From:	Andrew McCormick
To:	Stewart, Chris (DETI)
Cc:	McCormick, Andrew (DETI); Rooney, Eugene; Cooper, Trevor; Mills, John (DETI); Wightman, Stuart; Hill, Janice
Subject:	RHI McCormick to HOCS Tracked
Date:	02 February 2016 22:02:42
Attachments:	RHI McCormick to HOCS Tracked.DOCX

The attached should hopefully include John's changes as well as my own. Grateful for careful review and addition of any missing information.

Grateful if someone could look at this asking the question if there is anything I would regret excluding or including when the NIAO has completed a study and I am preparing for a PAC attendance.

Many thanks.

From: Andrew McCormick
Permanent Secretary

Tel: 29441

Email: andrew.mccormick@detini.gov.uk
janice.hill@detini.gov.uk

Date: 28 January 2016

Our ref: PS DETI [xxx/16]

To: HOCS
~~David Sterling DFP~~

Cc David Sterling
Chris Stewart
Eugene Rooney
Mike Brennan
John Mills
Stuart Wightman

RENEWABLE HEAT INCENTIVE (RHI)

1. In my note of 28 January I indicated that I would provide you with a fuller explanation and timeline of the genesis and evolution of the current RHI difficulty and DETI's response. I am also responding to the points raised in David Sterling's letter to me of 29 January.

2. In doing so I wish to address any incorrect impression given to you that both the problem and the solution were 'fully formed' and recognised in July 2015, and that DETI has failed to take the necessary action since then. In fact, whilst the problem began to emerge in early ~~summer~~spring, the full extent of the likely overspend and the need for suspension did not crystallise until December 2015. During that period DETI's actions developed in response to the evolving problem, in line with Ministerial decisions. The timeline of actions is set out at the Annex.

Background

3. The RHI schemes were introduced in parallel with comparable schemes for the rest of the UK led by DECC. They were central to the action to meet an Executive target (PFG) of having 4% of Northern Ireland's heating needs met from renewable sources by 2015, and a further target in the Strategic Energy Framework of achieving 10% renewable heat consumption by 2020. This is NI's

contribution to a binding UK target on renewable energy. The schemes have been given a high priority by Ministers Bell and Foster.

4. DECC introduced a non-domestic RHI scheme for GB in November 2011. DETI officials kept in touch with the emerging approach and developed a parallel scheme for Northern Ireland which was introduced in [month/year]. Both schemes are administered by OFGEM, which has responsibility for assessing applications and controlling contracts and payments.

5. The RHI legislation requires applications to be made after installation, that all properly made applications must be accredited. This means that it is possible for the demand for the scheme to increase without warning and without the natural constraint of an approving body needing to consider applications before eligible expenditure is incurred.

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~~4.~~6. From the outset, RHI schemes have been demand-led, and funded as Annually Managed Expenditure (AME). This recognised that demand can be volatile, and difficult to forecast. ~~HoweverThe GB scheme had a tiered tariff arrangement from the beginning, and from [month/year] a mechanism for cost control ("degression") was introduced. However~~From the outset, the AME funding arrangements were qualified by an expectation that demand would be managed year on year to remain within an overall cost envelope. In addition, HMT indicated that there would be a penalty ("..likely to be the order of 5~~%~~%") of any expenditure over 'budget' in any given year would be applied to Resource DEL (RDEL). The implications of this for the scheme design are covered below.

Contributing factors

~~5.~~7. There were ~~four~~ three factors that contributed to the exponential growth of projected spend, and the difficulty in bringing it under control:

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a. **The inherent vulnerability of the legislation** – The 'qualified AME' funding arrangements pointed to the need for demand management arrangements within the RHI legislation. However, the legislation was enacted without including any powers to close or suspend the RHI schemes. This was also the case in GB, though from [month/year] a mechanism for cost control ("degression") was introduced there. ~~Control mechanisms were only introduced later in GB.~~ While a consultation was carried out on a "Phase II" implementation of RHI in NI in 2013 which might have resulted in the replication of some of the GB~~se~~ changes, priority was given to introducing the domestic RHI scheme (which was part of Phase II). This was because the RHI scheme as a whole was underperforming and priority was given to measures to boost take up. The domestic RHI was finally introduced in December 2014 and only after ~~the~~that scheme ~~was~~had been fully implemented by spring 2015 were some resources freed to consider the changes to the non-domestic scheme. At that time the focus was on expanding the scheme. ~~, and with inadequate control mechanisms. It compares particularly unfavourably to GB legislation in this regard. A further opportunity was missed in [2013] when additional controls were introduced to GB legislation. No decision to replicate those controls in NI was taken at the relevant time (winter 2013-2014) and it may simply be that that issue was not seen as a priority issue, given that demand was very low at that time, or perhaps the issue was overlooked. This meant that, when difficulties emerged, DETI's response was slowed by the need for legislative change.~~

