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FROM: **Emer Morelli** **cc:** *Copy distribution list below*

DATE: **16 JANUARY 2017**

TO: **MÁIRTÍN Ó MUILLEOIR, MLA**

ADDRESSING THE DEFICIENCIES IN THE NON DOMESTIC RENEWABLE HEAT INTIATIVE (RHI) SCHEME

Issue:	**Approval of Business Case to "Address the deficiencies in the Non-Domestic RHI Scheme".**
Timing:	**Desk Immediate/Urgent**
Need for referral to the Executive:	**Approval of Business case does not require Executive approval.**
Presentational Issues:	**Likely interest from Media, Political Parties and Public.**
Freedom of Information:	**In the event of a request for disclosure of information contained in this submission under the FOI Act, the request would be considered in the context of the relevant provisions of the legislation including any relevant exemptions that may be applicable.**
Financial Implications:	**Successful implementation of preferred option in business case will reduce future costs of RHI scheme.**
Legislation Implications:	**Preferred option will be implemented through sub-ordinate Regulation.**
North/South Implications:	**None**

Statutory Equality Obligations:	**Not Applicable**
Recommendations:	**That you note this background brief and:**
	(b) agree that Supply approves the preferred option as presented in the business case. A draft copy of the DoF approval letter is attached at Annex B.

Issue

1. DfE submitted a business case to address the deficiencies in the Renewable Heat Incentive Scheme for DoF Supply approval on Wednesday 11 January 2017. This submission provides high level detail on Supply's consideration of the business case and seeks your agreement to Supply's approval of the business case. This is also informed by your meeting with officials on 16 January 2017.

Background

2. There is a need to reduce the net cost to the Executive of the RHI scheme in the 2017-18 financial year as the first stage of a wider programme to ensure the value for money (VfM) and financial sustainability of the scheme going forward. The business case focuses on changes to the tariff regime, with the aim of aligning the return to investors to the original VfM objectives intended under the RHI Scheme.

3. The business case considers a number of options with the preferred option being Option 2: Move all the Pre-November 2015 tariff Medium Biomass boilers (and also the small numbers on the Small Biomass Tariff) to the tariffs introduced in November 2015. These tariffs are 6.5p for the first 1,314 metered hours per annum then falling to 1.5p. Payments are capped at 4,032 hours per annum after which no payment is made for heat generated. These tariffs were designed to deliver a rate of return (IRR) of circa 12% to the typical or benchmark new entrant to the scheme based upon the information and assumptions pertaining at that time.

Advice

4. The business case models the likely cost of each option. It makes clear that this is a "*high level analysis*", which is based on assumptions around particular variables and which, in some cases, has had to gross up the data available to reach an ultimate cost estimate. While there is therefore some uncertainty around these cost estimates, what the analysis does demonstrate is that option 2, which essentially means bringing all recipients more or less into the post-November 2015 tariff structure, will significantly reduce the cost of the Scheme for 2017-18. What it also shows, though, is that for some recipients, the level of payment will continue to be substantial. The business case acknowledges this (para 5.7).

5. The business case does not include a sensitivity analysis of the impact of changes to key variables which drive the Rate of Return calculation, such as fuel prices. It is clear that adjusting these can have a significant impact on the potential Rate of Return, if not the overall cost of the Scheme. This also highlights the need to ensure that the tariff is reviewed regularly to take account of factors such as changes in relative fuel costs.

6. There are some other points to note in relation to the cost estimates. For example, there is the potential that the current cost of the Scheme (the status quo option, in other words) might be reduced through the 100% inspection regime that is to be introduced. There is no estimation of the saving that this might generate. Obviously, the greater the saving this achieves, the less the imperative for a revised tariff in order to bring the Scheme into line with the funding available.

Legal Advice

7. DoF has had sight of DfE's formal, written legal advice on three key points:

   (1) The risks of a successful challenge by an applicant to the selected options on any point of domestic judicial review law;
   (2) The risks of successful challenge to the selected options on Human Rights grounds; and
   (3) The risk of a successful private law action in contract or negligence by an applicant adversely affected by the selected options.

8. DfE's legal advice supports the preferred option insofar as that this option is "likely to survive a challenge under Article 1 of Protocol 1 of ECHR."

9. DoF has sought separate legal advice on the preferred option as set out in the business case. This advice concurs with DfE's legal advice on this issue. A copy of DoF's legal advice is attached at Annex A.

Supply Approval

10. Given that the preferred option has emanated from a high level analysis, DoF Supply has sought to build a number of safeguards into the attached draft approval letter at Annex B. Supply would intend to make the approval conditional on the following points:

    - **Implementation of Preferred Option**
      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.

      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**
  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.

  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**
  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.

  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**
  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

11. 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.

12. There is a significant risk that the favoured option proposed in the DfE business case will be subject to legal challenge. However, legal advice is that “there is a

reasonable prospect that a challenge based on legitimate expectation and Article 1 Protocol 1 ECHR can be successfully resisted."

13. A key objective of the inspection programme will be to increase public confidence that the governance of the scheme is robust. In order to further support that objective it would be useful if details of key aspects of the scheme, such as individual scheme user details (to include usage rates and type of business) could be made publicly available in so far as the terms of the scheme and data protection laws allow.

Recommendation

14. It is recommended that you agree that Supply approves the preferred option as set out in the business case to address the deficiencies in the RHI scheme. A draft copy of the Supply approval letter is attached at Annex B for your consideration.

Emer Morelli

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ANNEX B

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Stephen McMurray
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Netherleigh
Massey Avenue
Belfast BT4 2JP

xx 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.

It is noted that a key objective of the inspection programme will be to increase public confidence that the governance of the scheme is robust. In order to further support that objective it would be useful, but not a condition of this approval, if details of key aspects of the scheme, such as individual scheme user details (to include usage rates and type of business) could be made publicly available in so far as the terms of the scheme and data protection laws allow.

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.

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