National Audit Office

Report
by the Comptroller
and Auditor General

Department for Environment, Food & Rural Affairs
and the Rural Payments Agency

Managing disallowance risk

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Summary

1 Since 2005, the Department for Environment, Food & Rural Affairs (the Department) has incurred a total of £642 million in disallowance penalties.[1] Of this amount, the Department has already paid out £410 million and is expecting to pay a further £231 million in future years.[2] These penalties are imposed by the European Commission (the Commission) when it believes member states have not complied with its requirements for delivering the CAP (paragraph 1.11).

2 For many years the Comptroller and Auditor General has reported on material disallowance levels in his *Report on Accounts*, which accompanies the Department's financial statements. This report provides a fuller context to historical disallowance levels, at a time when the Department is implementing significant changes to the CAP and its own systems for the period to 2020. It is primarily an exposition of the facts about disallowance in England and we do not conclude on value for money. It is in three parts:

- **Part One** describes what the CAP is, how the Department administers it in England and how disallowance penalties arise. We also describe the Commission's assurance arrangements for the CAP.
- **Part Two** sets out why disallowance penalties arise in England and assesses the extent of future disallowance risk.
- **Part Three** sets out how the Department manages disallowance risk.

3 Our approach and evidence base is set out in Appendix One.

What is the Common Agricultural Policy?

4 The CAP is the framework of agricultural subsidies and rural development programmes agreed between the Commission and member states of the European Union (EU). The EU recently reformed the CAP and most of the new regulations came into force in 2014. We refer to the previous scheme as CAP 2005–14 and the current one as CAP 2015–20 (paragraph 1.1).

5 As with all public funds, the Commission, as the executive body of the EU, has a duty to member states' citizens to assure the regularity and propriety of payments made through the CAP. Therefore it seeks to verify that member states have adequate controls over the funds (paragraph 1.2).

1 This relates to the 2007-13 Single Payment Scheme, a number of smaller 2007-13 schemes and pre-2007 predecessor schemes. CAP 2015-20 schemes have not yet been subject to review by the Commission, and so levels of disallowance are not yet known.

2 Payments under the CAP scheme are denominated in euros. In translating amounts to pounds sterling, this report uses historical rates wherever possible. In respect of payments expected in the future, we assume based on June 2015 exchange rates that £1 equates to €1.40.

6 From 2015, the CAP will account for approximately 38% of the EU's budget and will be its largest programme. The CAP has two 'pillars'. Over the course of CAP 2015–20, pillar 1 will give around £2.3 billion per year in direct payments to UK farmers, provided they carry out certain agricultural activities and comply with standards in areas such as food safety, animal welfare, environmental protection and land maintenance. It also includes a number of contract support measures. Pillar 2 will give £0.5 billion per year to fund rural development programmes in the UK (paragraphs 1.3 and 1.4).

7 Member states have some discretion over how they implement the CAP in their own country. Responsibility in the UK is devolved to each of the devolved administrations. The Department was actively involved in negotiating with the Commission and other member states over reform of the CAP and simplifying it was a high priority. The Department believes the complexity of the CAP overall has increased despite its efforts, and expects implementation costs to increase by 15% (paragraphs 1.7, 1.8, 3.24 and 3.25).

8 The Commission estimated that the cost across all member states for controlling CAP spending in 2013 was around 7% of the total funds disbursed. The equivalent figure for the UK in 2013 was lower at around 4%, but the Department expects this to increase due to the added complexity of the reformed scheme (paragraph 1.8).

9 A member state may incur disallowance, in the form of a financial penalty, if the Commission considers that actions taken to control and administer CAP payments have not been compliant. The Commission will base any subsequent financial correction on its assessment of the potential risk to EU funds, or apply a flat-rate penalty where it cannot make a reasonable estimate. The flat-rate penalty is applied to the expenditure considered to be at risk and is set out in guidelines and statute. A member state can try to reduce the penalty by showing that the risk of loss to the fund has been overestimated. Assessment of losses and negotiations with member states can often take several years to conclude (paragraph 1.11, 1.14 and 1.15).

10 The Commission recently introduced 'action plans' to tackle what it perceives to be systemic failings on the part of member states. If the Commission is dissatisfied with a member state's progress against its agreed plans, the member state's agricultural payments may be suspended (paragraph 1.21).

