

**EXPLANATORY MEMORANDUM TO THE
VALUE ADDED TAX (REDUCED RATE) ORDER 2005**

2005 No. 726

1. This explanatory memorandum has been prepared by HM Customs and Excise 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 Group 2 (Installation of Energy-Saving Materials) of Part II of Schedule 7A (Charge at Reduced Rate) to the Value Added Tax Act 1994 (c. 23).

- 2.2 Article 3 adds air source heat pumps and micro combined heat and power units to the list of energy-saving materials in paragraph 1 of the Notes to Group 2.

- 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 Economic Secretary to the Treasury, John Healey 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) Order 2005 are compatible with the Convention rights.

7. Policy background

7.1 As part of its commitment to reducing the emission of gases responsible for global warming the Government has extended the reduced rate of VAT to the installation of air source heat pumps and micro-combined heat and power units in homes and certain residential and charity buildings.

7.2 Air source heat pumps use the air as a heat source to provide energy for heating and cooling. They can also be used to augment existing heating systems in same way as solar panels.

7.3 Micro combined heat and power units produce heat and hot water but, in addition, use the waste heat produced to generate electricity.

7.4 Encouraging the increased use of such products by reducing the rate of VAT on their installation should 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 on the public sector is nil.

9. Contact

Jack Fletcher at HM Customs and Excise Tel: 020 7147 0252 or e-mail: jack.fletcher@hmce.gov.uk can answer any queries regarding this instrument.

REGULATORY IMPACT ASSESSMENT (RIA)

Reduced rate of VAT on Air Source Heat Pumps and Micro Combined Heat and Power Units.

Purpose and intended effect of measure

(i) The objective

The measure will extend the reduced rate to the installation of air source heat pumps and micro-CHP in homes and certain residential and charity buildings. It is intended to promote energy efficiency, encourage use of new technologies and contribute to Government's commitment to reduce carbon dioxide emissions.

(ii) The 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 that energy efficiency is one of its priorities. Households are responsible for a quarter of all emissions, and need to be a significant part of strategy to achieve environmental goals.

(iii) Risk assessment

Renewable sources of energy, such as heat pumps and micro-CHP, offer a cost-effective and environmentally-friendly alternative to conventional sources of energy. However, the markets for these products are relatively new and still in their formative stages, which means that the cost of this technology is higher than conventional heating systems. A reduced VAT rate would support this young technology and help it to develop. It would help to reduce the price of this equipment, whilst giving a positive signal to consumers. This measure follows the implementation of the reduced rate for installation of other energy saving materials in previous years.

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.

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. 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 which, 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.

Environmental

Air source heat pumps

A dedicated air source heat pump is estimated to save in excess of two tonnes of carbon emissions per year. Thus the reduction in carbon emissions may be estimated for the projected growth in the market.

Carbon savings (tonnes)

2005/06	2006/07	2007/08	2008/09	2009/10
3,873	10,000	11,931	14,236	16,985

Micro-CHP

The estimate of carbon savings is based on an average 3 bedroom, semi-detached house, where it is assumed the micro-CHP unit can only provide 80% of heat demand and a supplementary condensing boiler is used to provide the additional 20%. The potential reduction in CO₂ emissions as a result of the projected number of units in operation each year, is illustrated below.

Carbon savings (tonnes; compared with condensing boilers)

2005/06	2006/07	2007/08	2008/09	2009/10
700	9,900	27,700	59,600	118,200

5. Costs

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

Option 2: Reduced rate.

Air source heat pumps

The likely cost to the Exchequer is likely to be less than £1m in the first year and up to £2.4m in the following three years.

Micro-CHP

The likely cost to the Exchequer of such a measure is likely to be £1m in the first year of introduction and rising to £5m in year two and £5m in year three.

The compliance burden will fall on installers of these products which, if they also install standard rated equipment, will have to deal with multiple VAT rates (though some may be doing so already, if they also install other energy efficiency equipment). However, the number of installers is small at the moment and they will welcome the introduction of a reduced rate for their services which follows extensive lobbying by the industry for such a move. The energy industry has experience of reduced rates which have been successfully introduced for installation of other energy savings products in recent years.

Competition Assessment

The introduction of a reduced rate for air source heat pumps and micro-CHP will make the products relatively cheaper in comparison with conventional heating systems and is likely to increase demand for the new technology at the expense of existing, less environmentally friendly technology. However, this is entirely the kind of behavioural

change that the Government intends the measure to encourage.

Securing compliance

The proposal will be introduced through a change to the VAT Act 1994. Customs and Excise will enforce the legislation through their risk and assurance programmes. For non-compliance the sanctions imposed will those as laid down in the VAT Act 1994.

Monitoring and Review

Customs and Excise 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, and will make full use of our continuing contacts with the industry.

Consultation

There has been informal consultation with the industry and wide consultation between the Department of Environment, Food and Rural Affairs, HM Treasury and HM Customs and Excise over the proposal.

Contact point

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REGULATORY IMPACT ASSESSMENT

Reduced rate of VAT on Air Source Heat Pumps and Micro Combined Heat and Power Units

Statement of Ministerial Approval

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
Economic Secretary to the Treasury