

**EXPLANATORY MEMORANDUM TO THE
VALUE ADDED TAX (REDUCED RATE) (NO. 2) ORDER 2005**

2005 No. 3329

1. This explanatory memorandum has been prepared by HM Revenue and Customs and is laid before the House of Commons by Command of Her Majesty.

This memorandum contains information for the Select Committee on Statutory Instruments.

2. **Description**

- 2.1 This Order amends Schedule 7A (Charge at Reduced Rate) to the Value Added Tax Act 1994 (c. 23) (“Schedule 7A”).

- 2.2 Article 3 adds boilers fuelled solely by wood, straw or similar vegetal matter to the list of energy-saving materials in paragraph 1 of the Notes to Group 2 (Installation of Energy-Saving Materials) in Part 2 of Schedule 7A.

- 2.3 The Committee is respectfully referred to the explanatory note to the Order for the specific detail.

3. **Matters of special interest to the Select Committee on Statutory Instruments**

None

4. **Legislative Background**

- 4.1 This Order has been made by the Treasury in exercise of their powers under sections 29A and 96(9) of the Value Added Tax Act 1994.

- 4.2 Section 29A(3) provides that the Treasury may by order vary Schedule 7A by adding or deleting from it any description of supply or by varying any description of supply for the time being specified in it.

- 4.3 Section 29A(4) provides that the power to vary Schedule 7A conferred by sub-section (3) may be exercised so as to describe a supply of goods or services by reference to matters unrelated to their characteristics and that, in the case of a supply of goods, those matters include, in particular, the use that has been made of the goods.

- 4.4 Section 96(9) provides that the power to vary Schedule 7A includes a power to add to, delete or vary any notes to that Schedule.

5. Extent

This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Financial Secretary to the Treasury, John Healey MP, has made the following statement under section 19(1)(a) of the Human Rights Act 1998:

In my view the provisions of the Value Added Tax (Reduced Rate) (No 2) Order 2005 are compatible with the Convention rights.

7. Policy background to Article 3

7.1 As part of its commitment to promote domestic energy efficiency and reduce the emission of gases responsible for global warming, the Government has extended the reduced rate of VAT to the installation of boilers which burn wood, straw or similar vegetal matter to produce heat and hot water in homes and certain residential and charity buildings.

7.2 This measure is an extension of the current support given to promote the development of domestic microgeneration technologies to improve Household Energy Efficiency, which is a key element of a long-term strategy to tackle climate change. Wood fuelled boilers use a sustainable fuel, burning wood and straw at up to 85% efficiency. The carbon released in burning is taken in from the environment during plant growth and, if not burnt, would naturally be released back into the atmosphere during decomposition, thus making wood fuelled boilers effectively a 'carbon neutral' energy source.

7.3 Encouraging the increased use of such products by reducing the rate of VAT on their installation should therefore have a positive effect in reducing carbon emissions.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

8.2 The impact of Article 3 on the public sector is nil.

9. Contact

Jamie Allen at HM Revenue and Customs Tel: 020 7147 0632 or e-mail: Jamie.allen@hmrc.gov.uk can answer any queries regarding this instrument.

REGULATORY IMPACT ASSESSMENT (RIA)

1. Reduced rate of VAT on the installation of wood fuelled boilers.

2. Purpose and intended effect

- The policy objective

This measure will extend the reduced rate to the installation of boilers fuelled solely by wood, straw or similar vegetal matter in homes and certain residential and charity buildings. It is intended to promote the use of sustainable energy sources, encourage use of new technologies and contribute to Government's commitment to reduce carbon dioxide emissions.

- Background

As part of its Climate Change Programme, the Government is committed to reducing emissions of the gases responsible for global warming. The Kyoto Protocol commits the UK to reduce its greenhouse gas emissions to, on average, 12.5% below 1990 levels between 2008 and 2012. The Government also has a national goal to move towards a 20% reduction in carbon dioxide emissions below 1990 levels by 2010.

The Energy White Paper published in February 2003 restated the Government's commitment to its climate change goals and emphasised energy efficiency as one of its priorities. Households account for nearly 30% of energy consumption and are responsible for a quarter of all emissions, and domestic energy efficiency needs to be a significant part of strategy to achieve environmental goals.

- Rationale for government intervention

The UK residential sector produces over a quarter of total UK emissions, thus making it important that methods of improving household energy efficiency, and development of sustainable sources of fuel are encouraged as a key element of the Government's long-term strategy to tackle climate change. Wood-fuelled boilers are described as carbon neutral in that the carbon released when the fuel is burnt is equal to that absorbed as the tree grows. Furthermore, less carbon is used in the operation of this equipment, as it needs little or no power to run it. However, these benefits need to be balanced against emissions generated by transporting the fuel from its place of production to the consumer.