b. **Exploitation of the vulnerability.** The existence of a vertically integrated poultry industry in NI, dominated by one large firm, meant that demand for the RHI could be (and was) very rapidly stimulated, and was accelerated further when it became known that scheme controls were to be introduced. This was exacerbated by having a large number of installers / suppliers established through the GB RHI scheme(s) readily available to exploit this demand. In the space of 6 weeks in Autumn 2015, the number of installations doubled from the 900 that had been received in the previous 3 years. The underlying risk of exploitation was disproportionately large in NI. Whilst our RHI budget is set as a Barnett proportion of the GB budget, NI's share of the UK poultry industry is much larger, at some 20 %. Over 75% of Moy Park (one of UK's largest poultry producers) production is based in NI,~~[x20] %.~~ Therefore, the response by the poultry industry had a disproportionate effect in NI - at peak demand in October 2015, NI application numbers were running at 200% of total GB numbers~~some [10%] of UK RHI applications were originating in NI~~.

8. ~~**Prolonged**~~The third factor was **prolonged uncertainty over the available budget cover**. From July, discussions took place with DFP and Treasury to seek additional budget cover, while controls were being put in place. It took until November/December 2015 for a definitive ~~decision to be made and~~position to be communicated by Treasury that the budget for ~~2015-16 and~~ the years covered by the 2015 Spending Review would continue be limited to a Barnett share of the DECC budget. Had this been known before the November Spending Review outcome, DETI may have recommended to Ministers that we should move straight to suspension, rather than to introduce tariff controls.

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~~c.~~ ~~**Change in Treasury position**~~.

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9. At inception of the RHI schemes, the indication from ~~rule promulgated by~~ Treasury was that spend above allocation would attract a ~~5%~~ Resource ~~R~~DEL penalty. ~~It was not until 22 December that Treasury conveyed the decision that all overspending must be met from RDEL~~However, the quantum and mechanism was never confirmed formally (the indication was a penalty of the order of 5%). Also, the Treasury had indicated that should RHI spending in one year exceed the profile set in the Spending Review, then DECC (for the GB scheme) and (by implication) DETI for the NI scheme would need to repay this in future years. The Treasury position appeared to be based on the assumption that costs could be contained within the limits of affordability (if not in each financial year, then at least taking one year with the next). While at first formal cost controls were limited in the GB scheme, that was not initially a problem, and was corrected in April 2013~~[month/date]~~. ~~The NI scheme did not have a tiered tariff at the outset (the business case of [November ?] 2012 says that that was not appropriate for NI), nor did~~ DETI did not introduce a budgetary control mechanism (“degression”)

when DECC did so – at that stage. The NI scheme was underperforming, so there was no compelling reason to do so, other than the prudent default of keeping in step with GB, which may not have been seen as sufficient reason to act by the then Minister.

10. The DECC Minister of State wrote to the DETI Minister in November 2013 drawing attention *inter alia* to the changes DECC had made to ensure the affordability and value for money of the non-domestic RHI scheme. In response to a request for clarification about the NI Budget, he wrote again in January 2014 confirming that the NI allocation would be a Barnett Formula share of the DECC (GB) budget, and that that was a matter for HM Treasury. As indicated above, at that time the priority issue for the DETI team was the work on the domestic RHI scheme, and there was no presenting urgency in relation to cost control.

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11. When DETI began to act on the pattern of increasing costs in March 2015, the focus of attention was on securing additional budget cover. While DETI's Energy Division had known of the possibility of some risk to the Resource DEL, based on the HMT email of April 2011, ~~DETI Finance Directorate~~ we and DFP had been in effect working on the basis that RHI was still essentially an ~~a standard~~ AME ~~budget~~issue. Thus the approach we adopted, and which underlay our advice to Ministers, was that there was no material risk of an opportunity cost to other services. Not surprisingly, Ministers saw good reason to make the most of the opportunity for additional investment from an HMT-funded budget, and we had no obvious reason to behave otherwise.

