National Audit Office

Report
by the Comptroller
and Auditor General

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

Managing disallowance risk

HC 306 SESSION 2015-16 13 JULY 2015

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

Managing disallowance risk

Report by the Comptroller and Auditor General

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Comptroller and Auditor General
National Audit Office

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This memorandum examines past causes of disallowance, the risks of future disallowance arising from Common Agricultural Policy reform and how these risks are being managed.

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Key facts

£642m
amount of disallowance incurred since 2005 in England

£2.70
amount of disallowance in the UK for every £100 of funds received

38%
EU expenditure on CAP as a proportion of its total budget

£2.8bn	amount expected to be paid to farmers and other recipients in the UK each year over the period 2015–20
4%	estimate of how much the UK spends on controlling the Common Agricultural Policy (CAP) as a proportion of the total funds disbursed
49%	proportion of total disallowance caused by land mapping issues in England since 2005
£25m–£45m	value of investments currently under consideration for improvements in mapping capabilities
£215m–£370m	forecast savings by 2021 should all sources of mapping-related disallowance be addressed

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.

Part One

Background

Common Agricultural Policy (CAP) across the European Union

1.1 The Common Agricultural Policy (CAP) is the European Union (EU) framework of subsidies and rural development programmes. It was recently reformed, with the new regulations coming into force in 2014 and expecting to run until 2020. The previous scheme ran from 2007 until 2013, with the main regulations being agreed in 2005 and coming into force in 2007. In this report we refer to the 2007 to 2013 scheme as 'CAP 2005–14' and the current one as 'CAP 2015–20'.

1.2 The CAP regulations are periodically set by the EU following proposals made by the European Commission (the Commission) and agreed by the European Parliament and European Council.[3] As with all public funds, the Commission has a duty to member states' citizens to assure the regularity and propriety of payments made through the fund. It therefore seeks to verify that member states have established adequate controls over the funds.

1.3 The CAP comprises two funding 'pillars':

- Pillar 1 provides support for farmers' incomes. This is in the form of certain market support measures and also direct payments to farmers in return for carrying out agricultural activities and complying with standards on, for example, food safety, animal welfare, environmental protection and land maintenance.
- Pillar 2 provides funding for rural development programmes in member states. These can include activities for making agriculture more competitive, sustainable resource management, combating climate change and improving quality of life and economic opportunities in rural areas.[4]

3 The Commission is the executive body of the EU, responsible for proposing legislation and implementing decisions on the day-to-day business of the Union. The European Council defines the EU's overall political direction and priorities. It sets the EU's policy agenda, traditionally by adopting 'conclusions' during European Council meetings which identify issues of concern and actions to take.

4 Pillar 1 is financed primarily through the European Agricultural Guarantee Fund (EAGF) whereas pillar 2 draws funding from the European Agricultural Fund for Rural Development (EAFRD).

1.4 The CAP accounts for 38% of the total EU budget for 2015–20 and is the largest of its programmes. Over the course of CAP 2015–20, the UK will receive £20 billion, and payments will amount to an average of £2.3 billion per year under pillar 1 and £0.5 billion per year for rural development programmes under pillar 2 (**Figure 1**). The UK is the fifth largest beneficiary of pillar 1 after France, Germany, Spain and Italy.[5]

Aims of the CAP

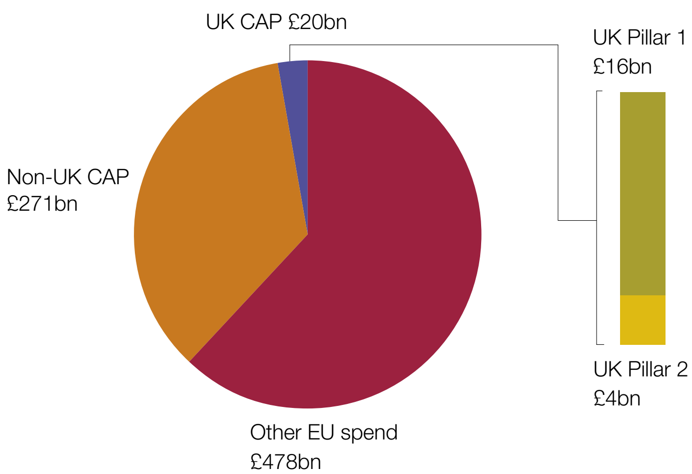
1.5 The EU's main aims for the CAP are to increase agricultural productivity in order to ensure a fair standard of living for producers, stabilise agricultural markets and ensure that food is available for consumers at reasonable prices. The CAP in England offers additional incentives for farmers to undertake good environmental land management practices, promote biodiversity and protect water quality. More broadly, the CAP aims to ensure that agriculture is competitive across the EU.

1.6 **Figure 2** overleaf sets out the key additional features of the new CAP 2015–20 programme.

Figure 1

Funding for CAP 2015–20

UK payments will receive £20 billion over the course of the current CAP



Note

1 Euros have been converted to Sterling on the basis of June 2015 exchange rate at €1.40 to £1.

Sources: European Commission, United Kingdom Common Agricultural Policy, May 2014. European Commission, Overview of CAP Reform 2014–2020, December 2013. European Commission, United Kingdom Common Agricultural Policy, May 2014.

5 European Commission, *United Kingdom Common Agricultural Policy*, May 2014.

Figure 2

The European Commission's aims for CAP 2015–20

CAP reform addresses three main challenges

The current reform of the CAP was broadly agreed in 2013 following three years of consultation and negotiation by member states. However, detailed implementation of the regulations continued to be introduced in 2014. CAP reform continues with the 'two pillars' approach first adopted in 1999, but strengthens the links between them for a more integrated approach to better support policy ambitions.

The European Commission identified three challenges facing the farming sector and rural areas and developed policy objectives to meet them:

- economic challenges and the objective of viable food production;
- environmental challenges and the objective of sustainable management of natural resources and climate action; and
- territorial challenges and the objective of balanced development.

In response to these objectives, CAP reform aims to improve competitiveness, sustainability, efficiency and effectiveness (for example, through better targeting of support, more equitable distribution of payments and a more strategic approach to spending).

An important new element of the policy framework is 'greening'. This will account for 30% of all direct payments under pillar 1. It will reward farmers for maintaining permanent grassland, providing ecological focus areas and diversifying their crops.

Source: European Commission, *Overview of CAP Reform 2014–2020*, December 2013

1.7 Member states implement the CAP based on laws enacted in the European Parliament and have some discretion in how they do this. The EU sets the broad policy objectives and agrees the underlying regulations. The Commission is responsible for ensuring member states put adequate control arrangements in place. Member states design and implement systems and processes to meet regulatory and national requirements and administer them.

1.8 The costs of administering and controlling the CAP are considerable. In 2013 the Commission estimated the total cost of controlling CAP expenditure for all member states at £2.8 billion per year, or around 7% of funds disbursed. The equivalent UK figure in 2013 was around 4%, but the Department for Environment, Food & Rural Affairs (the Department) expects this to increase given the additional complexity of the new scheme. The Department estimates the reformed CAP will be 15% more expensive to deliver than the old scheme. Member states must pay administrative costs themselves and cannot recover these from claimants, although some pillar 2 implementation costs can be paid for out of rural development programme funds through technical assistance.

