From:	Hill, Janice on behalf of McCormick, Andrew (DETI)
To:	HOCS
Cc:	Sterling, David; Stewart, Chris (DETI); Rooney, Eugene
Subject:	FOR ATTENTION OF ADDRESSEES ONLY - Renewable Heat Incentive
Date:	15 February 2016 13:34:54
Attachments:	PS DETI 021 16 - Perm Sec - HOCS - RHI - FINAL VERSION.DOCX
Importance:	High

Please see attached memo from Andrew McCormick.

Please note that this is solely for the attention of addressees and is not for further circulation.

Kind regards

Janice

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From: Andrew McCormick
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Date: 15 February 2016

Our ref: PS DETI 021/16

To: HOCS

Cc David Sterling
Chris Stewart
Eugene Rooney

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 either you or David Sterling that 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 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 developed a parallel scheme for Northern Ireland which was introduced in November 2012 for the non-domestic sector[1]. Both the GB and non-domestic schemes are administered by OFGEM, which has responsibility for assessing applications and controlling contracts and payments.

[1] A domestic RHI scheme, administered by DETI was introduced in December 2014.

5. The RHI legislation requires applications to be made after installation, and stipulates that all properly made applications <u>must be accredited</u>. 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.

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. 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. The penalty would be applied to Resource DEL (RDEL). The implications of this for the scheme design are covered below.

Contributing factors

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

   i. **The nature of the legislation**. The RHI legislation was designed to promote the take-up of renewable heat. The 'qualified AME' funding arrangements pointed to the need for demand management arrangements within the RHI legislation. However, the legislation, both here and in GB, was enacted without including any powers to close or suspend the RHI schemes. Interim suspension powers were introduced in GB from November 2012 and subsequently replaced by a system of formal tariff degression mechanism for cost control in April 2013. 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 changes. However, 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 that scheme had been fully implemented in early 2015 were some resources freed to consider the changes to the non-domestic scheme. At that time the focus was on expanding a previously underperforming scheme.

   ii. **Very rapid unforeseen expansion of demand.** The RHI is attractive to certain industries and sectors that are particularly significant within the NI economy. For example, 20% of the UK poultry industry is based in NI. Added to that there were a large number of installers / suppliers established through the GB RHI scheme(s) readily available to exploit this latent demand. The combination of these two factors contributed to a sudden increase in applications. 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. At peak demand in October 2015, NI application numbers were running at 200% of total GB numbers. The fact that introducing control mechanisms required legislative change meant that the sudden increase in demand easily outpaced our ability to respond effectively.

8. The third factor was **prolonged uncertainty over the available budget cover**. From June, discussions took place with DFP to seek additional budget cover, while controls were being put in place. It took until November/December 2015 for a definitive position to be communicated by Treasury that the budget for the years covered by the 2015 Spending Review would be limited to a Barnett share of the (decreased) 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.

9. At the inception of the RHI schemes, the indication from Treasury was that spend above allocation would attract a Resource DEL penalty. 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). DETI did not replicate the budgetary control mechanism ("degression") introduced by DECC in April 2013. The NI scheme was underperforming, so there was no compelling reason to prioritise this ahead of other changes such as the introduction of the domestic RHI scheme, other than the prudent default of keeping in step with GB.

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 pressing urgency in relation to cost control.

11. When DETI began to act on the pattern of increasing costs in March 2015, the focus of attention was initially 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, we and DFP had been in effect working on the basis that RHI was still essentially an AME issue. Thus the approach we adopted, and which underlay our advice to Ministers, was that there was no material risk of a material opportunity cost to other services. Not surprisingly, Ministers saw good reason to make the most of the opportunity for additional investment from a ring-fenced Annual Managed Expenditure 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, initially approaching HMT in October 2015. 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.

13. Around the time of the Chancellor's Spending Review Statement on 25 November, Treasury told DFP that all RHI overspending would have to be met from Resource DEL – and this was confirmed formally on 22 December. This 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 when the scheme was introduced 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.

14. DECC's negotiations with HMT during the Spending Review resulted in a reduction in the RHI budget for 2016/17. Whilst this presented no apparent difficulty for DECC, the corresponding reduction in our Barnett share further compounded the projected overspend in NI.

15. 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.

DFP approval

16. 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.

17. 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 in the relevant chain of command at every level from DP 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 sought. I have asked DETI's Head of Internal Audit to consider this particular matter as part of his investigation.

18. 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. 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

19. In May 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 at 31 March 2015. 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.

20. 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 advertising campaigns to stimulate demand.

21. 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.

22. 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 2015 to 1 November 2015. 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). <u>At that point, neither DETI nor DFP regarded complete closure or suspension of the scheme as necessary.</u>

23. The passage of the legislation through the ETI Committee and the Assembly was delayed (relative to the fastest possible sequence of events from the announcemmt on 8 September onwards) as a consequence of the Ministerial resignations in the autumn. This meant that the legislation was not passed until 17 November, coming into force the next day (timeline item 5). <u>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.</u>

24. 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:

i. DFP approved the business case for the scheme on 29 October, so that the expenditure after that date is regular.

ii. With HMT agreement, DFP allocated the necessary AME budget for 2015-16. It is helpful that HMT does not appear to have invoked its 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).
iii. 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.
iv. DFP confirmed on 21 December 2015 that it could not give retrospective approval to the expenditure between 1 April and 29 October 2015.

25. 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).

26. A draft Executive paper was sent to the Minister on 19 January (timeline item 9). Following the discussions in week commencing 25 January, (including taking the views of the Finance Minister) these were processed in order to proceed to the closure of the schemes at the earliest possible juncture, with the Executive having approved action by urgent procedure, and subject to the approval of the Assembly. Due to the urgent need to manage the financial risk, the Minister secured Executive agreement to proceed without public consultation, and without following the established convention of seeking Committee approval of the policy and draft legislation. The earliest possible date for the Assembly debate was Monday 15 February. The plan at that stage was that if the legislation was passed, the schemes would close on 16 February. The planned closure was announced on 5 February, following Executive approval, and this meant that less than two weeks public notice was given for that planned closure date. The advice from DSO was that the risk of challenge by judicial review is significant, stemming from the lack of consultation. The Minister was aware of this risk. He subsequently decided to delay closure until 29 February.

Whistleblowing allegation of fraud

27. The unprecedented increase in demand has clearly increased the risk of fraud. DETI has formally notified DFP and NIAO of the allegations received. 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.

28. As I indicated in my note of 28 January, DETI has responded to the large spike in demand 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. We are currently trying to establish through OFMDFM if contact details are available to facilitate a formal investigation. Internal Audit advice has also been sought to see how best to address the issue, and we will need to write formally to OFGEM (copied to DECC) to take this process forward as quickly as possible.

Comments

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

i. 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;

ii. 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 believed up to the Chancellor's Statement in December) not creating an opportunity cost for other DETI or NI Executive programmes.

iii. 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;

iv. 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, the RHI legislation requires applications to be made after installation, at which point all properly made applications <u>must be accredited</u>. This makes projecting demand very difficult. Forecasting was based on analysis of historical trends and experience in GB, and did not include any element of detailed forecasting. 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.

30. It is not difficult to conclude that, with perfect information, DETI might have opted for suspension 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 (i.e. the time taken between a

decision to install and actual installation which trigger application). Given the normal timescale for consultation and the legislative process, there would have been ample opportunity for applicants to ramp up demand before suspension could be introduced.

31. 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, following further submissions on 5 February.