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Subject: RHI Non Paper November 2016
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RHI Non Paper November 2016.docx

Stephen

Thanks for your recent advice around RHI. Further to our discussion yesterday, I attach a draft Non Paper which we hope to forward to UK Rep and the Commission later today. I would welcome your views on this, particularly around the highlighted section and what we should/can ask in writing. I think we agreed that the best way forward in terms of formal notification might be to:

(i) Pre-notify after Andrew's meeting
(ii) Consult in New Year
(iii) Formal Notification on Final Option
(iv) Public Consultation response (after Commission's decision is received)

We will need an economic analysis to be completed to inform public consultation (and final notification). The RHI Steering Group had previously discussed procuring economic analysis. However, given the urgency, I would suggest ASU could complete any analysis needed for the consultation and notification. Expert economic analysis can then be procured at a later date to develop the formula/mechanism for calculating the payment(s) to participants for the preferred option.

We discussed a number of key questions / issues for Andrew to explore at Wednesday's meeting. I've summarised these below, but please amend as you see fit.
Key Issues / Questions:

- We plan to Pre-notify the cost control options in the next few weeks, before consulting in the New Year followed by formal notification on the final option.

- How quickly can we get our proposed changes through the Commission? (Standstill??)

- How adverse are the Commission to the buy-out option? This will involve investment aid rather than operating aid.

- The Commission needs not to be obstacle to these changes given the public expenditure pressures involved.

- Confirm that there are no UK impediments to changes.

Happy to discuss.

Thanks, Stuart

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NORTHERN IRELAND RENEWABLE HEAT INCENTIVE

Background

The Northern Ireland Non-Domestic Renewable Heat Incentive (RHI) Scheme was introduced in November 2012. The scheme supports the UK objective of contributing to the Renewable Energy Directive target of 20% overall EC energy consumption from renewable sources by 2020 of which the UK's share of the target is 15%. The UK plans to achieve this through a combination of 12% renewable heat and 30% renewable electricity by 2020. In Northern Ireland, the renewable heat target is 10% by 2020.

The Commission granted State Aid approval for the Northern Ireland Renewable Heat Incentive Scheme on 12 June 2012 - SA.34140 refers. The State Aid approval in place covers a 20 year scheme supporting the following technologies:-

- Biomass
- Ground Source Heat Pumps
- Biomethane
- Solar Thermal

To date, the Scheme has incentivised over 2,100 renewable heating installations.

Tariff Changes in November 2015

Scheme uptake was initially low in the first few years with 409 applications received by the end of 2014. Following an increase in application numbers during 2015, the following changes were made to the most popular small and medium biomass technology on 18 November 2015:-

- The introduction of an annual tiered tariff where the first 1314 operating hours would be paid at the standard rate, reducing thereafter to 1.5 p per kWh;
- A widening of the medium biomass banding from 20-99Kwh to 20 - 199kWh, (in line with the UK mainland scheme); and
- An annual heat cap of 400,000kWh after which no payment would be made.

Whilst these changes impacted on new installations post 18 November 2015 they did not apply to pre November installations.

Scheme Suspension

An unprecedented spike in demand was experienced prior to the tariff changes in November 2015 with almost 1,000 applications received in ten weeks. This more than doubled the total number of installations on the scheme, creating significant budgetary pressures. With annual RHI payments exceeding the budget allocations provided by the UK Government, the significant overspend would have to be funded locally by the Northern Ireland Executive. This led to the scheme having to be suspended to new applications from 29 February 2016.

Another spike in demand was experienced prior to scheme suspension with a further 300 applications received. Total annual RHI expenditure for committed RHI payments is now over £50m creating an ongoing annual pressure of over £20m for the NI Executive for the next 20 years. Total RHI expenditure over 20 years is currently forecast to be £1.2 billion if no action is taken.

Scheme Reviews

Paragraph 38 of State Aid approval states: '*The UK authorities intend to hold the first review of the scheme in 2014, with changes_to be implemented in 2015. After that, the reviews will take place periodically according_to a programmed schedule. Reviews will in particular be used to monitor the_performance of the scheme and the development of the underlying costs for each_technology, so as to ensure that overcompensation is going to be prevented.*

No reviews of the scheme were completed until after scheme suspension in February 2016. Since then, the Scheme has been the subject of a number of highly critical reviews and allegations of potential scheme abuse. These reviews highlight that, while the original policy intentions of the scheme may have been laudable, significant failings in the design, oversight and control of the scheme have led to the potential for over-compensation and renewable heat usage being supported that is not useful or useable.

Over-compensation

The Department is conscious that the RHI scheme must operate within the terms and conditions of its State Aid Approval (SA.34140) and in line with Point 110 (b) of the European Commission Guidelines on State Aid for Environmental Protection.

The Commission's State Aid approval for the Northern Ireland scheme is based on scheme participants receiving an average rate of return of 12% over the lifetime of the technology.

The Commission's approval reads '...*the Commission notes that this* (the discount rate of 12%) *is the same rate used in the mainland UK scheme. Under the assessment of that scheme, the UK authorities submitted a detailed report from an independent consultant, which concluded that the necessary rate of return to incentivise renewable heat production ranges between 8 and 22%. The chosen rate of 12% is at the lower end of that range and it can be considered reasonable..*.'