How the CAP is administered in the UK

1.9 In the UK, responsibility for agricultural subsidies is devolved to the individual administrations and arrangements for implementing CAP differ between them. In England, the Department has overall policy responsibility. The Rural Payment Agency's (RPA's) principal role is to act as the paying agency for schemes administered in England and across the UK. It also administers pillar 1 and part of pillar 2. The remainder of pillar 2 is delivered through Natural England, the Forestry Commission and local delivery groups with the support of the RPA. **Figure 3** overleaf sets out these responsibilities in England.

1.10 Where a member state has more than one paying agency, as in the UK, CAP regulations require a single body to act as a point of contact between the Commission and the member state. The designated body is responsible for:

- co-ordinating financial and statistical reporting and responses to Commission auditors' enquiries; and
- harmonising activities between paying agencies.

In the UK, the body fulfilling this function is the UK Co-ordinating Body, which works closely with the paying agencies of the four devolved administrations.

Disallowance in England

1.11 Disallowance is the name given to financial penalties levied by the Commission when it considers actions taken by member states to control and administer CAP payments have been non-compliant. It can arise for many different reasons, for example because of delays in payments to claimants, if regulations are misinterpreted, or if the Commission identifies control weaknesses that are deemed to be a risk to EU funds. Since 2005, England has incurred disallowance totalling £642 million. It has already paid out £410 million and expects to pay a further £231 million in future years.[6]

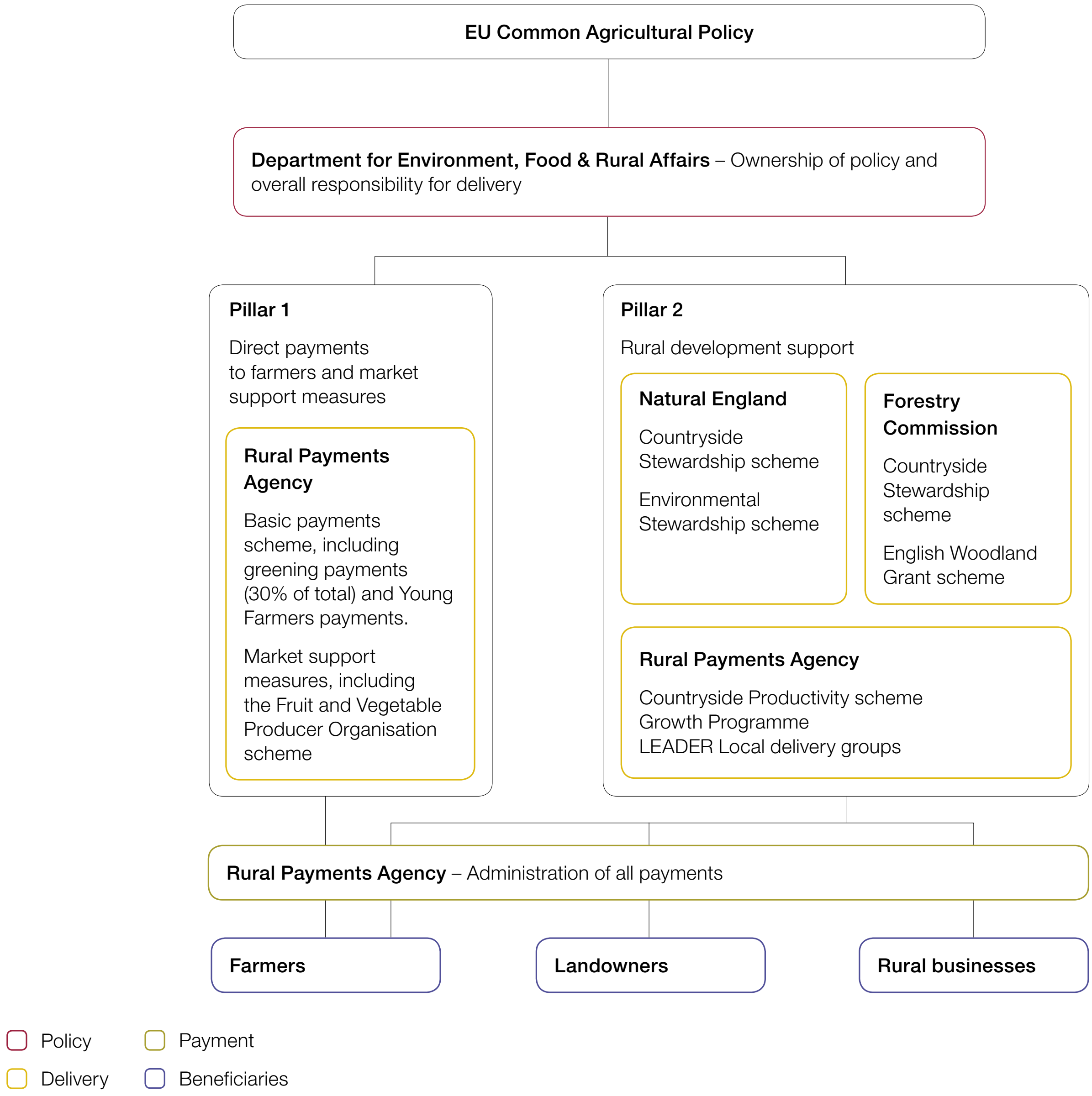
UK disallowance in context

1.12 Since 2005, the UK's disallowance penalties amount to £2.70 for every £100 of CAP funds it receives from the Commission.[7] This is the sixth highest figure out of the 28 member states. **Figure 4** on page 17 shows the UK's position in relation to the other member states as at June 2015. It is important to note that this is a snapshot at a particular point in time, so caution is required when interpreting this analysis. Many of the Commission's audits of previous scheme years are not yet complete and member states may be negotiating with the Commission over disallowance that has not yet materialised but could do so at any time.

6 Some audits and negotiations relating to CAP 2005–14 are not yet concluded, but the Department is not expecting further significant disallowance penalties to result from these.

7 This analysis has not been carried out for the individual countries within the UK.

Figure 3
CAP policy and delivery responsibilities in England



Notes

1 The Basic Payment Scheme replaces the Single Payment Scheme of CAP 2005–14.

2 Countryside Stewardship is the new land management scheme replacing the Entry Level Stewardship and Higher Level Stewardship schemes of CAP 2005–14.

3 The Department devolved management of socio-economic rural development schemes under pillar 2 to the Regional Development Agencies. When the agencies were abolished the Department brought this in-house. In 2014, it transferred the team responsible for administering these schemes to the RPA.