11 England currently has three live action plans (see Appendix Two), relating to mapping, the Fruit and Vegetable Producer Organisation scheme and the Rural Development Programme for England. In 2014 the Commission's audit work revealed weaknesses in the Rural Payment Agency's (RPA's) Rural Land Register and inspections which they believed affect the legality and regularity of area-based payments. This triggered an action plan to improve the administration of claims from 2015 onwards (paragraph 1.22).

Causes of disallowance

12 Disallowance can arise as a result of delays in payments to claimants, member states misinterpreting the regulations, or the Commission identifying control weaknesses that are a risk to EU funds. The main causes of disallowance in the UK under CAP 2005–14, which are explained in more detail in Part Two, were:

- late payments to farmers and other recipients (paragraphs 2.2 and 2.3);
- the quality and completeness of mapping data used to verify applications (paragraphs 2.6 to 2.12);
- shortcomings in cross-compliance controls (paragraphs 2.13 to 2.15); and
- the Fruit and Vegetable Producer Organisation scheme (paragraphs 2.16 to 2.21).

13 Late payments resulted in a penalty of €85 million (£58 million) in 2006, but this issue was resolved from 2007 onwards. Since then, mapping deficiencies have become the predominant issue. The Department has estimated that, without extra investment, disallowance from future mapping deficiencies could amount to between £215 million and £370 million by 2021 (paragraph 3.28).

The Department's management of disallowance risk

Strengthening governance

14 Overall responsibility for managing disallowance rests with the Department and it is financially liable for the penalties. The Department works with the key delivery bodies within its network to manage disallowance risk. These are the Rural Payments Agency (RPA), which is responsible for paying all EU funds, delivery of pillar 1 and part of pillar 2, and Natural England and the Forestry Commission, which administer the remainder of pillar 2 on the Department's behalf (paragraphs 1.9 and 3.3).

15 The Department has changed its governance arrangements for managing disallowance. In order to promote a more proactive and joined-up approach to managing disallowance across its network bodies, it refreshed the terms of reference and membership of its existing Disallowance Working Group (DWG), which now mainly deals with the day-to-day monitoring of disallowance risks. In addition, it created the Disallowance Steering Group above the DWG with a focus on monitoring progress and strategic decision-making (paragraphs 3.3 and 3.4).

CAP Delivery programme

16 **The Department and the RPA are implementing the CAP Delivery programme**. Its aim is to deliver the new Rural Payments IT system and an associated set of business processes, which will handle processing and payment of grant claims in England. It has been designed to deliver the CAP scheme more efficiently and to reduce disallowance risk cost-effectively. The IT system allows elements of the CAP claims process to be carried out online and includes automated checks to validate claims against CAP rules (paragraphs 3.13 and 3.14).

17 **The programme is behind schedule and the RPA has had to make changes to the system, which could increase the risk of disallowance**. Each time there is a change to the system, the RPA checks whether this will have any impact on disallowance risk. It also checks whether it has processes in place to mitigate any additional risk. However, the RPA has acknowledged that it may not always be able to fully identify the wider impact of changes, such as knock-on delays to the development of other system functionality (paragraphs 3.15 and 3.16).

18 **In March 2015, technical problems led the Department to suspend the online system that enabled famers to submit their claims and changes to their land data electronically, and revert to a partially paper-based system.** Compared to a fully implemented online system, this carries a higher risk in relation to manual data entry errors and claims being calculated incorrectly. This approach also carries a higher operating cost for the Department. These technical issues are therefore likely to cause delays for the Department both in mitigating disallowance risk and in making administrative savings (paragraph 3.17).

19 **The Department and the RPA have taken steps to assure themselves that the new systems and processes will promote compliance with EU requirements**. They have developed a separate Scheme Control Framework to map regulatory requirements to system controls, identify potential gaps and highlight where additional manual controls, such as on-site inspections, are needed (paragraph 3.18).

Improvements to mapping

20 **Issues with the quality and completeness of data in the RPA's Rural Land Register (RLR) have been the most significant drivers of disallowance**. The Commission requires member states delivering the CAP to operate a Land Parcel Identification System (LPIS) that allows all agricultural areas to be uniquely identified. In England, the RLR fulfils this regulatory requirement. However, the Commission has been critical that not all eligible and ineligible areas have been mapped correctly or based on the most up-to-date information. As a result the RPA has not met the requirement for data to be no more than three years old (paragraphs 2.7 and 2.8).

