful use of energy resources" and (iii) low-interest loans funded by federal and regional budgets

These funding mechanisms would have adverse effects on energy producers and consumers and taxpayers The imposition of taxes and penalties would have the effect of raising the marginal cost of power consumption The creation of a funding mechanism that uses penalties and loans would also increase the potential for abuse of the government's authority

Furthermore, the funds are not really "non-budget" Article 10 of the draft law provides for the financing of energy saving projects through a system of state credits Although it is unclear what is entailed by these credits, the language "up to 50 percent of the current discount rate" seems to indicate that they are actually government loans Article 10 states that the credits would be granted by the funds The source of funds for the credits would be the "Federal and republican budgets " The system of credits created by Article 10 undermines the idea that the funds would be non-budget entities

The draft law provides for three more sources of funding for the funds (i) payments for credits granted by funds, (ii) profits from operation and (iii) voluntary contributions by enterprises Payments for credits granted by the funds should not be considered a source of outside funding These payments are merely the repayment of money borrowed from the government The "profits" of the funds are speculative, and would not be actual "profits" if the loans were granted at subsidized interest rates While voluntary contributions could be pursued to fund energy efficiency activities, they can not be relied upon as a source of funds

c The GOK should consider alternatives to the development of dedicated energy efficiency funds

As stated above, the functions of the energy savings funds can and should be performed by the private sector The lending function of the funds -- supplying loans to entities to increase energy efficiency with short-term returns on investment -- can and should be provided by diverse sources that include electric utilities, domestic and foreign lending institutions, and suppliers of energy efficient technology

a Electric utilities can provide a viable alternative to dedicated energy efficiency funds through the development of demand-side management programs

Measures to improve energy efficiency should be regarded as alternatives to traditional energy supply Investment in energy efficiency will reduce the need for investment in power generation plants, in transmission and distribution networks, and in fuel supply To the extent that energy efficiency is improved by a customer, the cost of operation of the utility company supplying the energy will be reduced

For example, if an industrial plant replaces one of its old 100 kW electric motors (assume 80% efficiency and therefore 125 kW of electric power needed) with a modern new high efficiency 100 kW motor (with 90% efficiency and therefore only 111 kW electric input), the electric utility company will

be called upon to provide about 14 kW less power, and 11% less kWh of energy In this example, the electric utility company gains a benefit (called avoided costs), since it will not be required to provide equipment to meet 14 kW of load and will save 11% of fuel that would have otherwise been required Society will also benefit because there will be 11% less pollution through power plant emissions

Some of these savings may be passed on to customers through utility demand-side management (DSM) programs, which have been established in many countries to encourage energy efficiency improvements In a DSM program, the electric (or gas) utility company works in partnership with its customers to facilitate energy efficiency investments A utility company engaging in DSM programs may perform any or all of the following roles

(1) providing information to its customers about energy efficiency technologies, and energy saving practices,

(2) transferring some of the utility company's avoided costs to the customer, in the form of direct payments to the customer following the installation of energy efficiency technologies, and/or

(3) serving as a bank, loaning money to its customer for the financing of the purchase and installation of energy efficiency technologies, with the customer repaying the loan together as part of its periodic utility bill In order for this process to become effective, a mechanism would have to be put into place for utilities to enforce payment of electric and gas bills and to be permitted to seek termination of service for nonpayment

We recommend that the GOK encourage energy efficiency through the development of voluntary demand-side management measures that benefit both the utility company and the end-user

b <u>Enterprises that sell energy efficient technologies can market themselves to industries by identifying quick returns on investment from the installation of energy efficient mechanisms</u>

If a viable industrial user of energy can effect substantial energy savings in the short-term but does not have sufficient capital resources to purchase and install the energy efficient technology, the seller of the technology can sell and install the technology on credit based upon projections of savings and other sufficient financial credits

4 **Tax preferences for energy efficiency measures are <u>inconsistent with the market approach to energy efficiency</u>**

The draft law provides for several different tax preferences, including

- tax concessions for companies manufacturing energy efficient equipment (Article 9),
- accelerated depreciation of energy efficient equipment (Article 11), and
- preferential customs duties (Article 14)

The primary flaw in the adoption of these preferences is that they are subsidies that impair the development of a market economy and are inconsistent with a pro-competitive approach to encouraging energy efficiency If energy efficiency mechanisms are cost-effective and beneficial, they should not require subsidies to encourage them

As a practical matter, we have found in other countries that it is very difficult to obtain the agreement of the Ministry of Finance to waive certain taxes/duties for particular products

Moreover, the way the relevant provisions of the draft law are written, these incentives amount to a mere agreement to pass further legislation For example, Article 11 states that "the RF Government shall establish accelerated depreciation terms for specific types of efficient equipment " Article 11 does not empower any particular entity to establish such depreciation terms Without a specific grant of authority, tax preferences are nothing more than a statement of the intention of the current Congress to pass further legislation This statement of intention is worth little to power consumers interested in energy efficiency projects

5 **The Russian draft law does not effectively promote foreign capital investment.**

Article 13 of the draft law seeks to promote foreign capital investment in "energy efficiency promoting projects " Article 13 attempts to lure foreign firms into energy efficient projects by promising "export quotas and licenses for energy resources saved "

Foreign firms can offer significant experience in increasing energy efficiency Article 13, however, suffers from the same problems as the tax incentives discussed above The procedure for participating in such programs is to be established by the Council of Ministers (or the government) at some later date Furthermore, Article 13 provides no mechanism for the implementation of this program As drafted, it is extremely doubtful that Article 13 would find much favor with foreign investors

6. **Other Unclear Provisions**

Numerous other provisions have ambiguous and unclear language that would need clarification Below is a list of some of these provisions

a The Russian draft law is not clear on how the tax code would be modified to provide tax credits for energy savings

projects (Article 10) -- i e , how such tax credits could be obtained and what changes in the tax code need to be made in order to provide for such tax credits

b Article 20 of the draft Russian law provides that certain enterprises and organizations must receive energy efficiency expertisations Article 24 provides that the state fuel and energy surveillance body would have the right to perform expertisations However, neither Article clarifies whether the expertisation would necessarily have to be conducted by the state fuel and energy surveillance body or whether it could be conducted by other public or private organizations

c Article 21 does not set forth the procedure of how an entity can appeal an expertisation determination

d Article 25 provides that enterprises and organizations that do not have devices to monitor energy consumption are liable for the cost of the energy that they will consume under a contractual arrangement for the consumption of the energy plus a penalty of 25% However, this Article does not clarify (1) what type of contractual arrangement is contemplated, (2) what penalty would be imposed if no contractual arrangement exists, and (3) how this provision would work in conjunction with Article 19 (i e , whether this provision would apply except for those circumstances contemplated in Article 19)