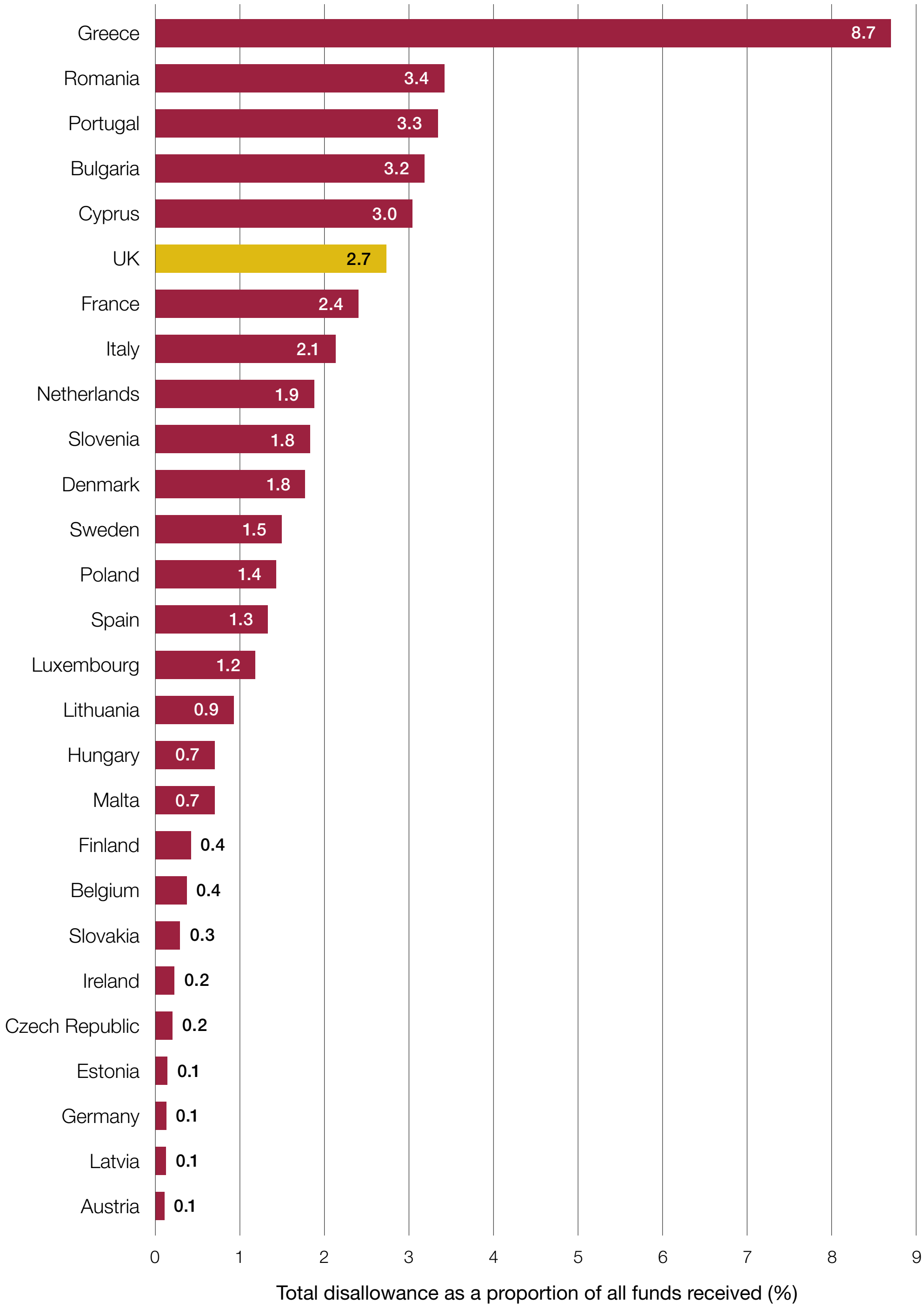
4 This structure only covers payments in England. Responsibility for other parts of the UK lies with the devolved administrations.

Source: National Audit Office analysis of departmental information

Figure 4

Disallowance as a proportion of total funds received from the Commission

The UK has the sixth highest levels of all member states



Note

1 As a new member state, Croatia has not yet incurred any disallowance and so has not been included in this figure.

Source: National Audit Office analysis of UK Co-ordinating Body information

How disallowance is calculated

1.13 Member states must have two types of control in place. Key controls are inspections and administrative checks to verify substantive elements of a claim and to ensure that amounts due to beneficiaries are accurate. Ancillary controls include administrative tasks to ensure claims are processed correctly, for example to ensure they are submitted within defined timescales. Key control failures are more serious than ancillary failures and therefore attract higher disallowance penalties.

1.14 In the event of non-compliance, the Commission seeks to determine the extent of loss to the fund, in order to calculate a financial correction based on the amount that has been unduly spent. Where it cannot determine this through proportionate effort, the financial correction may be based on the extrapolation to the population of the error found in a sample. In the absence of evidence allowing the Commission to reliably estimate the funds at risk, it can apply a flat-rate penalty as a last resort, based on its assessment of the nature and gravity of the weaknesses found. The rate applied is set out in guidelines and statute.

1.15 When the Commission proposes disallowance, member states can seek to reduce the penalty by providing evidence that the Commission has overestimated the actual loss to the fund. They can do this by showing that non-compliance only applies to a subset of beneficiaries (this is known as 'ring-fencing') or by statistical extrapolation to accurately calculate incorrectly paid amounts.

How the Department recognises disallowance in its accounts

1.16 From an accounting perspective, the Department does not generally accrue for disallowance in the year to which it relates.[8] This is because the final amounts are often decided after negotiating with the Commission. As this process often takes several years, the Department instead accrues for disallowance against the year the penalty is agreed with the Commission. The delay can increase the final disallowance penalty, as the non-compliance may continue while negotiations are taking place. This also makes it hard to monitor trends in disallowance as the amount accrued in any one year does not represent the Department's performance in that year.

8 In this context, 'accrue' means acknowledging a liability that the Department knows with certainty that it has to pay. The Department also makes provisions in its accounts for amounts it expects with reasonable certainty to have to pay.

How the CAP is audited

1.17 A number of different bodies provide assurance over the CAP. However, each body employs a different approach and the Commission itself provides minimal detail about its own methodology. The core audit regime for the CAP is the Commission's clearance of accounts procedure. This involves a financial clearance audit to assess the propriety of the paying agency's accounts, and also a conformity clearance audit to examine all aspects of control over a scheme.

1.18 Financial clearance audits are carried out by a certification body. In England, the National Audit Office carries out this role by certifying the RPA's accounts and giving an opinion on the annual assurance statement. From 2015, certification bodies will also carry out audits of legality and regularity on the underlying transactions of member states' accounts.[9] The results of this work may then help to inform the Commission's own audit work, by providing a robust and independent assessment of error.

1.19 The European Court of Auditors (ECA), whose broader role is to audit the EU's finances, checks that the Commission's procedures for administering the CAP are implemented correctly by paying agencies. It does this by carrying out its own inspections of a selection of paying agencies in a selection of member states. **Figure 5** overleaf sets out the audit arrangements for the CAP in England.

1.20 The Commission recently announced that it intends to complete all its audits within two years. There is therefore a risk of a 'bunching effect' in the early years of the current scheme as outstanding cases from CAP 2005–14 reach a conclusion while new cases arising under CAP 2015–20 are concluded more quickly.

Action plans

1.21 The Commission recently introduced action plans to tackle what it perceives to be systemic failings on the part of member states. Where an action plan has been imposed, the Commission has said that, in the worst case scenario, all payments to a member state could be suspended on a proportionate basis if it is dissatisfied with progress against its plan.