12. DETI and DFP had lengthy and detailed exchanges on this issue through the Autumn of 2015, and DFP sought to secure a clear understanding from HMT. DETI had initially sought clarification from DECC but had only received limited information. With hindsight, it is now clear that too much weight was placed on a single email from HMT which was clearly not a definitive statement and which was predicated on the existence of cost controls. Around the time of the Chancellor's Spending Review Statement on 25 November, Treasury told DFP

that all RHI ~~It was not until 22 December that Treasury conveyed the decision that all~~ overspending ~~must~~ would have to be met from Resource DEL – and this was confirmed formally on 22 December. This ~~, a decision that~~ transformed a relatively manageable problem into a criticality. This decision meant that, de facto, RHI ceased to be an AME-funded scheme. Had that decision been made or made known ~~at~~ when the scheme was introduced ~~an earlier stage,~~ the approach to the design of RHI would have been very different, and had the position been clarified earlier, we might have had an opportunity to introduce controls at an earlier stage. If we had stayed in step with GB, it would still have been possible for a significant spike in expenditure to have occurred (because degression would not kick in in the short time between application and commitment), but at least we would have been able to say we had taken all the control measures that had been taken in GB. .

~~d.~~13. David Sterling asked about the respective effects of the Treasury change in NI and GB.– Whilst DECC has not shared detailed information, it is understood that GB expenditure is expected to remain within budget, and hence the issue we face does not arise. As noted above, this reflects the relatively lower risk in GB, and the availability of demand-management controls without recourse to legislative change.

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~~6.~~14. The above factors were compounded by DETI's failure to seek re-approval for the scheme as required from 1 April 2015. This meant that an important opportunity to review the scheme and address its vulnerabilities was missed. ~~However, whilst this might have reduced the extent of the overspend to some degree (if legislative controls had been introduced earlier), it is improbable that it would have eliminated the problem. entirely Any legislative change required a period of consultation, and subsequent experience demonstrated all too clearly the propensity for an exponential spike in demand by a well-informed poultry industry in response to an impending change.~~

~~7.~~15. David Sterling asked for an explanation for the non-renewal of DFP approval. The explanation lies in a combination of staff changes and an administrative oversight. Subsequent to the requirement for re-approval being put in place, there were changes in DETI personnel at every level from DP~~Grade 7~~ to Permanent Secretary, and the corporate memory lapsed. Nevertheless, administrative arrangements ought to have been in place to trigger an application for re-approval at the appropriate time. They were not; and the matter came to light only when budget confirmation was ought. I have asked DETI's Head of Internal Audit to consider this particular matter as part of his investigation.

~~8.~~16. It is possible that had we sought fresh DFP approval in good time, more attention would have been given to the scope to introduce additional contingent constraints on expenditure which might have been helpful in reducing the risk of an acceleration in expenditure – though it has to be remembered that at that time, the level of expenditure was well below our hopes and there appeared to be little risk. Indeed, only a few months previously, towards the end of 2014, we had engaged in an advertising campaign in an attempt to increase expenditure.

Timeline

~~9.~~17. In May~~[June/July]~~ 2015, the RHI issue was drawn to my attention because the pattern of applications had begun to increase, and when it became clear that additional budgetary cover would be needed, it then emerged that the approval had expired several months earlier. I set the DETI team the task of simultaneously solving three interrelated problems:

a. to secure DFP approval for the scheme going forward – primarily an issue of investigating the VFM and establishing a satisfactory business case;

b. to seek retrospective approval for the expenditure incurred between the expiry of approval and the present time; and

c. to secure the necessary budget cover both for 2015-16 and the forward years.

~~10.~~18. Concern about rising expenditure became acute in July 2015. Throughout the period from July to December, DETI's actions were informed by a clear Ministerial steer to ensure that our response would be proportionate, and would not unduly prejudice the benefits of the scheme in terms of the renewable heat target, or the economic benefits to scheme applicants and installation firms. This was against a background of the scheme having *underperformed* prior to 2014, necessitating ~~an~~ advertising campaigns~~campaign~~ to stimulate demand. The Minister was wary of taking over-robust or precipitate action, and while officials were pressing for urgent action to constrain expenditure, it was quite reasonable for the political steer to reflect the benefits of maximising uptake, given that we had advised that this was funded from an AME budget. We might all take the view now that this was an underestimation of the financial risk. Nevertheless, it was the clear and consistently expressed view of the Minister. With hindsight, our advice as officials should have expressed more strongly the risk of a financial pressure – as it is always difficult to recover from a situation where a requirement to seek approval has been missed.

