

Instructions to counsel

## RENEWABLE HEAT INCENTIVE SCHEME

1. The Minister of Finance would be grateful for your advice in relation to possible corrective action to address the deficiencies in the non-domestic Renewable Heat Incentive scheme (RHI).

### Introduction

2. Energy policy is devolved to the Northern Ireland Assembly with the exception of nuclear power. The Department for the Economy (DfE) is responsible for the development and maintenance of an appropriate legislative and policy framework for energy in Northern Ireland.
3. In July 2011, the Department of Energy and Climate Change (DECC) introduced a non-domestic scheme to incentivise the renewable heat market in Great Britain. The GB scheme [aimed to provide](#) a Rate of Return of 12% across most technologies with the exception of solar thermal. Northern Ireland was not included in the GB RHI Scheme. The differences between the heat and renewable heat markets in GB and Northern Ireland meant that it was [deemed to be](#) more appropriate to create a separate scheme suitable for the local market.
4. In July 2011, DETI consulted on proposals for a Northern Ireland Renewable Heat Incentive (RHI) for non-domestic consumers and the Renewable Heat Premium Payment Scheme (RHPP) for domestic consumers. Following the consultation process, the RHPP was launched on 24 May 2012 and the RHI followed on 1 November 2012.
5. To encourage businesses to invest in renewable heating systems, the scheme was demand-led where installations must be completed and commissioned prior to applying for accreditation.
6. The tariffs for both RHI schemes were developed on behalf of DfE through an external consultancy exercise carried out by CEPA and Ricardo-AEA. The tariffs were designed to cover the additional capital and on-going operating costs of renewable technology over a conventional fossil fuel heating system, whilst also seeking to provide an internal rate of return of 12% on the additional costs of installing and operating a renewable heating system.
7. The total amount payable to an applicant in any year is based on their metered usage in that year. For each kilowatt (kW) hour of heat energy produced by an eligible [non-domestic](#) installation, participants receive periodic support payments based on a tariff rate for a period of 20 years following accreditation (please see

regulation 36(1) and (3) of the Heat Incentive Scheme Regulations (Northern Ireland) 2012 S.R. No. 396) (Annex A).

8. The GB scheme at its outset provided for tiering of payments, a higher Tier 1 tariffs payable up to 1,314 hours and a lower Tier 2 rate for anything thereafter (The Renewable Heat Incentive Scheme Regulations 2011 S.I 2860 – regulation 37). Taking advice from CEPA and Ricardo-AEA, DfE considered there was no need to introduce tiering within the NI RHI scheme.
9. The non-domestic RHI scheme was given effect to by the Renewable Heat Incentive Scheme Regulations (Northern Ireland) 2012 S.R. No. 396. The Department also published procedural guidance for participants and applicants in connection with the NI Scheme (Annex B).
10. The NI Scheme is administered on behalf of DfE by the Office of Gas and Electricity Markets (“Ofgem”) which has responsibility for assessing applications, accrediting installations, making support payments and monitoring / enforcing compliance. DfE has responsibility for the policy framework and for setting payment tariffs.
11. Since its introduction in November 2012, two amendments have been made to the NI Regulations.
12. ~~In response to a spike in applications around April 2015 for medium biomass installations, DfE brought forward legislation to reduce incentives for new applicants. By April 2015, DfE should have approached DoF seeking to reapprove its existing scheme for non-domestic installations. It was at this stage DfE neglected to seek this reapproval. It should also be noted that there was a formal public consultation in 2013 which, amongst other things, sought views on the introduction of cost control measures.~~ In November 2015 it introduced a tiered tariff for small and medium biomass technologies (where the tariff drops after 1314 annual operating hours) for new applications, along with an annual cap for eligible heat payments (400,000 kWh over which no further tariffs is paid). These changes were implemented by the Renewable Heat Incentive Schemes (Amendment) Regulations (Northern Ireland) 2015 S.R. 371 – Annex C). A spike of almost 1000 applications (mostly medium biomass) was received in the run up to these changes, this alone more than doubled the total scheme applications.
13. In ~~December 2015~~January 2016, HMT confirmed that NI Annually Managed Expenditure allocation for RHI ~~would be had been~~ capped at 3% of the GB budget. This resulted in the NI Block facing an annual pressure of over £20 million for the next 20 years. This resulted in the second amendment to the RHI. You may be interested to note paragraph 49-53 of the NI Audit Report (Annex E).