21 **The Department has developed a number of projects to improve the currency and accuracy of the maps in the RLR**. These will allow it to be updated from a number of different sources, rather than relying on information submitted by farmers. In 2014, the Department also appointed an external supplier to provide remote sensing and aerial photography to meet the new mapping requirements of CAP 2015–20, such as being able to identify hedges and features that are ineligible (paragraphs 3.19 to 3.23).

Conclusion

22 **Since 2005, the UK has incurred disallowance penalties of £2.70 for every £100 of CAP funds paid out**. This is the sixth highest figure out of the 28 member states. This only provides an indication of the relative position of countries as they can incur further disallowance penalties at any time (paragraph 1.12).

23 **The Department has developed investment proposals that focus mainly on further improving mapping capabilities**. A number of options are currently being assessed and are expected to require an investment of between £25 million and £45 million. Should all sources of mapping-related disallowance be successfully addressed, the Department estimates that a saving in the range of £215 million to £370 million could be realised by 2021 (paragraph 3.28).

24 **The Department's accounting officer has a duty to consider the cost of disallowance to the wider public purse, and should continue do so even when the Department's direct incentives to reduce disallowance are limited by current financial arrangements.** HM Treasury has ring-fenced the funding it provides for disallowance penalties, and any unused amounts are either carried over to future years or passed back to HM Treasury (paragraphs 3.30 and 3.31).

Risks of future disallowance

25 **While the Department has an ambition to reduce disallowance overall, it does not expect to be able to reduce it to zero in the foreseeable future**. The Department told us that, in some instances, it may tolerate a certain level of disallowance, for example where the cost of avoiding the penalty was forecast to be higher than the penalty itself (paragraph 3.32).

26 **It also expects disallowance to increase as a result of other changes made by the Commission:**

- **The Commission has increased the number of controls by disaggregating some key controls into their constituent elements**. This increases the potential number of areas where it could find non-compliance. Furthermore, the so-called ‘ratchet effect’ removes the cap for multiple failures and this could now result in flat-rate penalties of up to 10%.
- **The Commission has said it intends to conclude its audits within two years**. This means a bulge of cases is likely during the early years of the current scheme as outstanding cases on CAP 2005–14 reach a conclusion alongside new cases that will be concluded more quickly.
- **The current CAP is more complex than the scheme it replaces, despite the UK’s efforts to simplify it**. Many features of CAP 2015–20, such as mandatory crop diversification and other greening measures, are new and member states have no experience of implementing and controlling them. The Department and the RPA anticipate a risk that the Commission will disagree with the Department’s interpretation of the reformed regulations (paragraph 3.33).

27 **The Department and the RPA have made good progress over the past year in developing their approach to disallowance**. This has been through improving governance, a better understanding of the causes of disallowance, developing systems and processes to manage disallowance risk, adopting a more proactive approach in dealings with the Commission, and improving management information. Nevertheless, there are persistent problems, chief of which has been deficiencies in mapping capabilities. The Commission has recently introduced new mapping requirements and controls in the current CAP. The Department is addressing this by exploring options for additional investment to reduce disallowance risk.

Recommended priorities for reducing disallowance risk

28 Given the increased complexity of the reformed CAP and the introduction of more stringent controls, the Department and the RPA will need to maintain a continued focus on reducing disallowance risk. We recommend that the Department should focus in the immediate future on:

a developing and maintaining its evidence base to support the case to HM Treasury for investment, based on a robust analysis of future disallowance that could be avoided;

b working with HM Treasury to ensure the right incentives are in place and to realise the benefits from the Department's investment proposals for the public purse as a whole;

c responding to the new, more complex rules by ensuring that new systems and control processes are fit for purpose and that beneficiaries understand their revised obligations;

d focusing improvement effort on potential control failures that have the potential to trigger higher penalties under the reformed CAP;

e ensuring that any decision it takes to tolerate a risk of disallowance is underpinned by sound evidence, and closely monitoring any resulting disallowance to ensure the case for tolerance remains valid;

f collecting data to support arguments for ring-fencing or to assure the Commission over the actual loss to the fund arising from control failures;

g working proactively with the Commission to address the risks of ambiguity or disagreement over how the regulations are implemented;

h keeping under review its successes and failures in past negotiations with the Commission in determining its approach to future settlements; and

i continuing to point out the cost of complexity of the CAP.