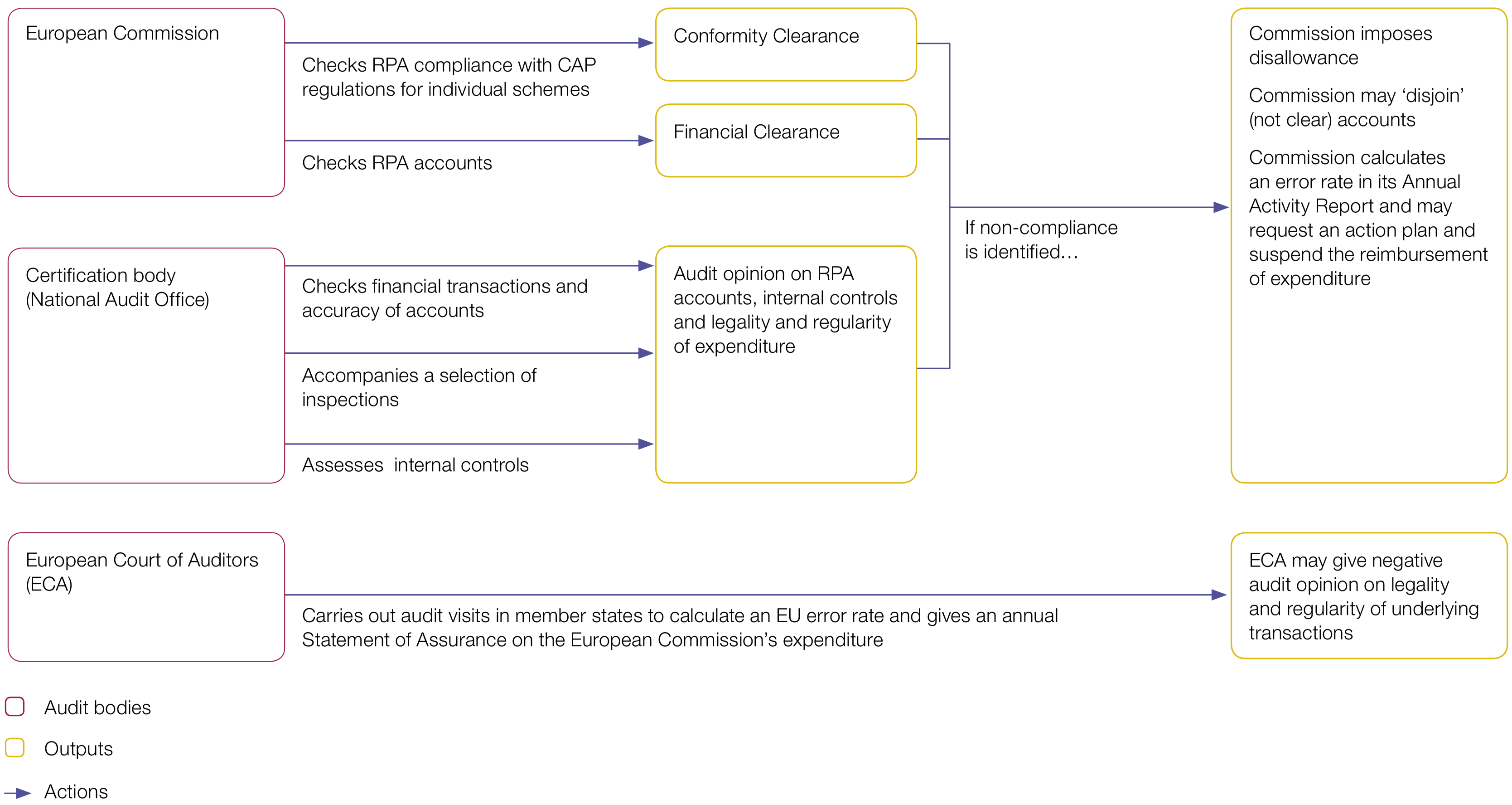
1.22 England currently has three live action plans to address the Commission's concerns. These relate to England's Land Parcel Identification System, the Rural Development Programme for England, and the Fruit and Vegetable Producer Organisation scheme. Appendix Three sets out the details of each action plan.

9 Audits of legality and regularity examine legal and administrative compliance, including the probity and propriety of administration, financial systems and systems of management control.

Figure 5

Audit arrangements for the CAP in England

Three different bodies audit the RPA's delivery of the CAP



Source: National Audit Office analysis of departmental information

Part Two

Causes of disallowance

Causes of disallowance in England[10]

2.1 This section sets out the main causes of disallowance penalties in England. Under the Common Agricultural Policy (CAP) 2005–14, the main causes related to:

- late payments;
- mapping;
- issues with the entitlements register;
- cross-compliance controls; and
- the Fruit and Vegetable Producer Organisation scheme (**Figure 6** overleaf).

Late payments

2.2 Disallowance can arise if payments are not made within the window required by the regulations each year. In 2006, the Rural Payments Agency (RPA) missed the European Commission's (the Commission's) target to make 96% of the payments by the end of June. This resulted in a penalty of €85 million for that year. Total disallowance for late payments over CAP 2005–14 amounted to €107 million, but no late payment penalties have been incurred since 2010.

2.3 We reported on issues faced by the RPA at the start of the previous CAP.[11] We found the RPA had:

- underestimated the amount of work involved in mapping farmers' land;
- not allowed enough time to test new IT systems; and
- underestimated the amount of work involved in processing claims, due to an absence of adequate management information.

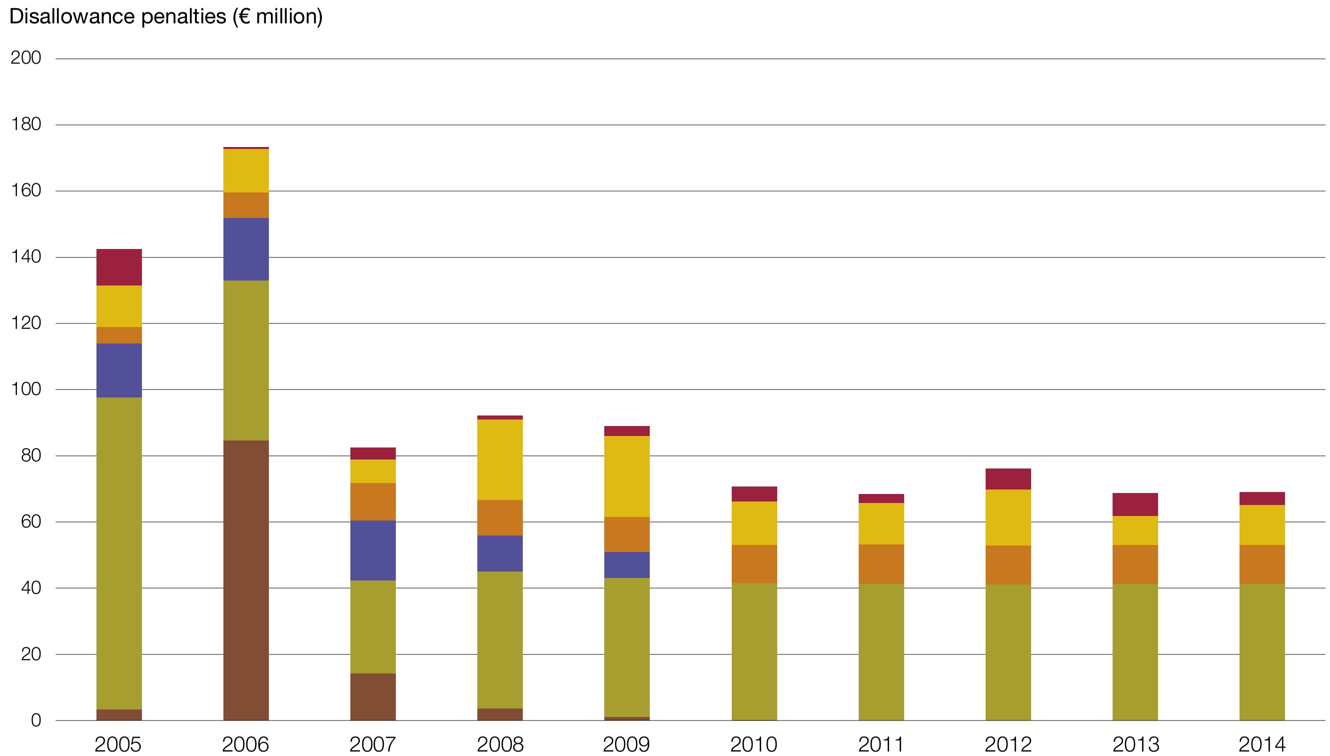
10 The analysis of disallowance causes in this part of the report are based on the Department's analysis which has not been audited by the National Audit Office. The Department presented its analysis in euros and we have not converted the amounts to pounds due to the variable exchange rate over the period concerned.

