EMER MORELLI
Head of Supply Division

Public Spending Directorate
Room P7
Rathgael House
Balloo Road
BANGOR BT19 7NA
Tel No: 028 91858128 (x 68128)
email: emer.morelli@finance-ni.gov.uk

Department of Finance
An Roinn Airgeadais
www.finance-ni.gov.uk

Stephen McMurray
Head of RHI Taskforce
Netherleigh
Massey Avenue
Belfast BT4 2JP

25 January 2017

Dear Stephen

ADDRESSING THE DEFICIENCIES IN THE NON DOMESTIC RHI SCHEME - BUSINESS CASE

Thank you for your letter of 11 January 2017 in which you recommended the DfE business case 'addressing the deficiencies in the non domestic RHI scheme' to DoF for approval.

The business case states that "the purpose is to assess the available options to reduce the net cost to the Executive of the Renewable Heat Incentive scheme in the 2017-18 financial year as the first stage of a comprehensive programme to ensure the value for money and financial sustainability of the scheme going forward." It is noted that a comprehensive programme for an enduring solution has yet to be designed and will be informed by further review and consultation. This longer term, wider programme will be supported by a more substantive business case in due course.

The business case estimates that the successful implementation of the preferred option could reduce the 2017-18 cost of the RHI scheme to £25.3m, from the £49.7m projected if no action is taken.

The shortcomings in the design and implementation of the RHI scheme are well documented in both the NIAO report (July 2016) and the PwC report (November 2016). DoF is therefore well sighted on the significant value for money and affordability concerns associated with the scheme. While DoF's primary concern was VFM in the period prior to the November 2015 amendments, both considerations have been the subject of discussions from December 2015. Following the closure of the scheme to new applicants in February 2016, DoF has, as part of the regular stocktake process and in dedicated meetings in May 2016 and

October 2016, sought advice from DfE on the potential options available to DfE to reduce the significant RHI overspend and ensure VFM. DoF therefore welcomes the submission of a proposal to begin to address this issue.

As was the case in October 2015, DoF has been afforded limited time to consider this complex issue. In assessing the business case, we have noted the following assurances provided by DfE both within the document submitted and through our recent engagement:

- An immediate move to an enduring solution runs the very real risk that a best value for money solution is not achievable (para 4.11)
- DfE remains content that the tariff structure introduced in November 2015 represents value for money (S McMurray email 11 Jan 2017).
- DfE has received formal, written legal advice and this provides support to the preferred option in the business case and the contingency plan as set out at para 8.10 (S McMurray letter 13 Jan 2017).
- DfE has considered the risks arising from the need for European Commission notification and this will be taken into account when setting the date for the new regulations to come into force. (S McMurray letter 13 Jan 2017).

While it is agreed the status quo position is not sustainable, the limited range of ‘do something’ options considered within the business case reduces the certainty that the preferred option represents the optimal way forward. That said, if implemented as outlined within the business case, the preferred option will significantly improve the value for money of the scheme while minimising the overspend.

In that context, and having considered the detail of the business case and the additional assurances provided by DfE, DoF is content to grant approval for DfE to proceed with the preferred option. This approval is conditional on the following -

Implementation of Preferred Option

1. DfE is satisfied that their legal advice supports the introduction of the preferred option, and that the decision to proceed on a time limited basis at this stage does not increase the risk of a legal challenge.

2. DfE is satisfied that the risks attached to State Aid notification for the RHI scheme in its entirety, to include the proposed amendment as set out in the preferred option and the existing post November 2015 amendments, have been adequately considered and appropriately mitigated.

Audit and Inspection

3. The recommendations of the PwC report are implemented in full as outlined within the November 2016 report. Any decision not to

implement a recommendation should be approved by the DfE Accounting Officer and notified to DoF.

4. DfE should implement a comprehensive programme of inspection and audit as a matter of urgency. For each instance of fraud detected DfE should provide evidence that all possible steps have been taken to recover payments in full and appropriate action taken to prevent future occurrences of the fraud detected.

Longer term solution

5. It is recognised that the preferred option is the first stage of a longer term process to ensure the value for money and sustainability of the scheme going forward. Given the significant budgetary risks associated with the scheme it may be useful if DfE seeks the views of an informed third party as it develops its proposals, for example the policy team at BEIS. Given that the RHI scheme operates across the UK, albeit under differing models, an informed third party could help inform the reasonableness of any proposals and the associated costs.

6. The longer term resolution must also incorporate all appropriate safeguard mechanisms to reduce risks to the public expenditure position (eg fuel price adjustment mechanisms).

Review

7. It is noted that DfE will take a decision in November 2017 as to whether the longer term solution can be implemented by the start of 2018-19 or whether the approach for 2017-18 will need to be implemented for another year. Given the potential significant budgetary risks associated with any delay, DoF requires that the DfE Accounting Officer advise formally DoF of the outcome of any such decision in November 2017.

Conclusion

As outlined above, DoF has been afforded a very limited window to review the proposals and, while it is accepted that a tariff reduction is required, it is difficult for DoF to conclude that the proposed changes will deliver the optimal outcome. That said, it is acknowledged that the status quo is not acceptable from a value for money or budgetary perspective and action must be taken.

DfE’s response to this issue to date has not been as timely as it could have been. The next twelve months will be critical in ensuring there is a satisfactory, long term solution to this issue. It will be vital that the business case for this long term solution is accurate, comprehensive and informed by specialist and, where necessary, external advice. DoF will expect the business case to contain comprehensive consideration of a wide range of options. In considering options which involve the continuation of an annual incentive payment there must be in-depth consideration of controls to ensure individuals are not over-compensated and the scheme remains affordable. The recent engagement on annual adjustment for fuel price differentials is one example of an issue which should be considered.

In addition to the project specific conditions set out above DoF approval is also subject to the strict adherence to the following conditions:

- that there are no substantial changes to the scope/scale of the project as described in the business case.

- that the costs or assumptions vary by no more than 10% from the value stated.

Requests for revised approval will take account of factors such as:

- Where Supply is approached on the earliest indication that compliance with one or more of the above conditions is under question.

- Adherence to correct appraisal procedure.

Should the request for DFP Supply approval be declined, these factors, along with any other mitigating circumstances will be taken into account when determining the extent of the irregular spends.

It should be noted that this approval relates solely to agreement to proceed with the project. It does not imply approval for expenditure to be incurred beyond existing agreed public expenditure controls.

Emer Morelli

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Cc David Sterling
Andrew McCormick
Mike Brennan
Heather Cousins
Michelle Scott