~~11.~~19. The course of action agreed with the Special Adviser and recommended to the Minister on 8 July 2015 (item 1 in the timeline in the Annex) was twofold:

- to legislate to introduce tariff controls as soon as possible; and
- to review the underpinning legislation and bring forward proposals for further controls in due course.

~~12.~~20. Following further discussion with the Special Adviser in August (timeline item 2), during which the potential to moderate the tariff reduction was explored, the Minister agreed the recommended way forward on 3 September 2015 (timeline item 3). This was followed by a public announcement on 8 September. The timescale for securing Ministerial agreement meant that the target date for introducing the controls slipped from 1 October 2016 to 1 November 2016. DFP, whilst being rightly critical of DETI's failure to seek re-approval, did not demur from this approach, and agreed to the revised tariff approach on 29 October (timeline item 4). At that point, neither DETI nor DFP regarded complete closure or suspension of the scheme as necessary. .

~~13.~~21. The subsequent passage of the legislation through the ETI Committee and the Assembly was delayed as a consequence of the Ministerial resignations in the autumn, and the Speaker's ruling on the conduct of Ministerial business by another Minister (we had sought to make a strong case that the subordinate legislation on the RHI would be introduced by Minister Foster but the Speaker ruled that this was not compatible with the rules applying to Assembly business). ~~The Business Committee did not schedule the debate as quickly as had first been hoped.~~ These factors meant that the legislation was not passed until 17 November, coming into force the next day (timeline item 5). Unfortunately, the 10 week period between the announcement of changes on 8 September, and their coming into effect on 17 November left ample opportunity for a spike in demand. This was beyond DETI's control.

~~14.~~22. Demand~~The situation was monitored closely, and demand~~ continued to grow~~;~~ well beyond even the highest estimates from earlier in the year. DFP and DETI officials had extensive discussions in this period:

a. DFP approved the business case for the scheme on 29~~[23]~~ October, so that the expenditure after that date would be regular;

b. With HMT agreement, DFP allocated the necessary AME budget for 2015-16 on [ ] – it is helpful that HMT does not appear to invoked it's previously stated position (that any AME overspend in one year would have to be repayed in the next year, nor has it applied the 5% penalty;

c. DFP and DETI had several speculative discussions on the budgetary implications. DECC made it clear to DETI that this was a matter between HMT and the NI Executive and that they had no responsibility for the issue.

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~~c.~~d. DFP confirmed on 21 December 2015~~[ ]~~ that it could not give retrospective approval to the expenditure between 1 April and 29~~[23]~~ October 2015.~~;~~

~~d. DFP and DETI had several speculative discussions on the budgetary implications. DECC made it clear to DETI that this was a matter between HMT and the NI Executive, and that they had no responsibility for the issue.~~

23. On 31 December, in recognition of the serious financial risk, further advice was offered to the Minister, recommending legislation to provide for the suspension of both RHI schemes (timeline item 6). This was agreed at a meeting with the Minister on 11 January (timeline items 7 and 8).

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~~15.~~24. A draft consultation paper and Executive paper were sent to the Minister on 19 January (timeline item 9). Following the discussions last week, these are now being processed in order to proceed to the closure of the schemes subject to the consideration of the response to consultation.

Whistleblowing allegation of fraud

25. The unprecedented increase in demand has clearly increased the risk of fraud. Administration of the GB and NI non domestic RHI schemes is managed by Ofgem who operate a regime of site audits for both jurisdictions. Based on application numbers, a number of targeted visits are undertaken plus a sample of other installations. For the NI RHI they use a 3% figure in line with the funding allocation percentage to identify the number of site audits to be undertaken.~~.~~

~~16.~~As I indicated in my note of 28 January, DETI has responded to the large spike in demand~~this~~ by initiating procurement of additional auditing and checks. For the current financial year this equates to 6 visits. DETI has however provided an additional funding for extra Ofgem audits this financial year. A business case is also being prepared to procure an independent audit assurance body which will undertake a range of site audits on both the NI non domestic and domestic schemes. This will supplement the Ofgem programme of audits under the non domestic scheme. It is planned that around 200 audits (1 in 10) will be undertaken per annum under both schemes, (400 total). Subject to approvals, it is anticipated that this extra audit resource will be available from 1 April 2016. Your minute of 27 January enclosed correspondence to the First Minister, alleging abuse of the scheme. This has been brought to the attention of Ofgem as have previous allegations of this nature in ~~OFGEM (~~the past. We are currently trying to establish through OFMDFM if contact details are available to facilitate a formal~~managing authority) and asked for an urgent~~ investigation. ~~I have also asked DETI's Head of~~ Internal Audit advice has also been sought to see how best to address~~to investigate~~ the issue. ~~matter.]~~

