



JESSICA

***JOINT EUROPEAN SUPPORT FOR SUSTAINABLE
INVESTMENT IN CITY AREAS***

**FINANCING ENERGY EFFICIENCY RENOVATIONS IN THE LATVIAN
HOUSING SECTOR**

Study

FINAL REPORT

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A. INTRODUCTION AND PURPOSE OF THE STUDY

JESSICA - Joint European Support for Sustainable Investment in City Areas - is a policy initiative of the European Commission (EC) developed jointly with the European Investment Bank (EIB) and in collaboration with the Council of Europe Development Bank (CEB) which is aimed at supporting sustainable urban development and regeneration through financial engineering mechanisms.

The aim of this legal study is to examine the alternatives for financing energy efficiency renovations of multi apartment buildings in Latvia and review how energy efficiency renovation works could be increased by providing financing through a JESSICA structure.

The scope of this study is to:

- Review existing JESSICA structures; examples of JESSICA and other financing structures available for renovations of multi apartment buildings in Estonia and Lithuania;
- Analyse JESSICA financing products; description and the terms and conditions of the possible JESSICA product i.e. the financing of energy efficiency renovations of multi apartment buildings for apartment owners, housing associations or administrators or to multi-apartment houses with a high level of indebtedness directly or through the ESCO model, and review the current bank financing terms and conditions of renovations of multi apartment buildings.
- Analyse the legal framework; review the current legal framework in Latvia to identify any obstacles to the provision of JESSICA financing (including JESSICA financing to ESCOs);
- Determine if State aid issues related to JESSICA financing and ESCOs may arise in connection with implementing JESSICA in Latvia, and if so how they may be best addressed;
- Review technical assistance; undertake an analysis of the market to identify institutions or organisations which may have the legal and technical capacity and know-how to provide such technical assistance to final recipients of JESSICA financing

When performing the Study the Consultant co-operated with the steering group established by the Ministry of Economics of the Republic of Latvia and European Investment Bank, as well as had interviews with other stakeholders.

JESSICA

Under procedures applicable in the 2007-2013 programming period, Managing Authorities (MAs) in the Member States are offered the possibility to invest some of their Structural Funds (SF) allocations in financial engineering instruments (revolving funds) supporting urban development and so recycle financial resources in order to enhance and accelerate investments in Europe's urban areas. These financial instruments are Urban Development Funds (UDFs) investing in Public-Private partnerships (PPPs) and other projects included in integrated plans for sustainable urban development.

Alternatively, MAs can decide to channel funds to UDFs using Holding Funds which are set up to invest in several UDFs. This is not compulsory, but does offer the advantage of enabling MAs to delegate some of the tasks required to implement JESSICA to expert professionals.

JESSICA responds to the need to support sustainable urban transformation by addressing a perceived shortage of investment dedicated to integrated urban renewal and regeneration projects and was therefore launched with a view to providing new opportunities to MAs responsible for the implementation of SF Operational Programs (OPs) in the current programming period by:

- ensuring long-term durable support to urban transformation processes through the revolving character of the SF's contributions to JESSICA financial engineering instruments;
- contributing financial and managerial expertise from specialist institutions such as the EIB, the CEB, other IFIs and financial institutions;
- leveraging additional resources for PPPs and other urban projects in the regions of the EU; and
- creating stronger incentives for successful implementation by final beneficiaries.

JESSICA which is the result of the partnership established between the Commission, EIB and CEB, can also act as a powerful catalyst for the establishment of the partnerships between MS, regions, cities, EIB, CEB, other banks, investors, etc. that will be required to address the problems with which urban areas are currently confronted.

JESSICA UDF investment in urban projects should be structured so that along with financial returns adequate to ensure that the resources employed can operate as revolving funds, adequate socio-economic impacts are also taken into account and achieved by implementing the projects. In this way, JESSICA is expected to build up a lasting funding legacy of EU and national public money, to be reinvested in the long term in the field of sustainable urban transformation.

More background information about JESSICA may be found on the websites of the EU Commission (Directorate General for Regional Policy) (www.jessica.europa.eu) and of EIB (www.eib.org/jessica).

EU Funds

Latvia as a member state of the European Union (EU) implementing the EU regional policy uses financial assistance provided by the EU for economic and social development. Largest financial instruments within the framework of which Latvia receives financial assistance are the EU funds: European Regional Development Fund (ERDF), European Social Fund (ESF) and Cohesion Fund (CF).

ERDF has been established in 1975 in order to equalize the differences within the European Community. Within the framework of this fund the assistance is given to the less developed regions, mainly concentrating on improvement of public infrastructure and promotion of entrepreneurship. Cohesion Fund is one of the financial instruments of the European Union's regional policy and aims at reducing economic and social disparities between member states and between regions. The Cohesion Fund was set up with the aim to finance large infrastructure projects in the fields of environmental protection and transport. It provides the financial contribution to projects, which complement achieving the EU objectives in the fields of environment and transport, implementation of EU policies and compliance with requirements laid down in the directives.

ERDF allocation to Latvia in programming period 2007-2013 is EUR 2.4 billion (EUR 2 440 017 364) or 53.86% of total EU fund allocation stated in the National Strategic Reference Framework.¹ CF allocation to Latvia in programming period 2007-2013 is EUR 1.5 billion (EUR 1 539 776 553) or 33.99% of total EU fund allocation stated in the National Strategic Reference Framework.²

National strategic reference framework and operational programmes

Key national medium-term programming document for 2007-2013 is the National Strategic Reference Framework prescribing common EU fund acquisition strategy, but programming

¹European Regional Development Fund. <http://www.esfondi.lv/page.php?id=952> (official website of EU Funds Managing authority in Latvia; accessed on 30 January 2012).

² Cohesion Fund. <http://www.esfondi.lv/page.php?id=954> (official website of EU Funds Managing authority in Latvia; accessed on 30 January 2012).

documents are made of three Operational Programmes and Operational Programme Complements with the help of which EU fund investments are managed in Latvia.

The National Strategic Reference Framework³ is a policy programming document which lays down a common strategy for the obtaining of the EU Structural Funds and Cohesion Fund resources, and provides coordination between the funds and the operational programmes. The document for Latvia has been approved by the Cabinet of Ministers.⁴

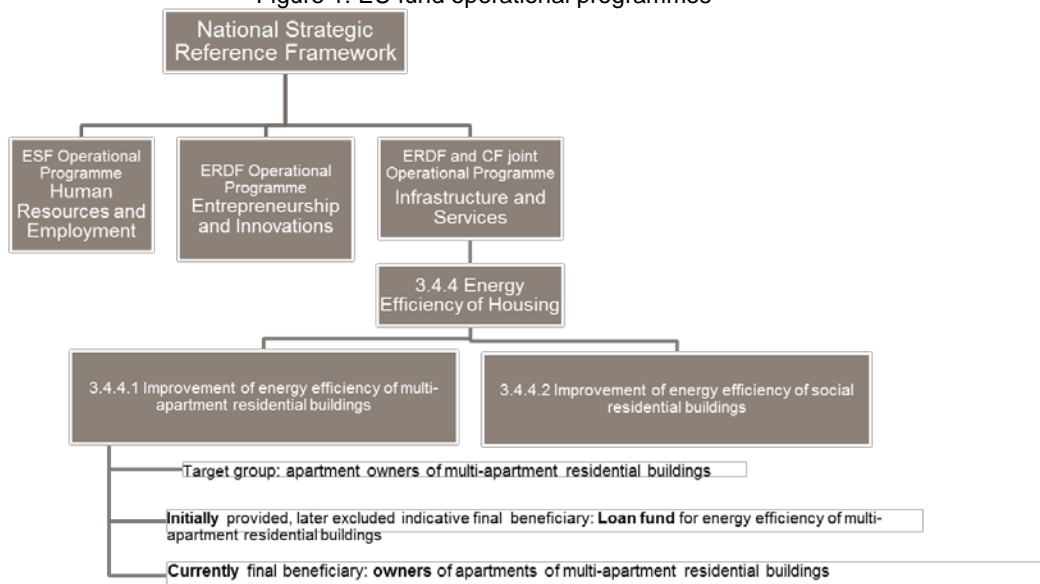
According to the National Strategic Reference Framework 2007-2013⁵ the EU Structural Funds and the Cohesion Fund investments are managed through three operational programmes:

- (i) European Social Fund Operational Programme „Human Resources and Employment“;
- (ii) European Regional Development Fund Operational Programme „Entrepreneurship and Innovations“;
- (iii) ERDF and CF joint Operational Programme „Infrastructure and Services“.

"Quality Environment for Life and Economic Activity" was determined as one of the priorities in the operation programme „Infrastructure and Service“. Whereas "Energy Efficiency of Housing" was established as one of the measures. The object of the measure is to promote availability, sustainability and efficiency of housing, to reduce social tension in the territories of municipalities through investment in the measures for housing renovation, and energy efficiency of multi-apartment residential buildings and social residential building to provide the socially unprotected groups with adequate housing.

Two activities were prepared for the measure „Energy Efficiency of Housing“ – activity 3.4.4.1 „Improvement of energy efficiency of multi-apartment residential buildings“ and activity 3.4.4.2 „Improvement of energy efficiency of social residential building“.

Figure 1: EU fund operational programmes



³ National Strategic Reference Framework 2007-2013, CCI:2007LV161NS001, approved by the Cabinet of Ministers on 23 October, 2010. <http://www.esfondi.lv/page.php?id=478> (official website of EU Funds Managing authority in Latvia; accessed on 30 January 2012).

⁴ 20 July 2007 Cabinet Regulation No. 389 "On draft national strategic framework document", published in the official gazette *Latvijas Vēstnesis* on 22 July 2007, effective as from 20 July 2007, and 29 October 2007 Cabinet Regulation No. 669 "On national strategic framework document", published in the official gazette *Latvijas Vēstnesis* on 31 October 2007, effective as from 29 October 2007.

⁵ National Strategic Reference Framework 2007-2013, CCI:2007LV161NS001, approved by the Cabinet of Ministers on 23 October, 2010. <http://www.esfondi.lv/page.php?id=478> (official website of EU Funds Managing authority in Latvia; accessed on 30 January 2012).

Climate Change Financial Instrument

Climate Change Financial Instrument (CCFI) is the Republic of Latvia state budget programme. The aim of CCFI is to prevent global climate change, adaptation to the effects of climate change and contribute the reduction of greenhouse gas emissions (for example, implementing activities to improve the energy performance of buildings in both public and private sectors, the development and implementation of technologies that use renewable energy resources, as well as the implementation of the integrated solutions to reduce greenhouse gas emissions).⁶

CCFI activities are regulated by the concluded international agreements for the sale of the assigned amount units of Latvia, as well as approved legislation, such as the law "On Participation of the Republic of Latvia in the Flexible Mechanisms of the Kyoto Protocol".⁷ The financing is formed by the proceeds from the assigned amount units purchase agreements which are made within the international emissions trading under the Kyoto Protocol. Decision on the sale of the assigned amount units is made by the Cabinet of Ministers.

Tenders have been carried out under the CCFI programme based on Cabinet of Ministers Regulation, including on use of renewable energy resources for reduction of green house emissions, use of renewable energy resources in the household sector, low energy consumption buildings.⁸

Covenant of Mayors

In 2007 when implementing the new energy policy the European Union adopted a package "Energy for a Changing World"⁹ where it put forward an initiative regarding Covenant of Mayors of the European cities which was prepared and signed in Brussels on 10 February 2009. Riga adopted the decision on signing the Covenant of Mayors already on 30 September 2008.¹⁰ Other signatories from Latvia include smaller cities like Ikšķile, Jēkabpils, Jelgava, Ogre, Salaspils, Tukums, Valmiera.¹¹ At the moment more than 1 600 cities have joined the Covenant of Mayors. The main tasks for municipalities in ensuring sustainable energy in the cities are to:

- (i) to develop Sustainable Energy Action Plan (SEAP) for the period until 2020;
- (ii) to commit to reduce CO₂ emissions by more than 20 % by 2020 through an increase in energy efficiency by 20 % and by ensuring that renewable energy sources account for 20 % of volume of consumption in the energy mix;
- (iii) to organise Energy Days in the city on a regular basis;
- (iv) to acknowledge that many activities related to energy demand and renewable energy sources and which have to be carried out to combat adverse climate changes fall under the responsibility of municipalities or cannot be implemented without support from the municipality;

⁶ Par KPFI. http://www.varam.gov.lv/lat/darbibas_veidi/KPFI/merki/ (official website of The Ministry of Environmental Protection and Regional Development of the Republic of Latvia; accessed on 30 January 2012)

⁷ 08 November 2007 Law on On Participation of the Republic of Latvia in the Flexible Mechanisms of the Kyoto Protocol, published in the official gazette *Latvijas Vēstnesis* on 29 November 2007, effective as from 1 January 2008 with amendments.

⁸ CCFI implementation supervision. http://www.lvif.gov.lv/?object_id=299 (official website of the Environment Investment Fund; accessed on 30 January 2012).

⁹ European Commission Climate Action „Energy for a Changing World“. http://ec.europa.eu/climateaction/eu_action/index_en.htm (official website of European Commission; accessed on 30 January 2012).

¹⁰ 30 September 2008 Riga Council Decision No .4203 on authorisation to sign the Covenant of European City Mayors. http://www.riga.lv/LV/Channels/Riga_Municipality/Statutory_acts/default.htm (official website of Riga municipality; accessed on 30 January 2012).

¹¹ Signatories. http://www.eumayors.eu/about/signatories_en.html?q=Search+for+a+Signatory...&country_search=lv&population=&date_of_adhesion=&status= (official website of the Covenant of Mayors; accessed on 30 January 2012).

(v) to acknowledge that municipalities which are management bodies closest to the citizens are the ones that have to be at the forefront of activities to be carried out and be an example for others;

(vi) to acknowledge that responsibility for combating global warming is shared between municipalities and their national governments, and these institutions have to be independent from commitments of other parties when carrying out this task;

(vii) to involve civil society of the city in the drafting and implementation of the Action Plan.

Pursuant to the above listed tasks on 6 July 2010 the authorised institution in relations with the Covenant of Mayors - Riga Energy Agency received approval of the Riga City Council for the Riga Sustainable Energy Action Plan for 2010-2020.¹² Other cities, which have prepared and approved action plans include Jēkabpils, Jelgava and Tukums.¹³ The action plans foresee renovation of housing as one of the most essential tools for reaching goals set out therein, including energy efficiency. The main reason for such a decision is the overall deteriorating condition of the housing in Latvia, which produces high levels of heat losses.

B. LEGAL FRAMEWORK FOR THE MANAGEMENT OF MULTI – APARTMENT RESIDENTIAL BUILDINGS IN LATVIA

In this section the regulation environment around ownership and management of multi-apartment block buildings is analysed to provide background information for energy efficiency renovations and for any future financial instrument.

1. Ownership of an apartment

The Latvian apartment sector is mainly regulated by Civil Law¹⁴, the Apartment Properties Law¹⁵ and the Law on the Management of Residential Buildings¹⁶. According to the aforementioned legislative acts an apartment is not a separate immovable property but part of a residential building, being a separate immovable property.

Pursuant to the Law on Management of Residential Buildings¹⁷ a residential building is 1) a composition of a building that has been constructed and commissioned as a residential building and, in accordance with the cadastral survey file¹⁸, is a residential building (also apartment property building), buildings (structures) belonging thereto and a land plot, on which it is located, if the land together with the residential building form a single immovable property or is part of the apartment properties forming a residential building, or 2) a part of a building, which has been recognised by governmental institutions as appropriate for use and, in accordance with the cadastral survey file, is a residential building, buildings (structures) belonging thereto and the land attached to a residential building. Further a residential building is regarded to be a multi-apartment residential building, where, pursuant to the building inventory plan, there is more than one apartment, artist's workshop or non-residential premises and auxiliary buildings and structures functionally as part of the building.

¹² Riga City Sustainable Energy Action Plan for 2012 - 2020. http://www.rea.riga.lv/files/RIGA_SEAP_2010-2020_EN.pdf (official website of Riga Energy Agency).

¹³ Available at <http://www.jekabpils.lv/JKP/Default.aspx>, <http://www.jelgava.lv/aktuali/>, <http://www.tukums.lv/>.

¹⁴ 28 January 1937 Civil Law, Sections on Rights of Things, effective as from 1 September 1992 with amendments.

¹⁵ 28 October 2010 Apartment Properties Law, published in the official gazette *Latvijas Vēstnesis* on 17 November 2010, effective as from 1 January 2011 with amendments.

¹⁶ 4 June 2009 Law on Management of Residential Buildings, published in the official gazette *Latvijas Vēstnesis* on 19 June 2009, effective as from 1 January 2010.

¹⁷ 4 June 2009 Law on Management of Residential Buildings, published in the official gazette *Latvijas Vēstnesis* on 19 June 2009, effective as from 1 January 2010 with amendments.

¹⁸ Cadastral survey pursuant to 1 December 2005 National Real Estate Cadastre Law is the determining of borders and obtaining of data characterising the unit of land and a part of a unit of land on the terrain, the outline of the structure and group of premises and the preparation of cadastral survey documents.

Thus there exist two types of apartment ownership – ownership of apartment as part of the residential building and ownership of apartment as part of the apartment property.

Ownership of apartment as part of the residential building

Apartment as part of the residential building belongs to a person, if the residential building has not been legally divided in apartments/apartment properties.

Such type of the apartment ownership has occurred historically upon the denationalisation of the real properties after regaining of independence in Latvia, and is not so common anymore in Latvia. These are usually buildings constructed prior to 1940.

Ownership of apartment as part of the apartment property

Apartment as part of the apartment property belongs to person if the residential building has been legally divided into apartments/apartment properties. This is a more common type of ownership in towns of Latvia.

According to the Apartment Properties Law the apartment property is an independent immovable property, which has been legally partitioned in a residential building. A residential property as a whole shall consist of an individual property and the relevant undivided share of the joint property. The individual property and the undivided share of the joint property included in the apartment property shall be legally inseparable.

There are the following elements of the individual property:

- (i) the structural non-load bearing, enclosing and finishing elements of the premises or a group of premises (including internal partitions, ceilings, floor and wall finishes, doors);
- (ii) engineering networks and engineering communications to the vertical connecting pipe of the joint property;
- (iii) engineering equipment components (including kitchen facilities, ventilation installations, toilet, shower and bath facilities), without which the elements of the existing share of the joint property residential building can function independently; and
- (iv) enclosing windows and doors of the individual property.

An existing joint property share shall include the following:

- (i) external enclosing structures (including walls, architectural elements, the roof, windows and doors of premises for common use, also exterior doors) of the residential building and external premises thereof (galleries, balconies, loggias, terraces), internal load bearing constructions (including supporting walls and columns, as well as separate enclosing walls of the property), intermediate coverings (including heat and sound insulation layers), premises for common use (including attics, stairwells and cellars), as well as the engineering communication systems, devices servicing the residential building and other inseparable elements functionally associated with the exploitation of the residential building, which do not belong to an individual property (including the heating elements within the boundaries of the apartment, if their functional activity depends on the existing engineering communications of the joint property);
- (ii) the auxiliary buildings and structures belonging to the residential building,
- (iii) the land plot, on which the relevant residential building is located, if it does not belong to another person.¹⁹

The undivided share is determined according to the total area of the individual property in proportion to the total area of the entire individual properties existing in the residential building.

Taking into account that the apartment property consists of two parts (the apartment and the relevant undivided share of the residential building, where apartment is located, and the land

¹⁹ Article 4 of the Apartment Properties Law.

plot, on which the residential building is located) the apartment owner is not only an owner holding complete rights of control over the apartment property but also a joint owner with limited ownership of the undivided shares of the residential building.

The Apartment Properties Law sets out the general rights of an apartment owner and the restrictions on the use of the property if the use of the ownership rights affects the existing joint property share. Hence when considering performance of any energy efficiency renovation works in a residential building the dual nature of apartment ownership shall be taken into account, in particular with respect to the procedure for adopting any decisions on energy efficiency renovation works.

Rights of an apartment owner

The apartment owner has complete right of control, including the following rights:

- (i) to possess and use his/her apartment property, obtain benefits, use it at his/her own discretion and generally use it in every way, insofar as the owner is not restricted by laws and insofar as it does not create disturbances for other apartment owners;
- (ii) to alienate, including donate, the apartment property;
- (iii) to pledge and otherwise burden the apartment property with property rights;
- (iv) to transfer the apartment property to the use of other persons;
- (v) to lodge family members and other persons in the apartment property;
- (vi) to participate in the management of the residential building; and
- (vii) to use the existing joint property share, insofar as limitations of use are not specified by decisions taken by the community of apartment owners.

The apartment owner also has the right to reconstruct, renovate or restore the apartment, insofar as it does not affect the existing joint property shares or other apartment properties, without having to co-ordinate with other apartment owners, but observing the provisions of the law. Observing the provisions of the law, the apartment owner has the right to reconstruct, renovate or restore the enclosing windows and doors of the apartment without co-ordinating with other apartment owners, if the community of apartment owners has not decided otherwise. If the reconstruction, renovation or restoring of an apartment affects the existing joint property share, it shall be necessary for the apartment owner to receive consent of the community of apartment owners. If the reconstruction, renovation or restoring of the apartment affects another apartment, it shall be necessary for the apartment owner to obtain the consent of the relevant apartment owner.

Duties of an apartment owner

According to the Apartment Properties Law the apartment owner has the following duties:

- (i) to participate in the management of the residential building;
- (ii) to cover the management expenditure of the residential building in accordance with the procedures specified in the Law on Apartment Properties;
- (iii) to settle accounts for the received services, which are related to the use of the apartment property (for example, heating, cold water, sewerage and removal of household waste);
- (iv) to pay the taxes applied to the apartment property;
- (v) to make lease payments for the use of land, if the residential building is located on the land belonging to another person;
- (vi) to treat with care the existing joint property share, observing the conditions for use thereof, as well as all the sanitary and fire safety requirements and other requirements specified in regulatory enactments in order not to cause harm to the safety and health of other persons, the quality of the surrounding environment, and to ascertain that those provisions and conditions are observed by persons lodged in his or her apartment property;
- (vii) to ensure the possibility for specialists authorised by the community of apartment owners or the administrator to perform activities in the apartment property, which are necessary for the establishment and normal functioning of communications, building

- structures and other elements related to exploitation of the residential building, as well as provide the possibility to inspect the apartment; and
- (viii) to execute the decisions taken by the community of apartment owners.²⁰

Duty to cover expenditure related to residential building

An apartment owner as any owner of property has a duty to maintain his or her property. The general duty of an owner is governed by Civil Law, while the special provisions in relation to apartment properties are provided in the Apartment Properties Law.

The Civil law provides three types of expenditures differentiating them by the added value they attribute to the property and the duty to compensate them and they are the following:

- (i) necessary expenditures (the expenditures by which property's existence is maintained or protected from total destruction, collapse or devastation);
- (ii) useful expenditures (the expenditures which improve the property, namely, increase income from it);
- (iii) enhancement expenditures (the expenditures which make the property only more convenient, pleasing or more attractive).

The Civil Law states that the necessary expenditures shall be reimbursed to everyone who has made them, except for a person who has acquired the property by criminal means.²¹ Useful expenditures shall be reimbursed to persons who have, in good faith, administered the property of another as if it were their own, provided they have not yet received reimbursement, having received income from such property, which shall be set off in such cases.²² Those expenditures shall be reimbursed only to the extent that they have increased the value of the property. However, if the increase exceeds the amount of the expenditure itself, only those expenditures may be recovered. If the amount of the reimbursable useful expenditures is not commensurate with the means of persons, for whose property they are made, or if the payment of the reimbursement will place too large a burden on such persons, they may not be compelled to reimburse them; but, in such case, the opposing party may remove all the improvements made from the property of the other person, to the extent possible without the property being damaged.

The above described rules are general rules for the compensation of expenditures, but in relation to apartment ownership requirements imposed by the Apartment Properties Law shall also be considered.

The Apartment Properties Law²³ provides that an apartment owner, according to the respective joint property share owned, shall cover the expenditure specified on the basis of a decision of the community of apartment owners for the performance of mandatory management activities of the residential building. Mandatory management expenses include not only expenses necessary within the meaning of the Civil Law, but also expenses for mandatory management activities e.g. the keeping of records (Latvian: *mājas lieta*).

Further, pursuant to the Apartment Properties Law²⁴, an apartment owner, according to the respective joint property share owned by him or her, shall cover the expenditure specified on the basis of a decision of the community of apartment owners for the performance of other management activities of the residential building, which ensure improvement and development of the residential building, promote the formation of optimal management expenditure thereof, and apply to:

- (i) the changing of elements, installations or communications, which are in the joint property of the residential building, if such changing results in reduction of the maintenance costs of the building;

²⁰ Article 10 of the Law on Apartment Properties.

²¹ Article 866 of the Civil Law.

²² Article 867 of the Civil Law.

²³ Article 13 of the Law on Apartment Properties.

²⁴ Article 13 of the Apartment Properties Law.

- (ii) measures, which result in reduction of expenditure for services related to the use of the residential building.

Those expenses described as other expenses in the Apartment Properties Law comply with the description of useful expenses in the Civil Law and accordingly reimbursed, if they increase the value of the property.

Community of Apartment owners

All apartment owners of the residential building make up a community of apartment owners – an administrative body of the residential building, (the community of apartment owners), which does not have legal personality. This concept of a community of apartment owners is used in the Apartment Properties Law to describe all apartment owners.

Pursuant to the Apartment Properties Law²⁵ the community of apartment owners has the right to decide any matter, which relates to the existing joint property share. The community of apartment owners, by entering into a relevant contract, may authorise another person to decide a matter, which is within the competence of the community, except the following:

- (i) alteration of the existing joint property share (increasing, decreasing);
- (ii) the specification of the procedures for the use of the existing joint property share between apartment owners;
- (iii) establishment and revoking of the right of first refusal of apartment owners;
- (iv) granting and revoking of authorisations;
- (v) specification of restrictions for the right of use;
- (vi) transferring for use of the existing joint property share;
- (vii) the form of administration of the existing joint property share;
- (viii) assigning of individual or all administrative activities of the residential building to an administrator;
- (ix) the procedures for the determination and payment of the management expenditure of the residential building; and
- (x) other matters, which the community of apartment owners has specified as such, that only fall within the competence of the community of apartment owners.²⁶

When taking a decision of the community of apartment owners, each apartment owner has as many votes as there are apartment properties in his or her ownership. A decision of the community of apartment owners is drawn up in writing and is binding upon all apartment owners, if apartment owners, who represent more than a half of the apartment properties of the residential building, have voted “in favour”, except the cases where another number of votes are necessary for taking of a decision or a larger necessary number of votes has been specified by the community of apartment owners itself.

The cases where another number of votes are necessary for taking of the decision of the community of apartment owners is provided in Article 17 of the Apartment Properties Law and they are the following:

- (i) In order to take a decision regarding alteration of the existing joint property share (increasing, decreasing) or regarding the specification of the procedures for the use of the existing joint property share between apartment owners, it shall be necessary that all apartment owners vote “in favour”;
- (ii) In order to take a decision regarding establishment of the right of first refusal, it shall be necessary that all apartment owners vote “in favour”.
- (iii) In order to take a decision regarding granting and revoking of authorisations, it shall be necessary that apartment owners who vote “in favour” represent at least two-thirds of all apartment properties.

²⁵ Article 16 of the Apartment Properties Law.

²⁶ Part 2 of Article 16 of the Apartment Properties Law.

The decision of the community of apartment owners can be declared void by the court if the decision or the procedures for taking thereof are contrary to the provisions of the Apartment Properties Law. An action may be brought only within three months from the day when the person concerned becomes aware, or should have become aware of the decision of the community of apartment owners, but no later than one year from the day of taking of the decision.

Application of consumer rights

The community of apartment owners as an administrative body of the residential building represents the common position of the apartment owners in relations with third parties. In a case the community of apartment owners concludes an agreement with a service provider, e.g. a building management company; the Consumer Rights Protection Law should apply to the established relationship. Therefore the below considerations shall be taken into account when entering into any legal relationship with a community of apartment owners.

According to the Consumers Rights Protection Law²⁷ a service provider is a person, who within the scope of his or her economic or professional activity provides a service to a consumer. By concluding agreements with consumers or consumer community (in this case the community of apartment owners) the service provider has to observe the principle of equal treatment – both parties have to be provided with equal rights, which means that the agreement is made on the basis of negotiations on equal footing and no party may impose without consent certain terms of agreement.

The Consumer Rights Protection Law also provides for situations where the provisions of the agreement could be regarded as unfair. Unfair provisions included in an agreement entered into between a service provider and a consumer shall not be in force from the moment of entering into agreement, but the agreement remains effective if it may continue functioning also after exclusion of the unfair provisions.

If a dispute has arisen between the consumer and the service provider regarding whether the provisions included in the agreement are unfair, any of the party of agreement is entitled to apply to court, but the consumer is also entitled to apply to the Consumer Rights Protection Agency. Upon resolving a dispute or carrying out other procedural actions arising from the agreement entered into between a service provider and a consumer, the court shall evaluate the provisions of the agreement, and for the resolution of the dispute shall not apply the unfair provisions provided for in the agreement in relation to the consumer.

2. Management of multi-apartment residential building

Pursuant to the Law on Management of Residential Buildings²⁸ residential building owners have an obligation to manage their residential buildings.

The residential buildings should be managed according to the following principles:

- (i) continuity of the management process which ensures preservation of the quality of the residential building throughout the period of exploitation thereof;
- (ii) selection of as optimal management work methods as possible, including agreement on optimal management costs of the residential building, in relation to the solvency of the owner of the residential building;
- (iii) the content and quality of the provided services shall ensure the preservation of the properties of use (quality) of the residential building throughout the period of exploitation thereof;
- (iv) preclusion of invasion of the safety or health of an individual during the management process; and

²⁷ 18 March 1999 Consumers Rights Protection Law, published in the official gazette *Latvijas Vēstnesis* on 1 April 1999, effective as from 15 April 1999 with amendments.

²⁸ 15 February 2007 Law On Management of European Union Structural Funds and the Cohesion Fund, published in the official gazette *Latvijas Vēstnesis* on 23 February 2007, effective as from 1 March 2007 with amendments.

- (v) provision of the preservation and improvement of the surrounding environment during the management process.²⁹

The Law on Management of Residential Buildings sets out mandatory management activities and other management activities, which do not fall within the scope of mandatory activities. The mandatory management activities are as follows:

- (i) maintenance (physical preservation) of the residential building in accordance with the requirements of regulatory enactments:
- sanitary servicing of the residential building,
 - provision of heating, cold water and sewerage, as well as removal of household waste;
 - inspection, technical servicing and current repairs of the residential building, the facilities and communications located therein,
 - provision of the requirements set out for the residential building as an environmental object, and
 - provision of the fulfilment of the minimal energy efficiency requirements set out for the residential building,
- (ii) planning, organisation and supervision of administrative work, including:
- preparation of an administrative work plan, including a plan of measures necessary for the maintenance of the residential building,
 - preparation of the relevant annual draft budget, and
 - organisation of financial accounting;
- (iii) keeping of the file of the residential building;
- (iv) entering into a contract with the owner of the land parcel regarding the use of the land attached to a residential building; and
- (v) the provision of information to the state and municipal institutions.³⁰

Other management activities are activities, which are related to the management of the residential building and are performed in accordance with the instructions and means of the residential building owner. Those activities include the activities related to improvement and development of the residential building and preparation of a long-term plan of measures necessary for this purpose.

The apartment owners may perform all of the above management activities by themselves as the community of apartment owners or decide to assign the performance of management of the residential building to a building manager. Management of a residential building shall be performed on the basis of a building management contract.

Establishment of entity for management of residential building

The Law does not restrict the rights of the community of apartment owners to choose the form of the entity to establish. It could establish a capital company, an association, a co-operative society or an individual business person.

The association of apartment owners is the most common form of management of a residential building in Latvia,

Co-operative society of the apartment owners

The regulation of the co-operative society is provided in the Co-operation Societies Law³¹. The co-operation is a voluntary association of natural persons and legal entities³², and, if it is formed for management of multi-apartment residential buildings, it is not by law a commercial entity.

²⁹ Article 4 of the Law on Management of Residential Buildings.

³⁰ Article 6 of the Law on Management of Residential Buildings.

³¹ 05 February 1998 Co-operative Societies Law, published in the official gazette *Latvijas Vēstnesis* on 24 February 1998, effective as from 10 March 1998 with amendments.

³² Clause 5 of Part 1 of Article 1 of the Co-operative Societies Law.

The founders of the co-operative society may not be less than three persons. The founders and also members of the co-operation society of apartment owners may be only natural persons or legal entities that are the owners of an apartment in the building, which is managed by the relevant co-operation society of apartment owners, recognise and comply with the articles of association of the society and have made an investment in the equity capital of the society in accordance with the procedures specified in its articles of association, as well as make other payments provided for in the articles of association and decisions of the society.

The co-operative society of the apartment owners shall be registered in the Enterprise Register.

The co-operative society of the apartment owners takes its decision in accordance with procedure provided for in its articles of association and they are binding upon all its members.

The co-operative society of the apartment owners has its own capital. The capital is formed of the sum of co-operative share values of all members of the society. A member of a co-operative society shall have at least one co-operative share. The maximum number of co-operative shares of a member is specified in the articles of association. According to Article 31 of the Co-operation Societies Law a co-operative society has to create a reserve capital, which by a decision of the general meeting of members (meeting of authorised persons) shall be utilised to cover the loss of the society. The reserve capital consists of:

- (i) the joining fee, if such has been provided for in the articles of association of the co-operative society and
- (ii) unclaimed dividends and co-operative shares.

The maximum amount of the reserve capital is not limited.

Association of the apartment owners

The regulation of the association of the apartment owners is provided in the Associations and Foundations Law³³. An association is a voluntary union of persons founded to achieve the goal specified in the articles of association, which shall not have a profit-making nature.