14. The second amendment was in February 2016, the primary purpose of which was to give power to the Department to suspend the NI Scheme where it does not, or is likely not to, have sufficient budget to meet the cost of support payments (The Renewable Heat Incentive Schemes (Amendment) Regulations (Northern Ireland) 2016 S.R. 47 – Annex D) . These Regulations were made on the 16<sup>th</sup> February 2016. The notice of suspension was published two days later on the 18<sup>th</sup> of February 2016 – suspending the scheme to new applicants from 29th February 2016 (Annex F).
15. Prior to the scheme closing, a further spike in applications increased the RHI commitments for both Domestic and non-Domestic RHI schemes to circa £50m pa.

Comment [HW1]: Check figure

### **Pre – November 2015 Installations:**

16. The changes introduced by the RHI 2015 Regulations (i.e. tiered tariff for small and medium biomass technologies, along with an annual cap for eligible heat payments) only applied to installations accredited on or after 18th November 2015 (see regulation 10 of the Renewable Heat Incentive Schemes (Amendment) Regulations (Northern Ireland) 2015, amending Regulation 36 of the Renewable Heat Incentive Scheme Regulations (Northern Ireland) 2012).
17. This leaves DfE with a problematical group of participants, those on medium biomass, pre 18<sup>th</sup> November 2015, installations which (owing to the absence of tiering/cap at the outset of the RHI scheme) are receiving excessively generous tariffs. This means that for these participants greater amount of grants are obtained, as there is no upper limit of the energy that will be paid for. Effectively, the more energy generated, the more they receive in support payments (see paragraph 39-42 of the Northern Ireland Audit Office Report)
18. Certain matters have arisen in connection with the RHI scheme, the effect of which has been to stimulate the need to deal with these pre November 2015 installations:
- (a) Allegations of abuse within the RHI scheme;
  - (b) State Aid approval; and
  - (c) Financial pressures on the NI Block Grant.
19. These matters form part of the Northern Ireland Audit Office Report (paragraph 28 – 60).
20. If I may briefly refer to each:

### Allegations of Abuse

21. Following allegations of abuse of the RHI scheme DfE commissioned an independent report (from PriceWaterhouseCoopers) to review allegation of abuse received by it. This resulted in a report entitled "Project Heat Final Report". (Annex G)
22. The report highlights significant weaknesses around the legislation, scheme controls and audits – all of which have resulted in unnecessary heat being generated, which would not have been generated by fossil fuels, and an on-going requirement for the Department to make payments in respect of such heat.
23. PWC conducted a series of site inspections to test the veracity of the allegations received by the Department (the methodology for these site inspections is explained in section 5 of the Heat Report). The sample of site inspections equates to 295 installations, representing £185.6 M estimated RHI payment, which is 20% of the total RHI payments for the entire NI scheme.
24. You will note that at section 5 of the report (page 18) the results of inspection were categorised as follows:
25. Category 1: Participants generating heat for an eligible purpose within the intentions of the scheme.
26. Category 2: Participants generating heat for an eligible purpose, which does not meet the intentions of the scheme.
27. Category 3: Participants generating heat for an eligible purpose, but using heat in a way that's not energy efficient.
28. Category 4: Generating heat which may be for an ineligible purpose and therefore may be in breach of the scheme
29. Paragraph 5.29 of the Interim Heat Report might provide a feel for how these categories relate to real cases on the ground:
30. *"5.29 Installations classified as a 2 appeared to have an eligible purpose, however that purpose while potentially complaint, seemed contrary to the intentions or spirit of the scheme and therefore may take advantage of its design weaknesses. Installations classified as a category 3 also appeared to have an eligible purpose but were considered to be using the heat they generated inefficiently."*