11 Comptroller and Auditor General, *The delays in administering the 2005 Single Payment Scheme in England*, Session 2005-06, HC 1631, National Audit Office, October 2006; Comptroller and Auditor General, *A progress update in resolving the difficulties in administering the Single Payment Scheme in England*, Session 2007-08, HC 10, National Audit Office, December 2007; Comptroller and Auditor General, *A second progress update on the administration of the Single Payment Scheme by the RPA*, Session 2008-09, HC 880, National Audit Office, October 2009.

Figure 6

Main causes of disallowance in England 2005–2014

Mapping deficiencies were the most significant reason for disallowance



	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Other	10.8	0.7	3.5	1.2	2.9	4.4	2.7	6.3	6.8	3.9
Fruit and vegetable scheme	12.5	13.2	7.2	24.3	24.3	13.0	12.5	16.9	8.9	12.0
Cross-compliance	5.0	7.6	11.4	10.8	10.8	11.6	11.9	11.8	11.8	11.8
Entitlements register	16.4	18.9	18.1	10.8	7.8	0.0	0.0	0.0	0.0	0.0
Mapping	94.3	48.3	28.1	41.5	42.0	41.3	41.3	41.1	41.2	41.3
Late payments	3.3	84.7	14.2	3.6	1.0	0.3	0.0	0.0	0.0	0.0

Note

1 The amounts are shown against the year to which the disallowance relates and not when it is accrued in the Department's accounts. The delay is due to the process of renegotiating the final amount with the Commission (see paragraph 1.17).

Source: National Audit Office analysis of departmental data

Entitlements

2.4 There were also significant issues in establishing farmers' entitlements with the previous CAP. This resulted in €72 million of disallowance. To qualify for a payment a farmer must hold entitlements as well as an area of farmland. The RPA issued entitlements at the start of CAP 2005–14 based on historical data relating to farm activity and land use as required by European regulations.

2.5 The RPA needed accurate mapping information in order to work out entitlements. It had not carried out all the mapping work required to establish entitlements and consequently made errors in allocating them. To resolve these errors, the RPA had to review and manually correct more than 34,000 cases where it had identified a risk of error.

Mapping

2.6 Issues with land mapping have resulted in disallowance of €460 million since 2005, 49% of the total over this period. Paying agencies must operate a Land Parcel Identification System (LPIS) that allows all agricultural areas to be uniquely identified. The Commission considers the LPIS to be a key element of the control framework. The data and standing information it contains form the basis for checking farmers' and landowners' declarations about the eligibility of their land. In England, the RPA's Rural Land Register (RLR) is designed to fulfil this requirement. The LPIS is vital to both pillar 1 and pillar 2, as eligible and non-eligible features often differ between the two pillars.

Quality and completeness of map data

2.7 Issues with the quality and completeness of data in the RLR have been the most significant drivers of disallowance. The Commission requires data in member states' LPIS to be less than three years old to ensure payments are based on up-to-date information about land types and boundaries, and has been critical that not all eligible and ineligible areas have been mapped correctly or based on sufficiently up-to-date information.

2.8 The Commission has also challenged weaknesses in the assessment of eligible features. The Ordnance Survey maps used as the basis for the RLR do not identify features that are ineligible for direct payments, such as hedges and shrubland. Areas of commons land were also previously not mapped to the same standard as other data, although this has now been resolved.[12]

12 Commons are land which people other than the owner can use in specified ways under traditional rights, for example to graze animals.

Use of map information

2.9 Disallowance has resulted from weaknesses in the RPA's processes for updating the RLR with additional data as these become available, for example if a farmer is found to have built a shed or man-made track on part of their holding. The ability to update the RLR is one of the Commission's key requirements.

2.10 The Commission also expects all available mapping data to be used to check claimants' applications. It identified weaknesses in the UK which led to further disallowance. For example, the RPA did not provide cross-compliance inspectors with historical aerial photographs of the land they were inspecting. This would have allowed changes to declared land use and boundaries to be identified more easily.

2.11 Failure to comply with LPIS requirements has the potential to attract a 5% flat-rate penalty as it is a key control failure. In the case of England, the RPA successfully argued that the risk to the fund was significantly less than 5%. For 2006 onwards, the Commission auditors have accepted the evidence provided and reduced the flat-rate penalty from 5% to a discretionary level of 2%. However, the RPA informed us that it is finding it increasingly challenging to gather the required information to support ring-fencing arguments against LPIS penalties because of the lack of progress in updating the RLR.

Future mapping requirements

2.12 The reformed CAP will require the RPA to add extra mapping features to the RLR that it currently does not possess. This is to control new greening requirements designed to enhance the environmental outcomes of the CAP, such as ecological focus areas, crop diversification and permanent pasture. Although these new mapping requirements are not required until 2018, disallowance will be incurred if this deadline is not met. The RPA will need to increase the number of administrative and on-the-spot checks it carries out at considerable cost until the mapping functionality is in place.

Cross-compliance controls

2.13 The EU's cross-compliance mechanism ties EU support for farmers to compliance with standards of environmental care, the condition of agricultural land, public health, animal and plant health, climate change and animal welfare. It covers direct payments and certain rural development and wine sector payments. England's cross-compliance regime has to date attracted €35 million in disallowance over the course of CAP 2005–14.

2.14 In order to check that claimants are following cross-compliance rules, inspectors from the RPA and the Animal and Plant Health Agency visit and inspect a certain proportion of holdings each year. While they are on the farm, inspectors typically check land and facilities, and any relevant records the farmer should be keeping, such as data on animal movements or use of pesticides.

2.15 Most cross-compliance disallowance has been incurred because the control and inspection regime was not up to the standard required by the Commission. For example, the Commission thought checks on animal ear-tags had not been thorough enough and that too few on-the-spot checks had been carried out. The Commission has also expressed concern that the RPA and the Animal and Plant Health Agency had been too lenient when enforcing cross-compliance, for example issuing warning letters rather than applying penalties.

Fruit and Vegetable Producer Organisation scheme

2.16 The Fruit and Vegetable Producer Organisation scheme intended to increase the buying power and market position of small fruit and vegetable producers across Europe. To qualify for assistance, producer organisations must be recognised as such by member states according to criteria set by the Commission.[13] However, the Commission has consistently disagreed with the way the UK interprets the recognition criteria.