The founders of the association of the apartment owners may not be less than two persons. The founders and also members of the association of the apartment owners may be natural persons and legal entities, as well as partnerships with legal capacity. There are no requirements for the minimum amount of the equity capital of the association of the apartment owners. The association of the apartment owners shall be registered in the Register of Associations and Foundations.

The association of the apartment owners takes its decisions in accordance with the procedure provided in its articles of association and they are binding upon all its members.

The association is liable to the extent of all its own property. The association is not liable for the obligations of a member and the member is not liable for the obligations of the association.

In a case the community of owners has adopted a decision on establishment of the association or the co-operative society and some apartment owners do not become members of it, nevertheless the decisions of the association or the co-operative society regarding the management of residential building shall be binding upon such apartment owners due to the fact that, according to the above, management of the building is the obligation of every apartment owner. Decisions of the association or co-operative society are not binding upon such apartment owners, if those decisions provide for obligations larger than the ones provided by the law.

³³ 30 October 2003 Associations and Foundations Law, published in the official gazette *Latvijas Vēstnesis* on 14 November 2003, effective as from 01 April 2004 with amendments.

Management contract

The regulation which is applicable to legal relationship arising from the management contract is provided in the Civil Law and the Law on Management of Residential Buildings.

The Law on Management of Residential Buildings provides for the rights of the community of apartment owner to take a decision regarding authorisation of another person to decide matters, which are within the competence of the community, by entering into a relevant contract. The relevant contract called "the management contract" can be concluded regarding assignment of all or individual activities of management of the residential building. Pursuant to the Civil Law, the management contract shall be regarded as an authorization contract, thus the provisions of the Civil Law regarding the authorization contract shall apply to the management legal relationship.

The Civil Law defines the authorization contract as a contract, pursuant to which an authorised person/assignee undertakes to perform a certain assignment for the other party (person granting the authorisation, authorising person, assignor), and the person granting the authorisation undertakes to recognise the activity of the authorised person as binding on him or her, except the authorised person has exceeded the limits of assignment given to him or her. If an authorised person has exceeded the limits of his or her authorisation, actions performed by him or her shall be valid only insofar as they are performed in accordance with the assignment.

It is prohibited for an authorised person to gain profit for himself or herself from the assignment, and he or she shall transfer everything he or she has gained or obtained through the authorisation to the person giving assignment, including all property, rights and claims he or she has obtained on the basis of the assignment, also including excess profits he or she has gained as a result of mistake or by exceeding the scope of his or her authority, excepting only what the authorising person has granted to him or her from such gains.

An authorised person shall also transfer to the person giving assignment the profit received or to be received, benefit, interest and everything that was entrusted to him or her for the performance of the assignment.

All the aforementioned provisions are applicable to administrator in cases the community of apartment owners and the administrator has concluded the management contract.

The Law on Management of Residential Buildings stipulates the general information and conditions which should be provided in the management contract:

- (i) the contracting parties;
- (ii) the address of the residential building, where the management activities shall be performed;
- (iii) the mandatory management activities specified in accordance with the Law on Management of Residential Buildings assigned to the administrator;
- (iv) other management activities assigned to the administrator in accordance with the as decided by the residential building owner (apartment owners);
- (v) the deadlines and procedures for the provision of a report on the fulfilment of the management activities, including a report on the use of the financial means transferred to the administrator;
- (vi) the procedures, by which the administrator shall provide information to the residential building owner (apartment owners);
- (vii) matters, in which the residential building owner (apartment owners) has authorised the administrator to take decisions on his or her behalf, to enter contracts on his or her behalf, as well as to make payments and receive payments, to represent the residential building owner (apartment owners) in court;
- (viii) the amount of management expenditure related to the fulfilment of the assigned management activities, the procedures for the determination and payment thereof, indicating separately:

- a relevant amount of mandatory expenditure, the procedures for the determination and payment thereof,
 - the amount of other expenditure related to the administration of the residential building, including improvement and development of the residential building, the procedures for the determination and payment thereof, and
 - the remuneration for management, if the contracting parties agree thereupon, as well as to the procedures for the determination and payment of such remuneration;
- (ix) the provisions regulating the provision of information related to the management of the residential building to state and municipal institutions;
 - (x) the scope of the sub-contracting, if the contracting parties reach agreement on sub-contracting the assigned management activities;
 - (xi) the procedures for amending and termination of the management contract;
 - (xii) the procedures for the taking over of the obligations and things arising from the management contract in the case of entering into, amending or termination of the contract;
 - (xiii) the validity period of the management contract; and
 - (xiv) the scope of the accountability of the administrator and the time of setting in thereof.

Concurrently with conclusion of the management contract the parties sign a delivery and acceptance certificate, according to which the obligations and things arising from the management contract are transferred to the administrator. Such a certificate forms an integral part of the management contract.

The management contract is binding upon all apartment owners and the obligations acquired on the basis of the assigned management activities are applied to every apartment owner.

Administrator

The management contract shall be concluded with an administrator. According to the Law on Management of Residential Buildings an administrator is a natural person or a legal entity that on the basis of a management contract performs the management activities assigned by the owner of residential building (apartment owners). The administrator must comply with the professional qualification requirements stipulated in the Law on Management of Residential Buildings. If the administrator is a legal entity, an employee of the legal entity performing the management task assigned in the management contract of the relevant building, he/she must comply with the professional qualification requirements stipulated in the Law on Management of Residential Buildings.

The administrator has the following competence:

- (i) During performance of the management task provided in the management contract, the administrator is obliged to comply with the requirements of the regulatory enactments regulating residential building management and other regulatory enactments, as well as the principles for the management of a residential building;
- (ii) The administrator is obliged to provide to the residential building owner (apartment owners) current, unambiguous and complete information regarding the regulatory enactments binding upon the residential building owner (apartment owners) and the obligations arising there from, regarding the obligations of the administrator arising from the management task, as well as, upon the request of the residential building owner, regarding matters, which relate to the management task;
- (iii) The administrator is obliged to warn the residential building owner (apartment owners) in writing regarding urgent measures needed to be taken to prevent ruination, collapse or destruction of the residential building, as well as calculate the estimated costs of these measures;
- (iv) The administrator is obliged to inform apartment owners in due time regarding actions or failure to act of an individual apartment owner (including the non-fulfilment of the liabilities acquired on the basis of the management task), which affect or may affect the interests of other apartment owners, as well as to present unambiguous and complete

- information regarding those matters upon an individual request of the residential building owner (apartment owners).
- (v) The administrator is not entitled to use the savings accumulated by the residential building owner:
 - for covering of loss caused as a result of his or her activities;
 - for settlement of unfulfilled obligations of the residential building owner (apartment owners) (settlement of debts, etc.).
 - (vi) The administrator may alienate or transfer, pledge or burden the residential building with property rights, conduct legal proceedings, carry out novations, as well as make and receive payments only if it has been provided for in the management contract.

The administrator should register in the Register of Administrators within one month after entering into the management contract. Everyone has the right to have access to the entries of the Register of Administrators.

The administrator is liable to the residential building owner (apartment's owners) for the fulfilment of the management tasks assigned to him or her in accordance with the Law on Management of Residential Buildings, the Civil Law and the provisions of the concluded management contract. The time when the administrator becomes liable shall be specified in the management contract. If the administrator fails to comply with the requirements of the laws while performing the management task, the administrator shall be liable in accordance with the procedures specified in laws.

Disputes between the administrator and the community of apartment owners arising from the management contract shall be solved by a civil court according to the civil procedure, as well as could be solved by an administrative court in accordance with the administrative procedure in cases, when the grounds of the dispute are violation of rights of the community of apartment owners as community of consumers. The consumer protection regulation could also be applicable in disputes arising from an agreement concluded between the administrator as an authorised person of the community of apartment owners and service provider, including a creditor.

The most common type of administrator in Latvia is a limited liability company or a co-operative society of the apartment owners. The management contracts with natural persons usually are concluded in situations of small residential buildings with few apartments.

C. LEGAL FRAMEWORK FOR ENERGY EFFICIENCY RENOVATIONS IN LATVIA

1. Legal grounds

On August 1, 2006, the Cabinet approved the Energy Development Guidelines for 2007-2016³⁴. The Guidelines contain the government policy, development objectives, and priorities in the sphere of energy both within the medium-term and long-term period. Those Guidelines also include a commitment to promote energy efficiency as one of the key priorities for the energy sector development in Latvia and intention to support energy efficiency measures in the energy end use sectors.

The Guidelines established that in Latvia the dwelling quality is the lowest in comparison with the EU countries, residential buildings are comparatively old and with low thermal isolation. 25% of buildings of the total number of residential houses have been built before 1940, when mainly brick, stone wall and wooden structures were used. Intensive construction of residential houses was carried out during the period from 1946 to 1992, i.e., 71% of the total number of residential houses was built. During that period the dwellings were built mainly by using such construction materials in the external delimiting that do not comply with the current heat engineering and environmental requirements. From the perspective of use of energy for heating it has been established that the overall heat resistance of the building delimiting

³⁴ Energy Development Guidelines for 2007-2016. <http://polsis.mk.gov.lv/view.do?id=2017> (official data base of policy planning documents of the Republic of Latvia; accessed on 30 January 2012).

structures of multi-apartment buildings of different series is low (on average 180 kWh/m² per annum) and that there is extremely large loss of chargeable heat data even within a group of buildings of one series and within one territory. Thus very low heat resistance and energy efficiency is characteristic to such buildings. Specific thermal energy consumption for heating is high – within the range from 150 to 350 kWh/m² per annum. The buildings constructed after 1992, i.e., approximately 4% of the total amount of buildings, have been designed already according to the new control measures for delimiting structures, therefore the thermal energy consumption of those buildings could be comparatively lower.

Considering the established facts it was determined that in order to improve the quality of dwellings and to decrease the consumption of energy resources, it is necessary to implement the energy efficiency improvement measures in the residential houses, i.e., to perform renovation or reconstruction of such houses. Inter alia the Guidelines provide that:

- (i) During the period until 2016 the average specific thermal energy consumption in the buildings shall be decreased from 220-250kWh/m²/per annum to 195kWh/m²/per annum;
- (ii) Implementation of measures to increase the energy efficiency in the buildings shall be continued also after the guidelines period and the average specific thermal energy consumption of 150 kWh/m²/per annum shall be reached by 2020;
- (iii) The investments required for attainment of the entire energy efficiency potential within the housing sector have been assessed in the amount of LVL 1,100 million, for the time period from 2007 until 2016 the required investments are estimated at LVL 439 million.³⁵

The priorities of the energy efficiency strategy set out in the Guidelines are in line with the requirements of the Directive on Energy Performance of Buildings 2002/91/EC³⁶, the Directive on Energy End-use Efficiency and Energy services 2006/32/EC³⁷, the Directive on the Promotion of cogeneration based on a useful heat demand in the internal energy market 2004/8/EC³⁸ and the Directive on the Promotion of the use of Energy from Renewable Sources 2009/28/EC³⁹ and will contribute to the Latvian compliance with these Directives.

Today there are two principal legal enactments in the field of energy efficiency in Latvia. First, Latvia has implemented the requirements following Directive 2002/91/EC of the European Parliament and of the Council of 16 December 2002 on the energy performance of buildings by adopting Law on the Energy Performance of Buildings⁴⁰. Second, Latvia has implemented the requirements following from Directive 2006/32/EC of the European Parliament and of the Council of 5 April 2006 on energy end-use efficiency and energy services and repealing Council Directive 93/76/EEC by adopting Energy End-use Efficiency Law⁴¹.

1.1. Law on the Energy Performance of Buildings

The purpose of the law is to promote good use of energy resources and to improve the energy performance of buildings. It sets out the competence of the state and local government institutions in the field of energy performance of buildings, and the legal requirements and organisation of the energy certification of buildings. The general supervision and co-ordination of the field of energy performance of buildings is carried out by the Ministry of Economics. The Ministry of Economics develops and implements the policy for the energy performance of buildings, as well as implements measures in order to provide recommendations regarding inspection of boilers and air-conditioning equipment and improvement of efficiency to the consumers. The law also ensures that energy consumers will

³⁵ Energy Development Guidelines for 2007-2016, p. 37, 79,

³⁶ OJ L 1 of 4.1.2003.

³⁷ OJ L 114 of 27.4.2006.

³⁸ OJ L 52 of 21.2.2004.

³⁹ OJ L140 of 5.6.2009.

⁴⁰ 13 March 2008 Building Energy Efficiency Law, published in the official gazette *Latvijas Vēstnesis* on 2 April 2008, effective as from 16 April 2008 with amendments.

⁴¹ 28 January 2010 Energy End-use Efficiency Law, published in the official gazette *Latvijas Vēstnesis* on 17 February 2010, effective as from 3 March 2011 with amendments.

receive the reasonable amount of information on their energy consumption and on the possibilities of implementation of energy efficiency measures.

According to the law the minimum requirements for energy performance are determined. The minimum requirements for energy performance are determined only for the buildings to be reconstructed the total area whereof exceeds 1,000 square metres and the total reconstruction expenses whereof exceed 25% of the cadastral value of the respective buildings, or the reconstruction work whereof relates to 25% of the construction volume of such buildings, as well as for all buildings under construction. The minimum requirements for energy performance are applied to:

- (i) the overall heat engineering parameters of the architectural elements of external delimiting structures of the building;
- (ii) the technical systems of the building (heating, cooling, water supply, ventilation, air conditioning, lighting, solar, etc.).

The minimum requirements for energy performance of a building should be prescribed through building industry regulations. These regulations currently do not set out the requirements for energy performance. They have been included in a non-binding form of a declaration. However, in the future particular technical requirements might be set.

In order to assess the energy performance of a building an energy audit shall be performed. Pursuant to the Law on the Energy Performance of Buildings, energy audit is a procedure of building monitoring and data analysis, which is carried out in order to determine the energy flow in the building and to evaluate the possibilities of energy conservation. Energy audits and certification of buildings are performed by energy auditors. The energy performance of a building is assessed in accordance with Cabinet Regulation No. 39 Method for calculation of energy performance of a building⁴².

On 1 January 2012 the regulation specifying the minimum requirements for energy performance of multi-apartment buildings will come into effect. Such requirements were set by the Cabinet on 20 September 2011 by adopting Cabinet Regulation No. 154 Regulations on inspection, technical maintenance, regular repairs and minimum requirements for energy performance of a residential building⁴³. The Regulation sets out the obligations of a manager of a residential building to plan the measures for improvement of energy performance, including renovation of a residential building, if the average thermal energy consumption during the preceding three calendar years has exceeded 230 kWh/m² per annum. During planning of the renovation of a residential building the manager of a residential building has to carry out measures that 1) ensure such decrease of the thermal energy consumption of the building that the thermal energy consumption would be less than 230 kWh/m² per annum, and 2) ensure the highest savings of thermal energy as compared to the funds required for implementation of such measures. This is the first time when such a binding duty has been set regarding residential buildings. The procedure for planning and organisation of activities related to renovation and reconstruction of residential houses is specified in Cabinet Regulation No. 905.

According to the Law on Management of Residential Houses, the provision on compliance with the minimum requirements for energy performance of residential buildings will be a mandatory administrative activity for any residential house as from 1 January 2012.

1.2. Energy End-use Efficiency Law⁴⁴

⁴² 13 January 2009 the Cabinet Regulations, published in the official gazette *Latvijas Vēstnesis* on 3 February 2009, effective as from 1 March 2009.

⁴³ 28 September 2010 the Cabinet Regulations, published in the official gazette *Latvijas Vēstnesis* on 1 October 2010, effective as from 30 September 2010.

⁴⁴ 28 January 2010 Energy End-use Efficiency Law, published in the official gazette *Latvijas Vēstnesis* on 17 February 2010, effective as from 3 March 2011 with amendments.

The law aims at ensuring energy end-use efficiency and introduction of energy services as well as development of energy services market. The law applies to energy end-use, provision of energy services, energy trade, the operation of distribution systems and energy efficiency monitoring in each energy end-use sector – household, industrial, service, agricultural and transport sectors and in the public sector. The general national indicative target for energy savings is determined by the ministry responsible for the implementation of the energy policy, and it shall be achieved by using energy services and other energy efficiency improvement measures. The responsible ministry for implementation of the energy policy is the Ministry of Economics.

According to the Energy End-use Efficiency Law, apart from the previously mentioned Guidelines containing the government policy, a national short-term policy planning document in the field of energy efficiency – the national energy efficiency action plan – shall be developed.

The Second Energy Efficiency Action Plan of the Republic of Latvia for 2011 – 2013⁴⁵ sets out the following energy efficiency measures, which should lead to reaching the goals envisaged in the action plan:

- (i) Operational programme "Infrastructure and Service" activity 3.4.4.1 "Improvement of energy efficiency of multi-apartment residential buildings";
- (ii) Operational programme "Infrastructure and service", activity 3.4.4.2 "Improvement of energy efficiency of social residential buildings";
- (iii) Informative campaign "Dzīvosim siltāk (Let's live warmer)" for multi-apartment building residents.

The Plan also provides for the financial sources for energy efficiency improvement measures in the housing sector. It is anticipated to raise the funds from the ERDF, Technical assistance and private funds.

Table 1: Financial sources for energy efficiency improvement measures in housing sector

No.	Activity	Required funding (thousand LVL)	Funding source	Implementation year
1.	1) Supplemented Operational programme "Infrastructure and Service", activity 3.4.4.1 "Improvement of energy efficiency of multi-apartment residential buildings"	47 759 949	ERDF	2010 - 2014
2.	2) Supplemented Operational programme "Infrastructure and service", activity 3.4.4.2 "Improvement of energy efficiency of social residential buildings"	4 851 702	ERDF	2010 - 2015
3.	3) Informative campaign "Dzīvosim siltāk (Let's live warmer)" for multi-apartment building residents	3,5	Technical assistance and business person funding	2010 - 2013
TOTAL		52 615 151		

According to Article 9 of the Energy End-use Efficiency Law the state and municipal authorities shall promote energy efficiency improvement by:

- (i) organising several energy efficiency improvement measures and participating in the implementation thereof;
- (ii) ensuring introduction of cost-effective measures; and
- (iii) observing the condition that the relevant measures should be implemented in such a way that the greatest possible energy saving could be achieved in the shortest time period, avoiding significant negative impact on the environment.

⁴⁵ The Second Energy Efficiency Action Plan for 2011-2013, approved by the order No 460 of the Cabinet of Ministers on 16 September 2011, published in the official gazette *Latvijas Vēstnesis* on 20 September 2011, effective as from 16 September 2011.

Municipalities may also develop energy efficiency action plans on a voluntary basis. For example, the Riga City has developed the Sustainable Energy Action Plan for 2010 – 2020, which has been approved by the Riga City Council on 6 July 2010⁴⁶. Moreover, the Riga City has established a municipal agency Riga Energy Agency (REA).

Inter alia the Energy End-use Efficiency Law defines the term energy efficiency improvement measures, providing that those are the activities applicable to specific final consumer groups, which lead to verifiable and measurable or estimable energy efficiency improvement. Likewise the law contains the definition of the term financial instruments for energy savings – all financial instruments, such as funds, subsidies, tax rebates, credits, third-party financing, energy efficiency improvement contracts, guarantee of energy savings contracts and other related contracts that are made available to the market by the State, local government or private organisations in order to cover partly or entirely the initial project costs for implementing of energy efficiency improvement measures.

In the said law Latvia has implemented also the definitions of the energy service and energy efficiency service contract. Latvia has also adopted several norms related to distribution system operators and retail energy trade companies. Article 13 of the law provides that distribution system operators and energy traders are prohibited from performing any activities, which might delay the request and provision of energy services and other energy efficiency improvement measures, as well as hinder the development of the energy services market. Moreover, distribution system operators and energy traders shall offer energy services to end-consumers and are entitled to enter into agreements or contracts with end-consumers regarding the implementation of energy efficiency improvement measures. Distribution system operators and energy traders shall not be allowed to indicate which energy service distributor or certified energy auditor should be chosen by the end-consumer.

2. Financial assistance

The following sources for measures to increase energy efficiency of residential buildings may be established:

- (i) own funds of the apartment owners;
- (ii) bank financing;
- (iii) state and municipality co-financing;
- (iv) co-financing by the EU funds or other instruments;
- (v) energy service company or third party financing.

2.1. State and municipality co-financing

Article 5 of the Law on the Energy Performance of Buildings prescribes the rights of the state or local government to provide assistance for performance of energy audits, as well as for the renovation or reconstruction of buildings. The state or local government may provide assistance in carrying out of the measures of energy efficiency of residential houses in the cases and according to the procedures specified in the Law On Assistance in Solving Apartment Matters⁴⁷.

Accordingly Article 27² of the above law provides that the state, in conformity with the resources provided for in the annual State budget, and the municipality shall provide assistance to an owner (owners) of a residential house or an apartment owner for performance of energy-efficiency measures in the residential house.

⁴⁶ Riga City Sustainable Energy Action Plan for 2012 - 2020. http://www.rea.riga.lv/files/RIGA_SEAP_2010-2020_EN.pdf (official website of Riga Energy Agency).

⁴⁷ 6 December 2001 law On Assistance in Solving Apartment Matters, published in the official gazette *Latvijas Vēstnesis* on 22 December 2001, effective as from 1 January 2002 with amendments.

The procedures by which the aforesaid assistance is provided and the amount of assistance is determined pursuant to Cabinet regulation in case of the state assistance and municipality binding regulations in case of the municipality assistance.

2.1.1. State assistance

Cabinet Regulation No.59 has been adopted in 2008 on the grounds of the Law on Assistance in Solving Apartment Matters – Regulations Regarding the Amount of Co-financing from the State Budget and the Procedures for Granting thereof for Energy Efficiency Measures in Residential Houses⁴⁸. State co-financing is foreseen for the following activities:

- (i) energy audit of a multi-apartment residential building – 80% of the total expenses, but no more than LVL 400;
- (ii) renovation of a multi-apartment residential building – 20% of the total supported expenses;
- (iii) development of technical design of a multi-apartment residential building or preparation of a simple renovation documentation, if standard solution is not available, – 80% of the total expenses, but no more than LVL 2,500;
- (iv) preparation of the opinion of technical inspection of the multi-apartment residential building – 80% of the total expenses, but no more than LVL 400.

According to the regulations the beneficiaries of the state assistance are communities of apartment owners represented by an authorised representative.

The regulations provide for a fixed total co-financing amount to be used within the scope of regulations – LVL 698,034. The energy efficiency measures shall be applied in 2008 – 2010.

2.2. Co-financing by the EU funds or other instruments

2.2.1. Co-financing for multi – apartment residential buildings

On the basis of the law On Management of European Union Structural Funds and the Cohesion Fund of 15 February 2007⁴⁹ the Ministry of Economics is implementing energy efficiency improvement policy. By adopting Cabinet Regulation No.138 “Regulations regarding first to eight stage of the project application selection of the Activity 3.4.4.1 “Improvement of Heat Insulation of Multi-Apartment Residential Buildings” of the supplement to the Operational Programme “Infrastructure and Services”⁵⁰ the Ministry of Economics implemented the requirements arising out of Council Regulation (EC) No 1083/2006 of 1 July 2006 laying down general provision on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and repealing Regulation (EC) No 1260/1999. According to the explanatory note⁵¹ to the draft regulation the purpose of the regulation is to facilitate improvement of energy efficiency in the multi-apartment residential buildings so that sustainability of the housing fund and efficient use of energy resources are ensured. The first announcement on open project application selection was published on 10 March 2009 in the official gazette with the first selection round starting on 14 April 2009.

⁴⁸ 5 February 2008 Cabinet Regulation No. 59 Regulations Regarding the Amount of Co-financing from the State Budget and the Procedures for the Granting thereof for Energy Efficiency Measures in Residential Houses, published in the official gazette *Latvijas Vēstnesis* on 19 February 2008, effective as from 20 February 2008 with amendments.

⁴⁹ 15 February 2007 Law On Management of European Union Structural Funds and the Cohesion Fund, published in the official gazette *Latvijas Vēstnesis* on 23 February 2007, effective as from 1 March 2007 with amendments.

⁵⁰ 10 February 2009 Cabinet Regulation No.138 “Regulations regarding first to eight stage of the project application selection of the Activity 3.4.4.1 “Improvement of Heat Insulation of Multi-Apartment Residential Buildings” of the supplement to the Operational Programme “Infrastructure and Services”, published in the official gazette *Latvijas Vēstnesis* on 4 March 2009, effective as from 5 March 2009 with amendments.

⁵¹ Drafts of normative acts. <http://www.mk.gov.lv/lv/mk/tap/> (official website of The Cabinet of Ministers of the Republic of Latvia, accessed on 9 August 2011)

After its adoption Regulation No.138 has been amended several times. Mainly the introduced amendments concerned measures for facilitation of project application submission, including recognition of value added tax (VAT) to be an eligible cost, right to receive interim payment, provided the project implementation exceeds 6 months, simplifying of the application, energy audit form, increase in the financing intensity, if 10% of the apartment owners of the respective building have been recognised to be low income persons, changes in the co-operation institution, changes in the available financing. Regulation No.138 has been amended to cover the first to the eighth selection round.

Noting the extensive changes in the evaluation criteria and to avoid a situation that there are two regulations in force⁵² on the same subject matter on 5 April 2011 the Cabinet adopted Regulation No.272 "Regulations regarding ninth stage of the project application selection of the Activity 3.4.4.1 "Improvement of Heat Insulation of Multi-Apartment Residential Buildings" of the supplement to the Operational Programme "Infrastructure and Services". The Regulation came into force on 20 April 2011. The announcement of the ninth project application selection round was published in the official gazette on 21 April 2011 with the application filing date starting from 27 April 2011 and on 31 May 2011 acceptance of project applications for the eighth selection round was terminated.

The total funding to be allocated pursuant to the Regulation No. 272 and 138 made available in the activity is EUR 67 956 285.

According to the information provided by the Ministry of Economics as of 13 February 2012 the use of the ERDF funds is as follows:

Table 2: Used ERDF funds for energy efficiency measures in housing sector, data of the Ministry of Economics

Status of the project	Number	ERDF financing, LVL	Total eligible costs, LVL ⁵³
Completed	61	2 530 631	4 995 863
Concluded agreements	350	21 807 336	43 108 002
Approved projects	42	2 632 939	5 190 301
Under evaluation	64	3 906 722	7 576 365
Turned down, withdrawn, suspended	262	14 273 839	28 005 779
In total	779	44 689 091⁵⁴	88 413 931

2.2.2.1. Institutions in charge of the 3.4.4.1. activity "Improvement of Heat Insulation of Multi-apartment Residential Buildings" in Latvia

The responsible institution is the Ministry of Economics, which ensures implementation of the 3.4.4.1. activity "Improvement of Heat Insulation of Multi-apartment Residential Buildings", its

⁵² For the period from 27 April 2011 to 31 May 2011 simultaneously two regulations were in force.

⁵³ Total amount of money needed for renovation of multi-apartment residential buildings presented in the investment projects (costs that are not eligible, e.g., renovation of electrical wires, greening of the building territory etc. are not included). The financing not provided by ERDF is raised by apartment owners using their own savings or bank financing.

⁵⁴ EUR 63 586 847

supervision and control as well as ensures provision of information to the public and ensures publicity on issues related to implementation of the 3.4.4.1. activity.

The co-operation institution is the state agency Latvian Investment and Development Agency (LIDA), which is under functional supervision of the Ministry of Economics. The agency constitutes a committee for review of applications, sets out methodology for filling of applications, for evaluation of applications and prepares draft agreement for implementation of the project, reviews project applications, enters into agreement on implementation of the project with the beneficiary of the financing and accordingly performs supervision and control of the project implementation.

Until 1 May 2010 the co-operation institution was the Construction, Energy and Housing State Agency. It was a state government institution under supervision of the Ministry of Economics. Pursuant to the regulations of the state agency⁵⁵, the agency had the function of management and implementation of the EU Fund programmes in the field of construction, energy and housing as well as measures of improvement of energy efficiency in buildings and constructions.

The state agency was liquidated pursuant to 29 May 2009 Cabinet Order No. 353 On shutting down of the Construction, Energy and Housing State Agency⁵⁶. The state agency had to be shut down by 1 July 2010, where among other institutions the Latvian Investment and Development Agency had to take over the activities under the operational programme "Infrastructure and Services". The reasoning for the liquidation was optimisation of the state government system and of the civil service and decrease of administrative costs⁵⁷.

2.2.2.2. Supported activities pursuant to Regulation No.272

Pursuant to Article 12 of the Regulation No.272 financing is granted for:

- (i) performance of construction work in the common property of the multi-apartment residential buildings owned by apartment owners, including renovation or replacement of external wall windows within the delimitation of individual apartments, ensuring renovation of structural parts of the building foreseen in the technical design or simplified renovation documentation and performance of work on energy efficiency improvement measures foreseen in the building energy audit report;
- (ii) preparing of project documentation, project constructions supervision and supervision by author.

To comply with the requirements of the Regulation the project shall achieve the following results:

- (i) thermal energy saving after renovation of the multi-apartment residential building is at least 20% per year of calculated energy efficiency assessment in energy audit added to project application;
- (ii) the ratio of saved energy (MWh per year) over ERDF funding for the project (thousand LVL) is at least 2 or 1.6 if on the day of the submission of the project application more than 10% of the apartment owners in the residential building are low-income person;
- (iii) the energy consumption for heating after renovation will not exceed 120 kWh/m² (if the building has one or two storeys) or 100 kWh/m² (if the building has three or more storeys).

⁵⁵ 16 October 2007 Cabinet Regulation No. 694 Regulations of the Construction, Energy and Housing State Agency, published in the official gazette *Latvijas Vēstnesis* on 19 October 2007, effective as from 1 January 2008, lost force on 1 July 2010.

⁵⁶ 29 May 2009 Cabinet Order No. 353 On Liquidation of the Construction, Energy and Housing State Agency, published in the official gazette *Latvijas Vēstnesis* on 04 June 2009, effective as from 29 May 2009.

⁵⁷ Annotation to 29 May 2009 Cabinet Order No. 353. <http://mk.gov.lv/mk/tap/> (official website of the Cabinet of Ministers, accessed on 8 August 2011).

Article 8 of the Regulation provides that the community of apartment owners shall be deemed to be a project applicant. However, the project shall be submitted through the authorised person, who complies with the criteria set out in Article 8 of the Regulation.

Hence the Regulation provides that the financing may be requested for performance of construction work in the common property. It must be noted that the Regulation foresees a possibility to perform construction works also in relation to windows of outside walls within the parameters of separate apartment properties. According to Article 4 of the law on Residential Properties⁵⁸ the common property explicitly includes windows and doors of the common premises, but pursuant to Article 3 of the Law On Residential Properties⁵⁹ individual property expressly includes windows and doors delimiting individual property. Therefore when exercising the rights following from the Regulation it is required to have a decision making and activity of the community of apartment owners in relation to common property and a separate consent from the apartment owner in relation to its own individual property.

According to Article 13 of the Regulation the beneficiary of the financing may commence implementation of the project after a decision of the co-operation institution on approval of the project application has been taken or opinion of the co-operation institution on fulfilment of the conditions set out in the decision has been signed, expenses which are eligible prior to a decision of the co-operation institution on approval of the project application or signature of the opinion of the co-operation institution on fulfilment of the conditions set out in the decision, if the expenses are made no earlier than on 24 October 2006. These expenses are foreseen in Article 18(1) of the Regulation, namely, the costs for energy audit, technical survey, construction cost estimate and development of construction design or simplified renovation documentation and technical design expertise costs. If implementation of the project is commenced prior to the co-operation institution taking a decision on approval of the project application or signature of an opinion of the co-operation institution on fulfilment of the conditions set out in the decision (except the above listed limited activities and their expenses), all expenses are ineligible.

One project application includes data on the estimated construction work in one multi-apartment residential building even in cases where there are several residential buildings on one land plot in the same address, the common property whereof forms part of the apartment ownership of all apartment owners.

The Regulation provides for limitations for receipt of financing. Namely financing for multi-apartment residential building may be received if no other financing for this building within the

⁵⁸ Article 4 of the law On Residential Properties prescribes that an existing joint property share shall include the following: 1) external enclosing structures (including walls, architectural elements, the roof, windows and doors of premises for common use, also exterior doors) of the residential building and external premises thereof (galleries, balconies, loggias, terraces), internal load bearing constructions (including supporting walls and columns, as well as separate enclosing walls of the property), intermediate coverings (including heat and sound insulation layers), premises for common use (including attics, stairwells and cellars), as well as the engineering communication systems, devices servicing the residential building and other indivisible elements functionally associated with the exploitation of the residential building, which do not belong to an individual property (including the heating elements within the boundaries of the individual property, if their functional activity depends on the existing engineering communications of the joint property);

2) the auxiliary buildings and structures belonging to the residential building, except those referred to in Article 3(3) of this Law;

3) the land plot, on which the relevant residential building is situated, if it does not belong to another person.

⁵⁹ Article 3(2) of the Law On Residential Properties prescribes that elements of an individual property shall be:

1) the structural non-load bearing, enclosing and finishing elements of the premises or a group of premises (including internal partitions, ceilings, floor and wall finishes, doors);

2) engineering networks and engineering communications to the vertical connecting pipe of the joint property;

3) engineering equipment components (including kitchen facilities, ventilation installations, toilet, shower and bath facilities), without which the elements of the existing share of the joint property residential building can function independently;

4) enclosing windows and doors of the individual property.

scope of other project application has been received and if no financing has been received within the scope of the first to the eighth project application round pursuant to 10 February 2009 Cabinet Regulation No.138.