31. 5.30 *In general, installations serving the poultry, farm (predominantly mushroom farms) and general commercial sectors were scored in Category 1.*
32. 5.31. *Commercial sites with installations that operated process drying, drying of woodchip for their own boilers and sites with connected domestic use were mainly categorised from Category 2 to 4 inclusive.*
33. 5.32. *A significant number of drying operations were observed, that were considered to be wasteful and therefore inefficient, whether they were drying woodchip, manure or other material. Some of these operations are likely to be economically unviable in the absence of support payments under the NI Scheme, with the associated heat requirement unlikely to be met by an alternative form of heating. Most of the installations inspected relating to drying operations were classified as category 2, 3 or 4.*
34. 5.33 *A reasonably large number of sites were also inspected, where it was apparent that the majority or all of the heat output in respect to one or more boilers was serving a domestic residential property. It is possible that these installations may not be adhering to the Guidance relating to the treatment of domestic dwellings under the NI Scheme. Please refer to paragraph 5.66 for details of this evidence. These installations have all been classified as category 4.*
35. The result of this exercise would seem to suggest that the scheme itself does not fulfil the purposes of the underlying Energy Act, further it would appear the RHI scheme encourages a waste of generated heat and an unnecessary spend of public monies.

### **State Aid approval**

36. State aid notification was made to the European Commission in accordance with Article 108(3) of the Treaty on the Functioning of the European Union (TFEU) on 10 May 2012. European Commission raised no objection and State Aid approval was granted (Annex H).
37. You may be interested to note paragraph 41-45 of the Commission State Aid approval, which deals with the approach taken by officials in demonstrating (in respect of payments to prospective RHI participants) the absence of "overcompensation". The Commission's assessment of the RHI scheme begins at paragraph 52. I would refer you specifically to paragraph 63 in which the Commission addresses the issue of "overcompensation", which states:

Comment [HW2]: Check page refs

38. *As regards the discount rate of 12% applied in the calculations of levelised production costs for biomass, biogas and ground source heat production, the Commission notes that this 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. The so-called barrier costs represent a minimal part of the overall cost and their inclusion or exclusion from the discount calculation does not alter the final tariff – or, conversely, considering the non-financial costs as part of the profit, the rate of return becomes only slightly higher than 12%.*

39. Based on this evidence the Commission reasoned that the measure complied with the condition requiring the absence of overcompensation (paragraph 68 and 70 of the State Aid approval). The absence of overcompensation within the RHI scheme is one of the basis upon which the Commission considered the RHI measure to be compatible with Article 107(3)(c) of TFEU.

40. However the effect of the absence of cost controls has had for the pre-November 2015 participants is effectively that, dependant upon levels of consumption, many of these participants will, over the course of the 20 year scheme, receive a rate of return far in excess of the Commission-approved 12%. I refer you to examples contained in Annex A of the NI Audit Office Report. Some participants are in line to receive an average rate of return is in excess of 100%.

41. If payments continue at the current levels, the average rate of return for medium 99 KW biomass boiler installations on the pre November tariff is likely to be substantially more than the 12% originally anticipated. ▸

[42. DfE is required to notify the commission of any changes to the original parameters of the Scheme. To date there have been no re-notifications of the original scheme. At the present time DfE has advised that the RHI scheme \(pre and post November 2015 tariff changes\) remains valid within the extant State Aid approval. DfE has advised that it will re-notify the Commission in due course and seek approval to the revised scheme as required.](#)

### **Financial pressures on the NI Block Grant**

~~42-43.~~ An exposition of the financial pressures on the NI Block Grant is found at paragraph 49 – 53 of the NI Audit Office Report. This sets out the position with

regards to the effect the lack of cost controls within the RHI scheme will have on the NI Block Grant.

~~43-44.~~ Without corrective action, ~~over-circa~~ £1440 million of funding may have to be provided by the NI Block grant to meet the shortfall over the next five years if the Department were to honour all RHI commitments.

### **Advice**

~~44-45.~~ DfE has provided to DoF its Business case ~~for with a range of options to~~ address ~~ing~~ the deficiencies in the non-Domestic RHI Scheme (the 'BC'). In addition to it and the above mentioned ~~commitments~~ ~~comments~~, I attach a number of other background documents and a contents list.

