Department of Enterprise, Trade and Investment
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Date: 28 January 2016

Our ref: PS DETI 009/16

To: HOCS

Cc Chris Stewart
Eugene Rooney
John Mills

RENEWABLE HEAT INCENTIVE

1. In my note of 28 January I indicated that I would provide you with a fuller explanation of the genesis and evolution of the current RHI difficulty and DETI's response.

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, the full extent of the likely overspend and the need for closure did not materialise until December 2015. During that period DETI's actions developed in response to the evolving problem, in line with Ministerial decisions. The timeline of events is set out at the Annex, [and the relevant advice and Ministerial decisions are appended].

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

   i. **The inherent vulnerability of the legislation** – the legislation was enacted without including any powers to close or suspend the RHI schemes, and with inadequate control mechanisms. It compares particularly unfavourably to GB legislation in this regard.

   ii. **Exploitation of the vulnerability.** The existence of a vertically integrated poultry industry in NI, dominated by one large firm, meant that demand could be (and was) very rapidly stimulated, and was accelerated further when it became known that scheme controls were to be introduced. 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. That ability to exploit the vulnerability of the legislation appears to be unique to Northern Ireland.

iii. **Prolonged uncertainty over the available budget cover**. It took some months to establish that the budget would be limited to a Barnett share of the DECC budget. Had this been known before the November Spending Review outcome, DETI may have opted to move straight to suspension, rather than to introduce tariff controls. That would, of course, have been a decision for the Minister.

iv. **Change in Treasury position**. At inception of the RHI schemes, the rule promulgated by Treasury was that spend above allocation would attract a 5% Resource DEL (RDEL) penalty. It was not until 22 December that Treasury conveyed the decision that all overspending would be applied to RDEL, a decision that transformed a relatively modest problem into a criticality.

4. 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 highly 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 in response to an impending loss of opportunity.

5. Throughout the period from July to December, DETI's actions were informed by a clear Ministerial steer to ensure that our response did 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 campaign to stimulate demand. The Minister [and his adviser] were wary of taking over-robust or precipitate action. 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 and his advisor.

6. The course of action agreed with the Special Adviser and recommended to the Minister on 8 July 2015 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.

7. Following further discussion with the Special Adviser in August, during which the potential to moderate the tariff reduction was explored, the Minister agreed the recommended way forward on 3 September 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. <u>At that point, neither DETI nor DFP regarded complete closure or suspension of the scheme as merited.</u>

8. The subsequent passage of the legislation through the ETI Committee and the Assembly was delayed as a consequence of Ministerial resignations in the autumn, and the Speaker's ruling on the conduct of Ministerial business by another Minister *[DN Stuart, can we add any detail on this – perhaps for the Annex rather than here]*.

9. The tariff control legislation came into operation on [ ]. The situation was monitored closely, and demand continued to grow beyond all reasonable expectation. On 31 December, in recognition of the financial risk further advice was offered to the Minister, recommending legislation to provide for the suspension of both RHI schemes.

10. A draft consultation paper and Executive paper were sent to the Minister on 19 January. The Minister was on the point of approving these, but is reviewing the way forward in light of the concerns raised by the First Minister, deputy First Minister and Finance Minister on the need to achieve suspension as soon as possible. The Minister is considering whether it is feasible to proceed more quickly without public consultation.

11. David Sterling's letter of 29 January (copied to you) raised a number of specific questions.

12. Firstly, David asked for an explanation as to why DETI officials did not realise that DFP approval for the non-domestic part of the RHI scheme had expired on 31 March 2015. He also asked whether action at that time would have prevented or mitigated the current situation.

13. The explanation is a combination of personnel change and administrative oversight. In the period between the initial approval and its expiry there were changes in the management chain at every grade from Permanent Secretary to Grade 7, with a consequent loss of corporate sight of the requirement. Nevertheless, administrative arrangements ought to have been put in place to trigger a reminder. They were not, and the oversight did not come to light until clarification was sought on the budget. I have asked for the internal audit investigation to examine this matter in particular.

14. As noted above, application for re-approval at the right time might well have triggered early action to strengthen controls (including taking powers to suspend the schemes) in light of the increasing demand. However, the rapidity of the increase in demand is worth emphasising.

15. Secondly, David asked about the change in HMT treatment of expenditure. [DN need to clarify the question]

16. Thirdly, David asked for more information on the arrangements for market forecasting, and why these did not predict the spike in demand [DN add]. He also asked whether better forecasting might have caused DETI to stop the scheme rather than tighten controls. The answer is that, with perfect knowledge, it is very likely that the DETI Minister would have wished to close the scheme, had such a power been readily available.