2.2.2.3. Eligible and ineligible costs

The Regulation No.272 outlines the eligible cost positions in Article 18 of the Regulation, which include⁶⁰:

- (i) costs for cost estimates of energy audit, technical survey, construction design, or simplified renovation documentation preparation and technical design appraisal ;
- (ii) costs of project construction supervision and field supervision. The total eligible costs under cost positions i) and ii) may not exceed 10% of the total project eligible costs.
- (iii) construction work costs in the multi-apartment residential building;
- (iv) unforeseen expenses, which could be used to cover construction costs, provided they do not exceed 5% of the above cost positions i) to iii);
- (v) VAT on the eligible costs, if the applicant is not entitled to recover them pursuant to the regulatory enactments.

The eligibility of the construction work costs is made subject to the following:

- (i) professional third party liability of the designer has been insured for the amount, which is not less than LVL 100,000 per annum (this requirement does not apply to project applications submitted in the co-operation institution by 31 December 2011);
- (ii) the construction guarantee period covering at least two years from commissioning of the object has been insured for the amount, which is not less than 5% of the overall construction cost amount, or a guarantee issued by a bank registered in the Republic of Latvia has been issued with a validity term of two years from commissioning of the object for the guarantee amount, which is not less than 5% of the overall construction cost amount;
- (iii) construction supervision has been performed;
- (iv) construction works comply with the construction design in the stage of the detail design or simplified renovation documentation and requirements of regulatory enactments governing construction.

The following costs are not eligible within the operational programme pursuant to Article 21 of the Regulation:

⁶⁰ Article 18 of the Regulation provides that within the scope of the activity the following cost positions are attributable:

18.1. energy audit, technical survey, construction estimate, construction design or simplified renovation documentation drafting costs and technical design appraisal costs;
 18.2. project construction supervision and author supervision costs;
 18.3. construction work costs in the multi – apartment residential building:
 18.3.1. heat insulation and replacement of external delimiting structure construction elements, including renovation and replacement of external wall windows within the boundaries of separate residential properties;
 18.3.2. heating insulation of basement and upper floor covering;
 18.3.3. repair of staircases, if the energy efficiency work is performed in the staircases, not exceeding five percent of the total eligible costs of the project;
 18.3.4. renovation or reconstruction of heating and hot water supply system, save the installation, renovation or reconstruction of the thermal energy and hot water production;
 18.3.5. establishment, renovation or reconstruction of the ventilation system;
 18.3.6. renovation of functionally inseparable elements related to exploitation of the residential building prescribed in the detail design or simplified renovation documentation, if it ensures sustainability of the energy efficiency measures or the implementation of energy efficiency measures results in economy of thermal energy;
 18.4. unforeseen expenses, which could be used to cover construction costs, provided they do not exceed 5% of the cost positions specified in Articles 18.1, 18.2 and 18.3 above;
 18.5. the value added tax on the eligible costs, if the applicant is not entitled to recover them pursuant to the tax regulatory enactments.

- (i) costs which exceed the limits set out by the Regulation;
- (ii) costs which are incurred on the grounds of an employment agreement;
- (iii) the related insurance costs;
- (iv) establishment, renovation or reconstruction of the engineering communication system serving the building, which is not covered by the eligible costs under Article 18 of the Regulation.

Article 23 of the Regulation prescribes that the maximum intensity of the ERDF financing is 50% of the total eligible costs of the project. In case at least 10% of the apartment owners in the multi-apartment residential building have been granted the status of the low income person, the intensity is increased by 10%. In any case the maximum permitted ERDF financing shall not exceed LVL 35 per square meter of the total area of the residential building.

The project activities shall be performed within two years after an agreement on project implementation has been entered into with the co-operation institution.

2.2.2.4. Evaluation of the project applications and adoption of decisions

The project applications are reviewed by a commission, which consists of the members of the co-operation institution, the responsible institution and the Ministry of Economics.

Applications are evaluated pursuant to the set quality, compliance, administrative and ERDF financing granting criteria and applying the project application selection and evaluation procedure and project application evaluation forms set out in the regulatory enactments⁶¹.

⁶¹ The project application form enclosed to the Regulation provides as follows:

5.1. Conformity of the project applicant:

5.1.1. the project applicant possesses adequate and stable financial resources for implementation of the project;

5.1.2. the authorised person of the project applicant (in case of a legal entity) has not been declared by a court ruling to be insolvent, including is not involved in the rehabilitation proceedings or legal protection proceedings, the operation activity thereof has not been terminated, and it is not involved in the liquidation proceedings according to the information available in the commercial register;

5.1.3. during the project implementation the recipient of the financing or its authorised person has not submitted to the cooperation and responsible authority false information or has not intentionally deluded with respect to the implementation of the projects co-financed by structural funds;

5.1.4. a natural person has not committed crime in the interests of the authorised person of the project applicant (in case of a legal entity) resulting in involvement of the financial interests of the Republic of Latvia or the European Union, and no compulsory influence measures have been imposed on the authorised person of the project applicant (in case of a legal entity) under the Criminal Law ;

5.1.5. the project applicant or its authorised person has complied with or has not breached the terms for receipt of the financing;

5.1.6. construction of the multi-apartment residential building, where the heat insulation improvement measures are to be performed during the activity, was commenced prior to 1993 (inclusive), and it has been commissioned before 2002 (inclusive);

5.1.7. the multi-apartment residential building is divided in residential properties, and one owner owns no more than 20% of the total number of residential properties. The above percentage distribution does not relate to the residential properties owned by the state and municipalities;

5.1.8. the area of the non-residential premises located in the multi-apartment residential building does not exceed 25% of the total area of the residential building;

5.1.9. there are at least 2,000 inhabitants in the project implementation location (municipality) at the beginning of the year, when the project application selection round is closed;

5.2. Terms for receipt of financing:

5.2.1. the financing provided within the particular activity is not combined with the financing provided within the scope of another activity or individual support project. The expenses supported within the scope of another activity or individual support project will not be submitted for support within the scope of the present activity;

5.2.2. the particular project application is not, has not been and in case of approval of the project will not be submitted for financing or co-financing from other financial sources of the European Union or state and municipal budget funds;

5.2.3. the activities to be supported specified in the project application have not been commenced and the eligible expenses have not been incurred prior to adoption of the cooperation institution decision on approval of the project application or prior to signing of the cooperation institution opinion on the

The head of the co-operation institution on the basis of the evaluation of the commission, shall adopt a decision on approval of the project application, if the project application complies with the quality criteria and there is sufficient financing in the set selection round for the project having put in the priority order the project applications. A decision shall be taken within two months as from the end of the calendar month, in which the application has been submitted.

The financing beneficiary is obliged to sign the agreement on project implementation. The agreements has been prepared and approved by the LIDA as a standard model form.

2.2.2.5. Project implementation and ERDF financing receipt conditions

The Regulation No.272 lays down the following available financing payment types:

- (i) advance payment, which shall not exceed 20% of the requested ERDF financing amount, if the co-operation institution has the funds available;
- (ii) interim payment, which is made on the basis of the spent eligible expenses, but not more frequent than once every three months, if the project implementation duration exceeds six months;
- (iii) final payment, which is granted after implementation of the project on the basis of the spent eligible expenses.

The total amount of the advance payment and the interim payment shall not exceed 90% of the approved ERDF financing amount.

performance of the provisions prescribed by the decision, save the expenses specified in Article 17.1, which are attributable prior to adoption of the cooperation institution decision on approval of the project application or prior to signing of the cooperation institution opinion on the performance of the provisions prescribed by the decision, if such have been made no earlier than on 24 October 2006;

5.2.4. during the project implementation the publicity activities will be carried out in accordance with the requirements of the regulatory enactments within the area of implementation of the European Union funds;

5.2.5. the procurement procedures will be carried out within competition circumstances without secret agreements;

5.2.6. the eligible expenses specified in the project application will be made and registered in the accounting records of the recipient of the financing, they will be identifiable, separated from other expenses and traceable, and they will be proven by the respective original source documents;

5.2.7. the technical solutions of the submitted construction design comply with the requirements of 1 April 1997 Cabinet Regulation No.112 General Construction Regulations and Latvian Construction Standards, including LCS 002-01 Thermo-techniques of Building Envelopes (approved by 27 November 2001 Cabinet Regulation No. 495), LCS 201-07 Fire Safety of Structures (approved by 11 December 2007 Cabinet Regulation No. 866) and LCS 231-03 Heating and Ventilation of Residential and Public Buildings (approved by 23 September 2001 Cabinet Regulation No. 534);

5.2.8. development or renovation of the infrastructure finances as the result of the project is owned by the apartment owners of the multi-apartment residential building;

5.3. Project conformity:

5.3.1. the information included in the project application and appendices thereto is valid and true, and the co-financing of the European Regional Development Fund requested for project implementation will be used in accordance with the project description;

5.3.2. the project applicant is not aware of any reasons why the project could not be implemented or why the implementation thereof could be delayed, and confirms that the obligations specified in the project may be performed by the deadlines specified in the regulatory enactments governing the implementation of the respective European Union activity;

5.2.3. the thermal energy savings of the multi-apartment residential building after renovation will be no less than 20% per annum from the standard total consumption of thermal energy;

5.2.4. the type of use of the multi-apartment residential building, with respect to which the project application has been submitted, will not be changed or it will not be torn down for at least five years as from implementation of the project;

5.2.5. within three years after implementation of the project the authorised person of the project applicant will submit annual reviews on the consumption of thermal energy in the respective building [..].

The financing beneficiary may receive the advance payment, if the following conditions have been fulfilled:

- (i) the financing beneficiary has entered into agreement on project implementation with the co-operation institution;
- (ii) the financing beneficiary has entered into agreement with the contractor for at least 50% of the project total eligible costs;
- (iii) the financing beneficiary has submitted a tender plan to the co-operation institution;
- (iv) the financing beneficiary has commenced the first tender procedure no later than within three months as from signing of the agreement on project implementation;
- (v) prior to the implementation of the project the financing beneficiary must open an escrow account with a credit institution. In case the financing beneficiary is a legal entity it may also open an account with the Treasury.

The financing beneficiary may receive the interim or final payment, if the following conditions have been fulfilled:

- (i) the financing beneficiary has entered into agreement on project implementation with the co-operation institution;
- (ii) the financing beneficiary has submitted a tender plan to the co-operation institution;
- (iii) the financing beneficiary has commenced the first tender procedure no later than within three months from signing of the agreement on project implementation;
- (iv) the financing beneficiary has opened a current account in a bank registered in the Republic of Latvia, through which all payments in relation to the project implementation are made;
- (v) the project progress report and other reports set in the agreement have been prepared and according to the deadlines specified in the agreement on project implementation have been submitted to the co-operation institution, and copies of documents are enclosed pursuant to the list of documents evidencing expenses prepared and approved by the co-operation institution;
- (vi) investments have been actually made and booked in the accounting of the financing beneficiary, the expenses may be established, separated from other expenses and verifiable, and they are certified by the respective original source documents and the source documents comply with the requirements of the regulatory enactments;
- (vii) after inspection by the co-operation institution and review of the project progress report the project implementation costs have been recognised to be eligible.

The co-operation institution is entitled to decrease pro rata the ERDF financing amount, if:

- (i) the amount of the actual financial resources used is less than foreseen in the project application;
- (ii) any of the activities foreseen in the agreement on project implementation has not been performed, but the aim of the project has been attained;
- (iii) the source documents evidencing use of the financing have not been submitted;
- (iv) the use of the resources is not proportionate and reasoned;
- (v) the tender procedures have not been performed according to the regulatory enactments governing procurement.

The co-operation institution is entitled to terminate the agreement on project implementation and accordingly the financing beneficiary is obliged to repay the granted financing in the instances provided in the agreement on project implementation and in the following cases:

- (i) if the financing beneficiary has not started tender procedure within 3 months from the day of signing of the agreement on project implementation;
- (ii) if the financing beneficiary has not entered into agreement with a contractor – construction company on renovation of the multi-apartment residential building within a year from the day of signing of the agreement on project implementation;

- (iii) if the financing beneficiary has not submitted the payment request for receipt of the financing for at least 50% of the eligible costs to the co-operation institution within 18 months from the day of signing of the agreement on project implementation.

In general the co-operation institution shall decide on recovery of the granted funding if the funding has been received but it has not been used in accordance with the requirements of the effective laws and regulations or the agreement on project implementation.

2.2.2.6. Procedure for settling of disputes

Pursuant to Article 23 of the Law on Management of European Union Structural Funds and the Cohesion Fund, a dispute regarding granted financing of a European Union fund shall be settled in accordance with the procedures specified in the Administrative Procedure Law, the Civil Procedure Law and other regulatory enactments.

Since the agreement on project implementation shall be considered to be a civil law agreement, the dispute resolution with respect to performance and termination of the agreement is subject to the court of general jurisdiction; the agreement may be terminated only according to the civil law procedure. The decision on redemption of the granted financing, in its turn, is adopted and may be contested and appealed in accordance with the administrative proceedings.

Performance of the agreement and implementation of the project is the responsibility of the beneficiary of the financing or the community of the multi-apartment residential building. Thus, if an authority has established the basis for redemption of the financing, the person it will direct against will be the beneficiary of the financing and not the authorised person that is the actual project implementer. The beneficiary of the financing will be able to bring a regress claim against the authorised person on the basis of the signed authorisation agreement.

It is not unequivocally clear from the currently valid norms of the Apartment Property Law how the authority would be able to bring a claim against the community of apartment owners and against what property such claim could be brought. There is no respective case law either.

2.3. ESCO financing structures in Latvia

2.3.1. Overview – Energy Service Company

Another mechanism for performance of energy efficiency measures in a multi-apartment residential building is by involvement of a third party, which ensures financing and implementation of the measures themselves. This relates to an energy service company. Directive 2006/32/EC on energy end-use efficiency and energy services defines an energy service company (ESCO) as a natural or legal person that delivers energy services and/or other energy efficiency improvement measures in a user's facility or premises, and accepts some degree of financial risk in so doing. The payment for the services delivered is based (either wholly or in part) on the achievement of energy efficiency improvements and on the meeting of the other agreed performance criteria.

The energy services are delivered based on a special type of an agreement. The Energy End-use Efficiency Law, which implements Directive 2006/32/EC, defines an energy efficiency service contract as a contract between the beneficiary and the provider of energy services regarding the implementation of specific energy efficiency improvement measures, if payment for investments in these measures is formed by the contractually agreed energy efficiency improvement.

Article 14 of the Energy End-use Efficiency Law sets out the conditions according to which an energy efficiency agreement must be made. The provision of energy services shall conform to the following conditions:

- (i) information is included in the energy efficiency service contract regarding:
 - the beneficiary of the energy services (customer),

- the provider of the energy service (contractor),
 - financing provided by third parties, if such is used,
 - energy end-use,
 - the recommended energy efficiency improvement measures,
 - the energy efficiency improvement measures guaranteed by the energy service provider and the evaluation thereof,
 - the project financing scheme,
 - the anticipated payment type, and
 - other issues;
- (ii) the energy service provider finances energy efficiency improvement measures entirely from his or her and a third party's financial resources or solely from his or her or solely from a third party's financial resources;
- (iii) the investments invested are fully covered from the energy savings acquired as a result of the introduction of contractually agreed energy services;
- (iv) the energy service provider is fully or partially liable for the financial, technical and commercial risks of the project.

It is foreseen that a model energy efficiency service contract is published by the responsible ministry on its internet homepage. However, at the time of making this Study no such form has been prepared yet. Therefore, currently the law defines the principles without setting out details on the contents of an energy management agreement.

2.3.2. Energy efficiency service contract

Within the scope of this Study we have identified only one energy service company in Latvia, which provides energy efficiency services as its principal activity and accordingly adopts one of the ESCO models described herein below, in particular, guarantees a certain level of energy efficiency improvement. It must be noted that several building management companies assist in implementation of energy efficiency measures in residential buildings, but they do not undertake this as an ESCO.

Noting the above for the purposes of this Study a model energy efficiency performance contract (hereinafter, the **EPC**) used in Latvia by SIA Renesco⁶² has been reviewed. This contract, as far as we have established being the sole such ESCO contract in Latvia, could be thus to a limited extent relied upon for the practice in Latvia.

For the purposes of this Study we describe the terms provided in the EPC drafted and used by SIA Renesco and corresponds to commercial practise of one company.

Further we note that while the EPC is not expressly referred to as following the model of the energy efficiency service agreement foreseen in the Energy End-use Efficiency Law, it is not contrary to the Energy End-use Efficiency Law. Otherwise the agreement is subject to the general terms of the Civil Law of Latvia governing service agreements.

Main terms and conditions of the EPC

Subject matter of the EPC

The main principle of the EPC is that the contractor – ESCO represents itself as a professional in the energy efficiency area, and hence undertakes to implement energy saving measures, provides renovation of elements of the building and thermal energy supply in the building, and in doing so the contractor assumes full risk for the commercial success of the measures. Further the contractor guarantees that subject to fulfilment of the conditions of the EPC by all parties the client payments to the contractor determined in the agreement in the framework of the calendar year will not exceed at its substance the payment as it would be for the thermal energy in case the energy saving measures would not have been implemented in

⁶² SIA Renesco, a company registered in the Enterprise Register of the Republic of Latvia under registration number 40103201913.

the building. Any changes in the payments are permitted, if they have arisen subject to changes in the energy tariffs.

The measures of energy saving and thermal energy supply are defined as all planning, technical, procedural and other services provided by the contractor in connection with the building, which include also services of preparation of a project or any other measures, as well as those services that the contractor provides subsequently after commencement of the main energy saving measures in order to optimize or safeguard the savings. Furthermore, energy-saving and thermal energy supply measures include all maintenance services, which the contractor must provide to ensure their functioning, and thus compliance with the targets of the energy saving measures.

Parties to an EPC

The contract is made among three parties – (i) the ESCO acting as the contractor, (ii) apartment owners (hereinafter, the **client**), and (iii) the building management company.

On behalf of the apartment owners the contract is signed by an authorised person of the apartment owners or by a representative of their respective entity. Noting that decisions on management of the building and issuing of authorisation falls within the competence of the community of apartment owners, pursuant to the Law On Apartment Ownership, the community of apartment owners decide on signing of an EPC, whereby they agree to make a fixed monthly payment for the heating and hot water services in return to energy efficiency improvement measures and services; and accordingly authorise a representative to act in relation to the EPC.

Validity of the contract

The EPC is entered into for a period of 20 years, which is counted from a set date from which the client has to make payments according to the contract. However, with regard to settlements the contract shall actually remain in force until the client or the house management company has made all due payments to the contractor.

Termination

The contract provides for two sets of grounds for termination, first, termination of the contract prior to expiry of its term and, second, termination on reasonable grounds. The principal issue in relation to such termination is recovery of the investments made by the contractor by implementing energy efficiency measures.

First, if the client terminates the contract subject to the conditions provided in the contract, the contractor applies the progressive compensation scheme, which means that the amount of the compensation is based on the net present value, which is calculated as the sum of all the expected income minus all the expected expenses, which the contractor would have had, if the contract would not have been terminated.

The compensation is payable within 6 months from the day the client has claimed the compensation. Hence, although the contract provides for a possibility to terminate the EPC on the part of the client, the financial consequences of such a termination will be heavy and likely to prevent the client from taking such a decision.

For the other two parties – the building management company is entitled to terminate the contract with no specific reasons by notifying the parties two months in advance and the contractor may terminate the contract by notifying the parties two months in advance in case financing of the renovation project is not possible due to occurrence of certain circumstances, for example, financial crisis, withdrawal of credits, subsidies or assigned financing or other similar cause. Hence the building management company and the contractor are entitled to terminate relatively freely without having any negative financial consequences.

The second set of grounds for termination is in addition to the above and does not require a prior notice and is applicable in case the contract has been seriously violated several times, which include the reasons that are:

- (i) serious for the client including any case when the quality of the services provided by the contractor do not comply with the quality standards;
- (ii) important for the contractor including any case when the client has not been able to settle a monthly payment on a regular basis and the total debt of the building exceeds a certain fixed amount. In this case the client is obliged to pay compensation to the contractor according to the progressive compensation scheme.

It follows from the above that although the EPC provides for specific grounds to terminate the contract, the important issue for consideration is the restitution to be performed upon termination, and on the part of the client such a duty to compensate the investments, if not the lost profit, by the contractor would in most scenarios be a heavy burden and hence serve as a deterring aspect, unlike for the building management company and the contractor.

Obligations of the contractor

The services and measures to be performed by the contractor according to the contract are divided into compulsory measures and discretionary measures, where compulsory measures⁶³ are such measures, which are not subject to the contractor's discretion and which shall be performed provided that the parties to the contract fulfil their duties; and discretionary measures are such measures, on the implementation of which the contractor may decide. The decision on the measures to be implemented is solely at the discretion of the contractor, and the client is not entitled to refuse implementation of such measures, unless the client can prove general unfairness or veto rights by the client are applicable. The veto rights of the client are applicable in case the client has established that any measures are contrary to the regulatory enactments, including decisions of municipality. Restrictions of discretion by the contractor are set by the quality criteria in the contract, in particular, the measures shall comply with the generally accepted standards under the Latvian construction rules and they shall be optimally appraised with respect to planning and costs.

Upon implementation of the measures the contractor undertakes duties in relation to maintenance of energy saving and energy supply measures, including the following:

- (i) the contractor shall take care of maintenance of all energy saving and energy supply measures provided by it, i.e. for building structures or installations, devices, objects and systems integrated or installed in the building;
- (ii) the contractor shall guarantee that at the end of the contract the applied energy measures are in a condition, which may be regarded as secure and operative taking into account normal wear and tear.

⁶³ The Contract provides the following compulsory measures: (i) to provide the building with proper weather protection and maintenance, preventing, within the set limits, water infiltrations and damage of constructions; (ii) to guarantee supply of thermal energy for heating of floor space during the heating season to such an extent as to comply with the indoor standards, except for periods when supply of thermal energy or electricity via main networks is not provided by the local thermal energy or electricity supplier; (iii) to guarantee hot water supply and eliminate possible problems all year round, except for periods when supply of thermal energy or electricity via main networks is not provided by the local thermal energy or electricity supplier; (iv) to assure, within the set limits, a proper level of ventilation in the apartments in order to avoid mould and excessive moisture, except for cases when the existing ventilation system has been constructed incorrectly, it cannot be repaired or rebuilt without making substantial reconstruction of the building. In such cases the contractor is entitled to use alternative solutions for ventilation and air change providing, within the set limits, equivalent effect; (v) to provide functioning of hot water and heating equipment, junctions and pipelines installed or implemented by the contractor during the entire operation period of the Contract; (vi) to provide functioning and efficiency of heat insulation materials, installed or implemented by the contractor according to their specification and normal depreciation; (vii) the Contractor carries out cosmetic repairs of the staircase in order to obtain an aesthetic appearance.

Henceforth the contractor is not only obliged to implement the measures, but also to maintain them for the term of the contract.

Financing by the contractor

The contract does not provide for any financing to be provided by the contractor and foresees the risk guarantee⁶⁴ undertaken by the contractor.

From the point of view of investments made in the building all investments made by the contractor according to the contract remain full property of the contractor until all payments due to the contractor have been made by the client and/or the building management company. Accordingly, the contractor may at any time remove its property, if technically possible, in case the client delays any payment for more than 30 days. If any investments made by the contractor are not separable from the building they remain at the possession of the client, but without the right to separate, encumber or pledge the respective investment. In practice the rule in relation to separation of the investment from the building may be problematic, as most of the investment made is likely to be part of the building and not separable.

Obligations of the building management company

The building management company is obliged to read the meters of the building and calculate de facto energy consumption in the previous month, calculating the monthly payment for the client and recording the charge for hot water and heating and to carry out its distribution among owners of apartments, and accordingly invoicing the client.

The building management company calculates the difference between the client's monthly payment and de facto thermal energy consumption; from that sum it deducts 2.5% for administrative charge and 2% guarantee charge for its services and transfers the remaining calculated sum to the contractor's bank account. Thus it receives a fee for the provided services and a guarantee payment.

It follows from the terms of the contract that it is in principle the duty of the building management company to ensure that the contractor receives full payment for the services rendered by the contractor under the contract, irrespective of possible changes of legal status of the building, possible decisions of general meeting of the owners of apartments in future or change of the owners of individual apartments.

The above duty of the building management company in reality means that the risk for not collecting payments from the apartment owners is shifted to the building management company, which shall put in place payment collection measures and accordingly suffer, if the established collection measures fail. So there is no risk of not receiving the payments put on the contractor. In any case the building management company has claim rights against the apartment owners, which in this relation are not secured by any security.

Client

The client is generally responsible for maintenance, renovation and modernization of the building constructions, and the client may not dismantle or substantially change the

⁶⁴ The contract provides for a risk guarantee in the following wording: the main contribution of the contractor is undertaking of commercial risk by providing that the implemented energy saving and thermal energy supply measures during validity of the contract will not increase the energy base line in the settlement period calculated according to the terms of the contract, without changing the calculation principles defined in the contract. It follows that the contractor undertakes commercial risk, which means that the contractor will be able to work with profit or have a positive balance in relation to the respective building by not increasing the payments to be made by the apartment owners and having implemented the energy saving and thermal energy supply measures. In practice this risk guarantee in conjunction with the undertaking of the contractor to retain the payments to be made by the apartment owners on the same level, means that the apartment owners will be entitled to challenge any payments above the level provided in the agreements.

equipments installed by the contractor, their adjustments, as well as facilities, heat insulation or other materials without having received the contractor's written consent.

In the relations with the contractor the client ensures, in particular, support for achievement of maximum energy efficiency performance following the requirements set by the contractor and listed in the contract and general co-operation duty in relation to provision of information, necessary consents and providing access to all areas in the building. The client is encouraged to provide to the contractor the warning and notice of the non-compliance with the quality standards stipulated in the contract in the shortest possible time.

In relation to the choice of measures to be implemented by the contractor the contract provides for rights of the apartment owners to veto the measures to be applied by the contractor. In case the contractor does not agree, an independent expert may be involved by the contractor to evaluate the measure, and the opinion of the expert is binding.

2.3.2.1. Payments

According to the terms of the contract a monthly payment due from the client is to cover the following services:

- (i) energy saving and energy supply measures, including maintenance and additional services of any kind, such as training of and instructions to the client's personnel;
- (ii) commercial risk assumption;
- (iii) implementation and maintenance of the energy management system;
- (iv) replacement and setting up of energy saving and energy supply equipment and installations;
- (v) project management;
- (vi) attraction of investments, management of loans and cash flow;
- (vii) obtaining of required public permits and approvals.

The apartment owners will have to make payments calculated according to the baseline, which remain unchanged during the validity of the contract, unless tariffs change. The contract provides for two separate calculation basis for baseline – one for energy costs of space heating and one for energy costs of hot water, and those are calculated according to a set formula.

Further adjustment of the baseline for energy costs for space heating is foreseen in case of changes in climate conditions, indoor comfort conditions and fuel energy tariffs. Similarly adjustment of the baseline for energy costs for hot water is foreseen in case of changes in fuel and energy tariffs. Likewise in case use of the building changes during validity of the contract, then such activities may also influence costs, which have to be accordingly adjusted. The contract defines changes in the use of the building as extension or reduction of the area of the building to be heated, respective installation or removal of production units, appliances or other facilities resulting in a significant increase or reduction of thermal energy consumption or other indicators of the building change, changes of the building use form (for example opening of shops, restaurants and offices etc.).

The contract stipulates one month as the settlement period of the client for the services. The client makes payment on the basis of an invoice issued by the building management company. Further the contractor issues an invoice to the building management company for the amount that is due for heating of floor space, hot water and loss from hot water circulation system in the previous month.

As in any commercial contract penalties for delay in payments are foreseen. However, in case of exceeding 30 days the contractor, upon notifying the client and the building management company 3 days in advance, is entitled to terminate provision of services to the delaying apartment owner and to prohibit using the investments made in the building. If the total debt of the building for the services provided by the contractor exceeds 30% of the total cost of the services the contractor, upon notifying the client 3 days in advance, is entitled to terminate provision of the services to the entire building and prohibit using of the investments made in

the building. In practice this would mean that the contractor terminates provision of heating and hot water, but the contract would remain in force.

A mirroring penalty for provision of services by the contractor in undue quality, i.e., the indoor temperature in an apartment of the building for a fixed period has been lower as compared to the agreed comfort standards; the apartment owner receives a 10% discount on the services provided by the contractor.

It follows from the above that the model that is currently practiced in Latvia is based on the principle that an ESCO as the general contractor undertakes to implement energy efficiency measures and energy supply services at its own cost and risk, and the client pays for the services and measures the payment, which is equal to a fixed payment calculated based on the values of the services and costs at the time of entering into EPC. The investments made by the contractor remain the property of the same until expiry of the term of the contract or early termination upon receipt of compensation from the client.

2.4. Practical implementation of energy efficiency renovations from the financing point of view

Pursuant to the publically available information energy efficiency renovations in the multi-apartment residential building sector are performed mainly with support of third party financing. No information is publically available on the renovations performed using only the own funds of the apartment owners.

2.4.1. Bank and EU fund co-financing model

A typical third party financing model used in Latvia is bank financing in combination with the EU funds as granted pursuant to Regulation No.272. Observations show that the apartment owners are not ready to invest their own funds in the renovation process notwithstanding the expected energy savings. Indisputably, there are miscellaneous conditions, for example, apartment owners do not trust each other, state institutions, banks and contractors, as well as they still lack information of energy efficiency.⁶⁵ In the same way the apartment owners individually or the community of apartment owners do not have savings to cover 50% of project costs, since the maximum intensity of the ERDF funding is 50% or 60% of the total eligible costs of the project in this case pursuant to the Regulation No.272. From discussions with financing institutions it follows that banks are also more open to issuing loans for a project, if a competent institution has already approved the project and recognized as supportable, i.e. has partly assumed responsibility and risk.

⁶⁵ Presentation prepared by Zane Galinska of the Ministry of Economics on Activity "Improvement of Heat Insulation of Multi-Apartment Residential Buildings" .

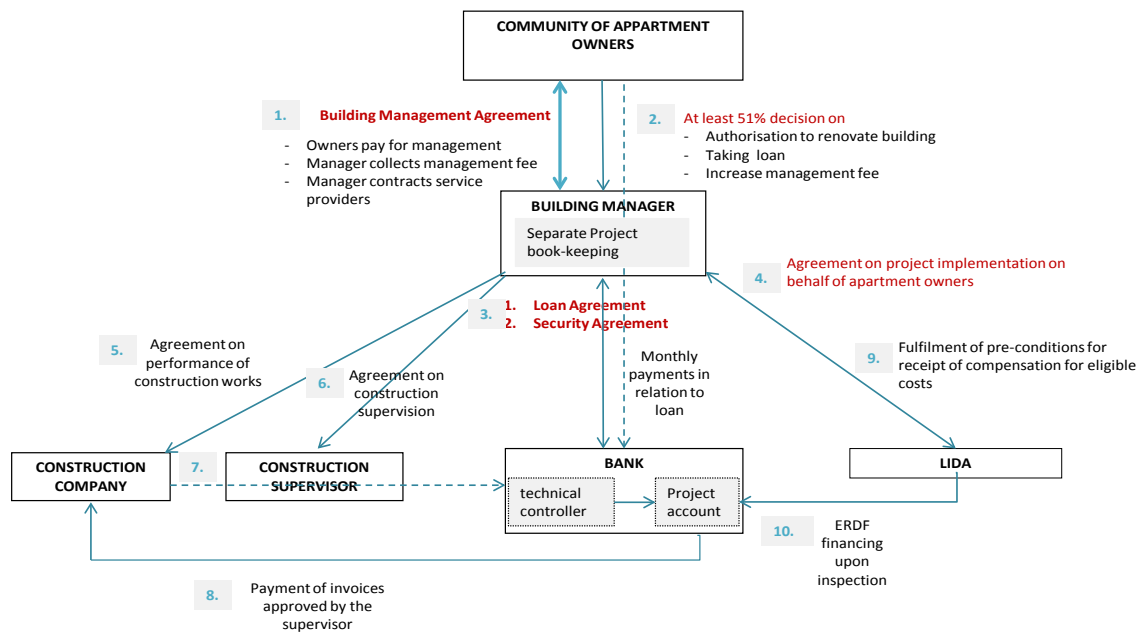


Figure 2 implementation of renovation of a multi apartment residential building with involvement of Bank and EU fund co-financing.

The operation of the joint third party financing model, inter alia, the activities to be performed, for energy efficiency renovation of multi-apartment residential building, is described in more detail below.

- (iv) Despite the fact that, pursuant to the Regulations, the project applicant as well as the final beneficiary is the community of apartment owners of the multi-apartment residential building, banks do not give financing directly to the community or apartment owners. Since the apartment owners submit the project application via mediation of an authorised person, banks practise to finance the authorised person directly, who most frequently is the building manager established in a form of limited liability company or the community of apartment owners, which is represented by one apartment owner. Moreover, the banks usually treat such a loan as a normal commercial loan. In practice the renovation loan differs from the normal commercial loan by the form of its collateral.
- (v) The decision of a community of apartment owners on borrowing a loan and the respective increase of the management fee is the precondition for the building manager to receive the financing from the bank as well as to commence renovation of the respective building. The banks also require adopting a decision to take over the loan, if the building management agreement has been terminated upon initiative of the community of apartment owners. Further the banks also require that the payments for the provided services to the building manager are made timely and fully on a regular basis. .
- (vi) The building manager enters into a loan agreement with a bank in its own name and the building manager acts as the borrower in relations with the bank. Such liability of the building manager is booked on its balance sheet as its own liability. Apartment owners are not a party to the loan agreement with the bank, although they are the final beneficiaries of the loan and the apartment owners have authorised the building

manager to borrow the loan for renovation of the building and have decided on the increase of the management fee (partly for repayment of the loan) and have undertaken not to change the building manager without the consent of the bank. In fact the building manager acts as an intermediary and receives a fee for such service from the apartment owners for the comfort of the bank.

