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Sent: 14 December 2016 11:48
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Subject: EXEC-1094-2016 : DFE DRAFT EXECUTIVE PAPER - FUTURE OF THE NORTHERN IRELAND RENEWABLE HEAT INCENTIVE
Attachments: Template.doc; EXEC 1094 2016 Memo final.pdf; Executive Paper Version 1.docx

Reference: EXEC-1094-2016

Subject: EXEC-1094-2016 : DFE DRAFT EXECUTIVE PAPER - FUTURE OF THE NORTHERN IRELAND RENEWABLE HEAT INCENTIVE.

Referred To: TEO execomm secretariat

Date Referred: 14/12/2016

Please see attached papers.

Comments should be forwarded to Executive Secretariat at execomm@ofmdfmni.gov.uk using the Proforma by Close of Play on 21 December 2016.

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Regards,
Pauline Boyle Central Correspondence Unit 88242

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From the Office of the Minister



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FROM: SIMON HAMILTON MLA

DATE: 14 DECEMBER 2016

TO: EXECUTIVE MINISTERS

FUTURE OF THE NORTHERN IRELAND RENEWABLE HEAT INCENTIVE

I attach an Executive paper setting out the currently position and options under consideration for controlling costs associated with the Non Domestic Renewable Heat Incentive Scheme.

I am also copying this to the Attorney General, the Departmental Solicitor, and the First Legislative Counsel and to the Executive Secretariat.

A handwritten signature in black ink that reads "Simon Hamilton".

SIMON HAMILTON MLA

MEMORANDUM E ()

FROM: SIMON HAMILTON MLA

DATE: 14 DECEMBER 2016

TO: EXECUTIVE

VERSION 1

DRAFT EXECUTIVE PAPER – FUTURE OF THE NORTHERN IRELAND RENEWABLE HEAT INCENTIVE

Introduction

1. This paper outlines some of the options under consideration for proposed changes to the Northern Ireland Non-Domestic Renewable Heat Incentive (RHI), with the aim of controlling future costs associated with the scheme. I have made it clear both publically and to the Permanent Secretary that action on this issue is the absolute top priority of the Department. The aim is to:
 - ensure compliance with the terms of the State aid approval of the scheme; and
 - ensure a proper balance between the rights of scheme participants, and the public interest of meeting the requirements of the Renewable Energy Directive without unreasonable cost to public finances.
2. In addition, the Department is taking urgent action to tackle abuse of the scheme and to identify and act on any potential fraud.

Background

3. The (RHI) Scheme was introduced in November 2012. The scheme supports the UK objective of contributing to the Renewable Energy Directive target of 20% overall EC energy consumption from renewable sources by 2020 of which the UK's share of the target is 15%. The UK plans to achieve this through a combination of 12% renewable

heat and 30% renewable electricity by 2020. In Northern Ireland, the renewable heat target is 10% by 2020. A separate RHI scheme is applicable to the rest of the UK.

Scheme Performance & Tariff Changes (November 2015)

4. Scheme uptake was initially low in the first few years with 409 applications received by the end of 2014. Following an increase in application numbers during 2015, the following changes were made to the most popular small and medium biomass technology on 18 November 2015:-
 - The introduction of an annual tiered tariff where the first 1314 operating hours would be paid at the standard rate, reducing thereafter to 1.5 p per kWh;
 - A widening of the medium biomass banding from 20-99Kwh to 20 - 199kWh, (in line with the UK mainland scheme); and
 - An annual heat cap of 400,000kWh after which no payment would be made.
5. These changes were considered to be necessary and proportionate. Their aim was to ensure that the policy objectives of the scheme would continue to be met (including compliance with the Renewable Energy Directive), whilst ensuring that:
 - the potential for overcompensation (stemming from an over-generous tariff) would be reduced;
 - expenditure would remain within budget limits; and
 - the potential for fraud and abuse would be reduced.
6. Whilst these changes impacted on new installations post 18 November 2015 they did not apply to pre November installations.

Scheme Suspension

7. It soon became clear that the scheme changes introduced in November 2015 were too late. In the 10 week period between the announcement of the changes and their implementation, there was an unprecedented spike in demand, with almost 1,000 applications received in ten weeks. This more than doubled the total number of installations on the scheme, creating significant budgetary pressures.
8. This led to the scheme having to be suspended to new applications from 29 February 2016. Another (smaller) spike in demand was experienced prior to scheme suspension with a further 300 applications received.

Scheme Issues

9. Since suspension, the scheme has been the subject of a number of highly critical reviews and allegations of potential scheme abuse. These reviews highlight that, while the original policy intentions of the scheme may have been laudable, significant failings in the design, oversight and control of the scheme have led to the potential for over-compensation and renewable heat usage being supported that is not useful or useable.

Over-compensation

10. The Department is conscious that the RHI scheme must operate within the terms and conditions of its State aid Approval (SA.34140) and the European Commission Guidelines on State Aid for Environmental Protection.