2.17 The scheme has been audited four times in the UK between 2005 and 2011 with over €120 million arising in disallowance penalties. In order to address the Commission findings, the RPA has undertaken a number of exercises reviewing the recognition of UK producer organisations. As a result since 2005, the number of organisations has halved from 68 to 33. Following negotiations, the Commission confirmed that the final penalty arising from an audit in 2009 will be reduced from the €55 million originally proposed to €34 million.

2.18 The scheme is an example of differences arising between the Commission's regulatory intentions and member states' interpretation. It was not designed with the UK's relatively developed market and production conditions in mind. The Commission's view is that many UK producer organisations were not established according to the 'spirit' of the scheme. This is because UK producer organisations often included vertical elements of the production chain, including aspects of packing, distribution and marketing.

13 The recognition criteria require that producer organisations must have: at least five individual grower members who are separate entities; an annual turnover of €1 million marketable production (unless recognised for mushrooms or nuts, in which case the threshold is €250,000); and a democratic structure giving members equal say in the management and operation of the producer organisation.

2.19 Other more developed northern European member states with conditions similar to the UK, such as the Netherlands, Austria and Germany, have also attracted criticism from the Commission regarding the exact interpretation of EU rules concerning the criteria for recognising producer organisations. At the end of 2012, the Management Authority in the Netherlands established stricter recognition standards. Like the UK, the Dutch authorities have presented an action plan to the Commission, and believe that the criteria for recognition need further clarification.

2.20 The ambiguity of the recognition criteria for the Fruit and Vegetable Producer Organisation scheme is further illustrated by the fact that the RPA currently has to comply with two contradictory legal judgments challenging its removal of some producer organisations' recognition in 2006. In one case, the European Court of Justice upheld the RPA's decision to remove recognition. However, in a separate case brought through the Scottish courts, the legal provisions of the scheme were interpreted much more flexibly and the judgment was made in favour of the producer organisation.

2.21 The Fruit and Vegetable Producer Organisation scheme has not been reformed as part of the new CAP programme. Thus the substantive issues which have led to disallowance so far remain the same. The Department is seeking to reduce the risks through negotiation with the Commission and other member states on simplifying and clarifying the EU legislation which sets the detailed rules for the scheme.

Policy choices

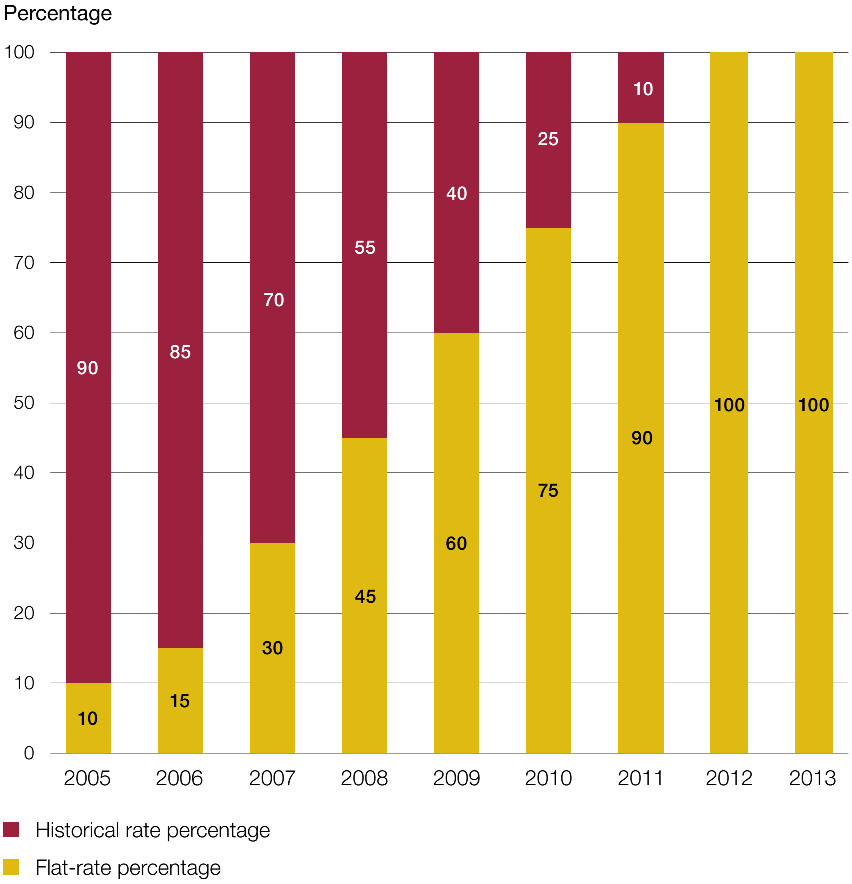
2.22 The payment delays at the start of CAP 2005–14 were due in part to the complexity of many claims. The Department chose to implement a 'dynamic-hybrid' system where farmers' payments were based on a moving scale between historical claim values and a flat-rate per hectare (**Figure 7**). This was the most complex model available and Germany and Finland were the only other countries that chose it. The key difference was that these countries allowed themselves an extra year to implement the model, as this was permitted by the Regulation. While the Department's decision to implement the dynamic-hybrid system was consistent with ministers' desired policy outcomes, the Department did not fully understand the complexity of delivering it at the time.

2.23 The dynamic-hybrid choice allowed farm subsidies to be decoupled from historical payments – a stated policy aim at the time – while also enhancing environmental outcomes (for example, by requiring claimants to engage in good land management practices). The area-based element meant different types of landowners could now claim for certain types of activities in return for keeping their land in good agricultural and environmental condition. For example, many new claims were based on activities such as pig rearing, establishing horse paddocks, and fruit and vegetable growing.

Figure 7

England's implementation of the dynamic-hybrid model

The proportion of a farmer's payment based on historical claim values reduced over the course of CAP 2005–14. By the end of the programme, claims were based entirely on a flat rate



Source: National Audit Office

Part Three

The Department's management of disallowance risk

Overview

3.1 This part of the report sets out the Department for Environment, Food & Rural Affairs (the Department's) approach to managing disallowance risk. The Department described the three strands of its disallowance strategy in a paper for ministers in September 2014:

- **strategic**, including actions to simplify European Union (EU) regulations and improve the EU's approach to controls;
- **tactical**, including challenging the European Commission's (the Commission's) audit findings and disallowance decisions, and actions to improve compliance; and
- **operational**, including investments to reduce disallowance risk and ensure simplicity in implementing the Common Agricultural Policy (CAP).

3.2 The Department's strategy seeks to address systemic weaknesses identified in its previous approach. It includes actions to strengthen governance arrangements across the Department's network bodies, improve management information and understanding of the key drivers of disallowance, develop systems and processes to manage disallowance risk, and adopt a more proactive approach with the Commission.

Strengthening governance

3.3 Overall responsibility for managing the risk of disallowance rests with the Department, which is financially liable for the penalties. It has sought to strengthen governance and develop a more proactive approach. In the run-up to CAP reform, the CAP steering group was responsible for managing disallowance. However, this group had much broader responsibilities related to negotiating CAP reform in the UK's interests. When negotiations concluded, the Department felt it needed a stronger focus on disallowance before the reformed CAP was introduced. In December 2014, it refreshed the terms of reference and membership of its existing Disallowance Working Group (DWG) and also created the Disallowance Steering Group (DSG) sitting above the DWG to monitor progress and drive strategic decision-making. **Figure 8** sets out membership and the main responsibilities of these two groups.