Recent analysis carried out by the Department shows that participants with 99KW biomass installations on the flat 6.5 p/KWh tariff (pre 18 November 2015) could be set to receive rates of return in excess of 100% if payments continue for 20 years. This far exceeds the 12% rate of return approved by the Commission.

In comparison, the maximum rate of return for a 199 KW heating system installed on or after 18 November 2015 is 19%. Although higher than 12%, this is within the 8 to 22% range referenced in the Commission's approval as necessary to incentivise renewable heat production.

Load Factor / Running Time

Paragraph 34 of State Aid approval states: '*In order not to provide perverse incentives to waste heat, each reference installation is calibrated to have a specific load factor and the tariff is calculated with reference to that load factor. For example, a load factor of 15% means that the installation is used at full capacity for 15% of the time*'.

In reality, the actual load factor or 'running time' for many installations is in the range of 80% to 100%. This means that around 1,800 scheme participants on the flat pre November 2015 tariff are set to receive excessive payments much higher than what was envisages in the original Notification. While the Department accepts that some installations have a legitimate basis for 24/7 use (for example, poultry farms), it is now evident that a tiered tariff should have been employed from the outset (as was the case with the RHI Scheme in the rest of the UK) to avoid over-compensation and remove any perverse incentive to waste heat to increase payments.

We are therefore minded to extend the November 2015 tiered tariffs and cap to all small/medium biomass installations. This will assist in ensuring that scheme participants do not generate heat for the predominant purpose of increasing their support payments.

Potential Scheme Abuse

On 29 July 2016, the Department commissioned an independent review into allegations relating to abuse of the non-domestic RHI Scheme. In addition to examining the scheme guidance and controls, the Review considered whether installations generated heat for an eligible purpose but whether they met the policy intentions of the Scheme. That is to generate heat, by renewable means, which would still need to be generated without the incentive of the RHI Scheme.

The review conducted 80 site visits comprising 295 installations over 78 businesses. These installations represent around 20% of payments for the entire RHI Scheme.

The results of the site inspections were allocated to one of four categories as follows:

- Category 1: Participants generating heat for an eligible purpose within the intentions of the scheme
- Category 2: Participants generating heat for an eligible purpose, which does not meet the intentions of the scheme
- Category 3: Participants generating heat for an eligible purpose, but using heat in a way that is not energy efficient
- Category 4: Generating heat which may be for an ineligible purpose and therefore may be in breach of the scheme

The Review found that only 47% of inspection result fell into category 1, (they were considered to be generating heat for an eligible purpose within the intentions of the scheme). This is obviously a matter of grave concern and work is ongoing to investigate the potential to take enforcement action where there is evidence that there has been non-compliance with the eligibility requirements.

Corrective Action

The Department is urgently taking forward action to address these weaknesses, improve the scheme's value for money and reduce future costs. There are three key work streams:

- Governance and Control

  Strengthening the governance and control arrangements between the Department and the scheme administrators (Ofgem).[a]

- Audit and Enforcement

  Implementing a much more rigorous approach to audit, inspection and enforcement including taking forward appropriate action on the Category 2/3/4 cases identified through the independent review.

- Cost Controls

  Given the magnitude of the State Aid, Value for Money and public expenditure costs associated with the scheme, the Department is considering to potential cost control options:

  i) Revoking the legislation, terminating the scheme and provide participants with 'buy-out' payments for each installation to cover the capital costs and the 12% rate of return they should have received in line with State Aid approval.

  ii) Amending the scheme legislation to extend the November 2015 tiered tariffs and cap to all small/medium biomass installations. This will bring the rates of return back in line with the level (8-22%) approved by the Commission. It will also significantly remove the incentive for scheme participants to generate heat for the predominant purpose of increasing their support payments.

  iii) Amending the scheme legislation to provide all scheme participants on the small/medium biomass tariffs (pre and post November 2015) with a single annual payment to cover their capital payback and return (deducting any payback already received) along with a much lower ongoing tariff of around

[a] Office of Gas and Electricity Markets

to cover the increased running costs of biomass against oil. This option would bring the levels of support back into line with the EU State Aid approval. It would also reduce the incentive to generate heat solely for the purposes of increasing RHI payments.

All three options will have to be subject to further consideration and expert advice. However, we are of the view that the proposed tariff changes would not have any adverse trade effects or distort competition among member states.

Commission Views

It is our view that without these corrective actions, the Scheme may not be compatible with the terms of its State Aid approval given that the existing scheme design and tariff has resulted in over-compensation and renewable heat usage being supported that is not useful / useable. We have already received a clear informal signal from the Commission that this is likely to be the case.

Although the actions to improve scheme governance, control and enforcement are already underway, any benefits in terms of reduced or recovered aid are likely to take years and involve legal action.

The cost control measures will however, have a much more immediate effect. These also involve significant challenges but initial legal advice confirms that there are no UK legal impediments to the changes proposed. There are also no trade effects associated with any of the three options.

We would be grateful for the Commission's views on the cost control options proposed particularly with regard to the implications of a single 'buy-out' payment

Next Steps

Following the meeting on Wednesday 7th December, the Department is minded to provide pre-notification to the Commission on options to amend the non-domestic RHI scheme prior to a public consultation in the New Year and formal notification of the preferred option identified by the consultation.