The introduction of a reduced rate, taken as one element of a package of Government measures, would give a positive signal to consumers, investors and producers of both boilers and sustainable biomass-based fuels, and could impact on behaviour as well as encouraging further development of a sustainable energy source. This measure follows the implementation of the reduced rate for installation of other energy saving materials in previous years.

3. Consultation

- Within government

Department of Trade and Industry and Department of the Environment, Food and Rural Affairs indicate support for the introduction of a reduced rate.

- Public consultation

The Carbon Trust, the Biomass Task Force and the Renewable Power Association have all recommended a reduced rate of VAT for wood fuelled boilers.

4. Options

1. **Do nothing**, retaining the standard rate of VAT (17.5%) on the installation of such equipment.
2. **Apply a reduced rate of VAT (5%)** to the installation of such equipment.

5. Costs and benefits

- Sectors and groups affected

The reduced rate will benefit households and certain charity buildings not used for business purposes. The reduced rate will affect both boiler producers and installers and will be charged by businesses that install the equipment (and supply it in association with the service of installation). The market is currently small within the UK; at present there are approximately 300 wood-fuelled boilers in operation in the UK, with 34 installers registered with the DTI under their Clear Skies scheme.

The proposal will have no race, Northern Ireland or other equality impacts.

- Benefits

Option 1: Do nothing. Under this option there would be no loss of taxation revenue to the Exchequer and no compliance burdens on industry.

Option 2: Apply a reduced rate. Potential lifetime carbon savings for wood fuelled boilers are estimated at 341tC from uptake in 2006-07 rising to 858tC in 2010-11. VAT provides a targeted response to the main causes of market failure, by:

- reflecting the environmental costs of purchases. VAT rates are able to do this more effectively than many other policy instruments can. Reducing the rate of VAT on energy efficient and energy saving products lowers the price differential between them and energy inefficient goods. This helps correct market failure by reflecting more closely the cost to the environment of less efficient products.
- targeting the final consumer. Reducing the rate of VAT leads to a fall in the price of the products that, in turn, triggers increased demand and encourages the development of energy-efficient products.
- sending out a clear signal to the market, which helps to reduce the impact of imperfect information on consumer's decision-making.
- Costs

Option 1: No change. There would be no compliance burdens on the industry or fiscal costs to the Exchequer.

Option 2: Apply a reduced rate. The likely cost to the Exchequer will be £0.6M in 2006-07 rising to £1.7M in 2010-11. In environmental terms, wood-fuelled boilers emit higher levels of carbon monoxide, nitrogen oxides and sulphur than equipment that uses energy from renewable sources, such as solar, wind or hydropower. The compliance burden will fall on installers of these products who will have to deal with multiple VAT rates, if they also install standard rated equipment. However, the energy industry has experience of reduced rates, which have been successfully introduced for installations of other energy saving products in recent years.

6. Small Firms Impact Test

The introduction of a reduced rate of VAT for wood fuelled boilers is an extension of reduced rates for a range of energy saving materials, that currently have a limited impact on small firms. The compliance burden of dealing with multiple VAT rates will fall on installers, some of whom will be small firms, if they also install standard rated equipment.

However, reduced rates have been successfully introduced for installations of other energy saving products in recent years. The Pellet Club, the representative association of the wood fuelled boiler industry, has supported the introduction of a reduced rate on behalf of its members and small firms involved in the industry will benefit from increased demand as a result of the reduced rate. Small Firms in general will not be affected by the measure which only applies within residential and charity buildings.

7. Competition assessment

The measure will affect the boiler market including both producers and installers. For wood fuelled boilers the market within the UK is small with fewer than 50 installers currently registered with the DTI. This measure has passed the simple competition filter. However, the introduction of a reduced rate for wood-fuelled boilers is likely to increase demand for this technology at the expense of existing, less environmentally friendly technologies. However, that is exactly the kind of behavioural change that this measure is intended to encourage.

8. Enforcement, sanctions and monitoring

The sanctions imposed for non-compliance will be those as laid down in the VAT Act 1994.

9. Implementation and delivery plan

The reduced rate will be introduced through a change to the VAT Act 1994, coming into effect on 1st January 2006. Guidance on the measure will be issued in a Business Brief on 5th December 2005.

10. Post-implementation review

H M Revenue & Customs and the Treasury will endeavour to monitor the effect of the introduction of the reduced rate, as distinct from other causes of changes in demand for these products.

11. Summary and recommendation

This measure encourages the domestic use of a sustainable energy source and contributes to the Government's commitment to reduce carbon dioxide emissions and promote microgeneration. This is an extension to a range of reduced rates that already exist for this purpose and with which the energy industry are familiar.

Contact details:

Jamie Allen

HM Revenue and Customs

0207 147 0632

Jamie.Allen@hmrc.gsi.gov.uk

REGULATORY IMPACT ASSESSMENT (RIA)

Reduced rate of VAT on the installation of wood-fuelled boilers.

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

**John Healey MP
Financial Secretary to the Treasury**

Date: 30/11/05