- (vii) The building manager pledges the rights of claim against the apartment owners (commercial pledge) as the security for the loan. In addition the bank and the building manager enter into an assignment agreement (pursuant to the Latvian law, consent of the debtor is not required), under which, in case of default of the building manager under the loan agreement, the bank has direct rights of claim against the apartment owners.
- (viii) According to common practice banks provide 100% of the necessary financing. Additionally bank requests security, which is usually as follows:
 - future cash flow (pledge over the claims of the managing company against the apartment owners or an assignment agreement in case the borrower is an apartment owner's association).
 - fixed term deposit in the amount of 1-3 month credit payments (optional).
- (ix) Usually a decision on the project approval adopted by LIDA is a pre-condition to make a loan available to the building manager. The building manager as the authorised person enters into the project implementation agreement with LIDA on behalf of the apartment owners. Apartment owners are the final recipients of the EU financing and the responsible persons.
- (x) To develop the renovation project approved by LIDA the building manager enters into the construction agreement with a contractor selected through a public procurement procedure. The applicable public procurement procedure differs depending on the ownership of the shares of the building manager. In case a municipality owns the shares of the building manager, the Public Procurement Law applies. However, if the authorized person is a building manager which is a private company or community of apartment owners, Cabinet Regulations No.65 Regulations regarding the Procurement Procedure and the Procedures for the Application thereof to the Projects Financed by the Commissioning Party⁶⁶ shall be applied. Namely, for the procurement of goods or services, the estimated contract price of which is LVL 50,000 or more, or for the procurement of construction work, the estimated contract price of which is LVL 120,000 or more, the contract awarding procedure in accordance with those Regulations shall be applied.
- (xi) Performance of construction supervision during the project implementation is a pre-condition for recognition of construction expenses as eligible costs. The building manager enters into construction supervision contractor. Construction supervision shall be performed by a certified supervisor. No public procurement rules apply (due to being under threshold – LVL 3,000 if the Public Procurement Law applies, LVL 50,000 if Cabinet Regulations No.65 apply), costs shall be reasonable. The supervisor's obligations and responsibility are set by law. The supervisor mainly controls compliance of the construction process with the law and approved detail design.
- (xii) According to the conditions of a typical construction agreement, a contractor is obligated to perform monthly reports on the performed works. Such a report forms the grounds for monthly invoices. Usually banks require submission of such monthly reports and additionally require approval of the construction supervisor on the report.

⁶⁶ 5 February 2008 Cabinet Regulation No. 65 Regulations regarding the Procurement Procedure and the Procedures for the Application thereof to the Projects Financed by the Commissioning Party, published in the official gazette *Latvijas Vēstnesis* on 8 February 2008, effective as from 9 February 2008

- (xiii) Banks pay constructor's invoices on the grounds of approval by the construction supervisor. According to unofficial information only one bank engages internal technical controllers, who verify fulfilment of the construction works prior to the payment of an invoice. In case the constructor needs advance payments (rarely), banks request an appropriate bank guarantee.
- (xiv) The building manager implements the project in accordance with the signed project implementation agreement with LIDA, coordinates and manages public procurement procedure, submits reports and all the necessary information and ensures possibility for LIDA to control the implementation process.
- (xv) In practice LIDA compensates costs covered already from the bank loans. Upon prior written request of the building manager and the respective financing bank LIDA usually transfers the ERDF financing to the account of the building manager opened for the respective project and loan.

Liabilities arising from the mutual agreements involved in the typical third party financing model are presented in the below scheme.

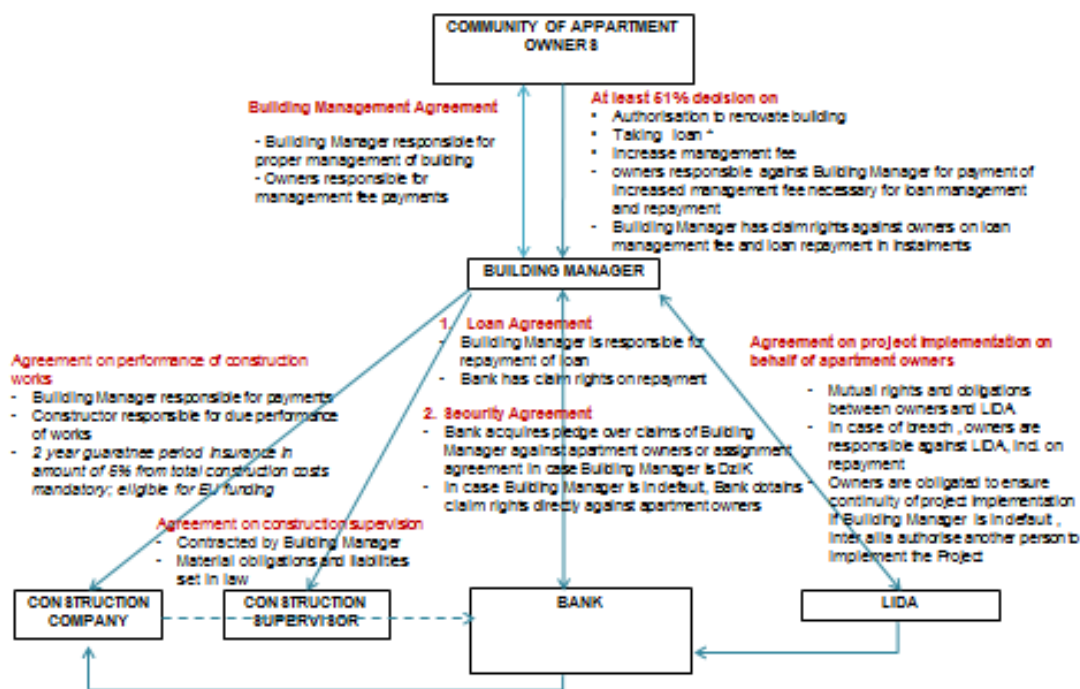


Figure 3: Liabilities in the Bank and EU fund co-financing model.

In case the building manager defaults on monthly payments the bank may exercise its rights under the assignment agreement and send out letters to the apartment owners requesting payment of management fee directly to the bank.

As to acceleration of loan in case of default the situation is not straightforward. In the standard terms of a loan agreement the bank has rights to accelerate the loan (terminate the loan agreement and request immediate repayment of the loan and penalties, interest etc.) in relation to the building manager subject to fulfilment of the conditions foreseen therein.

However, acceleration of the loan in relation to the apartment owners is debatable. First, it has to be included in the decision of the apartment owners that in case of default of the

building manager the outstanding loan together with all penalties, interest may be requested from the apartment owners. As far as it has been possible to conclude from the discussion with banks, this is not the practice. On the contrary the decision of the apartment owners sets out a duty to make monthly payments. Second, apartment owners are consumers and accordingly protected by the Consumers' Rights Protection Law⁶⁷, in particular, for the liabilities arising out of the loan agreement to be binding upon the apartment owners they have to be expressly negotiated and agreed upon, otherwise such liabilities could be recognized not binding upon the apartment owners. According to the current court practice possibilities of a bank to request repayment of the loan with all penalties, interest directly from apartment owners as fully entitled parties to the loan agreement are low.

Some of the banks also require including a decision on taking over of the loan from the building manager by the apartment owners in the decision of the apartment owners when deciding on taking of loan for renovation. The enforcement of such a decision is debatable as well, since for the apartment owners to become a party to the agreement there must be free will on their part and noting that they are subject to the Consumers' Rights Protection Law, the terms of the agreement have to be negotiated and agreed upon. Based on the Latvian court practise it is unlikely that the apartment owners could be forced to become a party to a renovation loan agreement.

Further, in case of default of the building manager the rights to enforce the commercial pledge arise and the bank will be entitled to sell its claim rights to a third party. Assignment agreement is usually used to avoid the pledge enforcement procedure, and those are the alternative measures. Hence, if the bank sells the claim rights according to the terms of the commercial pledge agreement (usually sale without an auction for a market price) the bank will acquire the sales price as payment for the outstanding loan. The major issue in relation to enforcement of the pledge rights is finding a buyer for such claim rights.

It should be also noted that it is unlikely that a multi-apartment building at any time would be without a building manager, because it not only has to ensure payments to the bank, but also ensure provision of utilities, maintenance and other services. Hence, in case the building manager has been recognised insolvent, has been liquidated or otherwise no longer fulfils the duties for other reasons, the apartment owners should be interested in having a replacement building manager as soon as possible, since some of the utility services are provided through the building manager (the apartment owners do not have a direct contract with the service provider). The interest in the management of loan repayment for the building manager is in that it receives a certain fee for the provision of such service.

Therefore it follows from the above that there is a legal inconsistency in the scheme currently applied by the banks in relation to renovation loans. As it is possible to conclude from the discussions with the representatives of banks, banks recognise that inconsistency, but there have not been any defaults till now, which could test the system and the model.

2.4.2. ESCO model

Based on our limited research we have found the following structure of implementation of the EPC in Latvia, which is usually done in combination with the ERDF co-financing described above in this Study. The below scheme provides a graphical description of the various persons involved in the renovation process of a multi-apartment residential building and their respective liabilities.

⁶⁷18 March 1999 Consumer Law on Management of Residential Buildings, published in the official newspaper *Latvian Vēstnesis* on 1 April 1999, effective as from 15 April 1999 with amendments.

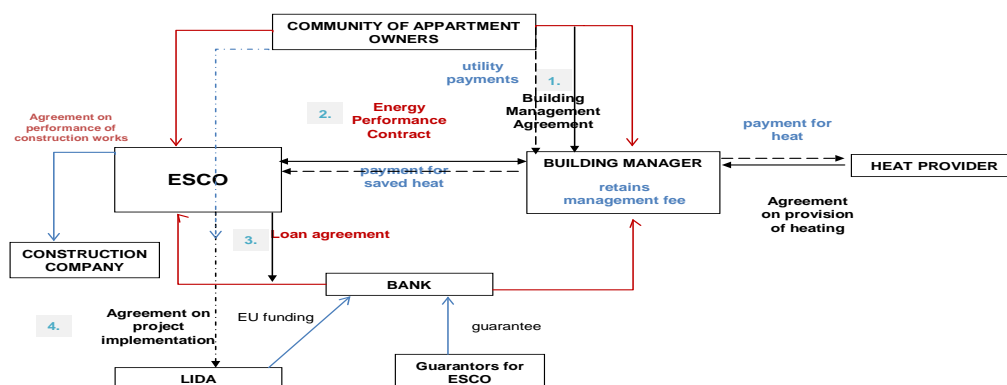


Figure 4: implementation of renovation of a multi apartment residential building with involvement of ESCO and ERDF co-financing.

The structure is based on the following agreements:

- (i) A building management agreement, which is entered into between the community of apartment owners and a building management company in relation to provision of building management services as described in the Law on Management of Residential Houses, including mandatory activities and activities per choice of the community of apartment owners. In addition the building manager enters into an agreement on provision of heating and hot water services with the heat provider as an intermediary for the community of apartment owners.
- (ii) The EPC, which is entered into among the ESCO as the contractor, the building management company and the community of apartment owners represented by an authorised representative. In some instances the ESCO financing bank acts as a party to the EPC to ensure that it has control over fulfilment of the contract, in particular, that there are no changes in the parties to the EPC. Since the building management company provides security in the form of commercial pledge over the accounts receivable from the apartment owners of the residential building to be renovated in favour of the financing bank, it is in the interests of the bank to retain the pledgor.

As described above ESCO implements energy efficiency measures and services by using its own resources in the multi-apartment residential building and in return receives a fee equal to the saved energy from the apartment owners through intermediary of the building management company. Thus the ESCO undertakes risk for the volume of the saved energy.

Within the scope of the EPC the building management company calculates and collects payments from apartment owners and further makes payment to the heating company and the ESCO, deducting the administrative charge and guarantee charge for its services.

The apartment owners through their authorised representative undertake to ensure due co-operation with the contractor; and apartment owners pay a fixed fee for heating and hot water, which is adjusted pursuant to the terms of the EPC, to the building manager.

Further it follows from the above that the ESCO enters into agreements with third parties to ensure implementation of the measures and provision of services, including agreement on performance of construction work and supply of necessary equipment.

- (iii) To finance the energy efficiency measures and services the ESCO (in its own name) enters into a loan agreement with a financing bank. The bank treats such loan agreement as a commercial loan, where the risk of repayment of the loan lies on the ESCO as the professional in the energy efficiency activities.

The bank requires the ESCO to provide several securities for the loan – a commercial pledge, which is a public pledge, registered on the ESCO's assets, a financial collateral on the ESCO's current accounts opened at the financing bank, a guarantee provided by the parent company of the ESCO and a commercial pledge given by the building management company on the accounts receivable from the apartment owners.

- (iv) Noting availability of the ERDF co-financing the bank financing is usually combined with the ERDF co-financing by entering into an agreement on project implementation with LIDA.

Within the scope of the agreement with LIDA the ESCO acts as the representative of the apartment owners and as such it enters into the agreement with LIDA on implementation of the project (receipt of EU co-financing for renovation of multi-apartment residential building) and accordingly undertakes the liabilities arising out of the agreement. The ERDF financing is consequently transferred to the bank account of the ESCO according to the terms of the agreement on implementation of the project, which further shall be applied for repayment of the loan issued to the ESCO. In this relation we would like to note that there is a discrepancy between the beneficiary of the ERDF co-financing and the use of the ERDF co-financing, which is described below.

Liabilities of the parties

In relation to the above agreements we further outline the consequences in case of default of any of the parties involved in the structure.

- (i) Default on the part of the apartment owners

In case apartment owners fail to make any payment to the building management company under any of the two agreements – the building management agreement or EPC, it will be the liability of the building management company to collect payments from the apartment owners. There is no security to be enforced. Hence, it is a civil law claim on fulfilment of the agreement (collection of debt).

- (ii) Default of the building management company against the ESCO under EPC

In case the ESCO fails to receive its fee, it will be the liability of the building management company. The ESCO may raise claim against the building management company or the Contractor is entitled to collect payments directly from the apartment owners, without involvement of the building management company, or assign such duty to any third party. There is no security to be enforced. It is the duty of the building management company to make payments to the ESCO.

- (iii) Default of the ESCO against the financing bank under loan agreement

In case ESCO defaults on payments to the bank, the bank will have several options and as a first step it will be likely to enforce the provided securities, first, using the financial collateral.

As a further step the bank could enforce the commercial pledges placed on the ESCO's assets (sale of assets at a market price to a third party with or without an auction) and on cash flow from apartment owners (most likely that there is an assignment agreement as a tool for enforcement of commercial pledge).

Thus the bank will be entitled to collect payments directly from the apartment owners. The apartment owners according to the decision of the community of apartment owners in relation

to signing the EPC have a duty to make fixed monthly payments, a portion of which is transferred by the building management company for payment of the received services and the remaining portion is due to the ESCO (no right to request repayment of the loan). Thus the bank would be entitled to receive the portion of the payment otherwise due to the ESCO. It is unlikely that the bank will be entitled to accelerate the loan and thus receive repayment of the loan from the apartment owners, as the scope of the duty of the apartment owners is limited to fixed monthly payments.

Finally the bank still has a guarantee for the loan agreement of the ESCO, so it may bring a claim against the guarantor to make the outstanding payments.

It must be noted that 50% of the loan is repaid to the bank by ERDF co-financing, which is regarded by the banks as sort of a security for the loan. However, in such case there is a legal discrepancy with respect to the fact that the loan issued to the ESCO (in its own name) has been repaid by ERDF co-financing, which is granted to the apartment owners through ESCO as an authorised person. So in principle the ESCO becomes the beneficiary of ERDF co-financing, although the Regulations provide that the beneficiaries of the ERDF co-financing are the community of apartment owners.

We have not established that there is a practice that the apartment owners take any decision in relation to re-payment of the ESCO loan with the ERDF co-financing. Further we have not established that the repayment of the ESCO loan by the ERDF co-financing affects the amounts of payments the apartment owners make to the building manager under the EPC either. Therefore there are grounds for considering that the ERDF co-financing has not been properly applied, pursuant to the Regulations and the agreement on implementation of the project.

D. REVIEW OF ESCO FINANCING STRUCTURES IN OTHER EU MEMBER STATES RELATED TO ENERGY EFFICIENCY IN HOUSING

1. ESCO financing structures in EU Member States related to energy efficiency

Energy service companies (hereinafter, **ESCOs**)⁶⁸ have been operating in the EU area on a large scale since the late 1980s – early 1990s. However, the energy service market is not performing to the full extent of its possibilities and this is a case even in countries with a particularly developed ESCO sector. On the other side changes towards a more favourable legislative framework focused on energy conservation, increased activity in the refurbishment and modernisation of private real estate and a stronger environmental awareness have been able to counterbalance the negative effect of the financial crisis and negative attitude toward energy efficiency projects.

The review of existing ESCO financing structures and its main operating models in various EU countries, main problems ESCO face today and important patterns in the future development of this sector are described below.

1.1. Main standard ESCO financing structures

In an Energy Performance Contracts (hereinafter, **EPC**)⁶⁹, investments can be financed either by the building owner, by an ESCO itself, by a government or by a financial institution. When

⁶⁸ „A natural or legal person that delivers energy services and/or other energy efficiency improvement measures in a user’s facility or premises, and accepts some degree of financial risk in so doing. The payment for the services delivered is based (either wholly or in part) on the achievement of energy efficiency improvements and on the meeting of the other agreed performance criteria“, Directive 2006/32/EC of the European Parliament and of the Council of 5 April 2006 on Energy End-use Efficiency and Energy Services (Energy Services Directive).

⁶⁹ „A contractual arrangement between the beneficiary and the provider (normally an ESCO) of an energy efficiency improvement measure, where investments in that measure are paid for in relation to a contractually agreed level of energy efficiency improvement“, Directive 2006/32/EC of the European

project is financed not by the building owner or energy service provider, such financing structure is called third-party financing (hereinafter, **TPF**)⁷⁰. Currently across the EU five main EPC models, in which ESCO plays certain role, can be singled out⁷¹:

- (i) Guaranteed savings. Under a guaranteed savings model, the ESCO assumes the entire design, installation and savings performance risks, but does not assume repayment credit risk of customers. Consequently, guaranteed savings contracts are not applicable to ESCO financing provided internally or through TPF with ESCO borrowing. The projects are financed by the customers who can also obtain financing from banks, from other financing agency, or a TPF entity. The key advantage of this model is that it provides the lowest financing cost because it limits the risks of the finance institutions to their area of expertise, which is assessing and handling customer's credit risk. The customer repays the loan and assumes the investment repayment risk. If the savings are not enough to cover debt service, then the ESCO has to cover the difference. If savings exceed the guaranteed level, then the customer pays an agreed upon percentage of the savings to the ESCO. Usually the contract also contains a provision that the guarantee is only good, i.e. the value of the energy saved will be enough to meet the customer debt obligation, provided that the price of energy does not go below a stipulated floor price⁷².
- (ii) Shared savings. Under a shared savings contract the cost savings are split for a pre-determined length of time in accordance with a pre-arranged percentage: there is no 'standard' split as this depends on the cost of the project, the length of the contract and the risks taken by the ESCO and the consumer⁷³. Under this model ESCO assumes both performance and credit risk (as the client takes over some performance risk, it will try to avoid assuming any credit risk). This is why a shared savings contract is more likely to be linked with TPF, with ESCO financing or with a mixed scheme with financing coming from the client and the ESCO whereby the ESCO repays the loan and takes over the credit risk. The ESCO therefore assumes both performance and the underlying customer credit risk – if the customer goes out of business, the revenue stream from the project will stop, putting the ESCO at risk⁷⁴. On one side this model allows to free customer's balance sheet but on the other creates leverage and increased capital requirement problems for ESCOs. Such a high indebtedness sometimes leads to refusal by financial institution to finance particular energy efficient Project even if the Project itself is profitable and acceptable.
- (iii) Delivery contract. This model is also known as Supply Contracting, Energy Supply Contracting or Contract Energy Management (CEM) and is focused on the supply of a set of energy services (such as heating, lighting, motive power, etc.) mainly via outsourcing the energy supply. Chauffage is also a form of Delivery Contracting. In a chauffage arrangement the fee for the services is normally calculated based on the client's existing energy bill minus a certain level – often expressed as percentage – of (monetary) savings, with a guarantee of the service provided. Alternatively, the customer may pay a rate, for instance, per square meter⁷⁵. The ESCO may also take over the purchase of fuel and electricity.
- (iv) Build-own-operate-transfer model (hereinafter, **BOOT model**). A BOOT (build-own-operate-transfer) model may involve an ESCO designing, building, financing, owning

Parliament and of the Council of 5 April 2006 on Energy End-use Efficiency and Energy Services (Energy Services Directive).

⁷⁰ „A contractual arrangement involving a third party — in addition to the energy service provider and the beneficiary of the energy efficiency improvement measure — that provides the capital for that measure and charges the beneficiary a fee equivalent to a part of the energy savings achieved as a result of the energy efficiency improvement measure“, Directive 2006/32/EC of the European Parliament and of the Council of 5 April 2006 on Energy End-use Efficiency and Energy Services (Energy Services Directive).

⁷¹ P. Bertoldi and S. Rezessy, *Energy Service Companies in Europe. Status Report 2005*, European Commission, DG JRC (2005), pages 23 – 28.

⁷² Id., page 24.

⁷³ Id., page 23.

⁷⁴ Id., page 24.

⁷⁵ Marino, P. Bertoldi and S. Rezessy, *Energy Service Companies Market in Europe. Status Report 2010*, European Commission, DG JRC (2010), page 6.

and operating the equipment for a defined period of time and then transferring this ownership across to the client. This model resembles a special purpose enterprise created for a particular project. Clients enter into long term supply contracts with the BOOT operator and are charged accordingly for the service delivered; the service charge includes capital and operating cost recovery and Project profit. Usually this model does not involve separate performance guaranty against present consumption. Rather the payment is agreed depending on the equipment installed and services delivered. This model is usually used in renovation (modernization) of public or commercial non-residential buildings due to its specific needs (e.g. specific energy saving equipment is needed, specific curve of utility (heating, electricity, water, etc.) demand (maximum demand during operating hours on weekdays, etc.)). Belgium and Ireland⁷⁶ can be mentioned as examples where a BOOT model is used very frequently in non-residential energy efficiency projects. Sometimes this model is also used in residential energy efficiency projects but in this case certain conditions must be met. Firstly, client (owner (-s) of the apartments) must agree to enter into a long term contract which encompass the provision of all utility services and maintenance. Secondly, the financial capacity of the client must satisfy requirements imposed by the financing institution (e.g. commercial bank). And finally, a strong ESCO capable of establishing a special purpose enterprise for each (or group of) project and substantial managerial experience is needed.

As it can be seen each of those models has a distinctive financial structure and thus different parties involved in the process. The table below summarizes and compares the main performance based energy services contracts and their financial mechanisms:

Table 3: Main performance based energy services contracts and their financial mechanisms

EPC		Guaranteed savings	Shared savings	Delivery contracting	“BOOT” model
Short description		ESCO guarantees a certain level of energy savings determined from the baseline energy consumption level.	The ESCO guarantees cost savings which are split between the ESCO and the building owners for a pre-determined length of time in accordance with a pre-arranged percentage.	ESCO takes over complete responsibility for the provision to the client of an agreed set of energy services with a discount compared to regular payments	ESCO designs, builds, finances, owns and operates the equipment for a defined period of time and transfers this ownership across to the building owners
Financial structure		The building owners finance the implementation of the projects (e.g. through a TPF loan or own resources).	ESCO engages in multilateral contract with the building owners and TPF institutions and provides both financial and full project implementation services.	ESCO engages in financial contract with the building owners and undertakes responsibility for providing sufficient energy performance level using its own financing capabilities.	Debt (or lease) instalments for the equipment used in projects is paid by ESCO and resemble payments of the building owners for the services provided.
Assumption of risks:	ESCO	Saving performance in terms of <u>energy level</u> .	Saving performance in terms of <u>energy price and credit risk</u> .	Saving performance in <u>overall energy costs</u> .	Saving performance in <u>overall energy cost, credit risk, management risk</u> .
	Owners	Credit risk Non-payment risk.	Non-payment risk.	Non-payment risk.	Non-payment risk.

⁷⁶ Id, page 11 and 37.

Peculiarities of the implementation	Lower interest loans are possible when public body owners are perceived as less risky client compared to a private ESCO.	Useful when an ESCO is entering new market as the building owners assume no credit risk. Preferable for large ESCOs due to high leverage ratio.	ESCO provides all the associated maintenance and operation during the contract. Useful where the customer wants to outsource facility services and investment.	Special purpose enterprise may be created for a particular energy saving project.
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As it can be seen from the presented summary of various EPC models, ESCOs in energy saving projects provide overall performance guarantees as well as assume certain levels of credit risk. Bearing of the performance risk can be regarded as a part of usual ESCO business activity whereas assumption of credit risk can raise difficulties the implementation of projects due to high level of leverage needed to implement EPC. The main models used and how various EU member states are implementing energy saving projects is presented further.

2. Overview of ESCOs practice in the EU area

ESCOs operations in different EU member states differ not only in the way they engage in legal relationship with other concerned parties but also in financial scheme they use in energy retrofitting projects. Each of the countries involved in EPC activities have their own legal, financial and economic practice and expertise in dealing with various issues emerging in ESCOs operations. Despite these disparities several EU countries that have succeeded in certain energy efficiency projects can be pointed out.

2.1. Germany

Germany can be regarded as the European ESCO leader. Developed banking structure and high public awareness determine that the most popular model used in EPC in Germany is delivery contracting and guaranteed savings (under which ESCO bears saving performance guarantee in terms of energy level and owners assume credit and non-payment risks). A variety of policy instruments, which support the energy services market, such as information and energy advice for private residential and non-residential buildings, public subsidies, negotiated agreements with the main utility associations, information and other public awareness programmes contribute to everyday increasing popularity of ESCO. Extreme growth of the ESCO market in Germany can be also attributed to a good mix of governmental support (including both technical and financial support), non-governmental programmes and favourable conditions such as the energy taxes (ecologic tax reform), which were increased considerably during the energy sector liberalization along with an increase in energy prices. The implementation of a large number of municipal projects along with public-private partnerships also had a strong demonstration effect by introducing the ESCO and EPC concepts on the market⁷⁷. The financing of ESCO projects in Germany is usually based on governmental grants (subsidies) for energy efficiency projects and credits from various financial institutions. All government's funding is managed by the KfW, a non-profit group owned by the government (80 %) and federal states (20 %). KfW raises funds on the financial markets and transfers this capital, via commercial banks, to program applicants in the form of lower interest loans. Since 2005, additional subsidies from federal government are used by KfW to improve the financial conditions of the programmes and to expand their volume. Thus, KfW offers different products: loans (majority) and loans combined with a grant element of 5 - 17.5% of investment costs targeting a wide spectrum of applicants (enterprises, public bodies, individuals and collective households). KfW's Förderbank promotes housing construction and modernisation and energy conservation on the part of commercial enterprises and local communities. KfW's funding programs target around 95% of existing buildings in Germany⁷⁸.

⁷⁷ A. Marino, P. Bertoldi and S. Rezessy, *Energy Service Companies Market in Europe. Status Report 2010*, European Commission, DG JRC (2010), page 28.

⁷⁸ *Id.*

KfW does not in principle provide loans or any other financial product directly to investors (with the exception of public institutions), but to credit institutes. ESCOs may borrow the required amounts through TPF (or finances the project from own resources). Financing received by building owners from KfW is not combined with ESCO financing – both parties cover their part of the energy saving project from different financing sources. It must be mentioned that ESCO financing is usually based on a non-recourse forfeiting cash flow from the owner of the building which is being renovated (modernised). This means that the ESCO is not responsible in case of a default by the building owner (the ESCO only provides a saving performance guarantee) – in this case the ESCO pledges the cash flow of the project and thus the TPF institution undertakes the credit risk of the client.

Besides the mentioned private ESCO sector, there is also a public energy saving incentives. Among the said incentives Public Internal Performance Commitments (hereinafter, PICO) as a popular public ESCO alternative can be pointed out. In a PICO model a unit within a public agency or department acts as an ESCO. The unit organizes, finances and implements energy efficiency cost savings mostly through a fund set up with municipal funds. This allows larger cost savings and the financing of less profitable projects, which would not be financed by a private ESCO. One of the main PICO forms is public internal performance contracting that makes use of existing internal capacities and know-how. Any profits resulting from energy efficiency investments remain entirely with the public administration. While being an ESCO project itself, it does not contain a energy saving guarantees because there are no sanction mechanisms within a single organization. PICO model theoretically can also be used as an alternative to ESCO model in the multi-apartment buildings renovation. In such a case the homeowners association or the administrator of common property would act as an ESCO within the multi-apartment building and would be responsible for all the activities that otherwise would be carried out by the “real” ESCO. However a lack of know-how in the area of modernisation, as well as the insufficient managing capacities and the said absence of energy saving guarantees make PICO model difficult to apply in the residential sector.

2.2. Hungary

Hungary is usually regarded as an example of ESCO success story. ESCO model was started to use as early as 1990s. In the beginning EPC was almost exclusively employed in non-residential private (industrial sites) and public (infrastructure and public buildings) sector. In 2001 the Hungarian Government launched a program called *Panel Program* providing support in the form of grants to the renovation of prefabricated buildings. It integrated similar proportions of government, municipal and home-owners' resources (1/3 – 1/3 – 1/3) in order to speed up the energy-related renewal of prefabricated buildings. *Panel Plus Program* provides low interest loan for the residents to cover their part of investment. 380.000 flats were partially renovated between 2001 and 2009 (total investments exceeding 1 billion EUR).

The most common scheme in Hungary is known as “Energy Saving and Financing Balance System” (EBS). It is based on a balanced sharing of results and risks by the partners therefore it can be stated that shared savings model (ownership of the equipment installed is transferred to apartment owners immediately after its installation) is employed. ESCOs are procured in a central government procurement procedure (no procurement needed in municipal level). Generally financial scheme of Hungarian model can be regarded as favourable mix of viable governmental incentives and affordable means of financing:

- (i) *State and/or Municipality Grants* (33 % - 66 % of total financing (lower grant rate if direct applicant is ESCO));
- (ii) *Owners finance structure:*
 - a part of the owners pay in cash;
 - the rest of the owners take a loan to finance their own part and the one guaranteed by ESCO as well as to pre-finance the support granted by the local government (a combination of (interest granted) loan and a preferential loan provided by Housing Saving Bank System (repayment period: 65 – 105 months).
 - the share of joint expenses to be paid by owners will be increased to pay off the loan.

Several main success factors of ESCO's model implementation in Hungary can be pointed out:

- (i) positive banking sector experience with energy efficiency projects through international programs (Hungarian Energy Efficiency co-Financing Program (HEECP) in 1997 and HECP-2 in 2001, Environment and Energy Operation Programme (EEOP) in 2007);
- (ii) development of ESCO-type off-balance-sheet financing models for energy efficiency projects (leasing, etc.);
- (iii) early liberalization of the electricity and natural gas markets resulted in the rise of utility prices and therefore provided favourable starting positions to the ESCO market;
- (iv) Successful sequencing of the implementation of ESCO model:
 - governmental programs to help build capacity and increase awareness in the energy efficiency sector;
 - provision of loans at subsidized interest rates (EBRD, IFC, GEF through local FI);
 - technical assistance (various energy agencies) to help develop and structure financially viable projects;
 - provision of in-country support (by EBRD, IFC, GEF, etc.) for accessing financing opportunities of the projects.

2.3. Sweden

Sweden can be regarded as an example of how a timely and comprehensive response to challenges facing an implementation of energy saving projects can help boost an ESCO market. The ESCO business in Sweden experienced two upsurges, respectively in the 1980s and in the early 1990s but neither of these established the ESCO business concept on the market⁷⁹. Among other factors such a failure could also have been attributed to common problems pertaining the development of ESCO markets across EU (the main problems are pointed out in the next section of this part of a Study). However due to certain mix of measures taken by the central government Sweden ESCO market undergone a strong development (especially in public sector) during the last years⁸⁰.

The main financial instrument used to finance energy efficiency project was Climate Investment Programme (KLIMP) scheme. The KLIMP supported municipalities and other local actors to receive grants (up to 30% of the investment) for long-term investments that reduce greenhouse gas emissions⁸¹. The said financial aid together with a steady rise of energy prices kick-started a fast development of various energy efficiency projects across the country (projects included renovation of schools and hospitals, refurbishment of other various public buildings, installation of energy efficient street lighting, etc.⁸²).

The following additional factors of success can be pointed out:

- (i) A governmental agency STEM (Swedish Energy Agency) undertook active role in promoting EPC model between potential clients and consulting private entities (including main real estate developers and construction companies such as SKANSKA or ABB) about the advantages of energy efficiency projects;
- (ii) Guidelines for the EPC process structure, clear frameworks, definitions and standard contract provisions clarifying roles and responsibilities and for the saving guarantees in order to raise the confidence on the ESCO market⁸³ were developed;
- (iii) The use of modern information technology, sensors and web communication has been the prerequisite for the new type of EPC contracts;
- (iv) Good examples or demonstration projects of EPC seem were of a vital importance for building owners;
- (v) TPF model with the pledging of receivables from an energy efficiency project was broadly used and helped to overcome financing shortages of ESCOs while implementing large scale projects.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² Forsberg et al. *How to kick start a market for EPC. Lessons Learned from a mix of measures in Sweden*. Swedish Energy Agency (2007); Eskilstuna, Sweden.

⁸³ *Id.*

2.4. Denmark, Spain, United Kingdom

In this group of countries ESCO is mainly used in industrial and large commercial or complex building projects and co-generation, district heating and supply side projects in the public sector. Having in mind mentioned area of ESCO operation, delivery along with shared savings are the most common contractual schemes. Commercial banks are the most common source for ESCO project financing but in recent years governmental grants were made available for certain type of energy saving projects. The cost savings and opportunity to finance the replacement of old infrastructure with the energy savings and the opportunity to improve the green image internally and externally are a strong motivation both in the private and public sectors.

