



The future of the Government's flagship Green Deal programme hangs in the balance after an intensifying tax dispute with the European Commission.

Brussels bureaucrats have warned Whitehall to overhaul the tax rules regarding energy-saving materials or face the prospect of massive fines at the European Court of Justice.

Currently, the UK Treasury levies a reduced rate of five per cent VAT for insulation materials for walls, ceilings, floors and water tanks. However, the full 20 per cent rate of VAT still applies to energy efficient windows and doors.

In August, the European Commission warned the UK Government the reduced five per cent tax rate is unlawful and it must change the law or face the prospect of the European Court imposing huge financial penalties.

The UK Government is fiercely disputing the ruling but this week a spokesperson for Europe's Tax Commissioner Algirdas Šemeta said it was unlikely the challenge will be successful and said the UK had only this week filed the formal paperwork to appeal.

"The current infringement proceeding is on the application of the reduced VAT rate to some goods and services which according to the VAT directive would not be subject to this rate," she added.

"How this infringement interacts with the eligibility criteria of investments under the Green Deal is a domestic UK issue on which we do not have comments."

However, she warned of a lengthy delay to a final outcome as the Commission deals on average with 400 to 500 infringement cases a month.

If, as threatened, Europe sticks to its ruling it means the Green Deal will be grounded because it will no longer be financially viable.

The energy-saving programme is underpinned by the so-called 'golden rule', which means the expected financial savings must be greater than the costs attached to the energy bill.

The imposition of an unexpected quadrupling in tax will rule many green improvements out of the scheme.

A spokesman for Department of Energy and Climate Change (DECC) admitted the department is closely monitoring the situation but did not want to discuss the implications while the crunch decision from Brussels is awaited.

If, as expected, the case is referred to the European Court of Justice to impose financial penalties the issue could drag on until the middle of next year at the earliest.

In the meantime, the Government is desperate to avoid repeating a boom similar to the Feed-in Tariff for solar PV as it may be penalised further to compensate for the retrospective difference in tax levels.

The October 1 launch of the Green Deal was played down by Ministers although earlier this month the Energy Secretary Ed Davey announced that householders insulating their homes would be able to claim up to £1,000 in cash from the Government in January.

The dispute has been simmering for decades as the UK Government gradually expanded the list of energy-saving devices that qualify for lower rate VAT.

As the rate on electricity and gas consumption has long been set at five per cent, the UK Government thought it appropriate to reduce the levels for energy conservation to the same level.

It is only now, 12 years after the five per cent rate for some key energy-saving measures was introduced, that the EC is challenging their legality. And it is seeking to force the UK Government to remove all exemptions, thereby raising the VAT rate for all energy efficiency actions to the full 20 per cent.

Shortly after the General Election, the EC tax inspectorate indicated disquiet about these lower VAT rates because they were beyond the permissible categories for reductions.

A 'formal notice' followed but HMRC believed they had answered the objections. HMRC then received an official Reasoned Opinion, claiming that the existing concessions were in breach of Annex 3 of the latest VAT directive. This states that the five per cent rate is permitted only for the "provision, construction, renovation and alteration of housing, as part of a social policy".

The Cabinet Office minister Oliver Letwin, briefed by HMRC, has strenuously rejected the claim that installing energy saving measures does not have a social purpose.

As well as issues raised by having a flagship policy disrupted, the Government also faces the problem of achieving carbon targets, energy security and its pledges on eradicating fuel poverty, three of the aims of the Green Deal.

Three-quarters of the energy used in UK homes is for heating rooms and water, which accounts for 13 per cent of UK emissions. Workplaces account for 20 per cent of the total. To help meet the UK carbon budgets emissions in homes and communities must be reduced by 29 per cent

and by 13 per cent in workplaces by 2022.

The energy efficiency sector in the UK already accounts for around 136,000 jobs, and had sales of £17.6 billion in 2010/11.

Sales in this sector have grown by over four per cent per year in the UK since 2007/08, and are projected to grow by around five per cent per year between 2010/11 and 2014/15.

With millions of the UK's ageing houses being energy inefficient, the potential of the retrofit market is estimated at £500 billion.