~~45-46.~~ You will see that DfE's favoured approach for 2017-18 is option 2:

~~46-47.~~ Move all the Pre November tariff Medium Biomass boilers (and also the small numbers on the Small Biomass Tariff) to the tariffs introduced in November 2015. The tariffs are 6.5p for the first 1,314 metered hours per annum then falling to 1.5p. Payments are capped at ~~400,000 kWhs-~~ per annum after which no payment is made for heat generated. These tariff were designed to deliver a rate of return (IRR) of ~~C~~circa 12% to the typical or benchmark new entrant to the scheme based upon the information and assumptions pertaining at that time.'

~~47-48.~~ There are a number of non-legal aspects to the BC in respect of which DoF Supply have sought clarification (Annex x), and of course the BC may not be economically ~~+~~ or financially robust. DoF will resolve those issues to its satisfaction and I will update you with anything ~~rel~~levant in due course.

~~48-49.~~ As well as the options identified in the BC, it would also be possible in principle to revoke the the scheme in its entirety, subject to offering compensation to those affected to cover capital costs and a rate of return of 12% (reduced to take account of any return/payback received to date).

~~49-50.~~ I understand that DfE has asked the Attorney General for advice in relation to the legal risks associated with the favoured option. It is not clear as to when or whether that advice will be provided to the DoF – you will note at para 6.20 that it states that "*Formal, written, legal advice is currently awaited on these matters and will be incorporated or appended to this business case in due course*". In any case,

the Minister of Finance has asked that he be provided with his own advice. I would therefore be grateful for your opinion on:

- the risks of a successful challenge by an applicant to option 2 on any point of domestic Judicial Review law ECHR grounds, particularly legitimate expectation or A1P1;
- on consideration of the documentation for individual applicants, the risks of a successful private law action by an applicant for breach of contract or negligence;
- if you feel able to comment, whether any of the other four options identified would be preferable in terms of risk or outcome.

| ~~50-51.~~ I am sure that an early consultation would be of benefit; and I am available to discuss at any time.

**From:** [Brennan, Mike](#)  
**To:** [Widdis, Hugh](#)  
**Cc:** [Murphy, Stephen \(DoF\)](#); [Morelli, Emer](#); [Martin, Paula](#)  
**Subject:** RE: Emailing: RHI ITC v1  
**Date:** 13 January 2017 11:11:59

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Hugh -that's fine - content at this end

Thanks

M

-----Original Message-----

From: Widdis, Hugh  
Sent: 13 January 2017 11:09  
To: Brennan, Mike  
Cc: Murphy, Stephen (DoF); Morelli, Emer; Martin, Paula  
Subject: Re: Emailing: RHI ITC v1

Mike

Many thanks. We have inserted some other legal material and tidied up but not changed the substantive questions. In the interests of time are you therefore content that we issue to counsel?

To note also that SCC has been retained by DfE on an unconnected RHI matter, being a threatened JR against the release of recipient details. Neither he nor I would see a conflict, and I would still see him as most suited for the DoF brief, are you content?

Stephen

Could you please assist Paula in inserting these into the latest draft, and on receipt of Mike's being content, issue asap? I am detained in Clare House on other business but can speak on the phone.

Thanks

H

Sent from my BlackBerry 10 smartphone.

Original Message  
From: Brennan, Mike  
Sent: Friday, 13 January 2017 11:01  
To: Widdis, Hugh  
Cc: Murphy, Stephen (DoF); Morelli, Emer  
Subject: RE: Emailing: RHI ITC v1

Hugh - many thanks. I've tracked a few suggested amends in the attached.

It will be interesting to see how DfE propose taking this issue to the Assembly floor in the absence of Executive endorsement!

M

-----Original Message-----

From: Widdis, Hugh  
Sent: 12 January 2017 16:28  
To: Brennan, Mike

Cc: Murphy, Stephen (DoF)  
Subject: Emailing: RHI ITC v1

Mike

I attach a draft of instructions to Dr McGleenan QC. We intend to add a paragraph or two about legitimate expectation, drawing attention to, *inert alia*, the FM's letter to the banks. For now, I would be grateful if you would correct any factual errors you see, and confirm that at para 49 I have formulated accurately the questions which the Minster wants answered.

Thanks

H

Your message is ready to be sent with the following file or link attachments:

RHI ITC v1

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