Figure 8
Governance for the Department's management of disallowance risk

	Membership	Key responsibilities are to:
Disallowance Steering Group (DSG)	Chaired by: Department director general, Policy Delivery Group Membership: Department directors for Rural Development, Sustainable Land Management, Better Regulation, Finance and Performance and EU and International; deputy director EU Strategy, head Rural Development Programme England (RDPE) Policy, RDPE programme manager. RPA director for finance and EU Reporting and Compliance director; UK Co-ordinating Body director; Natural England representative.	Provide clear leadership on policy decisions which impact on disallowance. Assess and review disallowance risk and causes. Consider and discuss mitigating actions proposed by DWG. Assess priorities for addressing risks and value-for-money arguments. Consider impact of disallowance on future budgetary requirements. Consider proposals on level of disallowance provisions needed.
Disallowance Working Group (DWG)	Chaired by: Department deputy director, CAP schemes Membership: EU action plan owners (Department), deputy director RDPE Policy, Finance performance planning and governance business analyst and CAP Schemes Policy. RPA directors for EU Reporting and Compliance and External Relations, UK Co-ordinating Body director, CAP-D head of Business Architecture, Natural England nominated deputy.	Review potential impact of policy decisions on delivery and potential disallowance. Review progress on EU action plans. Monitor levels of disallowance. Consider and prioritise mitigating actions, including discussion of EC audit findings. Provide direction for the day-to-day management of disallowance across the network.

Source: Department for Environment, Food & Rural Affairs

3.4 The DWG brings together the working-level expertise and detailed knowledge from across the network needed to monitor risk effectively. The DSG, comprising more senior officials, provides strategic decision-making and the necessary oversight and challenge to keep the overall strategy on track. We found widespread agreement among the officials we spoke to that these new governance arrangements represent a significant improvement.

Understanding the causes of disallowance

3.5 Developing a better understanding of the underlying causes of disallowance is central to the Department's strategy. It has developed the Disallowance Assessment Reporting Tool (DART) to improve its information about the causes of disallowance. The DART classifies disallowance into nine categories, such as late payments and mapping issues. It shows trends dating back to 2005 and projected forward to 2021. Projections are based on three different investment scenarios ranging from 'do nothing' to investing between £25 million and £45 million, combined with additional running costs for further checks and inspections. The Department is considering a range of options and assessing their value for money to determine what level of investment can be justified.

3.6 The model underpinning the DART is based on assessing the costs of the different investment scenarios and the scale and risk of potential disallowance penalties. These were agreed in workshops held by the Department with policy and subject matter experts in its network. The Department believes this work has helped to develop greater consensus across its network bodies and secured greater senior buy-in for its investment proposals.

Being more proactive

3.7 The DART is an example of the Department being more proactive in tackling the risk of disallowance. It is also seeking to be more proactive in its approach to the Commission. For example, before the Commission agreed the Fruit and Vegetable Producer Organisation action plan, the Department started implementing elements of it, engaged the Commission in discussion on its contents and provided a first update on progress.

3.8 The experience of the devolved administrations and other member states suggests that a more proactive approach to dealing with the Commission can pay dividends. This is because the Commission has tended to look favourably on those taking pre-emptive remedial actions. For example, Northern Ireland's paying agency told us it gained considerable credibility with the Commission through audits of legality and regularity to which it voluntarily submitted in 2011 and 2012.

3.9 More generally, the German co-ordinating body suggested to us that member states should try to work collaboratively with the Commission and learn lessons from their past negotiations. It has found that its own efforts have helped it to understand the types of argument that are likely to hold sway with the Commission.

3.10 For example, in cases where the findings of the Commission's auditors are justified, the German paying agencies have found it more cost-effective to accept these findings and then argue for a reduction in penalty rather than continuing to dispute the findings themselves. Being prepared with the management information necessary for this approach has therefore been a high priority for the German paying agencies. In January 2015, several German paying agencies incurred a disallowance penalty initially estimated at €40 million for weaknesses in on-the-spot checks for animals. Because Germany was able to demonstrate that not all of its paying agencies were affected, the Commission set the penalty at €12.2 million.

3.11 Since 2005, the Rural Payments Agency (RPA) has used the opportunities to negotiate with the Commission's audit services to reduce potential disallowance. This has included building relationships with lead auditors and providing arguments that have allowed for the Commission to make more proportionate assessments of the risk to the Fund.

3.12 The RPA told us it has also prioritised its resources to address the Commission's observations and ensure that follow-up audits demonstrate progress against the control weaknesses that represent the greatest potential risk. The RPA estimates that this has resulted in disallowance penalties of around €400 million being avoided for pillar 1 and pillar 2 schemes relating to the period from 2005 to 2011, achieved through its negotiations with the Commission.

CAP Delivery programme

3.13 The CAP Delivery programme, currently being implemented by the Department and the RPA, was set up to deliver the new Rural Payments IT system for processing grant claims and payments in England. The system includes:

- a new online interface for beneficiaries to input claims and map data electronically for the first time; and
- checks designed to automate claims and payments against the rules of the new CAP, as implemented in England, and to manage beneficiaries' land and mapping records.

3.14 A main aim of the programme is to deliver the CAP more efficiently and to reduce disallowance risk cost-effectively. The Department commissioned Deloitte to review the impact of implementing the CAP Delivery programme on disallowance risk. The review highlighted ten main risks, of which four were deemed to have high potential impact.[14] The findings of the review were reported in March 2014 and the report served as a first step towards creating a shared understanding of the causes of disallowance across the network.

3.15 The programme is currently behind schedule. Changes to the IT system have been necessary, some of which could impact on disallowance risk. To manage this risk, the RPA's compliance director signs off every change to the system to confirm that:

- there is no impact on disallowance risk; or
- the impact is understood and processes have been put in place to capture any data necessary to support ring-fencing arguments if disallowance penalties are incurred.

3.16 However, these processes only apply to the direct impact of any IT changes. The RPA has acknowledged that it may not always be able to fully identify the wider impact of IT changes, such as knock-on delays caused to the development of other system functionality.

14 These were land, the implementation of an effective compliance framework, the impact of policy decisions, and greening.

3.17 In March 2015, as a result of technical problems, the system allowing farmers and agents to submit their claims and changes to their land data electronically was suspended and the Department decided to revert to a partially paper-based approach. The move back to paper forms and the need to manually validate information in customer applications against that held in the system will delay the savings that the RPA expected from reducing the need for manual data input. It also increases the chance of introducing errors, although the RPA told us it is mitigating this through its quality control measures.

Scheme Control Framework

3.18 The Scheme Control Framework is complementary to the IT system. It is a separate system that sets out how controls are meeting each of the Commission's regulatory requirements, identifies any potential gaps in compliance and highlights where any additional manual controls, such as on-site inspections, are needed. The framework will enable the RPA to demonstrate to the Commission what controls are in place for each individual regulation.

Improvements to mapping

3.19 The Department and the RPA have targeted significant resources at improving mapping capability to the standard the Commission wants. The greening requirements of the new CAP have also created an additional need to identify and control these new map features.