3. Problems and perspectives of ESCO financial structures

Having analyzed main structural schemes of ESCO and presented different groups of EU member states implementing various EPC further main perspectives and problems of this sector in EU area are pointed out.

3.1. Perspectives of ESCO in EU area

Focused policy support and supportive policy frameworks

It is essential to have a sound legislative framework that enables ESCO type projects and policies and measures that promote energy efficiency investments. In order to promote ESCO projects in the public sector a number of important steps are necessary⁸⁴:

- (i) Firstly, adaptation of the public procurement laws must take place in order to facilitate the evaluation of EPC providers and adapt the project cost evaluations in order to take into consideration lifecycle costs, including maintenance and energy costs.
- (ii) Secondly, update of the procurement regulations by allowing group tendering and permitting the evaluation of EPC providers on other grounds than previous EPC projects would facilitate the entrance of new and smaller actors in the market.
- (iii) Third, clear, practical and ready-to-use guidelines on how to apply energy efficiency criteria in public procurement procedures are needed in order to improve the practical implementation of energy efficient public procurement.

It must be also mentioned that clearly allocated responsibility is needed in order to prevent overlaps and to ensure competence. A favourable policy framework can shorten the payback time of energy efficiency investments and raise the awareness of energy efficiency measures, lowering investment risks⁸⁵. Certification, such as the energy performance certificates of buildings, is important in order to increase the demand for energy audits and monitoring requirements, facilitating energy saving estimations available through proper statistics and increase awareness. Concerted effort is needed in order to legitimate the business model and to overcome real or perceived risk aversion through financial instruments. This could be achieved via loan guarantees by recognizing the contractual model and the establishment of funding mechanisms, such as revolving funds that co-finance projects at lower interest rates⁸⁶. The said financial structure is especially important in cases where a result of performed energy saving project can not be pledged to guarantee a provided loan (renovation of multi-apartment buildings, modernization of street lighting, implementation of energy efficiency measures in public buildings, etc.). In such instances loans backed by savings guarantees from ESCOs⁸⁷ can help in structuring certain loan model. It is also helpful when a building

⁸⁴ A. Marino, P. Bertoldi and S. Rezessy, *Energy Service Companies Market in Europe. Status Report 2010*, European Commission, DG JRC (2010), page 94.

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ A typical TPF model allows ESCO to pledge receivables from an energy saving project to a financial intermediary and thus reduce its credit risk. In such a case financial intermediary undertakes to collect periodic installments from a client and uses this cash flow to cover debt payments and interest. When

owner is willing to minimize the risks and the costs of certain energy saving project. By arranging the financing of the EPC project this way also benefits the ESCO market to grow more rapidly due to reduced need for the ESCO to be as financially solid as to be able to arrange financing within their own organisation or through a third party.

Project bundling

Successful project bundling strategies can help overcome many of the key barriers to financing of ESCO projects. To achieve sufficient scale, a certain system is required to allow the aggregation of individual projects, technologies, service offers, and investments into a larger and more comprehensive project, which could be interesting for larger ESCO or bigger financial institutions. Public-private partnerships are also encouraged and can become an important tool in implementing various regional energy saving projects that without involvement of local municipalities would not be economically sound enough to attract private investments.

Accreditation and standardization to build market confidence

The establishment of a national legal framework for the identification and the establishment of quality standards and certification schemes for ESCO are essential in order to boost the ESCO markets and maintain confidence in them⁸⁸. The standardization of common core contractual provisions including clear frameworks, definitions, measurement and verification standards and an accreditation system is essential in order to raise the confidence on the market.

Facilitating the access to appropriate forms of financing

The engagement of financial institutions is crucial for the establishment of a successful ESCO market. In developing ESCO markets public authorities or development financing institutions need to present customized financial products to cope with various barriers to energy saving projects in each national market. For example, special purpose credit lines and revolving funds may be appropriate tools when there are liquidity constraints in the banking sector or the need to provide long-term credits to finance institutions⁸⁹. A guarantee scheme or other risk managing tools may be appropriate when the financing sector perceives that the risk of ESCO projects is too high. Where private capital of ESCO is insufficient to comply with the minimum equity requirement, a complementary instrument is needed, such as subordinated debt. There is also a wide range of instruments that can be used to finance EPC among those being various special guarantee programmes, special purpose credit lines or revolving funds. There is also a possibility to expand partnerships between financing sources and various utility providers or city agencies in order to facilitate implementation of various different energy saving projects.

Establishment of ESCO associations and the facilitation of collaboration with national energy agencies

An ESCO association can act as a reference point for ESCO customers and suppliers and, by grouping and concentration of ESCO professionals, can represent the point of view of the industry with a unified voice⁹⁰. In addition, the establishment of an association or a similar platform or forum could concentrate resources in information dissemination and capacity building. The association can create a support network for potential clients with capacity building, give direct advice, and access to information. The association could organize workshops and knowledge sharing events with ESCO, potential clients (municipal representatives, facility managers, etc) and financial institutions in order to increase the

whole debt and interest are paid, all cash flow is directed to ESCO. Under certain arrangement it is also possible to split periodic installments between a financial intermediary and ESCO from the beginning of a project.

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

knowledge of how ESCO engage in projects and what benefits can ESCO bring to project management from a risk reduction, financial and environmental perspective. Collaboration with national energy agencies can boost the implementation of various energy saving projects that need governmental assistance or infrastructural support.

3.2. Problems of EPC implementation

Low awareness of and lack of information about the ESCO concept

Despite widespread so called “green campaigns” EPC as a possibility to combine “green” project and economically and financially efficient modernization of various building in most EU member states is still not considered as preferable option to most owners. This can also be blamed on the low priority of energy efficiency measures countrywide and the lack of sustainable and long term policy therefore must be responsible for it.

Mistrust from the clients

Unclear public procurement procedures, long and complex process of acquiring of building permissions and similar burden are the source of mostly negative attitude to various energy saving incentives including ESCO. Also lack of success stories and not sufficient and sometimes unprofessional management operations by the companies in the field themselves lead to unwanted reactions from the building owners. This mistrust is as well caused by the lack of accepted standardized measurement and verification procedures. It can be also mentioned that the principal/agent dilemma with split incentives in the housing sector influence tense relationship between owners and ESCO.

High perceived technical and business risks

In the markets where shared saving or delivery models of EPC prevail high operating risk of ESCO usually leads to the undertaking only those projects which are only clearly profitable and efficient. Other energy saving projects are not being considered because preferred discount rate for them do to high perceived risk is to immoderate.

Lack of appropriate forms of finance

This problem is already addressed in perspectives of ESCO section earlier in the study. The main issue ESCOs are facing in different member states is absence of particularly design financial instruments which would not only provide needed capital to the companies but would also let solve various problems mentioned above (high perceived risk or mistrust from the clients).

Summarizing it can be stated that the numbers of policies and actions that can be set up to directly support the ESCO market are limited. However, a number of legislative, structural and market related changes have altered some national ESCO markets⁹¹ by producing indirect effects on the supply of and the demand for energy efficiency and thus boosting the implementation of various energy saving projects.

E. REVIEW OF EXISTING JESSICA STRUCTURES

1. Financing Renovations in Estonia

1.1. Overview

The Estonian multi-apartment buildings renovation programme started in 2003 and continued until 2007. It consisted mainly of the provision of 50% grant for the costs of preparation of energy audits, building design documents and technical supervision and of a 10% grant for the costs of renovation works. The state support for renovations was mainly provided from the state budget. The multi-apartment renovation programme was administered by Estonian

⁹¹ See Hungary and Sweden ESCO markets overview above.

Credit and Export Guarantee Fund KredEx (“**KredEx**”), which was established by the Ministry of Economic Affairs and Communications in year 2001 with the purpose, among other things, to facilitate the improvement of housing conditions of Estonian population by offering financing solutions aimed at energy efficiency⁹².

Eventually such grant scheme for multi-apartment buildings renovations was not successful because of insufficient amount of grants and due to the fact that grants were given only after the completion of renovation works⁹³. Due to this reason the residents had to take ordinary commercial loans to pre-finance the performance of renovation works; however, these loans have had too short repayment periods and too high interest rates⁹⁴.

In 2007 the new programming period 2007-2013 of the European Union Structural Funds started. The ERDF funds have been allocated for the energy efficiency of residential housing in Estonia under the Operational Programme for the Development of Living Environment and its priority axis three “Development of energy sector”. With these ERDF financial resources and in view of the existence of demand for additional support for renovations, it was decided to establish the KredEx revolving fund for the purpose of supporting renovations. During the establishment, the Estonia authorities secured additional financial recourses by way of a loan from the Council of Europe Development Bank (hereinafter, **CEB**).

In 2008 – 2009 the mechanism for the provision of long-term renovation loans with preferential interest rate was developed. In 2009, the first renovations loans were issued by the selected financial intermediaries. This preferential renovation loans scheme has replaced the 10% grant, which was used to cover renovation costs. Estonia has been the first in Europe to apply such innovative financial scheme for multi-apartment building renovations, under which loans with a very low interest rate are provided⁹⁵.

Table 4: Current Financing Structures for Renovations in Estonia

Financing structures	Amount of financing	Financing sources
Renovation loan for financing renovation works	Fixed interest rate for 10 years (not more than 4.4%)	ERDF and CEB funds allocated to the KredEx fund
Grants for renovations works	From 15% to 35% depending on the energy savings achieved	Funds allocated from trade in amount units assigned to Estonia under article 17 of Kyoto Protocol to the United Nations Framework Convention on Climate Change
Grants for energy audits, building design documents and technical expertise	50% of the costs, but not exceeding the established maximum amounts	ERDF funds allocated to the Operational Programme or the Development of Living Environment, priority axis three “Development of energy sector”

1.2. Establishment of JESSICA Structure

KredEx has started development the model of renovation loan acting in co-operation with German Development Bank KfW Bankengruppe⁹⁶. It was announced that European Union Structural Funds will be used and the loans will be brought to the market in the first half of 2009. For that reason from April to the beginning of December 2008, together with different ministries, meetings with the European Commission were held to clarify the conformity of the programme terms with European Union regulations. As a result of these meeting, the

⁹² Introduction <http://www.kredex.ee/1534> (official website of KredEx).

⁹³ Mirja Adler, *The Housing Fund perspective – Estonia*, presentation dated 6 August 2010. http://ec.europa.eu/regional_policy/archive/funds/2007/iii/doc/pdf/jessica/20100608_6_estonia.pdf (official website of European Commission)

⁹⁴ Renovation loan for apartment buildings. <http://www.kredex.ee/renovation-loan-for-apartment-buildings> (official website of KredEx).

⁹⁵ *Guarantee and loan activity of housing sector: Credit and Export Guarantee Fund KredEx Annual report 2009*, http://www.kredex.ee/aastaruanne2009/eng_pdf/2009_eng.pdf, page 30 (official website of KredEx).

⁹⁶ *Ibid.*

programme was approved by the European Commission at the end of November and by the Minister of Economic Affairs and Communications in December, 2008.

As only a limited amount of EUR 17 million was allocated for the provision of renovation loans from the ERDF, it was decided to combine the ERDF funds with a EUR 29 loan million from CEB. In connection with a decrease in ratings of financial intermediaries, CEB requested a state guarantee for the loan and finally agreed to disburse its funds in June 2009⁹⁷. Hence, the KredEx fund of total EUR 49 million has been created.

Swedbank and *SEB Bank* were selected as financial intermediaries and the first operational agreement was signed on 28 May 2009. Since 25 June 2009, apartment buildings can hence apply for renovation loans⁹⁸. As from this date more than 230 renovation loan agreements have already been signed.

KredEx website on housing renovations: <http://www.kredex.ee/1402/>.

Table 5: KredEx programme implementation steps and schedule in Estonia

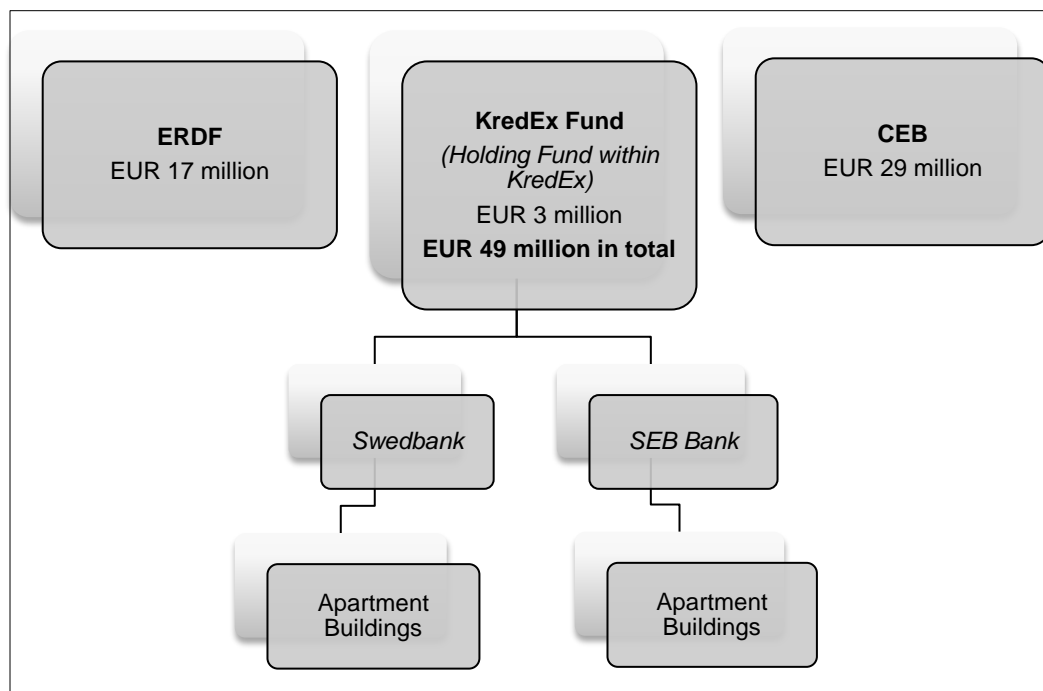
Action	Date of event	Days as needed
Start of negotiations with the EC	April 2008	
Approval of the EC and establishment of KredEx fund	December 2008	270 days
<i>Signature of first Operational Agreement</i>	28 May 2009	148 days
The funds of the CEB transferred to KredEx fund	June 2009	150 days
Start of offering renovation loan to final beneficiaries	25 June 2009	27 days

Figure 5: KredEx Programme Implementation Scheme in Estonia⁹⁹

⁹⁷ *Guarantee activity of housing sector*: Credit and Export Guarantee Fund KredEx Annual report 2008, http://www.kredex.ee/aastaruanne2008/eng_pdf/2008_eng.pdf, page 23 (official website of KredEx).

⁹⁸ *Guarantee and loan activity of housing sector*: Credit and Export Guarantee Fund KredEx Annual report 2009, http://www.kredex.ee/aastaruanne2009/eng_pdf/2009_eng.pdf, page 30 (official website of KredEx).

⁹⁹ *Guarantee and loan activity of housing sector*: Credit and Export Guarantee Fund KredEx Annual report 2009, http://www.kredex.ee/aastaruanne2009/eng_pdf/2009_eng.pdf, page 30 (official website of KredEx).



1.3. Key Features of Financial Product for Renovations in Place

The currently operating multi-apartment renovation programme in Estonia combines two types of financing – provision of preferential renovation loan accompanied by loan guarantee (if necessary) and grants.

1.3.1. Renovation loan

Renovation loans for renovation of multi – apartment buildings are provided by the financial intermediaries selected as described in Section 1.2 above. Renovation loan may be granted only to apartment associations¹⁰⁰, building associations¹⁰¹ or communities of apartment owners¹⁰², out of which at least 80% of the apartment owners have to be physical persons. Social housing owned by the local municipality is regarded on equal terms with apartments owned by natural persons¹⁰³.

Applications for renovation loans are evaluated by the financial intermediaries – they review if all documentation required for a renovation project has been presented and received the necessary approvals, they also check if all decisions of apartment owners have been adopted. Renovation loan can only be used to finance renovation works of apartment buildings built before 1993. Renovation loan may be issued after an energy audit for a particular multi-apartment building is performed as only renovation works described in the

¹⁰⁰ An apartment association is a non-profit association established by apartment owners for the purpose of shared management of the legal shares of the buildings and plot of land, which are part of the object of apartment ownership and representation of the shared interests of the members of the association.

¹⁰¹ A building association is a commercial association the purpose of which is to support and promote the economic interests of its members through joint economic activity in the ownership and administration of an immovable or a right of superficies and of buildings, which form a part thereof enabling the members of the building association sole use of specified parts of the buildings.

¹⁰² A community of apartment owners is not a legal person. A community of apartment owners is created by virtue of law primarily for regulating the legal relationships concerning the object of common ownership of apartment owners in apartment buildings where no apartment or building association has been established. On the basis of an agreement, apartment owners may organise legal relationships concerning the object of common ownership differently than provided by law.

¹⁰³ Programme “Renovation loan of apartment buildings”, Directive No. 137 of the Minister of Economic Affairs and Communications, Clause 3.3.

energy audit may be financed with such loan.¹⁰⁴ The objective of a renovation loan is prescribed as achieving energy savings of at least 20% in apartment buildings of up to 2,000 m² and at least 30% in apartment buildings of over 2,000 m² of closed net surface area.¹⁰⁵

Renovation loan agreements are concluded by the financial intermediaries with apartment associations, building associations or communities of apartment owners, acting in their own name and financial intermediaries do not have a direct relationship with the apartment owners. The financial intermediaries usually require association to open and maintain an account with them.

Apartment associations, building associations or communities of apartment owners collect funds for loan repayment along with regular invoices for the utility services and other fees. The financial intermediaries do not have a direct relationship with apartment owners. The financial intermediaries may claim against an association and an association may in turn claim against apartment owners. Therefore, associations are finally responsible for all bad debts in the respect of financial intermediaries.

There is a possibility (not an obligation) to additionally use KredEx's guarantee together with a renovation loan. Only apartment association, housing association or a community of apartment owners are eligible to receive this guarantee. In order to be entitled to receive the guarantee, it is necessary to submit a valid resolution of the general meeting of apartment owners approving the start of the implementation of renovation project, the taking of the renovation loan and conclusion of a guarantee agreement.

The main features of the guarantee are the following:

- (i) The guarantee covers up to 75% of the loan principal, and is to be reduced proportionally by each loan repayment.
- (ii) The annual guarantee fee is 1.2% – 1.7% of the balance of the guarantee.
- (iii) In case of payment difficulties, the borrower may apply for temporary repayment of the loan on his behalf.
- (iv) KredEx covers the loan repayments of the borrower up to 12 months, but not more than 75% of the loan principal at the moment of the submission of respective application.
- (v) Interest in the amount of 1/2 of the loan interest is to be charged on the amount to be repaid for the loan repayments made by KredEx for the apartment building.

Table 6: Main Parameters of Renovation Loan in Estonia

Main Parameters of Renovation Loan in Estonia	
<i>Product</i>	Fixed interest loan
<i>Minimum loan amount</i>	EUR 6400 per an apartment building
<i>Interest/return</i>	Fixed interest for 10 years (not more than 4,4%)
<i>Maturity date</i>	Up to 20 years
<i>Currency</i>	Euro
<i>Payment frequency</i>	Monthly
<i>Self-financing</i>	At least 15% (this can be covered by parallel bank loans) Self-financing includes costs on energy audit and building project in the amount that is not covered by the grant from KredEx
<i>Prepayments</i>	No restrictions or added fees
<i>Re-financing</i>	Not allowed
<i>Maximum monthly instalment</i>	Not determined
<i>Borrower</i>	Apartment association, building association or community of apartment owners, acting in their own name
<i>Collateral</i>	Pledge over the rights of the apartment or building association or community of apartment owners to claim against the apartment owners

¹⁰⁴ Ibid., Clause 9.

¹⁰⁵ Ibid., Clause 6.

Main Parameters of Renovation Loan in Estonia	
<i>Loan write-off</i>	None
<i>Loan insurance or guarantee</i>	KredEx loan guarantees available for up to 75% of the principal for an annual 1.2%-1.7% fee on the outstanding balance
<i>Measures financed by renovation loan</i>	<ul style="list-style-type: none"> - full or partial insulation of facade of apartment buildings - refitting and insulation of roofs of apartment buildings - replacement of windows and exterior doors of apartment buildings - insulation of cellar ceilings of apartment buildings - insulation of roof ceilings of apartment buildings - replacement, refitting or rebalancing of heating systems of apartment buildings - replacement of apartment buildings' ventilation system by new heating return system or refitting of ventilation system - mounting facilities for the use of renewable energy in apartment buildings (excl. mounting of thermal pumps in district heating areas for apartment buildings using district heating system) - partial or complete reconstruction of the control system and other equipment of the lifts of the apartment building - finishing of commonly used premises of apartment buildings, if an integral part of reconstruction works - expenses connected with the energy audit, design and the supervision of renovation works

1.3.2. Grants

As from the year 2010, the following grants are provided from the funds allocated from trade in amount units assigned to Estonia under article 17 of Kyoto Protocol to the United Nations Framework Convention on Climate Change, according to the newly approved *Green Investment KredEx Scheme*¹⁰⁶:

- (i) 15% grant is given if a multi-apartment building achieves thermal energy savings of at least 20%–30% (depending on the size of multi-apartment building) and energy efficiency class E;
- (ii) 25% grant is given if a multi-apartment building achieves thermal energy savings of at least 40% and energy efficiency class D, and meets several additional requirements (e.g. facades are insulated as required, the heating system is refitted to enable regulation of heating in each apartment, windows are replaced);
- (iii) 35% grant is given if a multi-apartment building achieves thermal energy savings of at least 50% and energy efficiency class C, and meets several additional requirements (e.g. frontages are insulated as required, heating system is reconstructed to enable regulation of heating in each apartment, windows are replaced, ventilation system is replaced by new heating return system)¹⁰⁷.

Under applicable regulations it is required that renovation projects would achieve both parameters – determined amount of energy savings and particular energy efficiency class¹⁰⁸. As regarding the calculation of energy efficiency classes of multi-apartment buildings, these classes are determined strictly in accordance with legal regulations, which stipulate how energy efficiency classes are divided and determined. Following the Regulation No. 107 of Minister of Economic Affairs and Communications dated 17 December 2009 “Form and procedure for issuing energy performance certificates”, real energy consumption should be calculated. It is important to mention that this calculation is performed exceptionally from the data stipulated in documents (e.g. renovation project, design documentation etc.).

The overall cost of the renovation project has to be at least EUR 7,340 in order for it to qualify for the grant. These grants are to accompany the renovation loan in order to decrease the

¹⁰⁶ Terms and conditions of the use of „Support for the reconstruction of apartment buildings” of the Green Investment Scheme, Regulation No. 52 of the Minister of Economic Affairs and Communications (in Estonian: *Rohelise investeerimiskeemi “Korterelamute rekonstrueerimise toetus” kasutamise tingimused ja kord*).

¹⁰⁷ *Ibid.*, § 7.

¹⁰⁸ *Ibid.*

required share of self-financing, but the grant may also be combined with own funds of apartment owners¹⁰⁹. When applying for these grants, it is also required to submit the application to the financial intermediary for the provision of renovation loan. If the applicant has appropriate self-financing and does not use the renovation loan, the application is submitted to KredEx directly¹¹⁰.

Additionally to the above-mentioned grants provided under the *Green Investment KredEx Scheme*, KredEx also issues grants for the following preparatory renovations works:

- (i) 50% of the costs for energy audits (maximum EUR 700 per year);
- (ii) 50% of the costs for building design documents (maximum EUR 4,000 per year);
- (iii) 50% of the costs for technical expertise (maximum EUR 700 per year)¹¹¹.

These grants are provided from the ERDF funds allocated to the Operational Programme or the Development of Living Environment, priority axis three "Development of energy sector and they are issued after the completion the entire renovation project.

2. Financing Renovations in Lithuania

2.1. Overview

Lithuanian Renovation programme started in the year 2004, when the Government of the Republic of Lithuania approved Renovation (Modernisation) Programme of Multi-apartment Buildings¹¹² (the Renovation Programme). By the year 2005 State support for renovation was also stipulated in the Law on State Support for Acquisition or Lease of Housing and Renovation (Modernisation) of Multi-apartment Buildings¹¹³ (the Law on Support for Housing).

The initial Renovation Programme was based only on grants – it was possible to receive grants from the State budget up to 50% of the costs for renovations works and, in case apartment owners were low-income persons, up to 100% of these costs. In order to finance renovation works, it was required to take ordinary loans from banks with commercial interest rates for financing renovations. The state support for renovations was available only for apartment associations, and apartment owners who had not established apartment associations could not benefit from the Renovation Programme.

The Renovation Programme was quite successful, but the State budget resources allocated to this programme were limited and insufficient¹¹⁴. Therefore, it was decided to additionally use the European financial support from the programming period 2007-2013 of the European Union Structural Funds. Under the Priority 1 "Local and urban development, conservation of cultural heritage and nature and adaptation for tourism development" of the *Cohesion Promotion Operational Programme for the years 2007 – 2013*¹¹⁵, the funds of the ERDF have been allocated for the improving of housing conditions. It has been also indicated in this

¹⁰⁹ KredEx shall start issuing grants for the renovation of apartment buildings. http://www.kredex.ee/kredex-shall-issue-renovation-grant-for-apartment-buildings&tpl=1071&c_tpl=1047&op=extract (official website of KredEx).

¹¹⁰ Terms and conditions of the use of "Support for the reconstruction of apartment buildings" of the Green Investment Scheme, § 8(1).

¹¹¹ Terms and conditions of "Support of energy audit, evaluation of construction works and preparation of building design documentation", Regulation No. 48 of the Minister of Economic Affairs and Communications, § 8 (in Estonian: *Energiaauditi ja ehitise ekspertiisi tegemise ning ehitusprojekti koostamise toetamise tingimused ja kord*).

¹¹² Approved by the Resolution No. 1213 of the Government of the Republic of Lithuania dated 23 September 2004, *Official Gazette*, 2004, Nr. 143-5232; 2005, Nr. 78-2839; 2008, Nr. 36-1282.

¹¹³ Law on State Support for Housing, *Official Gazette*, 1992, Nr. 14-378; 2002, Nr. 116-5188.

¹¹⁴ JESSICA IN LITHUANIA: An Effort to Renovate Apartment Blocks. http://ec.europa.eu/regional_policy/archive/funds/2007/jjj/doc/pdf/jessica/31032011_7jessica_nwp_310_311_It_apartment_blocks.pdf (official website of European Commission).

¹¹⁵ Approved by the Decision of the European Commission No. C(2007) 3738, CCI 2007LT161PO0001, dated 30 July 2007 (with later amendments).

Operation Programme that financial engineering instruments such as JESSICA should be used while implementing tasks outlined in Priority 1¹¹⁶.

Therefore, it was decided to implement the JESSICA initiative in Lithuania particularly for financing renovation of multi-apartment buildings by the means of preferential loans to be granted to apartment owners.

In the year 2009, required amendments of the Law on Support for Housing were adopted and loans scheme grants for renovations works were reduced due to the introduction of preferential loan scheme. By the beginning of the year 2011, the financial mechanism for the provision of renovation loans from the funds of JESSICA Holding Fund was developed and became available in the market.

Table 7: Current Financing Structures for Renovations in Lithuania

Financing structures	Amount of financing	Financing sources
Renovation loan for financing renovation works	Fixed interest rate of 3%	Funds of JESSICA HF
Grants for renovations works	15% of costs for renovation works if energy efficiency savings of more than 20% are achieved	State budget and funds of JESSICA HF
	15% of costs for renovation works if energy efficiency savings of more than 40% are achieved	Funds from the Climate Change Programme
Grants for energy audits, building design documents and technical expertise	50% of the costs, but not exceeding the established maximum amounts	State budget
Grants for low-income persons	100% costs of preparation of the renovation project, administration costs of implementation of renovation project, costs of technical supervision of construction, credit insurance contribution, credit amount and interest	State budget

Table 8: Information on number of renovated multi-apartment buildings in Lithuania¹¹⁷

Multi apartment buildings	Number
Renovated in total	449
Renovated in accordance with JESSICA renovation loan	2
Prepare investment plans	179
Perform procurement procedures	140
Perform construction works	43

2.2. Establishment of JESSICA Structure

Implementation of JESSICA initiative in Lithuania started when on 11 June 2009 the Ministry of Finance, the Ministry of Environment of Lithuania and the European Investment Bank (the EIB) signed a Funding Agreement, establishing the JESSICA Holding Fund Lithuania for the purpose of investing funds in housing energy efficiency projects through the banking sector in Lithuania¹¹⁸.

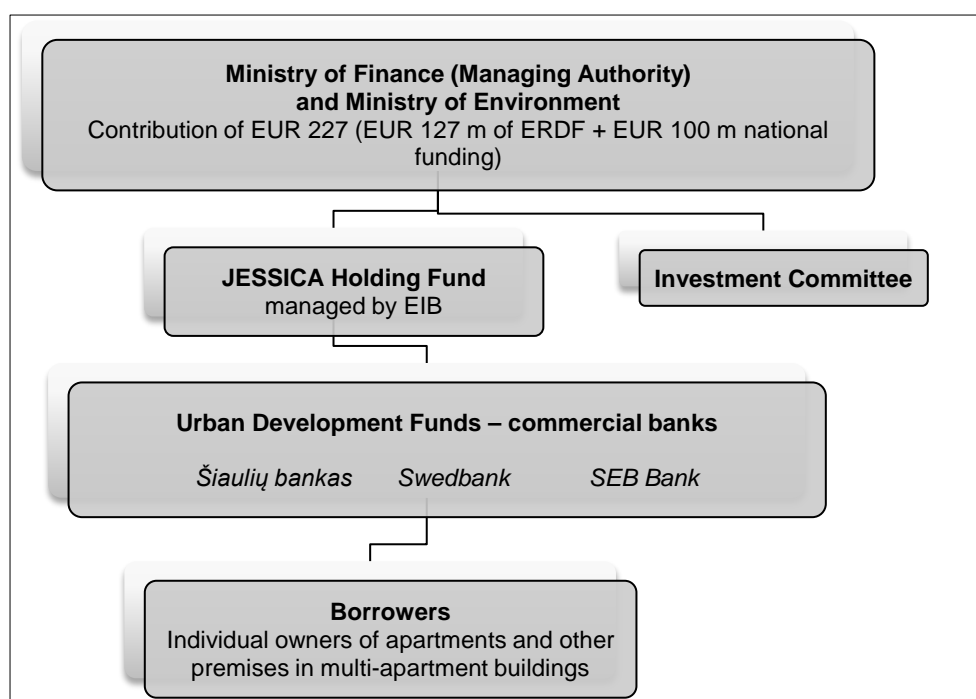
¹¹⁶ Cohesion Promotion Operational Programme for the years 2007 – 2013, p. 71, 78.

¹¹⁷ Source: <http://www.atnaujinkbusta.lt/>. Information for 23 February 2012.

¹¹⁸ JESSICA Holding Fund Lithuania: call for expression of interest. http://www.eib.org/products/technical_assistance/jessica/eoi/jessica-holding-fund-lithuania.htm (official website of European Investment Bank).

On 13 November 2009 the EIB, acting as JESSICA Holding Fund, launched a tender procedure for the selection of financial intermediaries as UDFs¹¹⁹. Operational Agreements were signed with the three selected UDFs *Šiaulių bankas*, *Swedbank* and *SEB bankas*. The UDFs provide preferential renovation loans to final beneficiaries since the beginning of 2011.

Figure 6: JESSICA Programme Implementation Scheme in Lithuania¹²⁰



2.3. Key Features of Financial Product

The currently operating Renovation Programme in Lithuania combines two types of financing – the provision of preferential renovation loans and grants. The provision of State support is administered by the Housing and Urban Development Agency (hereinafter, **HUDA**), which also consults apartment owners regarding renovation processes and provides to them certain technical support (for more information on HUDA's functions, please see Section F 1 of the Study).

The state support for renovation is granted to natural or legal persons owning apartments or other premises in multi-apartment building (hereinafter, **apartment owners**) with a condition that the amounts of State support do not exceed *de minimis* State aid limits established by European Union legislation¹²¹.

¹¹⁹Call for Expressions of Interest – Ref. IR-865. http://www.eib.org/products/technical_assistance/jessica/eoi/jessica-holding-fund-lithuania.htm (official website of European Investment Bank).

¹²⁰ Source: EIB.

¹²¹ Article 13 (1) of the Law on State Support for Housing; Clause 2.7 of the Government Resolution No. 1725 dated 16 December 2009 (Official Gazette, 2009, No. 156-7024); Part II of the Rules for Granting State Support for Renovation (Modernisation) of Multi-apartment Buildings and the

2.4.1. Renovation loan

The provision of preferential loans with a fixed annual interest rate not exceeding 3 percent is stipulated in the Law on Support for Housing as one of the forms of State support for renovation¹²². A renovation loan is granted by the selected financial intermediaries only if the renovation project estimates to achieve energy efficiency class “D” and sustainability of energy savings of at least 20%.

When preparing renovation projects, apartment owners and (or) administrators of commonly used premises¹²³ may apply to the financial intermediaries for the information on the terms and conditions of renovation loans. Apartment owners may freely choose among the financial intermediaries.

After the renovation project is finally prepared, the majority of the apartment owners of particular multi-apartment building (at least 50%) have to adopt the decision to implement renovation project and, for this purpose, to enter into renovation loan agreement¹²⁴. Decision of general meeting of apartment owners is binding to all apartment owners as well as to owners that have acquired ownership rights to apartments or other premises after such decisions was adopted¹²⁵. After the apartment owners' decision is adopted, administrator of commonly used premises concludes renovation loan agreement with one of the selected financial intermediaries acting on behalf of apartment owners as it is stipulated in the Law on Support for Housing¹²⁶.