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Comments

~~17.~~27. I think a few general points stand out from the details set out above and in the Annex:

a. first and foremost, there is no substitute for a good b/f system that triggers review of ongoing issues as they approach critical dates such as the expiry of approvals, and good risk management requires thought and attention to areas that can appear low risk;

b. when, and how strongly, to intervene when a trend changes is a non-trivial matter of judgement. I think it is highly understandable that the Ministerial position was to avoid rushed action when the underlying policy objective was good (hence its place in the PfG), and popular, and (as far as we ~~all knew and understood~~believed up to the Chancellor's Statement in December) not creating an opportunity cost for other DETI or NI Executive programmes.

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~~b.~~c. Communication with HMT Treasury is never easy, and in general we should never rely on semi-formal communications or unconfirmed statements – I know of examples from the early 1980s onwards where the outcome of an engagement with HMT was very different from our hopes and expectations based on official level exchanges. And we should always ensure that the formal channel of communication between DFP and the Devolved Administrations Spending Team in HMT is given pre-eminence, and any information gleaned outside that channel is treated circumspectly;

~~c.~~d. David Sterling asked for information on demand forecasting arrangements, and whether better forecasting might have prompted DETI to proceed to suspension, rather than introducing controls. As noted above, t~~T~~he RHI legislation requires applications to be made after installation, a~~. A~~t which point all properly made applications must be accredited. This makes projecting demand very difficult. Forecasting was based on analysis of historical trends, and did not include any element of market research. It is now readily apparent that this was inadequate in the face of such short-run volatility of demand (coupled with long-term consequences). We need to avoid this kind of process if possible and where it has to be adopted, to note carefully that it creates a vulnerability and plan accordingly.

~~18.~~28. It is not difficult to conclude that, with perfect ~~(or even better)~~ information, DETI ~~officials~~ might have opted for suspension~~recommended stronger action to bear down on the scheme~~ in July or September 2015. However, as noted above, it cannot be safely concluded that this would have obviated the difficulty, as the responsiveness of demand is capable of limiting the effectiveness of any new measure. The average lead-in time for a new RHI installation is 4 to 6 weeks (ie~~[DN is this~~ the time taken between a decision to install~~application~~ and ~~confirmation or~~ actual ~~physical~~ installation which trigger~~– presumably a binding contract is created when an~~ application). ~~is approved].~~ Given the normal timescale for consultation and the legislative process, there would have been ample opportunity for the poultry industry to ramp up demand before suspension could be introduced.

~~19.~~29. I will keep you apprised as matters proceed. I hope this is helpful.

ANDREW MCCORMICK

Annex

RHI TIMELINE OF COMMUNICATION

Item ref	TRIM reference	Content	Timescale
1	DT1/15/0120157	Submission to Private Office, seeking urgent cost control and administrative changes to the NI Renewable Heat Incentive (RHI) Schemes.	8 July 2015
2	DT1/15/0132370	Email from John Mills to Chris Stewart re queries from SpAd on proposed non domestic cost control measures.	11 August 2015
3	DT1/15/0143031	Submission Decision SUB-1075-2015 : ETI Committee RHI - Introduction of Cost Control Measures & Ensuring Effective Administration of Domestic Scheme.	3 September 2015
4	DT1/15/0189114	DFP approval for prospective RHI expenditure to March 2016. Non-Domestic Renewable Heat Incentive: Addendum -	29 October 2015
5	DT1/15/0175576	Submission to Private Office. Notification of Assembly motion re: the Renewable Heat Incentive Schemes (Amendment) Regulations (Northern Ireland) 2015.	6 November 2015 – cleared 10 November 2015
6	DT1/16/0000168	Sub - Future of Renewable Heat Incentive	31 December 2015 – decision conveyed orally
7	DT1/16/0003535	Response to SpAd queries on SUB-0001-2016 : Future of Renewable Heat Incentive.	7 January 2016
8	DT1/16/0015240	Email from Chris Stewart to John Mills confirming Minister's acceptance of recommendation on RHI at a meeting on 11 January	12 January 2106
9	DT1/16/0005996	Submission: Consultation on Closure of to RHI Schemes	19 January 2016 – approved [x].