17. However, such a power was not available and would have required legislative change[1]. Therefore, the timescale for implementing a decision to close would have included the timescale for public consultation, plus the time required for the legislative process. This would, in all probability, have been considerably longer than the typical lead time for an RHI installation of around 6 weeks. That, coupled with the proven responsiveness of demand suggests that a spike in demand could not have been avoided completely - the mere fact of announcing closure would have generated a spike long before the closure decision itself could be implemented.

18. I will keep you apprised as matters proceed.

ANDREW MCCORMICK

[1] As with most energy matters, the subordinate legislation required is subject to the affirmative resolution procedure.

Annex

RHI TIMELINE OF PRIVATE OFFICE COMMUNICATION

DT1/15/0120157	Submission to Private Office. Urgent cost control and administrative changes to the NI Renewable Heat Incentive (RHI) Schemes.	8 July 2015
DT1/15/0132370	Email from John Mills to Chris Stewart re queries from SpAd on proposed non domestic cost control measures.	11 August 2015
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
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RHI CLOSURE SUMMARY BRIEF

1. After a slow start, (non domestic) uptake increased rapidly during 2015, prompting me to introduce tariff controls in November.

2. However, in the run up to those changes, the number of installations on the scheme doubled with over 900 applications received in 6 weeks.

3. The increase means that PfG target of 4% renewable heat by 2015 has been exceeded and we would be well on track to reach the 10% target set for 2020.

4. However, this success comes at a price. Total expenditure for both RHI schemes in 2015/16 is now forecast to exceed **£30m**. Even if the schemes are closed by April, forecast RHI expenditure in 2016/17 is expected to be around **£45m**.

5. Our budget is based on a Barnett formula of circa 3% of the DECC budget (£838m), and the rise in applications means that we will overspend during this spending review period and beyond (up to 20 years).

6. The overspend is estimated at **£27m in 2016/17 falling to around £11m by 2020/21** (This, of course, all assumes that there are no further application spikes in anticipation of scheme closure.)

7. In light of this serious risk to the NI Block, I must take action to close the schemes at the earliest possible date.

RENEWABLE HEAT INCENTIVE - DRAFT SPEAKING NOTE

Introduction

Will cover 4 things:

- Background to RHI schemes;
- Progress of schemes and pattern of rising demand;
- Reason for suspension – significant overspend and risk to the NI block; and
- Whistle blowing allegation of fraud.

Background

1. The RHI schemes are 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.

2. The Non Domestic RHI scheme was introduced in November 2012 and the Domestic RHI scheme in December 2014. Both schemes provide payments for people to move from conventional heating (mainly oil) to sustainable heating such as wood pellets (biomass).

3. <u>Successful Domestic RHI</u> applicants receive an upfront payment of up to £3,500 along with 7 annual tariff payments - typically around £1,200; capped at a maximum of £2,500.

4. <u>The Non Domestic</u> RHI scheme involves 20 years of annual tariff payments, averaging around £24,000. The Non Domestic scheme therefore involves much larger and longer financial commitments than the domestic scheme.

Progress of schemes

5. After a slow start during the first two years, non domestic scheme uptake increased steadily during 2015. During the Autumn of 2015 there was an unprecedented surge in applications. This increase relates to one particular technology – biomass.

6. In response, the Minister brought cost control measures for the Non Domestic scheme forward in November 2015. However, in the run up to the November changes, the surge gathered pace, with a further 900 applications received in 6 weeks. This doubled the total number of installations under the non-domestic scheme.

Reason for suspension

7. The PfG target of 4% renewable heat by 2015 has been exceeded. However, this success comes at a price. The schemes are normally funded through Annual Managed Expenditure, reflecting their demand-led nature. However, there is an expenditure cap, set at 3% of the equivalent DECC budget. In the November Spending Review, Treasury decided that any expenditure in excess of this cap must be met from the NI block.

8. This means that the Block DEL will be penalised for any excess spend for a period of at least the next five years and possibly up to 20 years ahead, depending on the approach taken to RHI in future in GB.

9. Total expenditure for both RHI schemes in 2015/16 is now forecast to exceed **£30m**. Even if the schemes are closed by April, forecast RHI expenditure in 2016/17 is expected to be around **£45m.**

10. The overspend is estimated at **£27m** in 2016/17 falling to around **£11m** by 2020/21 (This, of course, all assumes that there are no further application spikes in anticipation of scheme closure.)

11. In these circumstances the Minister considers it necessary to suspend the schemes immediately to prevent further overspend.

12. Draft regulations were laid yesterday, and the motion for debate was tabled.