Apartment owners are responsible for the repayment of the renovation loan by themselves and administrator of commonly used premises acts only as an intermediate between the financial intermediary and apartment owners. Apartment owners are directly responsible for repayment of renovation loan¹²⁷. The financial intermediaries are finally responsible for collecting debts and have no ability to claim against administrator, but certain responsibilities of administrator of commonly used premises may be stipulated in renovation loan agreement.

The term of renovation loan agreement may vary depending on the multi-apartment building, but in any case it may not be longer than 20 years. Apartment owners have the right to repay the loan before the maturity date without incurring penalties or administrative charge¹²⁸.

Under the Law on Support for Housing, in case title to apartment is going to be transferred, all outstanding debts have to be covered and all other rights and obligations are to be transferred to the new apartment owner¹²⁹. Applicable legislation additionally stipulates that the fact that apartment owners have concluded the renovation loan agreement is to be registered with Real Estate Register¹³⁰.

Table 9: Main parameters of renovation loan in Lithuania

Main parameters of renovation loan	
Product	Fixed interest loan

establishment of the Maximum Monthly Instalment of the Accumulative Contribution and (or) Other Instalments for the Implementation of the Renovation (Modernisation) Project of a Multi-apartment Building, approved by the Government Resolution No. 1725 dated 16 December 2009 (*Official Gazette*, 2009, No. 156-7024) (hereinafter, the **Rules**).

¹²² Article 13 (1) (1) of the Law on Support for Housing.

¹²³ Administrator of commonly used premises may be either (i) association of home-owners of multi-apartment building, (ii) administrator, appointed by municipal authority, or (iii) person authorized under cooperation agreement concluded by apartment owners.

¹²⁴ Article 15 of the Law on Support for Housing.

¹²⁵ Article 4.85 (4) of the Civil Code.

¹²⁶ Article 15 of the Law on Support for Housing.

¹²⁷ Article 15 of the Law on Support for Housing.

¹²⁸ Clause 21 of the Rules.

¹²⁹ Article 16 (3) of the Law on State Support for Housing.

¹³⁰ Clause 18 of the Rules.

Main parameters of renovation loan	
<i>Minimum loan amount</i>	Minimum loan amount is not specified
<i>Interest/return</i>	Fixed interest for entire loan period at 3% p.a.
<i>Maturity date</i>	Up to 20 years
<i>Currency</i>	Euro
<i>Payment frequency</i>	Monthly
<i>Self-financing</i>	Accordingly to the operational agreements concluded between the financial intermediaries and EIB, the financial intermediaries may require from apartment owners a down payment accounting for not more than 5% of the value of the projects. This is not obligatory and the financial intermediaries may finance 100% of the project value.
<i>Prepayments</i>	No restrictions or added fees
<i>Re-financing</i>	Not prohibited
<i>Maximum monthly instalment</i>	Maximum monthly instalment to be paid for 1 m ² is to be determined for particular multi-apartment building
<i>Borrower</i>	Apartment owners
<i>Collateral</i>	Loan tied to the apartment, not the owner
<i>Investment subsidy</i>	15% of total investment into energy-efficiency measures
<i>Loan insurance or guarantee</i>	None
<i>Measures financed by renovation loan</i>	<ul style="list-style-type: none"> - Major repairs or reconstruction of the heating and hot water systems: <ul style="list-style-type: none"> - Replacement or refitting of the heating substation or the boiler house (individual boilers) as well as hot water preparation systems - Installation of balancing valves for stands - Improvement of heat insulation for pipelines - Replacement of pipelines and heating devices - Installation of individual heating accounting and thermostatic valves in apartments - Replacement or refitting of hot water system pipelines and installations; - Replacement or refitting of ventilation system; - Replacement of windows and entrance doors: <ul style="list-style-type: none"> - Replacement of windows - Replacement of entrance doors - Roof insulation, including construction of a new slope roof (except for construction of premises in the attic) - Installation of glass constructions for balconies (loggias) (if to be installed under one unified project for the whole multi-apartment building) - Insulation of façade walls - Insulation of cellar ceiling - Insulation of base floor; - Installation of alternative energy source (sun, wind, etc.) systems - Major repairs or replacement of elevators by replacing them by more energy efficient elevators - Replacement or repair of the common use engineering systems of the building (sewage system, electric installations, fire prevention installations, drinking water pipelines and installations ventilation system)

2.4.2. Grants

Grants are primarily intended to accompany the renovation loan in order to decrease the required share of self-financing or financing through renovation loan issued by the financial intermediaries. Grants are given only if after the renovation, the multi-apartment building achieves at least energy efficiency class "D" and the annual heat energy consumption¹³¹ between 110-145 kWh/m², subject to the size of the building according to the classification established by the Government¹³².

¹³¹ Parameters of hot water are not included while calculating annual heat energy consumption.

¹³² Article 13 of the Law on State Support for Housing.

In accordance to Lithuanian legislation, real energy consumption should be calculated. On the other hand, this calculation may be performed exceptionally from the data stipulated in documents (e.g. renovation project and design documentation etc.). Legal regulations set out very detailed technical methodology to calculate such consumption.

According to the Law on Support for Housing, the following types of grants are provided to apartment owners:

- (i) *Grants for project preparation, the technical supervision and administration.* The Law on State Support for Housing states that at least 50% of expenses for the preparation of renovation project, performance of technical supervision and administration costs related to the implementation of renovation project should be compensated. The Government has additionally determined that until 31st of December 2013 the State should compensate for up to 100% of the costs mentioned above (after this date – 50%)¹³³. These grants are to be allocated from the State budget¹³⁴ and are limited to:
 - Grants for project preparation may not exceed 5% (or 2% in case typical design documentation is used) of the price of the construction works, including VAT;
 - Grants for technical supervision may not exceed 2% of the price of construction works, including VAT.
- (i) *Grants for renovation investments.* The Law on State Support for Housing stipulates that 15% of expenses for investments in measures increasing energy efficiency shall be compensated. If renovation project is being financed through preferential renovation loan, the loan amount will be decreased accordingly. In case renovation project is not financed by renovation loan, this grant should be allocated from the State budget and transferred for apartment owners directly¹³⁵. As from 1 January 2012 there is a possibility to acquire additional incentive – grant of another 15% of expenses for investments in measures increasing energy efficiency. This grant, given from the fund of Climate Change special programme, is available for those apartment owners who achieve at least 40% energy savings after implementation of renovation project¹³⁶.
- (ii) *Grants for low-income persons.* State has also undertaken to cover 100% costs of preparation of the renovation project, administration costs of implementation of renovation project, costs of technical supervision of construction, credit insurance contribution¹³⁷, credit amount and interest which are to be incurred by low-income families and single residents¹³⁸. The eligibility for such support is separately determined by the Law on the Cash Social Assistance for Low-income Families and Single Residents¹³⁹, which defines apartment owners that may apply for such grants.

Apartment owners, while adopting the decision to implement renovation project, should also decide on the administration fee that is to be paid to administrator of commonly used premises during the period when the renovation project is being implemented. Nevertheless, it has to be noted that administration fees, which may be covered by the state grant is regulated. Under Lithuanian legal acts, it is determined that the state compensates not more than LTL 0.35 per sq. m per month of costs related to the management of renovation project implementation. As mentioned before, it is also determined that until 31 December 2013, the state shall compensate 100% and since 1 January 2014 – up to 50% of these costs¹⁴⁰.

¹³³ Article 13 (1) (2) of the Law on Support for Housing; Clauses 2.5 and 2.6 of the Government Resolution No. 1725 dated 16 December 2009 (*Official Gazette*, 2009, No. 156-7024).

¹³⁴ Clause 24 of the Rules.

¹³⁵ Clause 24 of the Rules.

¹³⁶ Article 15 (1) (5) of the Law on Support for Housing.

¹³⁷ Credit insurance here is mentioned for the purpose to guarantee for low income persons that in case credit insurance shall be required in renovation process, the state shall cover all those expenses for low income persons. Please note that current renovation programme in Lithuania does not foresee requirement to use credit insurance, therefore, financial mechanism of credit insurance is not created.

¹³⁸ The definition of single residents is described in Law on the Cash Social Assistance for Low-income Families and Single Residents. According to this Law, a single resident is a person who lives alone and is older than 18 years, not married or married but lives separate by the decision of court, do not have children or children lives with other parent because of courts' decision mentioned above.

¹³⁹ Law on the Cash Social Assistance for Low-income Families and Single Residents, (*Official Gazette*, 2003, No. 73-3352).

¹⁴⁰ Clause 2.6 of the Government Resolution No. 1725 dated 16 December.

F. TECHNICAL ASSISTANCE FOR RENOVATIONS

1. Technical Assistance for Renovations in Lithuania

1.1. Housing and Urban Development Agency

Housing and Urban Development Agency (“HUDA”) (lt. – *Būsto ir urbanistinės plėtros agentūra*) is the main authority providing technical assistance for renovation projects. Initial activities of HUDA were started in 1997 when separate consultancy centres were opened in different cities for the promotion of energy savings in multi-apartment buildings. In 2001, a separate legal person – in a form of public institution was established. In 2004, the Ministry of Environment became the stakeholder of HUDA. In 2007, the legal form of HUDA was changed – it was reorganised from public institution to budgetary institution¹⁴¹. HUDA is in charge of the development of concepts for urban planning, effective management and maintenance systems for housing, promotion of effective use of energy, and enhancement of energy-efficient modernisation of private and public buildings. More information on the activities of HUDA may be found on: www.bkagentura.lt; www.atnaujinkbusta.lt.

HUDA has 9 offices located in key cities (Vilnius, Kaunas, Klaipėda, Šiauliai, Panevėžys, Utena, Alytus, Telšiai and Tauragė) so that the information about housing modernisation projects and urban development issues could be available in every region of the country.

1.2. HUDA Functions in Renovation Process

In renovation process HUDA performs the following functions¹⁴²:

- (i) provides consultancy services;
- (ii) evaluates compliance of renovation project with EU and national legislation;
- (iii) administers and provides state support and evaluates project preparation, construction technical supervision and procurement documents;
- (iv) performs the functions of *de minimis* state aid provider;
- (v) evaluates compliance of actual renovations works with renovation measures set out in the renovation project; and
- (vi) supervises the process of technical supervision of construction.

1.2.1. Consultancy Services

HUDA provides consultations to apartment owners, apartment associations, administrators, municipalities and other persons interested in the renovation processes. HUDA's consultations cover the following issues:

- (i) preparatory steps for renovation;
- (ii) project preparation;
- (iii) project implementation; and
- (iv) provision of state support.

All HUDA's consultations are free of charge.

As part of consultation services, HUDA prepares and promotes certain standardized documents that may be used in renovations of multi-apartment buildings. For example, when preparing renovation project it is encouraged to use standard structural elements and designs of construction works. HUDA provides information on the available typical projects on its

¹⁴¹ *History*. <http://www.bkagentura.lt/index.php?1049492996>.(official website of Housing and Urban Development Agency of the Republic of Lithuania).

¹⁴² Clause 6 of Rules.

website¹⁴³. Additionally, there are intentions to prepare and to make public standard minutes of the general meeting of apartment owners when they are voting for renovation issues.

1.2.2. Evaluation of Renovation Project

One of the most important functions of HUDA is to revise and evaluate renovation projects. HUDA has to verify the compliance of the renovation project before the apartment owners adopts final decision on its implantation and before renovation loan agreement is signed.

After renovation project is prepared and publically discussed with apartment owners, it is necessary to present it for HUDA's review. Within 10 business days HUDA verifies the compliance of renovation project with the requirements of ERDF Regulation (eligibility of renovation measures) and national legal acts (format requirements)¹⁴⁴.

1.2.3. Provision of State Support and Evaluation of Documentation

HUDA administers the provision of state support for renovation, excluding:

- (i) renovation loans – these are granted by selected commercial banks; and
- (ii) payment of loan and interests on behalf of low-income families and single residents – these payments are made by municipalities.

State support, administered by HUDA, is granted to final beneficiaries after the implementation of renovation when administrator submits all required documents. Within 20 business days after receiving all documents, HUDA verifies them and evaluates if the goals of renovation project have been achieved (i.e. if required energy efficiency class and reduction of heat energy consumption have been achieved). Within 20 business days upon making a decision to provide state support, HUDA transfers the estimated amount of state support into the accumulative account of apartment owners and informs commercial bank, which has issued renovation loan.

Should it appear that false data has been provided, HUDA is entitled to adopt a decision to demand the granted state support to be returned¹⁴⁵. Therefore, before issuing the decision to provide state support HUDA verifies documents related to:

- (i) project preparation and payments (copies of reports, agreements, invoices and payment supporting documents of the procurement of these services);
- (ii) technical supervision of construction (copies of reports, agreements, invoices and payment documents of the procurement of these services);
- (iii) management costs of project implementation (copies of documents of apartment owners decision on established amount of management costs and payment supporting documents);
- (iv) certificate of energy efficiency of a building; and
- (v) construction completion certificate¹⁴⁶.

1.2.4. De Minimis State Aid

In accordance with the requirements of EU regulations, HUDA performs functions related to the registration of *de minimis* state aid. This process consists of the following stages:

- (i) Apartment owners that exercise economic activities in the apartment or other premises have to inform administrator on the exercised economic activities.
- (ii) Administrator has to apply to HUDA requesting to issue a certificate on the scope of possible *de minimis* aid to those particular owners.

¹⁴³ Clause 6.1 of Rules.

¹⁴⁴ Clause 20 of Rules on Modernization Project of Multi-apartment house preparation approved by Ruling No. D1-677 of Minister of Environment dated 10 November 2009, *Official gazette*, 2009, No. 136-5963.

¹⁴⁵ Clauses 29 to 31 of Rules.

¹⁴⁶ Clause 30 of Rules.

- (iii) HUDA has to check in the Register of Granted State Aid if any other *de minimis* aid has been already provided to those particular owners, calculate the amount of *de minimis* aid to be provided to them and evaluated if the total amount of aid shall not exceed allowed limits.
- (iv) HUDA issues certificate to administrator and administrator submits this certificate to the bank issuing renovation loan.
- (v) Following the conclusion of loan agreement, bank notifies HUDA and HUDA submits details of provided state support to the Register of Granted State Aid.

While calculating the amount of state support, which has been granted for respective owner, HUDA takes into consideration the respective part of each particular owner related to:

- (i) all grants provided for that particular multi-apartment building;
- (ii) difference between commercial interest rates and subsidised renovation loan interest rates. Only this difference between interest rates is regarded as being state aid for apartment owners¹⁴⁷.

1.2.5. Evaluation of Performed Works

HUDA performs visual (not technical) inspection of construction works. Transfer – acceptance deed of construction works are signed by contractor, construction technical supervisor and administrator. Within 5 business days after the transfer – acceptance deed of construction works are provided to HUDA, the officer of HUDA has to take actions in order to make sure if the works specified in the transfer – acceptance deed of construction contract works comply with the measures specified in renovation project. Usually this is performed by the officer of HUDA who visits the multi-apartment building under renovation and visually inspects the works performed.

In the above order confirmed Transfer – acceptance deeds are provided to the bank, which covers the costs of construction works on the basis on these certificates¹⁴⁸.

1.2.6. Supervision of the Technical Supervision Process

Additionally to specific functions directly related to renovation processes, HUDA is also entitled to supervise the process of technical supervision of construction in accordance with the Law on Public Administration. If HUDA determines violations in construction works and technical supervision of construction it has to inform the State Territorial Planning and Construction Inspectorate¹⁴⁹. Such powers of HUDA may also have effect on renovations – contractors involved in renovations may be more motivated to comply with all construction regulations and abide quality requirements.

2. Technical assistance for renovation in Latvia

2.1. Institutional level

2.1.1. State level

The Ministry of Economics develops and implements policies, *inter alia*, in the fields of energy, construction and housing and is the main institution responsible for adopting policies on energy efficiency in housing.¹⁵⁰ Further the Ministry also plans, implements and supervises development programmes and projects, involving funds of the European Union and other foreign funds.

¹⁴⁷ Clauses 8 to 13 of Rules.

¹⁴⁸ Clause 20 of Rules.

¹⁴⁹ Clauses 6.7; 55 of Rules.

¹⁵⁰ 23 March 2010 Cabinet Regulation No. 271 Regulations of the Ministry of Economics, published in the official gazette *Latvijas Vēstnesis* on 26 March 2010, effective as from 27 March 2010; with amendments; 6 June 2002 State Administration Structure Law, published in the official gazette *Latvijas Vēstnesis* on 21 June 2002, 1 January 2003; with amendments.

An institution subordinate to the Ministry of Economics is the state agency Latvian Investment and Development Agency. A state agency ensures provision of services within the scope of the state administration task implementation. Pursuant to the Regulations of LIDA¹⁵¹ the aim of the agency generally is facilitation of the development of foreign trade, attract foreign investments to Latvia, and implement programmes of state aid to private businesses. The Regulations of LIDA provide that the operation of LIDA is ensured by the state budget subsidies, own funds, including revenue from the provided services, revenue from state or municipal procurements, foreign financial assistance.

The Ministry and the LIDA are responsible for implementation the activity “Improvement of Heat Insulation of Multi – apartment Residential Buildings”.

On the basis of the law On Management of European Union Structural Funds and the Cohesion Fund of 15 February 2007¹⁵² the Ministry of Economics carries out the energy efficiency improvement policy. The responsible institution for implementation of the Cabinet Regulation No.138 “Regulations regarding first to eight stage of the project application selection of the Activity 3.4.4.1 “Improvement of Heat Insulation of Multi-Apartment Residential Buildings” of the supplement to the Operational Programme “Infrastructure and Services”¹⁵³ (hereinafter – the Regulations) is the Ministry of Economics, while the co-operation institution is LIDA, which is under functional supervision of the Ministry of Economics.

Ministry of Economics pursuant to the Regulations No.138 and the Regulations No.272 has the following competence:

- (i) ensures implementation of the operational activity, including it acts as the appeal institution for the decisions adopted by LIDA.
- (ii) informs the public and ensures publicity on issues, which are related to implementation of the activity.

LIDA pursuant to the Regulations No.138 and Regulations No.272 has the following competence:

- (i) forms a committee for review of project applications, drafts and approves the order of operation of the committee;
- (ii) prior to commencement of filing of project applications, drafts, approves and publishes on the internet site of the co-operation institution the methodology for filling in the application form, the rules on filling in of the project application evaluation and project application evaluation forms and a draft project implementation agreement;
- (iii) provides information to the applicant on preparing of project application;
- (iv) performs selection of the project applications and ensures evaluation;
- (v) adopts a decision on approval of the project application, conditional approval of the same or refusal of the project application and informs accordingly the project applicant;
- (vi) enters into agreement on implementation of the project with the financing beneficiary of the ERDF;
- (vii) evaluates and adopts a decision on project amendments in the regulatory enactments in the field of EU structural funds and in the agreement on project implementation;
- (viii) ensures supervision and control of the approved projects;

¹⁵¹ 23 December 2003 Cabinet Regulation No. 746 Regulations of the state agency “Latvian Investment and Development Agency”, published in the official gazette *Latvijas Vēstnesis* on 30 December 2003, effective as from 1 February 2004; with amendments.

¹⁵² 15 February 2007 Law On Management of European Union Structural Funds and the Cohesion Fund, published in the official gazette *Latvijas Vēstnesis* on 23 February 2007, effective as from 1 March 2007 with amendments.

¹⁵³ 10 February 2009 Cabinet Regulation No. 138 “Regulations regarding first to eight stage of the project application selection of the Activity 3.4.4.1 “Improvement of Heat Insulation of Multi-Apartment Residential Buildings” of the supplement to the Operational Programme “Infrastructure and Services”, published in the official gazette *Latvijas Vēstnesis* on 4 March 2009, effective as from 5 March 2009 with amendments.

- (ix) provides information to the financing beneficiary on implementation of the project and fulfilment of conditions of the agreement on project implementation;
- (x) reviews and confirms the progress report and payment request of the financing beneficiary and prepares payment orders and costs declarations;
- (xi) ensures preparation of information to the responsible institution on implementation of the activity, in particular, the funding allocated from ERDF;
- (xii) analyses problems, which relate to implementation of the activity and project, and provides proposals to the responsible institution on improvements in implementation;
- (xiii) ensures data processing related to project applications and projects;
- (xiv) provides information to the public and ensures publicity on issues, which relate to the projects approved within the scope of the activity.

Costs related to implementation and development of programmes and projects involving EU funds are covered within framework of the Supplemented Operation Program "Infrastructure and Services" measure 3.7.1.1. "Assistance for Management of the Operation Programme "Infrastructure and Service" ERDF Co-finances Measures". The Cabinet of Ministers has adopted the Regulations No.918 of December 18, 2007¹⁵⁴ and determined the order for implementation of technical assistance to be provided by institutions involved in implementation of operational programmes.

2.1.2. Riga municipality level

The Riga Energy Agency (REA) has been established as a municipal agency through the Resolution on the Establishment of the Municipal Agency of Riga "Riga Energy Agency" made by Riga City Council on 23 January 2007¹⁵⁵. Pursuant to the above resolution the revenue of the agency is made of the municipal budget subsidy, income from services provided for a charge, funding from various projects.

The Agency pursuant to its by-laws has the following functions:

- (i) to draft and update the Development Concept of Riga District Heating System;
- (ii) to elaborate the Program for Increase of Energy Efficiency; to organize implementation of Program and related projects;
- (iii) to prepare an annual report on the current situation and the progress made in area of energy efficiency in Riga city;
- (iv) to establish the unit within Agency called Energy Efficiency Information Center;
- (v) to liaise with foreign and international institutions and organizations according to the area of authority of the Agency;
- (vi) to provide the service of energy auditors;
- (vii) to publish information materials and to provide information to mass media in the area of authority of the Agency;
- (viii) to cooperate with governmental and municipal institution, non-governmental organizations, other legal as well as physical entities, etc.

An information centre has been opened by the REA in October 2011, the tasks of which are provide information and consultations according to the state and municipal programs in energy efficiency to the general public.

2.2. Implementation of energy efficiency measures co-financed by ERDF

The implementation of the project is supervised, controlled and evaluated by LIDA. However, technical assistance is not only provided by LIDA, but also other institutions, which are involved in the construction process according to their specialised functions.

¹⁵⁴ Adopted on 18 December 2007, published official gazette *Latvijas Vēstnesis* on 28 December 2007, effective as from 29 December 2007, with amendments.

¹⁵⁵ The Resolution on the Establishment of the Municipal Agency of Riga "Riga Energy Agency", made by Riga City Council on 23 January 2007.

Construction documentation and permit

Pursuant to the Construction Law¹⁵⁶ construction works may be performed according to a construction design or simplified renovation documentation as foreseen in the General Construction Regulations¹⁵⁷ and for performance of construction works a construction permit is required. The institution responsible for co-ordination of the construction documentation and its approval is the municipal construction board, which also issues construction permits. The duty to ensure that the construction documentation is approved and construction permit is received lies on the client, i.e. project applicant. If these duties are observed, the construction will be regarded as performed legally, which will accordingly allow LIDA to consider these costs as eligible costs for the ERDF financing.

Construction supervision

Further the Regulations provide that eligible costs are costs of construction works subject to construction supervision¹⁵⁸, which makes it obligatory to have a construction supervisor in case of project implementation with ERDF financing.

The construction supervision is governed by the Cabinet Regulation on Construction Supervision¹⁵⁹, which provides the order according to which quality control of the construction works and materials is performed. Construction supervision is performed based on a separate agreement and by an independent third party, certified to be a construction supervisor. The construction supervisor certifies with the signature the inspected construction works in the construction documentation. Thus by including a condition for eligible costs in the Regulations, it is ensured that a third independent party controls the construction works and the materials used.

In addition when ERDF financing is used together with renovation loans issued by private banks, they sometimes use their internal construction controllers to verify fulfilment of the construction works as set out in the loan application and compliance of the specific positions in the cost estimate with the performed works.

Field supervision

Additionally according to the Regulations implementation of energy efficiency renovation works may be supported by the field supervision, the costs of which are eligible costs according to the Regulations.

The field supervision is performed according to the Regulations on Latvian Construction Normative LBN 304-03 – Regulations on field supervision of construction works.¹⁶⁰ The aim of field supervisions is to ensure the rights to implement the construction design in an authentic manner, not permitting any arbitrary deviations from the approved construction design as well as violation of the binding rules and standards. Field supervision is performed during the whole construction process and based on a respective agreement between the client and the author of the construction design or an accordingly authorised person.

¹⁵⁶ 10 August 1995 Construction Law, published in the official gazette *Latvijas Vēstnesis* on 30 August 1995, effective as from 13 September 1995, with amendments.

¹⁵⁷ 01 April 1997 Cabinet Regulation No 112 General Construction Regulations, published in the official gazette *Latvijas Vēstnesis* on 4 April 1997, effective as from 1 July 1997, with amendments.

¹⁵⁸ Article 18.3 and Article 19.3 of the Regulations No.272.

¹⁵⁹ 10 February 2004 Cabinet Regulation No. 75 Regulations on Latvian Construction Normative LBN 303-03 Construction Supervision Regulations, published in the official gazette *Latvijas Vēstnesis* on 13 February 2004, effective as from 20 February 2004, with amendments.

¹⁶⁰ 25 June 2003 Cabinet Regulation No 342 Regulations on Latvian Construction Normative LBN 304-03 – Regulations on author's supervision of construction works, published in the official gazette *Latvijas Vēstnesis* on 27 June 2003, effective as from 1 July 2003, with amendments.

Supervision by LIDA

In addition the draft agreement on project implementation sets out that a duty of LIDA is to ensure supervision, control over the project implementation as well as evaluate compliance of the project implementation with the respective documentation. Hence LIDA performs the visual control of the project implementation. LIDA may also contract an expert in the field during interim and final report evaluation to make sure that the costs in the cost estimate are reasonable and economically substantiated. Based on a decision of such an expert the state agency may decide on decrease of financing or termination of the agreement. It must be noted that involvement of an expert is not obligatory and it is solely within the discretion of LIDA.

Therefore it follows from the above that technical assistance is performed not only by LIDA, but also by the relevant municipal construction board as well as involved construction supervisor and author's supervisor.

2.3. Marketing and publicity strategy

Both the Ministry of Economics and LIDA shall provide information to public on the activity on "Improvement of Heat Insulation of Multi – apartment Residential Buildings". The REA actively co-operates with LIDA and the Ministry of Economics in relation to provision of information.

In 25 February 2010 an informative campaign "Live warmer" was started and a co-operation memorandum was signed. The memorandum was signed by the Latvian Association of Construction Engineers, Association of Technical experts, Latvian Association of Traders of Building Materials, Latvian Energy Efficiency Association, AS Swedbank, AS DnB Bank, AS SEB bank, Latvian Association of Construction Companies, Latvian Association of Manufactures of Doors and Windows, Latvian Association of Building Managers, Municipality of Liepaja, Riga Technical University, Zemgale Regional Energy Agency, Vidzeme Regional Energy Agency, Riga Energy Agency, Union of Latvian Engineers of Heat, Gas and Water Technologies and Latvian Association of Heating Companies to provide accessibility of information regarding housing renovation process. During 2010 and 2011 the memorandum was also signed by Latvian Association of Insurers, Latvian Association of Municipalities, LIDA, Embassy of Denmark, AS Latvenergo, AS Nordea bank, Latvian Association of Energy Auditors, Kurzeme Regional Energy and Development Agency, Latvian Association of Manufactures of Building Materials and Latvian Association of Big Cities,

The main task of the informative campaign "Live warmer" is to ensure availability of information on the "Improvement of Heat Insulation of Multi-Apartment Residential Buildings". As the renovation of multi-apartment buildings is complex process, the public is also informed of a wide range of other issues related to the process of renovation of multi-apartment buildings. Further, the mutual co-operation of associations has been promoted in order to ensure the flow of information on topical issues in the industry, to ensure availability of information to the apartment owners on financing sources for renovation of buildings, inform on advantages of housing renovation; educate on the conditions for quality renovation processes.

The Ministry of Economics with the cooperation partners organize different informative seminars and conferences within this informative campaign. The activities are financed from EU technical assistance and private funds.¹⁶¹

During the second half of 2011, the Ministry of Economics and LIDA together with regional information centres¹⁶² of EU Structural Funds organised multi-apartment housing renovation

¹⁶¹ Live warmer! <http://www.em.gov.lv/em/2nd/?cat=30267> (official website of the Ministry of Economics of the Republic of Latvia; accessed on 30 January 2012).

¹⁶² Pursuant to the Law on Management of European Union Structural Funds and the Cohesion Fund the following regulations have been adopted - 4 October 2011 the Cabinet Regulations No. 749 On the Order according to which publicity and visual identity requirements of the European Union Structural Funds and Cohesion Funds, as well as public information on the fund projects are ensured, published in the official gazette Latvijas Vēstnesis on 6 October 2011, effective as from 7 October 2011. These

days in all regions of Latvia. Also in various towns seminars were held on conditions for receipt of ERDF financing for renovation of multi-apartment residential buildings.

The information within the above informative campaign is widely publicised and we believe this could be continued in relation to any other financing instrument developed for housing renovation and energy efficiency measures. The current informative campaign is not solely limited to the ERDF financing, but rather to raise awareness of the society of this issue.

G. DESCRIPTION OF A POTENTIAL JESSICA LOAN PRODUCT IN LATVIA

1. General Description of a Potential Product

Demand for JESSICA financing

As described in Section E of the Study, currently renovations of multi-apartment buildings are mainly supported by providing grants from ERDF co-funding, which covers maximum 50% or 60%¹⁶³ of total eligible project costs. This grant system is already accompanied with lending as grants are issued only after performance of renovation works and when respective payments for renovation works have been made. In most cases apartment owners decide to acquire prior financing from commercial banks, rather than use their own financing. Particularly current Latvia's experience of combining grants from the funds of the ERDF and bank financing is an important basis for the creation of a JESSICA financial product for renovations of multi-apartment residential buildings.

Possible introduction JESSICA financial products in the Latvian market for renovations of multi-apartment residential buildings would be also based on the intentions to use principal benefits of financial engineering instruments, such as recycling of funds and leverage, and to feel positive effects to all main actors in the market of renovation of multi-apartment residential buildings – apartment owners, companies involved in building management and implementation of renovation projects, banks financing renovations and public bodies as well.

To increase interest in renovation of residential multi-apartment residential buildings real estate tax discounts could be considered. Since after performance of renovation works the cadastral value of the residential building increases, so would the real estate tax, which for the population is a deterring factor to start renovation. Hence to overcome this real estate tax discount could be considered for those residential multi-apartment buildings, which have been renovated for a term not exceeding 15 years. This is also a strategy proposed by REA in relation to the current situation.

Potential JESSICA loans for renovations

Possible JESSICA financial products could be constructed taking into consideration the actual models how multi-apartment residential building renovations currently are being implemented. Summarizing the current practice in Latvia and other EU countries, renovations in the housing sector are performed in one of the following ways:

- (i) by apartment owners themselves – in these cases apartment owners are usually assisted by a building manager; or
- (ii) by professionals – these are usually ESCOs acting in the field of energy efficiency renovations in housing sector.

After analysing the legal framework and market practice for financing of energy efficiency renovations in Latvia, the following JESSICA financing structures are proposed:

regulations foresee activities of the regional information centres in ensuring publicity and provision of information on EU funds projects.

¹⁶³ In those cases where at least 10% of apartment owners of the residential building have been granted the status of disadvantaged person permitted ERDF funding intensity may be 60% of the total eligible project costs.

- (i) where a renovation project is managed by the manager of the multi-apartment residential building in any form (i.e. association, co-operative society or limited liability company) – renovation loans could be provided to the multi-apartment building manager acting for the benefit of apartment owners. This financing structure does not exclude a possibility to enter into EPC with ESCO applying the guaranteed savings model;
- (ii) where a renovation project is managed by ESCO – renovation loans could be provided to ESCO with application of a shared savings model.

It would be beneficial for the housing sector, if the two above JESSICA financial products would be available in the market as alternative ones. Existence of such two alternatives would not exclude any potential actors in the housing renovations sector and would ensure that renovation projects are implemented more widely. In addition these models and their implementation structures are similar to the ones existing currently in Latvia and have become familiar in Latvia among the players in the housing sector market. Detailed description of the above models is provided further.

Replacement of grant system

One of the questions that should be resolved by the competent Latvian authorities is whether all available grants for renovations should be replaced by the proposed JESSICA financial product or whether some element of the grant system should be retained along with the proposed JESSICA financial product.

Under Article 43 (6) of the Regulation No. 1828/2006, enterprises, public private partnerships and other projects included in an integrated plan for sustainable urban development, as well as operations for energy efficiency and use of renewable energy in buildings, including in existing housing which are supported by financial engineering instruments, may also receive a grant or other assistance from an operational programme. In accordance with the COCOF Note, this provision allows operations for energy efficiency and renewable energy in buildings, including existing housing to be supported through loans, guarantees or equivalent instruments and to also receive grants. The European Commission emphasizes that such possibility of receiving both non-repayable assistance or grants and repayable investments opens up new opportunities to address a wide range of market gaps, namely through incentives for investments with long-term financial payback periods or for beneficiaries with low self-financing capacity¹⁶⁴.

Taking into consideration the above, it is possible create of one the following financing schemes for implementing renovations of multi-apartment buildings in Latvia:

- (i) The ERFD grants covering certain percent of eligible costs (considerably less than current 50%) could be combined with the preferential JESSICA loan. Such a system is currently applied in Estonia.
- (ii) Certain grants allocated from the funds of the state budget could be combined with the preferential JESSICA loan. Such a system is currently applied in Lithuania.
- (iii) All grants could be fully replaced by the JESSICA financial product, i.e. only provision of a preferential JESSICA loan would be available.