11. As detailed in section 3.2.1 of the Commission's State aid approval for the Northern Ireland scheme is based on scheme participants receiving an average rate of return of 12% over the lifetime of the technology.

12. The Commission's approval reads '*...the Commission notes that this (the discount rate of 12%) 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...*'

13. Recent analysis carried out by the Department shows that participants with 99KW biomass installations on the flat 6.5 p/KWh tariff (pre 18 November 2015) could be set to receive rates of return in excess of 100% if payments continue for 20 years. This far exceeds the 12% rate of return approved by the Commission.

14. In comparison, the maximum rate of return for a heating system installed after 18 November 2015 is 19%. Although higher than 12%, this is within the 8 to 22% range referenced in the Commission's approval as necessary to incentivise renewable heat production.

15. Officials discussed the issues with the European Commission on 7 December and that engagement is guiding the next steps we are taking.

Load Factor / Running Time

16. In relation to the comment above that renewable heat usage is being supported that is not useful or useable, paragraph 34 of State Aid approval states: *'In order not to provide perverse incentives to waste heat, each reference installation is calibrated to have a specific load factor and the tariff is calculated with reference to that load factor. For example, a load factor of 15% means that the installation is used at full capacity for 15% of the time'*.
17. In reality, the actual load factor or 'running time' for many installations is in the range of 80% to 100%. This means that around 1,800 scheme participants on the flat pre November 2015 tariff are set to receive excessive payments much higher than what was envisaged in the original Notification.
18. While the Department accepts that some installations have a legitimate basis for 24/7 use (for example, poultry farms), it is now evident that a tiered tariff should have been employed from the outset (as was the case with the RHI Scheme in the rest of the UK) to avoid over-compensation and remove any perverse incentive to waste heat to increase payments.

Budgetary Pressures

19. The Commission's approval reads *'As regards the budget of the notified measure, the UK authorities have allocated a budget of GBP 25 million from 2011 to 2015 specifically to renewable heat in NI. The budget is expected to increase by GBP 5 million per year from 2015 until 2020, which would imply approximately a total of about GBP 184 million in funds from the scheme to be paid until 2020. ...'*
20. The budget for the Northern Ireland Scheme was anticipated to be in the order of £22m in 2016/17 based on an annual increase of £5m. Based on the population share (3%) of the total UK budget, the Northern Ireland allocation in 2016/17 is £18.3m.
21. Due to the spikes in applications prior to the November 2015 changes and scheme suspension in February 2016, total annual RHI expenditure for committed RHI payments is now forecast to be over £50m creating an ongoing annual pressure of over £20m a year for the NI Executive for the next 20 years. Total RHI expenditure over 20 years is currently forecast to be £1.2 billion if no action is taken.

22. Actual expenditure is therefore significantly higher than what was approved by the Commission in 2012. The Department must also balance this budgetary obligation to RHI scheme participants against its wider obligation to safeguard against unnecessary cost to the public and the adverse effect on the Northern Ireland Executive's finances, and the need to comply with the regulations in relation to State Aid.

Potential Scheme Abuse

23. On 29 July 2016, the Department commissioned an independent review into allegations relating to abuse of the non-domestic RHI Scheme. In addition to examining the scheme guidance and controls, the Review considered whether installations generated heat for an eligible purpose and whether they met the policy intentions of the Scheme. That is to generate heat, by renewable means, which would still need to be generated without the incentive of the RHI Scheme.

24. The review conducted 80 site visits comprising 295 installations over 78 businesses. These installations represent around 20% of payments for the entire RHI Scheme.

25. The results of the site inspections were allocated to one of four categories as follows:

- Category 1: Participants generating heat for an eligible purpose within the intentions of the scheme.
- Category 2: Participants generating heat for an eligible purpose, which does not meet the intentions of the scheme.
- Category 3: Participants generating heat for an eligible purpose, but using heat in a way that is not energy efficient.
- Category 4: Generating heat which may be for an ineligible purpose and therefore may be in breach of the scheme.

26. The Review found that only 47% of inspection result fell into category 1, (they were considered to be generating heat for an eligible purpose within the intentions of the scheme). This is obviously a matter of grave concern and work is ongoing to investigate the potential to take enforcement action where there is evidence that there has been non-compliance with the eligibility requirements.

Corrective Action

27. The Department is urgently taking forward action to address these weaknesses, improve the scheme's value for money and reduce future costs. There are three key work streams:

- Governance and Control
Strengthening the governance and control arrangements between the Department and the scheme administrators (Ofgem).^a
- Audit and Enforcement
Implementing a much more rigorous approach to audit, inspection and enforcement including taking forward appropriate action on the Category 2/3/4 cases identified through the independent review.
- Cost Controls
Given the magnitude of the State Aid, Value for Money and public expenditure costs associated with the scheme, the Department is considering a number of potential cost control options.

Recommendation

28. The Executive is asked to note the current position and options under the consideration in the Department for the Economy. I am very happy to keep Executive colleagues updated as work progresses.

SIMON HAMILTON MLA

^a Office of Gas and Electricity Markets

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Please contact Executive Secretariat with any queries on 88026.