Should any portion of grants remain, the purpose thereof may be limited or specifically defined. For example, it is possible to provide grants for only preparatory issues, such as for preparation of energy audit, technical survey, construction design etc.

Eligibility of expenditure

As funds for the JESSICA initiative are to be allocated from the ERDF, the provisions of Regulation No. 1080/2006 regarding the restriction on possible expenditure should be taken into consideration. In accordance with Article 7 (1a) of the Regulation No. 1080/2006, the specific requirements for the expenditure of housing are stipulated:

¹⁶⁴ COCOF Note, p. 20. Please see Section 7 of this Study.

- (i) expenditure should be on energy efficiency improvements and on the use of renewable energy in the existing housing; and
- (ii) expenditure should not exceed up to an amount of 4% of the total ERDF allocation.

Due to the fact that multi-apartment buildings are currently supported by grants particularly allocated from the ERDF, the compliance of the renovation measures supported with the ERDF with the requirements of the Regulation No. 1080/2006 should have been already verified and confirmed by the competent Latvian authorities. Therefore, by means of the JESSICA funding, it is recommended to continue financing the same renovation measures as described in Section C, Part 2.2.2.3 of the Study.

Scope of projects

The scope of the multi-apartment buildings to be financed under the JESSICA funding could remain the same as currently supported with the ERDF grants:

- (i) buildings divided into apartments, where one owner does not own more than 20% of the total number of apartments;
- (ii) construction has been commenced before 1993 (inclusive) and has been commissioned by 2002 (inclusive);
- (iii) non-residential area of the multi-apartment residential building does not exceed 25% of the total area of the building;
- (iv) in the municipality, where the project is to be implemented, in the beginning of the year, when the selection round of applications is closed, are at least 2,000 inhabitants.

2. Preferential loan to multi-apartment building manager acting for the benefit of apartment owners

2.4. Loan product general terms and conditions

Borrower under loan product

Under the existing ERDF grant system in most cases a community of apartment owners has authorised a building management company, which is usually established in the form of a limited liability company, to enter into an agreement on ERDF co-financing and bank financing.

Though building management companies in the form of a limited liability company are widespread, other forms of building managers are also active in relation to implementation of energy efficiency measures using the ERDF co-financing and need to be recognised. These include such forms, where apartment owners have formed an association and co-operative society entrusted with building management duties. These are legal entities, though they are not commercial entities registered with the commercial register of the Republic of Latvia, which precludes them according to law to provide security in the form of a commercial pledge.

Therefore we propose to offer the JESSICA loan product to building managers¹⁶⁵, which would act for the benefit of apartment owners. An authorisation of the community of apartment owners and the respective scope of the authorisation will be included in the decision of the community of apartment owners under which the apartment owners agree to undertake implementation of energy efficiency renovations, including agree to make increased management fee for loan repayments. Accordingly the building manager will take loan in its own name subject to the community of apartment owners deciding on implementation of energy efficiency measures under certain conditions. The decision of the community of apartment owners is an obligatory pre-condition for implementation of energy efficiency measures by the building manager.

¹⁶⁵ „Building managers“ include all forms of entities performing building management duties.

It is worth noting that any multi – apartment residential building cannot operate without a building manager. The apartment owners are obligated to ensure that the building is managed and at least compulsory management activities are performed. Also the building managers according to law are obliged to implement at least minimum energy efficiency measures. Hence building managers based on the decision of the community of apartment owners would be best placed to act as the parties to the loan product.

In case there is a change of the building manager for the building, which is a risk for the loan product as it would affect the actual borrower of the loan product, the new building management company would need to take over the loan liabilities and also comply with certain financial and commercial standing as accepted by the lending institution. To ensure such steady change of the building management company it would be necessary to set in the Law On Management of Residential Buildings that, if the apartment owners have decided on implementation of energy efficiency measures and have decided that the building manager takes loan for implementation of the same, then such financing agreement is binding on the new building management company subject to consent of the lending institution.

In case the ownership of an apartment is transferred, all outstanding debts to the building manager in relation to the renovation would need to be taken over by the new apartment owner, along with all other rights and obligations.

Public register of renovation loan

Further to ensure that there is public information on the liabilities related to a specific multi – apartment residential building, so as to prevent third parties, including acquirers of apartment properties or potential building managers, a public register, e.g. held by the Ministry of Economics, could be established listing the buildings, the owners of which have decided on and received renovation loan for implementation of energy efficiency measures. It would be important to ensure that any new acquirer could have access to public information on the liabilities undertaken by the community of apartment owners for the purposes of public credibility of such information. As a result of which such third persons will be prevented from claiming lack of knowledge of such liabilities.

Confirmation of loan conditions and securities

As to the loan payment mechanism, the decision of the community of apartment owners simultaneously when deciding on implementation of energy efficiency measures should include a clear decision on the acceptable terms of the loan agreement and respective increase in the monthly payments to the manager to cover the monthly loan payments. Such a legally binding decision of the community of apartment owners is the basis for the loan repayment instalments.

Further the form of the provided security to the lending institution will depend on the legal form of the building manager. If the building manager is a legal entity registered with the commercial register, the accounts receivables should be pledged in favour of the lending institution in the form of a public commercial pledge. As an efficient measure for enforcement of such a pledge the building manager and the lending institution should enter into an assignment agreement under which in case of default of the borrower, the building manager, the lending institution will be able to require that apartment owners make monthly payments directly to the lending institution.

In case other legal entities not registered with the commercial register act as the building managers, the security could be requested in the form of a deposit for a certain number of loan repayment amounts as well as a valid assignment agreement under which apartment owners will make monthly payments directly to the lending institution in case of default of the borrower, while in this case without a public commercial pledge. As in the case above the security will be based on the monthly payments of the apartment owners.

Financial capacity of the building management company

To prevent as far as possible situations when building management companies default in the liabilities, we would advise to set also financial criteria for the building managers applying for loan product, at least such as are provided currently for the authorise person in relation to receipt of the ERDF grants¹⁶⁶. Further the building manager should be from the list of the certified management companies to be held by the Ministry of Economics starting from 1 January 2012.

In order to improve legal certainty in case of default of the building manager and to prevent challenges by the existing or future apartment owners, we would suggest setting in the Law On Management of Residential Buildings that all expenditures incurred by the building manager for the residential building or on behalf of the apartment owners, within the scope of a legally adopted decision of a community of apartment owners, shall be borne by the apartment owners according to their joint property share in the residential building. It would be advisable to increase the required number of votes for adoption of such a decision on renovation and respective increase of management fee for financing of the renovation up to two thirds of votes.

Approval of projects

Finally, in relation to the energy efficiency measures a certain quality of the energy efficiency projects should be ensured. Taking into account that the lending institution might not be in a position to evaluate such projects, we propose that they are approved by a certified energy auditor and performed according to the construction law rules, including construction supervisor and field supervision. It would be worth considering requesting approval of the projects by specialised institutions, like local energy agencies or LIDA, to improve their quality, ensure reaching of energy efficiency targets and ultimately ensure consequent payment discipline of the apartment owners.

2.5. Principal conditions for granting JESSICA loan product

We have identified the following principal conditions for granting loan to the building manager for the benefit of the community of apartment owners:

(i) **Building management agreement.**

This agreement is concluded between the community of apartment owners and a building manager. Under this agreement the building manager will undertake to provide management activities in relation to the building, in particular, to ensure implementation of energy efficiency measures and services. For the purposes of the JESSICA loan product this agreement should contain appropriate provisions for termination thereof with a duty of the manager to transfer the liabilities undertaken in relation to the specific building to the new building manager.

For control purposes the lending institution could be willing to join the building management agreement. It would ensure that the lending institution is in a position to influence directly any change of the building manager. Alternatively the apartment owners in their decision could undertake certain obligations in favour of the lending institution, i.e., to fulfil the instructions of the lending institution in relation to replacement of the building manager.

(ii) **Decision of the community of apartment owners.**

Depending on organisation of the process, there could be one or several decisions of the community of apartment owners deciding on performance of energy efficiency measures. Notwithstanding the number, the subject of such a decision will be approval of implementation of energy efficiency measures, a certain cost estimate and work

¹⁶⁶ Please see Section C of this Study.

project for the measures. The decision will also contain an assignment to the building manager to perform and to finance the project, approving increase in the management fee to a certain amount for repayment of the loan based on monthly payments. Also the above mentioned decision to have the lending institution as part of the building management agreement shall be taken.

Additionally the community of apartment owners will need to undertake thereunder at all times to have a diligent building manager, and in case the building manager does not comply with such criteria, the apartment owners are obliged to change the manager¹⁶⁷.

The community of apartment owners shall take these decisions with at least two thirds of votes in favour.

(iii) Energy efficiency measures project.

The energy efficiency measures will be based on an energy efficiency measures project, which should be based on an energy auditor report and accordingly prepared by a professional company. The building manager could for these purposes engage any appropriate professional or an ESCO, which could also be engaged in implementation of the project under the guarantees savings scheme.

To ensure higher quality of the projects a competent institution, like LIDA, energy agencies, could be required to confirm appropriateness of the energy efficiency measures project. Additionally as its implementation involves construction works, it has to be approved also by the construction board.

(iv) Renovation loan agreement.

This agreement is concluded between the building manager in its own name as its own obligation, and the lending institution subject to a decision of the community of apartment owners.

The purpose of the agreement is implementation of energy efficiency measures in a certain multi – apartment residential building.

The disbursement of loan is made to the bank account of the building manager against invoices for the goods or services in relation to the project.

(v) Commercial pledge agreement.

Along with the loan agreement a commercial pledge agreement will be required in relation to building managers, which are legal entities registered with the commercial pledge register. This agreement secures repayment of loan by the building manager. A commercial pledge is registered in the public register on the accounts receivables by the building manager from the respective apartment owners in favour of the lending institution.

(vi) Assignment agreement.

This agreement is concluded between the building manager, notwithstanding its legal form, and the lending institution. Under this agreement in case of default of the building manager, the apartment owners will be obliged to make monthly repayments of the loan directly to the lending institution.

This is a measure for enforcement of the commercial pledge agreement.

¹⁶⁷ Taking into account that it could be difficult to enforce, in case no voluntary decision is taken by the community of apartment owners, some incentives from the loan conditions could be applied, e.g. loan write-off.

- (vii) Construction agreements and other agreements for implementation of the energy efficiency project

These agreements will be concluded by the building manager to ensure implementation of the project, where the main agreement will be a construction agreement and its supervision agreement, as well as delivery of equipment and other works for implementation of energy efficiency measures. Public procurement will be applied for selection of contractors and the same public procurement criteria could be applied as currently to the ERDF grants, where the guiding principle is economically grounded price.

The building manager based on an appropriate decision of the community of apartment owners could also entrust implementation of the project to an ESCO by implementing a guarantee savings scheme, including the construction process, but this would depend on the choice made by the building manager and community of apartment owners.

- (viii) Guarantee

Further it must be noted that according to the Construction Law any construction works shall be given a guarantee period of 24 months from the date of completion of the same. Construction process is usually covered by a performance guarantee or a guarantee period guarantee, in the form of an insurance or bank guarantee. The terms of these documents may be agreed by the parties. Likewise it is common practice that for equipment a certain guarantee is also provided, though the applicable laws do not set any obligatory term. These aspects may be treated as pre-conditions for ensuring duly fulfilment of the construction works.

2.6. Liabilities of the parties

Further we outline the consequences in case of default of a party in the structure of the JESSICA loan product:

- (i) default of an apartment owner against the building manager

The apartment owner has the scope of rights and liabilities agreed in the decision of the apartment owners, in particular make payments to the building manager. In case the apartment owner defaults on payments, the building manager will be entitled to apply penalties as provided in the building management agreement and raise claim against the apartment owner. There is no security to be enforced in this relationship.

The default of the apartment owner will not affect the duty of the building manager to implement the project and fulfil the terms of the loan agreement. Also the decisions of the community of apartment owners related to the renovation will be binding on an acquirer of the apartment.

- (ii) default of the building manager against the lending institution

The building manager will have undertaken the rights and liabilities under the loan agreement for the benefit of the apartment owners, but in its own name, which are accordingly included in the balance sheet of the building manager. In case the building manager defaults on payments, the lending institution will be entitled to exercise the penalties foreseen in the loan agreement and ultimately the rights arising out of the assignment agreement and request monthly payments by the apartment owners to be made directly to the lending institution. If deposit is established, then the lending institution will be able to cover the outstanding amount from the deposit. Also the lending institution will be entitled to enforce the pledge by selling the rights of claim to a third party for a market price.

In case other terms of the loan agreement will not be observed by the building manager, the lending institution could initiate the procedure for change of the building manager with the community of apartment owners.

(iii) default of the apartment owners against the lending institution

The relationship between the apartment owners and the lending institution is based only on the right to collect payments for repayment of loan by the lending institution, which follows from the assignment agreement.

Hence the lending institution has rights to collect monthly payments and pursuant to the terms of the decision of the community of apartment owners and provision of law request repayment of the whole loan amount.

2.7. Main parameters of the loan product

Based on the above a possible JESSICA loan product to the building manager could have the following characteristics:

Table 10 characteristics of possible JESSICA loan product to the building manager

Parameter	Description
<i>Product</i>	Fixed interest loan and/or other preferential terms
<i>Borrower</i>	Building manager, which is not an authorised entity, but acts for the benefit of the community of apartment owners
<i>Preconditions</i>	<ul style="list-style-type: none"> o Decision of the community of apartment owners o Agreement with the building manager in an acceptable wording o Energy efficiency measures project based on an energy audit report, prepared by an appropriate specialist and approved by competent state or municipal institution o Multi-apartment residential building complying with certain criteria: the building divided into apartments, non-residential area does not exceed 25% of the total area, one owner does not own more than 20% of the total number of apartments
<i>Payment frequency</i>	Monthly
<i>Security</i>	<ul style="list-style-type: none"> - Public commercial pledge on the accounts receivables from the apartment owners to the building management company; - In relation to building managers, which are not entities registered with the commercial register, a deposit and assignment agreement
<i>Prepayments</i>	No restrictions or added fees
<i>Loan write-off</i>	To be discussed
<i>Implementation of the project</i>	<ul style="list-style-type: none"> o Energy efficiency measures project reviewed by an energy auditor; o Construction process supervised by a construction supervisor and author's supervisor, both with professional civil liability insurance
<i>Measures eligible for financing</i>	Measures included in the project and approved by the energy audit report prepared by an appropriate specialist and measures included in the technical design or simplified renovation documentation that ensures sustainability of those energy efficiency measures and approved by a competent state or municipal institution
<i>Self – financing</i>	Certain minimum down-payment could be required

2.8. Obstacles for implementation of the loan product

Below we list certain obstacles, which could encumber the implementation of the above proposed loan product:

- (i) as experience in Lithuania has shown it is difficult to have sufficiently high demand for preferential renovation loans by apartment owners upon termination of the grant system. To overcome these difficulties maintaining of some grant element could be considered.
- (ii) interest of the lending institutions to issue renovation loans within the scope of the JESSICA loan product could decrease. Currently banks are active in lending renovation

- loans, since the ERDF grant is regarded as a form of security by the lending institutions.
- (iii) noting the limited experience with defaults of the renovation loans, from a legal point of view we doubt that in the existing structure of the ERDF grant system and bank lending, there is an actual possibility to accelerate the loan and request immediate repayment of the loan from the apartment owners, even if there is a respective decision in the decision of the community of apartment owners. We propose to resolve this issue by, first, requesting certain financial quality of the building management company and duty to change the building management company as well as binding nature of the renovation loan liabilities to the new building management company.

3. Loan product to ESCO

3.1. General principles and analysis of loan product to ESCO

Noting the existing limited experience in renovations of multi-apartment residential buildings through an ESCO model one of the aspects of such renovations is lack of experience in implementation of energy efficiency measures and partly also unwillingness of apartment owners and building management companies to get involved in the renovation process of residential buildings, a JESSICA loan or equity product to ESCOs could facilitate overcoming of these difficulties. There are few ESCOs in Latvia, though interest exists among the commercial entities. Support through JESSICA instruments could assist in developing this market, which may lead to development of professional companies in the field of implementation of energy efficiency measures.

From the legal point of view terms of the energy performance agreement shall be elaborated as foreseen in the Energy End-use Efficiency Law. Currently the law outlines the main terms of the EPC as follows: firstly, the provider of energy efficiency fully finances the measures from its own resources and third party resources or only from its own resources or only from third resources, and secondly, investments are fully covered by the resulting energy savings. Thus the ESCO assumes financial, technical or commercial risks fully or partly. From the definition provided the Energy End-use Efficiency Law we conclude that the state inclines to support the so-called shared savings ESCO model.¹⁶⁸

Further, if any JESSICA product is going to be offered to ESCO such companies shall be defined to provide qualitative criteria as to which company could qualify as an ESCO. It is also worth considering introducing a register of ESCOs held by the Ministry of Economics, similarly as for construction merchants.

Below we outline the loan product as possibly more demanded than equity or guarantee product in the potential ESCOs market. Though it must be admitted that depending on the scope of the loan product to cover renovation works costs, guarantee for the remaining financing of the renovation works costs could be also in demand.

3.2. Principal conditions for granting JESSICA loan product to ESCO

We have identified the following principal conditions which shall be fulfilled for receipt of JESSICA loan product by ESCO:

- (i) Energy Performance Contract.

This contract is entered into between the ESCO, building manager, community of apartment owners and lending institution, which is the basis for implementation of the energy efficiency measures project. Under this contract the ESCO undertakes to implement energy efficiency measures and provide subsequent services, similar to a general contractor, while the building manager ensures collection of the payments from the apartment owners as set in the EPC, which should cover the costs for utilities as

¹⁶⁸ Please see Section D of this Study.

well as energy savings in terms of money to be transferred to ESCO. The building manager receives a fee as a percentage for the provided services under EPC.

According to the Energy End-use Efficiency Law the Ministry of Economics has been assigned a duty to prepare and publish a model EPC.

The transfer of the title to the investments made by ESCO depends on the state aid solutions.

Change of the ESCO to EPC will be possible only with consent of the lending institution.

- (ii) Decision of the community of apartment owners.

The subject of the decision would be the approval of the implementation of energy efficiency measures, a certain cost estimate and work project for the measures. The decision will also contain an authorisation to the ESCO to perform and to finance the project and would approve the payment for the ESCO services based on energy savings and calculated under the contract.

The decision should be adopted by at least two thirds of votes in favour.

- (iii) Energy efficiency measures project.

The energy efficiency measures will be based on an energy efficiency measures project, which should be based on an energy auditor report and accordingly prepared by a professional company.

To ensure higher quality of the projects a competent institution, like LIDA, energy agencies, could be required to confirm appropriateness of the energy efficiency measures project. Additionally as its implementation involves construction works, it has to be approved also by the construction board.

- (iv) Renovation loan agreement.

This agreement is concluded between the ESCO and the lending institution.

The purpose of the agreement will be implementation of energy efficiency measures in a certain multi – apartment residential building.

The disbursement of loan will be made against invoices for the goods or services in relation to the project.

- (v) Commercial pledge agreement.

Along with the loan agreement a commercial pledge agreement will be required to secure repayment of loan by ESCO. The pledge will be registered on the assets on the ESCO, which could also include certain equipment or facilities installed in the respective multi –apartment residential buildings, and if the building manager is also a legal entity registered with the commercial register, also on the accounts receivables by the building manager from the respective apartment owners.

- (viii) Assignment agreements

These agreements are concluded between the ESCO and the lending institution and between the building manager, notwithstanding its legal form, and the lending institution.

Under these agreements in case of default in the loan agreement, the apartment owners are obliged to make monthly payments directly to the lending institution.

This is a measure for enforcement of the commercial pledge agreements.

- (vi) ESCO implements the energy efficiency measures project

Taking into account the ESCO model, e.g. shared savings, as proposed, on its own risk implements the energy efficiency services project, involving the construction companies and supplies of the required services and goods. The works shall be controlled by a construction supervisor.

3.3. Liabilities of the parties

Further we outline the consequences in case of default of a party in the structure of the JESSICA loan product to ESCO:

- (i) Default of apartment owners

The apartment owners in relation to payments have a duty to make payments to the building manager based on the building management agreement.

In case the apartment owners default on payments, the building manager will be entitled to request contractually agreed penalties and turn claim against the respective apartment owner.

There are no securities to be enforced.

- (ii) Default of the building manager under EPC against the ESCO

The building manager has a duty to ensure that the ESCO receives all due payments, which are collected from the apartment owners. ESCO is entitled to receive payments notwithstanding whether the apartment owners have fulfilled their payment liabilities.

Therefore in this relation the ESCO will be entitled to calculate penalties contractually agreed under EPC and raise claim against the building manager. Ultimately the ESCO could request change of the building manager.

There are no securities to be enforced.

- (iii) Default of the ESCO against the lending institution

In case ESCO defaults on payments against the lending institution, the lending institution will be entitled to exercise the rights arising out of the commercial pledges, if applicable, through assignment agreements and request monthly payments by the apartment owners to be made directly to the lending institution and/or request the building manager to make payments directly to the lending institution. Also the lending institution will be entitled to enforce the pledge by selling the rights of claim to a third party for a market price.

In this case the lending institution will also be entitled to enforce the pledge right over the assets of ESCO by selling the subject of pledge to a third party.

In case the lending institution accelerates the loan, it will be the liability of ESCO to return the loan.

3.4. Main parameters of the loan product to ESCO

Based on the above a possible JESSICA loan product to ESCO could have the following characteristics:

Table 11: characteristics of possible JESSICA loan product to ESCO

Parameter	Description
<i>Product</i>	Fixed interest loan
<i>Borrower</i>	ESCO
<i>Preconditions</i>	<ul style="list-style-type: none"> o Decision of the community of apartment owners to enter into EPC o EPC between the building management company, ESCO and lending institution, representative of apartment owners o Energy efficiency measures project approved by a competent institution
<i>Payment frequency</i>	Monthly
<i>Security</i>	Public commercial pledge on the accounts receivables from the apartment owners to the building management company and on the assets of ESCO
<i>Prepayments</i>	To be discussed
<i>Re-financing</i>	To be discussed
<i>Loan write-off</i>	None
<i>Implementation of the project</i>	<ul style="list-style-type: none"> o Energy efficiency measures project approved by an energy auditor; o Construction process supervised by a construction supervisor and author's supervisor, both with professional civil liability insurance
<i>Measures eligible for financing</i>	Measures included in the project and approved by the energy auditor and measures included in the technical design or simplified renovation documentation that ensures sustainability of those energy efficiency measures and appropriate state and municipal institutions
<i>Self – financing</i>	10 – 20% of the loan amount

4. Required amendments to law

In order to introduce the JESSICA loan products as set out above and to improve the clarity of the related legal relationships, we would propose the following amendments to the laws or new regulations:

- (i) Law On Management of Residential Buildings - if the apartment owners have decided on implementation of energy efficiency measures and have decided that the building manager takes loan for implementation of such measures, then such liabilities of the building manager are binding on any new building manager;
- (ii) Law On Management of Residential Buildings - all expenditures incurred by the building manager for the residential building or on behalf of the apartment owners, within the scope of a legally adopted decision of a community of apartment owners, shall be borne by the apartment owners according to their joint property share in the residential building;
- (iii) Regulations whereby a public register is created by the Ministry of Economics listing the buildings, the owners of which have decided and received renovation loan on implementation of energy efficiency measures and decided on taking of loan;
- (iv) Regulations whereby ESCOs are defined subject to qualitative criteria and included in a register of ESCOs held by the Ministry of Economics, similarly as for construction merchants.
- (v) To supplement Article 13 of the Law On Apartment Ownership with the new section providing that when an apartment owner sells the apartment, the buyer shall take over outstanding payment liabilities arising from the decision of the community of apartment owners on settlement of expenditures for the performance of building management activities.

5. Possibilities for borrowing by municipalities

5.1. Obligations of the municipalities to get involved in projects promoting (increasing) energy efficiency

Involvement of municipalities in the projects implementing energy efficiency in Latvia is regulated by the following legislative enactments:

- (i) Law on Municipalities;
- (ii) Law on Assistance in Solving Apartment Matters;
- (iii) Law on The Energy Efficiency of Buildings;
- (iv) Energy End-use Efficiency Law.

Laws and regulations do not provide direct obligations for municipalities to get involved in implementation of the activities increasing energy efficiency. However the municipalities are involved in this area by realizing one of its autonomous functions provided in the Law on Municipalities - to provide assistance to residents in solving apartment matters¹⁶⁹ or by realizing autonomous functions, which are performed as voluntary initiatives.¹⁷⁰

The Law on Assistance in Solving Apartment Matters¹⁷¹ provides that municipalities may provide assistance to an owner (owners) of a residential building or an apartment owner for the performance of energy efficiency measures in the residential building. The municipality may provide assistance for the performance of an energy audit, as well as for the renovation or reconstruction of the buildings in accordance with the opinion of the energy audit, observing the most efficient principle for the repayment of investments, the principles of sustainability,¹⁷² maximum energy saving and the utilisation of environment-friendly technologies.¹⁷² The procedure of the assistance is set in the secondary legislative enactments - binding regulations adopted by the Cabinet of Ministers. Detailed description of the municipality assistance in the energy efficiency renovations is provided in Section C, Part 2.1.2 of this Study.

Based on voluntary initiatives municipalities are entitled to perform various activities to increase energy efficiency, including development of energy efficiency action plans in the interests of the inhabitants of the respective administrative territory.¹⁷³ Also a municipality may adopt binding regulations to ensure fulfilment of a voluntary initiative. For example, the Riga City has developed the Sustainable Energy Action Plan for 2010 – 2020, which has been approved by the Riga City Council on 6 July 2010.

The municipalities by fulfilling their functions are entitled to establish organizations, societies, companies or invest in companies. In 2007 municipalities based on voluntary initiative commenced establishing of energy agencies with an aim to promote energy efficiency and use of renewable energy resources in public and private sectors as well as to ensure general availability of information on these issues. One of the examples of such organizations is the Riga Energy Agency.

Also Latvian municipalities have joined to the Covenant of Mayors established by the European Commission in 2008. Members of this covenant voluntarily undertake to promote (increase) energy efficiency in their territories and use renewable energy sources. The aim of the members of the covenant is to observe and exceed the target set by EU for decrease CO₂ emission by 20% until year 2020. This document has been accepted by more than 3000 European municipalities. In Latvia the municipalities of Riga, Jelgava, Jēkabpils, Tukums and Valmiera have already joined this covenant. Fulfilment of the liabilities undertaken by the Covenant of Mayors is vested in the energy agencies.

¹⁶⁹ Section 9 of Part 1 of Article 15 of the Law on Municipalities.

¹⁷⁰ Article 12 and Section 6 of Part 1 of Article 6 Law on Municipalities.

¹⁷¹ 6 December 2001 law On Assistance in Solving Apartment Matters, published in the official gazette *Latvijas Vēstnesis* on 22 December 2001, effective as from 1 January 2002 with amendments.

¹⁷² Part 1 of Article 5 of Law on The Energy Efficiency of Buildings.

¹⁷³ Article 12 of the Law on Municipalities and Part 3 of Article 9 of the Energy End-use Efficiency Law

The municipality may realize the above mentioned functions and other functions provided by law in accordance with the annual municipality budget or borrow the financial means in accordance with laws and regulations.

5.2. Social residential buildings

As mentioned in Section C of this Study within ERDF and CF joint Operational Programme „Infrastructure and Services“ two activities have been prepared for the measure „Energy Efficiency of Housing“ – activity 3.4.4.1 „Improvement of energy efficiency of multi-apartment residential buildings“ and activity 3.4.4.2 „Improvement of energy efficiency of social residential buildings“. The ultimate beneficiaries for this activity are tenants of social residential houses.

The support is available for social residential buildings owned by municipalities. A social residential building is defined by the Law On Social Apartments and Social Residential Buildings¹⁷⁴ and the municipality has the discretion of granting the status of a social apartment or a social residential building to real property owned by the municipality.

The beneficiary of the measure is a municipality and the aim of the measure is to increase energy efficiency of the social housing fund owned by the municipality, simultaneously raising its quality and sustainability and ensuring socially unprotected persons with appropriate residential space.

The financing may be requested for the following measures:

- (i) preparation of the project documents and supervision of the construction process and field supervision;
- (ii) decrease of energy resources consumption by the building, by ensuring at least fulfilment of two energy efficiency measures provided in the energy audit report;
- (iii) renovation and reconstruction of the building if at least two measures mentioned in the energy audit report have been realized.

According to the information provided by the Ministry of Economics as of 17 November 2011 two selections rounds of project applications have been completed and it is not planned to open any further selections rounds. Instead it is planned that the Environment Protection and Regional Development Ministry will organise tender of projects for energy efficiency of social buildings.

So far within the scope of this activity 59 projects have been approved with the total ERDF financing LVL 4 629 627,48, out of which as of 9 February 2012 15 projects have been completed with the total ERDF financing LVL 890 470,25. This number of the completed projects is said to increase due to termination of the construction season.

5.3. Municipalities rights to borrow

According to the Law on Municipality Budgets, a municipality is allowed to make short-term or long-term borrowings. A long-term borrowing is a borrowing with the maturity exceeding one year. Pursuant to Article 24 the municipalities are allowed to make long – term borrowings to perform economic and social programs. The total admissible increase of the municipalities' borrowings in the financial year is set by the annual law on state budget.

The Law on State Budget for Year 2011 provides the following amounts of increase of the municipalities' borrowings in the budget year of 2011:

¹⁷⁴ 12 June 1997 Law ON Social Apartments and Social Residential Buildings, published in the official gazette *Latvijas Vēstnesis* on 2 July 1997, effective as from 16 July 1997 with amendments.

- (i) increase in amount of 50 million LVL to ensure implementation of co-financed EU and other foreign financial aids projects, as well as for implementation of projects related to climate change financial instruments;
- (ii) increase in amount of 1 million LVL to ensure municipalities stabilization borrowing and to ensure implementation of co-financed EU and other foreign financial aid projects, as well as for implementation of projects related to climate change financial instruments;
- (iii) increase in amount of 40 million LVL for those infrastructure projects in which investments of the municipalities are not less than 75% from total expenses and the necessary borrowing is not more than 25% from total expenses upon putting into operation the object in 2011, and investment projects of municipality's boarding schools and social programmes;
- (iv) increase in amount of 3 million LVL for the investments to ensure prevention of emergency situations during the heating season and for purchase of fuel.

The Ministry of Finance is entitled to amend the above mentioned increase in the borrowings; nevertheless the sum of the increase may not be larger than the total increase of the borrowing provided for the municipalities.

The municipalities are allowed to borrow either in Latvia or abroad by issuing securities or entering into loan agreements. The general rule foresees that municipalities borrow by concluding loan agreements with the State Treasury. If a municipality intends to conclude an agreement with another lender, including a lender from abroad, the municipality has to receive approval from the Municipality Borrowing and Guarantee Control and Supervision Council and has to submit to the Ministry of Finance an application for implementation of a concrete project and a draft loan agreement. The Ministry of Finance is entitled to approve the transaction with the foreign lender, if its loan terms and conditions are more favourable than those offered by the State Treasury.

Taking into account the above it may be concluded that the municipalities, by observing the amounts of increase of the municipalities' borrowings in the budget year stated by the annual state budget law and by receiving an approval of the Municipality Borrowing and Guarantee Control and Supervision Council and the confirmation of the Ministry of Finance, could have rights to borrow from EU funds through UDFs with the aim to invest in energy efficiency renovations.

6. Fund Structure and Operation

The funds from the EDRF may finance expenditure in respect of an operation comprising contributions to support any of funds or other incentive schemes providing loans, guarantees for repayable investments, or equivalent instruments, for energy efficiency and use of renewable energy in buildings, including in existing housing¹⁷⁵. These operations may be organized in one of the following ways:

- (i) through the specifically established holding fund; or
- (ii) directly through the selected urban development funds (the UDFs) without establishing the holding fund.

The decision if the holding fund is needed while implementing the JESSICA financial engineering instruments should be taken by the national institution responsible for the implementation of financial engineering measures is the Ministry of Finance. According to the Law on Management of European Union Structural Funds and the Cohesion Fund of 15 February 2007¹⁷⁶ the Ministry of Finance is the Managing Authority, which tasks include ensure management of EU funds and their implementation efficiency, ensure drafting of planning documents and ensure management of technical assistance to implementation of EU funds and their implementation efficiency. Article 44 of the Regulation 1828/2006

¹⁷⁵ Article 44 of the Regulation No. 1083/2006.

¹⁷⁶ 15 February 2007 Law on Management of European Union Structural Funds and the Cohesion Fund, published in the official gazette *Latvijas Vēstnesis* on 23 February 2007, effective as from 1 March 2007 with amendments.

stipulates that where the structural funds finance financial engineering instruments organised through holding funds, the Member State or the Managing Authority shall conclude a funding agreement with the holding fund, setting out funding arrangements and objectives.

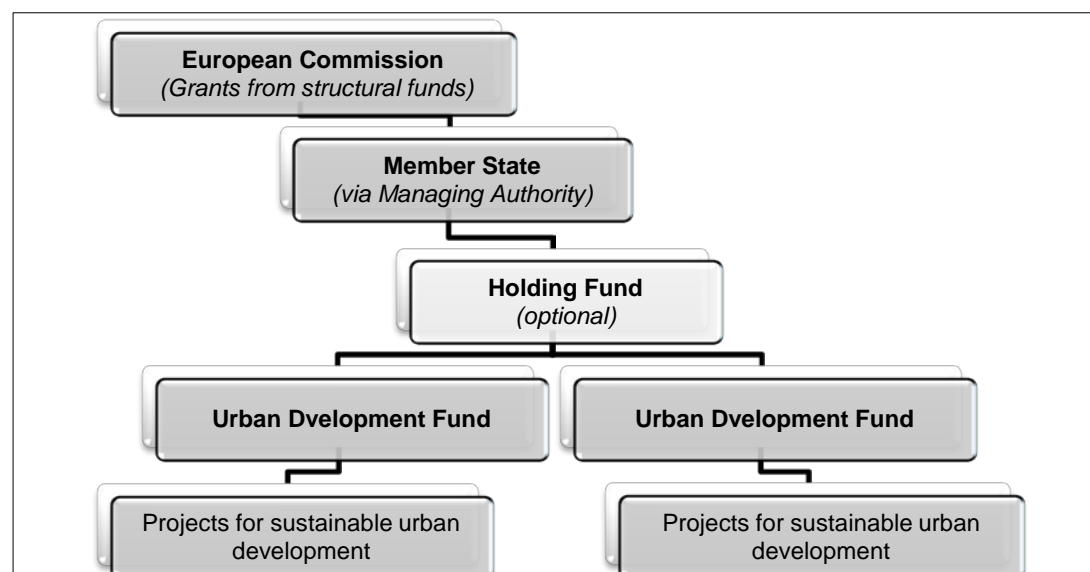


Table 12: JESSICA Implementation Scheme¹⁷⁷

6.4. Deciding whether to Establish the Holding Fund

The importance of the role of the holding fund should be evaluated thoroughly before making the final decision. As one of the most important issues to consider while deciding whether to establish the holding fund is proper evaluation of the potential UDFs, which could manage to act independently. As it is emphasized in *JESSICA – Holding Fund Handbook*¹⁷⁸, in most regions, potential UDFs are still at an early stage of their investment capabilities and the maturity of the market is not sufficient. Particularly in such cases the holding fund may play an important role in promoting the emergence of UDFs and in encouraging local public authorities to use the JESSICA initiative for their investments in sustainable urban development¹⁷⁹.

Main activities of the holding fund may be defined as follows:

- (i) implementation of the investment strategy, which has been agreed with the Managing Authority;
- (ii) selection of UDFs, pursuing the negotiations with UDFs regarding the operational agreements;
- (iii) evaluation and, where appropriate, review of the business plans submitted by UDFs;
- (iv) monitoring and control of the implementation of the operational agreements;
- (v) reporting on the progress of the various investments; and
- (vi) ongoing treasury management of the outstanding balance of the JESSICA funds¹⁸⁰.

Accordingly to the experience in other countries, the main advantages and added value of existence of the holding fund within JESSICA scheme are that the holding fund:

¹⁷⁷ Joint European Support for Sustainable Investment in City Areas. http://www.eib.org/products/technical_assistance/jessica/ (official website of European Investment Bank ; accessed on 30 January 2012)

¹⁷⁸ Joint European Support for Sustainable Investment in City Areas – Holding Fund Handbook, 2010. http://www.eib.org/attachments/documents/jessica_holding_fund_handbook_en.pdf (official website of European Investment Bank)

¹⁷⁹ Ibid., p. 14.

¹⁸⁰ Ibid.

- (i) ensures independent and professional management of funds by performing all main activities, such as treasury managements, risk management, monitoring, reporting on the implementation;
- (ii) may professionally allocate funds to several UDFs, which may have different features and characteristics according to the investment goals they pursue;
- (iii) may be a valuable temporary technical assistance structure, supporting the Managing Authority in the acquisition of sufficient skill and knowledge to manage and supervise the UDFs as it may be required in later stages;
- (iv) has a potential to manage the resources from different operational programmes¹⁸¹.

It should be noted, however, that the added value of the holding fund mechanism is lower if: (i) UDF-type structures are already active in the market; (ii) only one UDF is going to be selected; (iii) the Managing Authority already has expertise in urban planning, public-private partnerships, European Union fund management and financial engineering instruments. Also, the choice of establishing a holding fund can be complex and potentially time-consuming due to the need to reach agreement on the manner in which UDF capital can be invested, requiring validation at several levels within the holding fund structure. With a holding fund, an additional layer of reporting and monitoring is introduced¹⁸².

It is important to mention that other Member States are tending to choose the system with holding funds: currently the EIB manages 19 holding funds in 9 Member States, 1 holding fund has been set up with a national institution (in Estonia) and 3 UDFs are acting without holding funds (in Germany and the United Kingdom)¹⁸³.

Due to the fact that Latvia has limited experience in managing financial engineering structures, the establishment of the holding fund for the implementation of JESSICA initiative may have more preferences than drawbacks. The existence of the holding fund would definitely allow ensuring the most professional and efficient implementation of JESSICA product in the country. This would also comply with general practice of JESSICA initiative implementation in other Member States and, particularly for this reason, Latvia could benefit from all JESSICA related materials already created and used in other Member States. It is also worth mentioning that the same decision in Latvia has been made in relation to JEREMIE initiative were the EIF has been selected to act as the holding fund.

6.5. Options for the Establishment of the Holding Fund

In those cases where the Member State chooses to establish the holding fund, it should evaluate options provided by EU Structural Funds regulations. Commission Regulation (EC) No. 1828/2006 of 8 December 2006 setting out rules for the implementation of Council Regulation (EC) No 1083/2006 laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and of Regulation (EC) No 1080/2006 of the European Parliament and of the Council on the European Regional Development Fund (the Regulation No. 1828/2006) stipulates that financial engineering instruments, including holding funds, have to be:

- (i) independent legal entities governed by agreements between the co-financing partners or shareholders; or
- (ii) as a separate block of finance within a financial institution – in this case it is necessary to keep separate accounts, which distinguish the new resources invested in the financial engineering instrument¹⁸⁴.

Article 44 of the Regulation No. 1083/2006 defines three possible forms under which the holding fund may be implemented:

- (i) the award of a public contract in accordance with applicable public procurement;

¹⁸¹ Ibid. p. 15, 27, 28.

¹⁸² Ibid., p. 27, 28.

¹⁸³ Frank Lee, *JESSICA and Energy Efficiency*, 2011.

¹⁸⁴ Article 43(2) of the Regulation No. 1828/2006.

- (ii) the award of a contract directly to financial institution; or
- (iii) the award of a contract directly to the EIB or the EIF¹⁸⁵.

In any case it is highly recommended that the Managing Authority would have preliminary discussions with the European Commission and with the EIB in order to benefit from prior experience and to optimise the decision making process regarding the above schemes¹⁸⁶.

6.5.1. Public Procurement Process

This option requires for the Managing Authority to perform the selection of the holding fund through a procurement process. Public procurement in selecting the holding fund is meant to ensure that the selection of a particular institution is transparent based on clear and objective criteria, in accordance with market terms, and that no inadmissible preference is given to one institution over another.

It is important to notice that currently there are no current examples of JESSICA holding funds being selected through a procurement process¹⁸⁷. Such tendencies may be because of complexity of public procurement procedures – as in all typical procurement process, tender documents should be prepared in such a way that they would enable the Managing Authority to receive the best offers in terms of quality and financial conditions, and to select the best body for the role of the holding fund.

6.5.2. Direct Contract with Financial Institution

In those cases when it is decided to appoint financial institution (other than EIB or EIF) without organizing public procurement, such selection procedures may be performed without a call for proposals, if this is compatible with national law. It is expected that the said national law would:

- (i) designate the financial institution in question;
- (ii) present the public policy objectives justifying the direct award of a grant to it; and
- (iii) justify the existence within this financial institution of the expertise necessary for the successful accomplishment of the holding fund tasks¹⁸⁸.

The Guidance Note on Financial Engineering Instruments under Article 44 of Council Regulation (EC) No 1083/2006¹⁸⁹ (COCOF Note) stipulates additional recommendation regarding the selection of such institution – it is suggested that the target financial institution would be one already involved in activities related to urban development and in the management of financial engineering instruments¹⁹⁰.

Within this context two Latvian institutions may be mentioned:

- (i) Latvian Guarantee Agency¹⁹¹, which is a state-owned limited liability company where holder of state shares is Ministry of Economics of Republic of Latvia. Since 2003, this

¹⁸⁵ Within the context of JESSICA only EIB may be chosen as EIF is mandated to implement particularly JEREMIE initiative.

¹⁸⁶ *Preliminary steps to JESSICA implementation: Joint European Support for Sustainable Investment in City Areas – Holding Fund Handbook*, 2010. http://www.eib.org/attachments/documents/jessica_holding_fund_handbook_en.pdf, p. 24 (official website of European Investment Bank)

¹⁸⁷ *Ibid.*, p. 27.

¹⁸⁸ *Ibid.*, p. 7.

¹⁸⁹ European Commission, *Guidance Note on Financial Engineering Instruments under Article 44 of Council Regulation (EC) No 1083/2006*, http://www.eib.org/attachments/documents/jessica_cocof_february_2011_en.pdf (official website of European Investment Bank).

¹⁹⁰ *Preliminary steps to JESSICA implementation: Joint European Support for Sustainable Investment in City Areas – Holding Fund Handbook*, 2010. http://www.eib.org/attachments/documents/jessica_holding_fund_handbook_en.pdf, p. 26 (official website of European Investment Bank).

¹⁹¹ For more information on Latvian Guarantee Agency please visit: <http://www.lga.lv/en/about-us/>.

agency enacts tasks defined by state economic policy and backs businesses to attract new investments for further expansion. It is planned that this agency should take over the function of the EIF currently acting as the holding fund in Latvia within the framework of JEREMIE initiative.

- (ii) Latvian Mortgage Bank¹⁹², which is the only 100% state-owned commercial bank. It is currently active in the financing small and medium size enterprises.

6.5.3. Direct contract with the EIB

All but one JESSICA holding funds have been established in accordance with 43, par. 3 of the Commission Regulation (EC) No. 1828/2006 as a “separate block of finance” within EIB. Such selection of Member States may be explained by that fact that currently only the EIB has both the technical and financial competences to act as a Holding Fund, when requested by Member States and is a key player in the launch of the JESSICA initiative.

6.6. Initiation of the Holding Fund Activities

6.6.1. Funding Agreement

In order for the holding fund to properly start its operations it is necessary to sign the funding agreement between the Managing Authority and the body responsible for the ongoing management of the holding fund. The funding agreement is intended to define the terms and conditions for contributions from operational programmes to the financial engineering instrument.

The Regulation No. 1828/2006 provides for the conclusion of funding agreements at two levels:

- (i) Level I – when funding agreement is concluded between the Member State or the Managing Authority and the holding fund, where financial engineering instruments are organised through holding funds; or
- (ii) Level II – when funding agreement is concluded between the Member State or the Managing Authority (or the holding fund where applicable) and the individual financial engineering instruments¹⁹³.

The EU Structural Funds Regulations do not prescribe the content of the funding agreements in details and Member States and Managing Authorities have freedom to negotiate and conclude funding agreements. They may choose to follow existing models of other operations financed under the Structural Funds programmes or models used by in the market. In addition to ensuring that the funding agreements respect applicable EU and national law, as well as regulatory provisions applicable to the market, the funding agreements must, as a minimum, include the provisions indicated in EU Structural Funds Regulations¹⁹⁴.

According to Article 44(2) of Regulation No. 1828/2006, the funding agreement should at least contain the following elements:

- (i) the terms and conditions for contributions from the operational programme to the holding fund;
- (ii) calls for expression of interest addressed to financial engineering instruments in accordance with applicable rules;
- (iii) the appraisal and selection of financial engineering instruments by the holding fund;
- (iv) the setting up and monitoring of the investment policy or the targeted urban development plans and actions;
- (v) reporting by the holding fund to Member States or managing authorities;
- (vi) monitoring of the implementation of investments;

¹⁹² For more information on Latvian Mortgage Bank please visit: <http://www.hipo.lv/en>.

¹⁹³ COCOF Note, p. 8.

¹⁹⁴ COCOF Note, p. 9.

- (vii) audit requirements;
- (viii) an exit policy for the holding fund out of the financial engineering instruments; and
- (ix) the provisions for the winding-up of the holding fund, including the reutilisation of resources returned from investments made or left over after all guarantees have been honoured which are attributable to the contribution from the operational programme.

It is also recommended to cover the following issues:

- (i) governance rules of the holding fund covering the issues related to the implementation of the investment strategy;
- (ii) set-up of an Investment Committee (if applied). It is an option offered in order to improve the decision-making process, avoid conflicts of interest and enhance the overall fund's governance;
- (iii) holding fund budget, applicable fees and eligible expenditures; and
- (iv) appropriate measures to be taken in the event of a dispute (e.g. due to a delay or a failure of a party to comply with its obligations), and the provisions for termination of the contract¹⁹⁵.

After the signature of the funding agreement, the Managing Authority is able to transfer the funds to the holding fund¹⁹⁶.

6.6.2. Investment Strategy

One of the most important parts of the funding agreement is the investment strategy, which reflects the objects and targets of the established JESSICA initiative. All of the targets of the investment strategy have to be in line with respective operational programme.

In practice, the investment strategy usually sets out the principles of cooperation between the Managing Authority and the holding fund, where this is established, for the preparation, programming and implementation of the JESSICA instrument within the region or country. The investment strategy normally takes into account any relevant urban development priorities or evaluations and any integrated urban development plans or strategies included in the specific operational programme¹⁹⁷.

It is also possible that in those cases where no existing financial vehicle on the market is ready to take on the role of a UDF, the investment strategy can include additional actions to be taken by the holding fund or the Management Authority in order to identify appropriate partners¹⁹⁸.

6.7. Selection of UDFs

If the holding fund is establishment, it should proceed with procedures for the selection of the appropriate UDFs for the implementation of JESSICA initiative. If it has been decided not to establish the holding fund, these procedures are being implemented by the Managing Authority itself.

Two main options for the selection of UDFs are:

- (i) UDFs are procured in case potential UDFs already exist in the market; or
- (ii) creation of appropriate UDFs is initiated in cases there are no potential UDFs in the market¹⁹⁹.

¹⁹⁵ *Holding Fund Processes*. Joint European Support for Sustainable Investment in City Areas – Holding Fund Handbook, 2010, p. 30, 31. http://www.eib.org/attachments/documents/jessica_holding_fund_handbook_en.pdf (official website of European Investment Bank).

¹⁹⁶ *Ibid.*, p. 32.

¹⁹⁷ *Ibid.*, p. 17, 18.

¹⁹⁸ *Ibid.*

¹⁹⁹ *Ibid.*, p. 39.

Based on the current JESSICA initiative implementation in other Member States, the selected and operating UDFs usually fall in one of the following categories:

- (i) financial institutions – commercial banks, development banks, insurance companies, leasing companies, non-deposit taking finance companies, etc.;
- (ii) public institutions – public sector companies with explicit public sector support;
- (iii) corporate – limited liability companies, including public sector companies and utilities without implicit public sector support; and
- (iv) investment funds – venture capital funds, equity funds, etc²⁰⁰.

7. State Aid Issues

State aid issues may be present at various levels of implementation of JESSICA loan product in Latvia:

- (iv) selection of UDFs and/or other financial intermediaries;
- (v) provision of loans to management companies and co-operative societies of apartment owners acting for the benefit of apartment owners;
- (vi) aid to apartment owners and associations of apartment owners; and
- (vii) provision of loans or equity to ESCOs acting under EPC agreement.

7.1. Establishment of existence of State aid

In order to establish the existence of state aid under Article 107(1) of the Treaty on the Functioning of the European Union (Treaty) all of the following four conditions must be present:

- (i) the measure must be granted by the state or through state resources;
- (ii) the measure must confer an advantage on the recipient undertaking;
- (iii) the measure must be selective in so far as it favours only certain undertakings or the production of certain goods;
- (iv) the measure must be liable to distort competition and affect trade between EU Member States.

7.1.1. Granted by the state or through state resources

The first condition means that by granting the measure the state will incur a cost of some kind, regardless of whether state aid is granted directly by the state or by a public or private body designated or established by the state²⁰¹. The same will apply irrespective of whether the measure involves direct expenditure of state resources, or the state foregoes revenue that would otherwise have accrued to it. Therefore, financial transfers that constitute state aid are not limited to direct grants or subsidies, but may also include tax exemptions, loan guarantees, interest rate rebates, accelerated depreciation allowances, capital injections, provision of capital at favourable conditions, sale of state property at a devalued price, acquisition of overvalued goods, services or works, etc. In addition it is also necessary to demonstrate that the state is involved in adoption of the measure²⁰². Therefore, there may be

²⁰⁰ Ibid., p. 40.

²⁰¹ Case C-200/97 *Ecotrade Srl v Altiforni e Ferriere di Servola SpA (AFS)* [1998] ECR I-7907; Case C-379/98 *PreussenElektra AG v. Schleswag* [2002] ECR I-2099.

²⁰² Joined Cases 67,68 and 70/85 *Van der Kooy BV and others v. Commission* [1988] ECR 219; Case T-358/94 *Air France v. Commission* [1996] ECR II-2109.

cases where a measure granted by a public undertaking, which enjoys a sufficient degree of autonomy, will not be considered as granting state aid.

7.1.2. Advantage on the recipient undertaking

State aid may only be found when there is a favouring of certain undertaking or the production of certain goods. An advantage must be granted by means of a measure, which would not otherwise be available to the undertaking or certain goods (services), would not be produced (provided). In essence this means that an advantage exists if the beneficiary obtains something without an obligation to deliver services or goods of adequate value, or the beneficiary is relieved of a burden that it would otherwise have to bear from its own budget²⁰³.

In relation to commercial activities of the state or entities controlled by the state, it is considered that the advantage is granted when the state enters into transactions that are more favourable for the undertaking concerned than could be achieved under market conditions. By contrast, whenever the positive effect of a measure is obtained under normal market conditions, the undertaking does not obtain an advantage that would be relevant under Article 107(1) of the Treaty. It should also be noted that the mere fact that an undertaking enters into a transaction with a state or an entity controlled by the state is not sufficient to conclude the existence of state aid. From the undertaking's point of view there always should be a benefit resulting from entering into a commercial transaction, which should provide revenue and serve for improvement of its position in the market. However, this "advantage" is irrelevant as long as the transaction has been made under the conditions at which any undertaking (being in the position of the state) requiring the same services (goods) and acting on the basis of market economy principles, would also enter into the transaction²⁰⁴.

7.1.3. Selectivity

Apart from granting the advantage to the beneficiary, a measure must also be selective, i.e. favouring only certain entities or production of certain goods. On the contrary, the measure would not amount to state aid where the measure is of general nature and provides a benefit to all companies and/or goods.

7.1.4. Distortion of competition and affect trade between the Member States

Distortion of competition and effect on trade between Member States are two very broad concepts. For a finding of distortion of competition it is sufficient that a beneficiary undertaking is active in any industry where competition prevails²⁰⁵. Similarly, in order to establish that the measure may affect trade between Member States, it is sufficient to conclude that a beneficiary undertaking conducts activities involving trade between Member States, even if such activities are marginal to the undertaking's business²⁰⁶.

7.2. Notification requirement

According to Article 107(1) of the Treaty, any state aid, which satisfies the conditions listed therein, is incompatible with the common market and is prohibited. It may only be authorised, if the support is provided in compliance with acceptable justification for it. Where the state considers that the planned state aid qualifies under Article 107(1) of the Treaty, but may fall within the exceptions of prohibition provided for in the Article 107(3) of the Treaty, Article 108(1) of the Treaty requires Member states to inform the European Commission in advance of any plan to grant state aid. Member states are required to inform the European Commission of any plan to grant or alter state aid and they are not allowed to put such aid into effect before it has been authorised by the European Commission.

²⁰³ Case C-143/99 *Adria-Wien Pipeline GmbH v Finanzlandesdirektion für Karnten* [2001] ECR I-8365; Case C-5/01 *Belgium v Commission* [2000] ECR I-11991.

²⁰⁴ Commission Decision (EC) 2001/247 [2001] OJ L89/28.

²⁰⁵ Case T-55/99 *CETM v Commission* [2000] ECR II-03207.

²⁰⁶ Case C-142/87 *Belgium v Commission* [1990] ECR I-959.

7.3. Selection of UDFs and/or other financial intermediaries

For implementation of JESSICA initiative certain financial institutions may be engaged to act as administrators of funds. It is understood that such financial institution will be acting only as an intermediary vehicle for the transfer of aid, rather than a beneficiary of aid itself. The financial institution will not carry out any commercial activities in relation to the support granted other than channelling of support to final beneficiaries. As a result financial institution will not be considered as a beneficiary of State aid in the sense of Article 107(1) of the Treaty, provided that the conditions of the agreement with the financial institution fully reflect the current market remuneration in comparable situations.

In order to minimize the risk that selection and award of contract to the selected financial intermediary provides any economic advantage, which goes beyond market conditions, the financial intermediary should be selected through a public procurement procedure. In accordance with the relevant practice of the European Commission²⁰⁷, the use of competitive, transparent and non-discriminatory procurement procedure, which is in line with the EU public procurement rules, implies that the procuring authority is getting the best value for money (at fair market conditions, including the price) and creates a presumption that no State aid will be granted to the undertaking concerned. Accordingly, the financial intermediary for administration of funds should be selected through a public procurement procedure, which is in compliance with the EU public procurement rules.

7.4. Provision of loans to management companies and co-operative societies acting for the benefit of apartment owners

Conclusion by management companies and co-operative societies of loan agreements in their own name on behalf of the apartment owners should not raise state aid issues provided that loan agreements are concluded exclusively for the benefit of the apartment owners and the apartment owners have full discretion in deciding on whether a loan agreement will be concluded by the apartment owners themselves or by the management company.

As mentioned above, for State aid to fall under Article 107 of the Treaty such State aid, in addition to other conditions, must be granted from State resources and must also be imputable to the State²⁰⁸, which is a separate and cumulative condition²⁰⁹, which must be satisfied in order for the support to constitute State aid.

It is at the sole discretion of the apartment owners and not the Latvian authorities to decide to take a loan through the management company. Rather it is only one of possibilities to implement the energy efficiency project foreseen in the applicable laws. The apartment owners will decide on whether to utilize funds under JESSICA initiative in implementing the energy efficiency project, or to use other available means for its implementation.

Moreover, even if as a result of the decision of the apartment owners the management companies will be entering into the loan agreements, the management companies will not in any way benefit from concluding such a loan agreement, nor will they incur any significant risks related thereto. The managing companies will in fact serve merely as a vehicle for obtaining and allocating resources granted to the apartment owners and for their sole benefit. The funds shall be used by the management company to pay the contractors directly. The repayment of the loan shall also be secured by the apartment owners through pledge of receivables and assignment agreement for collection of receivables directly by the issuer of the loan.

The administration fee, which will be paid from the apartment owners own resources to the

²⁰⁷Case N 46/2007 "Welsh Public Sector Network Scheme", United Kingdom, 30.05.2007; Case N 425/2004 "Kaunas Free Economic Zone", Lithuania, 01.06.2005; Case N 24/2007 "Prague Municipal Wireless Network", Czech Republic, 30.05.2007.

²⁰⁸ See e.g. Joined cases 67, 68 and 70/95 *Van der Kooy BV and others v. Commission* [1998] ECR 219; case C-305/89 *Italy v. Commission (Alfa Romeo)* [1991] ECR I-1433; case T358/94 *Air France v. Commission* [1996] ECR II-2109.

²⁰⁹ Case T-351/02 *Deutsche Bahn AG v. Commission* [2006] ECR II-01047.

management company for its services will be subject to the agreement between the management company and apartment owners, who will also directly pay the relevant administration fee, thus no state resources will be utilized.

The same arguments are valid and applicable in case co-operative societies of apartment owners, which shall be considered as an undertaking within the meaning of State aid issues, enter into loan agreement for the benefit of apartment owners.

7.5. State aid to the apartment owners and associations of apartment owners

State aid rules with respect to apartment owners are applicable only if an apartment owner is considered to be an undertaking, i.e. an entity engaged in an economic activity. The term economic activity encompasses a broad range of activities and should be understood as any activity which involves the offering of goods and services on a relevant market. Therefore, apartment owners could be treated as undertakings for the purposes of state aid rules if they use their apartments to engage in economic activity.

In the exceptional cases, where apartment owners carry out economic activities in their apartments, support granted for implementation of modernisation project could be treated as state aid. Although exact amounts, which are required for implementation of energy efficiency project are unknown, it is estimated (by taking an example of similar projects implemented in Lithuania) that, on average, the amount needed for implementation of energy efficiency project per apartment should not exceed EUR 10,000, i.e. the amount of loan per apartment owner, and the basis for calculation of cash grant equivalent, should not exceed this amount.

However associations of apartment owners pursuant to law shall not have a profit-making nature, thus they in principle are not entitled to carry out economic activities.

Taking into consideration this average amount of State aid, any support granted to the apartment owners or association of apartment owners is likely to fall under Commission Regulation (EC) No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to *de minimis* aid (*De Minimis* Regulation)²¹⁰, which establishes that state aid up to EUR 200,000 over any 3 fiscal year period is considered *de minimis* aid and is exempted from notification requirement.

7.6. Provision of loans or equity to ESCOs

In cases when JESSICA initiative will be implemented by providing loans or equity to ESCOs, and this will be done at rates, which will be better than market terms, ESCOs will likely be receiving state aid pursuant to Article 107 (1) of the Treaty. Firstly, they will gain a competitive advantage, which they would not have obtained under normal market conditions. Secondly, the aid would be selective since it would be limited to ESCOs, which are engaged in implementation of energy efficiency projects. Finally, the aid would have the potential to affect the trade between Member States and to distort competition because ESCO companies are active in implementation of energy saving projects, i.e. a sector where trade between Member States takes place.

Thus, the measure would have to be notified to the European Commission prior to its implementation, unless the measure would fall under any of the existing exceptions, which relieve from the notification obligation.

A few most relevant exceptions for State aid granted to ESCOs in relation to implementation of the measure, which would allow granting of State aid without first notifying it to the European Commission are the following:

- (i) developing or adapting the measure to omit or minimise the element of State aid;

²¹⁰ (Official Journal L 379 of 28.12.2006)

- (ii) granting limited amounts of State aid under *De Minimis* Regulation;
- (iii) adapting the measure to satisfy the requirements of State aid granted to undertakings entrusted with the operation of services of general economic interest (SGEI).

7.6.1. Omitting or minimising the element of State aid

In order to eliminate the element of State aid in granting loans or equity to ESCOs must receive on that that they would be able to obtain under normal market conditions. Therefore, any financing must be granted to ESCOs under market conditions, i.e. financing should be granted at market cost and terms.

7.7. De minimis aid

De Minimis Regulation covers small amounts of State aid (*de minimis* aid) which do not constitute State aid in the sense of Article 107(1) of the Treaty.

To benefit under the *De Minimis* Regulation, State aid has to satisfy the following criteria:

- (i) The amount of the aid must not exceed EUR 200,000 (cash grant equivalent) over any three fiscal year period;
- (ii) The maximum amount of EUR 200,000 applies to the total of all public assistance considered to be *de minimis aid*;
- (iii) The ceiling of the maximum amount applies to aid of all kinds, irrespective of the form it takes or the objective pursued;
- (iv) The *De Minimis* Regulation only applies to transparent forms of aid, which means only aid for which it is possible to determine in advance the gross grant equivalent without needing to undertake a risk assessment. For instance, where the State aid is granted in the form of loans, the gross grant equivalent must be calculated on the basis of market interest rate prevailing at the time of granting of the State aid. The market interest rate is calculated in accordance with Communication from the Commission on the revision of the method for setting the reference and discount rates (2008/C 14/02).

Although we do not have any calculations of the exact amounts of State aid, which will be made available to ESCOs, it is our understanding that such amounts will be exceeded.

7.8. Services of general economic interest

Services of general economic interest (SGEI) mean economic activities that public authorities identify as being of particular importance to citizens and that would not be supplied (or would be supplied under different conditions) if there was no public intervention. The activity must exhibit special characteristics as compared with the general economic interest of other economic activities.

The criteria for determining whether the compensation may amount to State aid are derived from the judgment of the European Court of Justice in *Altmark*²¹¹ case. In its judgment the court held that public service compensation does not constitute State aid within the meaning of 107(1) of the Treaty provided that four cumulative criteria are met:

- (i) The recipient undertaking must actually have obligation to provide SGEI and the obligations must be clearly defined;
- (ii) The parameters on the basis of which the compensation is calculated must be

²¹¹ Case C-208/00 *Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH* [2003] ECR I-7747.

established in advance in an objective and transparent manner;

- (iii) The compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of SGEI obligations, taking into account the relevant receipts and a reasonable profit. Any compensation in excess of what is necessary to cover the costs incurred by the undertaking concerned is not necessary for the operation of the SGEI, and consequently would constitute incompatible State aid; and
- (iv) The undertaking for discharge of SGEI obligations should be selected through a public procurement procedure. Where the undertaking which is to discharge SGEI obligations is not chosen pursuant to a public procurement procedure, which would allow for the selection of the tenderer capable of providing those services at the least cost, the level of compensation needed must be determined on the basis of an analysis of the costs which a typical, well run undertaking would have incurred. In order to ensure that there is no overcompensation and to be in-line with UDF selection guidelines, ESCOs, even though their mandate will be foreseen in the applicable laws, should be selected on the basis of public procurement procedures, ensuring a transparent, fair and non-discriminatory process of selection of ESCOs.

If the above four conditions are not satisfied, State aid granted to ESCOs will meet the general criteria for the applicability of Article 107(1) of the Treaty, meaning that public service compensation would constitute State aid, which subject to prior notification requirements. However, the European Commission has issued a Decision of 28 November 2005 on the application of Article 106(2) of the Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest (Decision on SGEI), which specifies the conditions under which compensation to companies for the provision of public service is compatible with State aid rules and does not have to be notified to the European Commission in advance, even if it does not meet the *Altmark* criteria:

- (i) there must be a clearly defined public service mandate. This means that a legal act must establish (i) the nature and the duration of the public service obligations; (ii) the undertaking and territory concerned; (iii) the nature of any exclusive or special rights assigned to the undertaking; (iv) the parameters for calculating, controlling and reviewing the compensation; and (v) the arrangements for avoiding and repaying any overcompensation;
- (ii) there must be no over-compensation;
- (iii) compensation should not exceed EUR 30 million per year per undertaking; and annual turnover of less than EUR 100 million per undertaking.

Based on the above, in order for support to ESCOs not be treated as a State aid, which must be notified to and approved by the European Commission, the basis for ESCOs functioning and taking the role in renovation of multi-apartment houses should be foreseen in the applicable laws, which would also ensure that criteria established in *Altmark* judgement or the Decision on SGEI are fulfilled.

H. CONCLUSIONS

The need to renovate housing, and particularly multi apartment blocks, is enormous and improvement of the energy efficiency of such buildings is both a Latvian and EU priority objective. This action will also bring benefits of reduced energy bills for citizens, improved energy independence for the country, and significant potential for job creation in the energy services and construction sectors.

Expectations are that the Structural Fund grant allocation for multi apartment block renovations will be fully allocated towards the middle of 2012 and, together with a 4% upper limit imposed on the use of the funds for this specific purpose (a limit imposed in the Structural Fund Regulations themselves), the ability to allocate more ERDF funding for the remainder of the programming period is close to the limited. The potential investment need is also very significant, estimated at more than LVL 1 billion, with almost half of that expected to be undertaken before 2016. Delivering this level of investment will require significant levels of private sector funding, and there is also an argument to say that a more efficient way of using public sector grant funding should also be explored. This is where the JESSICA initiative represents a possible next step.

With this in mind, and based on a review of similar implementation structures in neighbouring Estonia and Lithuania, the proposal would be to establish a pilot revolving fund, during the current Structural Fund programming period, that will act both as a bridge to meet demand over the next two years, and possibly act as a “pathfinder” for the next EU Structural Fund’s programming period that should start in 2014. The need to make a smooth transition from one kind of support to another comes also from the Lithuanian experience where no renovations were made after grant financing at the amount of 50% was finished and preferential loans introduced – just preferential loans proved to be not motivating enough. Whether the revolving fund could be funded from remaining ERDF resources, carbon credit or other public funding sources remains for the Ministry to explore and decide upon.

Based on current demand levels for renovation work, such a pilot fund should be in the order of EUR 10-20m, and should most probably be implemented through local financial institutions as intermediaries (referred to as an Urban Development Fund should the JESSICA initiative be used). The report sets out at least two options for the financial product to be offered, both of which recognise the need still for an element of grant funding. This is felt necessary, given the expected psychological challenge of “converting” apartment block residents from grant to loan-type funding, and the fact that “deep” renovation measures often do not present sufficient cost saving potential to pay back within a reasonable period of time. Any grant element should be well targeted at those apartment blocks that achieve a certain minimum level of energy efficiency improvement.

Given the need to establish such a pilot fund in the shortest possible timeframe, we would recommend that this be implemented without the establishment of a holding fund. The procurement of such a financial instrument, which we think could be done before the end of 2012, could be undertaken by the Ministry themselves, using perhaps technical assistance from the EIB (which is well experienced in the procurement and establishment of such funds in the EU). Implementation on the ground, particularly if one is to consider the promotion of ESCO type models, could also be facilitated via the procurement of an “accredited” listing of contractors that apartment block building residents can then use without the need for individual procurement exercises, and hopefully providing some confidence that the “accredited” list have the minimum experience and financial standing to undertake the work.

Based on limited discussions with the banking intermediaries active in this sector in Latvia, one of the key risks is in respect of the repayment capability of individual residents in the buildings. With the current allocation of 50% grant funding, this risk is of course reduced, but with the introduction of a loan type instrument to substitute at least partially for this grant funding, the banking sector may indeed look for a form of credit guarantee/insurance product especially if the programme is to be accelerated and increased. Such role could potentially be played by the Latvian Credit Guarantee Agency.

In addition to technical assistance from EIB, there might also be the potential to receive complimentary long term loan financing from EIB. The ability to attract such funding would

very much depend on the credit quality of the financial intermediary chosen to act as the pilot fund and/or the availability of Latvian government support. It is recommended that this option be further explored.