3.20 The Commission last audited the Land Parcel Identification Systems (LPIS) in 2014. The Department has accepted the proposed correction for 2012 and 2013 of 2%. The Commission has been positive about the Department's actions in response to audits, but has requested faster progress and clearer milestones to be included in the LPIS action plan.

3.21 The Department is optimistic that its activities will improve the currency and accuracy of map data. These include projects allowing maps to be both manually and automatically updated from a range of different sources as they become available, such as aerial photographs, Ordnance Survey sources, remote sensing and even Google maps.

3.22 The RPA has also issued 200 hand-held GPS devices to inspectors. This improves the process of recording and uploading changes observed in the field onto the central LPIS system. The RPA has also introduced Proactive Land Change Detection, allowing land changes to be identified from aerial photography.

3.23 Following a successful pilot exercise, the Department recently appointed an external supplier to provide remote sensing and aerial photography services. The aim of this was to improve the detail of maps in the LPIS. The supplier was chosen following a competitive tender in 2014. Its main task will be to help capture the additional mapping features required for the reformed CAP, such as hedges and features that are ineligible.

Negotiating the new CAP

3.24 As well as having local discretion over how to implement the CAP regulations, member states can negotiate with the Commission over the formulation of the regulations themselves. The Department took an active role in negotiating CAP 2015–20 and is already preparing to negotiate the CAP regulations that will come into force from 2020 onwards.

3.25 The Department's objective during negotiations was to achieve a simpler, smaller and greener CAP. However, it had to balance this against other policy ambitions and factors. For example, the UK successfully resisted other member states' attempts to introduce a higher greening threshold that would only apply to claimants with more than 50 hectares. This would have taken a significant number of farmers out of the greening provisions and, although simpler to deliver, would have provided fewer environmental benefits. Although the UK had some success in its efforts to simplify the CAP, most officials acknowledge that CAP 2015–20 is more complex than the scheme it replaces.

3.26 The Department was not always successful in its negotiations. For example, under new crop diversification requirements, larger arable farmers must have three different crops on their arable land during the months of May and June. An on-site inspection during this period may be unable to verify this as the crops may not all be in the ground at the same time, particularly if some have already been harvested. The Department proposed that geo-tagged photographs and various documentary source should be permitted as evidence if the crops were not present at the time of inspection. However, the Commission has so far not accepted this. The Department is continuing to press the Commission to further simplify the new CAP and the associated Commission guidance.

3.27 The Department took more than 200 policy decisions relating to CAP reform, where it had local discretion over how to implement the rules. We reviewed a number of the decisions it took and found that, while simplicity was the main consideration, the Department often had to balance this against other factors when arriving at proportionate, risk-based decisions. These included:

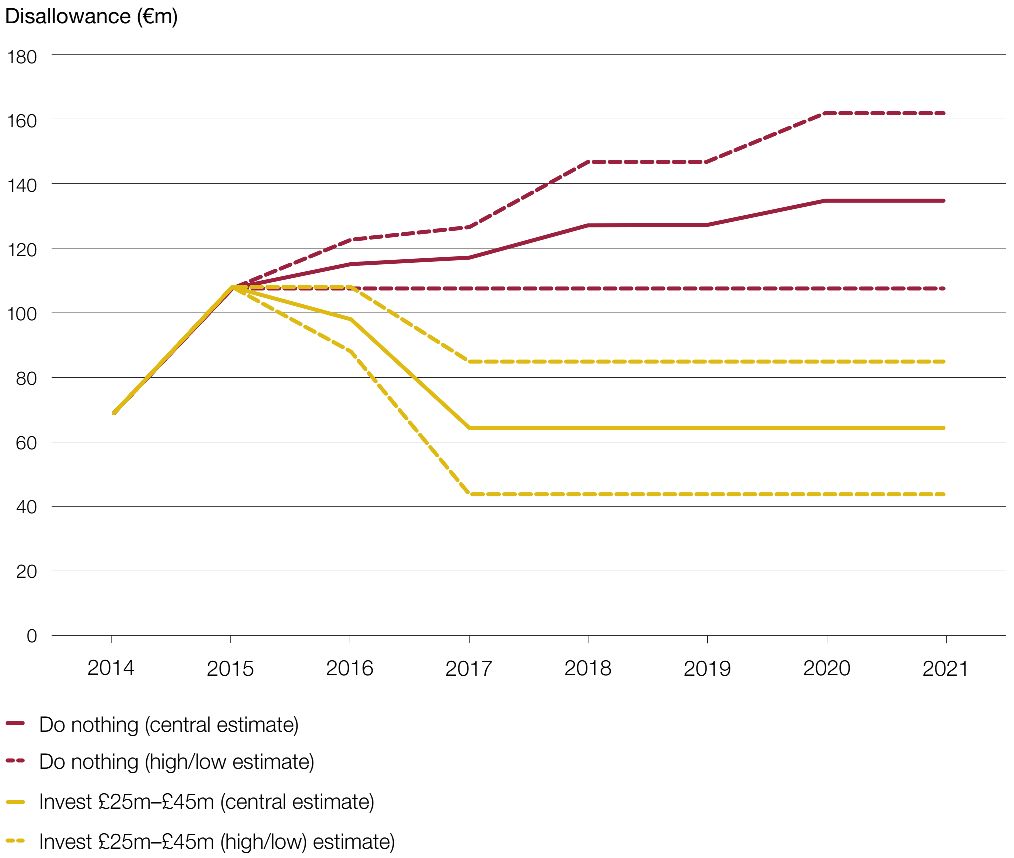
- ability to deliver;
- potential disallowance risk;
- the views of different stakeholder groups; and
- the prospect of successfully negotiating with the Commission over any additional disallowance (see Appendix Three).

Invest-to-save proposals

3.28 The Department is developing a disallowance investment plan setting out a series of 'invest to save' proposals. These focus on improving mapping and strengthening the controls environment by increasing the number, frequency and depth of inspections. The Department has forecast that, without additional investment, disallowance resulting from the reformed CAP's mapping requirements could reach between £215 million and £370 million by 2021, depending on the outcome of tactical mitigation efforts such as ring-fencing. The Department is currently developing investment cases that would allow it to deliver such savings in the areas of mapping and cross-compliance, requiring an investment in the region of £25 million to £45 million, and additional running costs for further checks and inspections (**Figure 9**).

Figure 9
Potential impact of investment on future disallowance penalties

An investment in the region of £25 million to £45 million could prevent disallowance of up to £370 million by 2021



Notes

1 The Department has modelled the risk of disallowance against two scenarios. Scenario 1 is a 'do nothing' entailing no investment at all. Scenario 2 requires an initial investment of between £25 and £45 million and additional annual running costs for further checks and inspections. The model assumes there will be no policy changes, that committed Rural Payments system functionality is delivered and that Action Plans that require no further investment are completed

2 These forecasts are based on the Department's model and have not been audited.

Source: National Audit Office analysis of departmental data

3.29 The Department told us that the ongoing development of the DART had enabled it to estimate costs and forecast savings in disallowance penalties for individual investment proposals. This has significantly improved the case for investment and the Department's ability to develop a robust assessment of options and put this case to its executive committee and HM Treasury. Further, it has encouraged senior buy-in to the proposals. As a result, the RPA has been encouraged by the Department's permanent secretary to develop further proposals for proactive investments that reduce disallowance.

3.30 As part of its 2010 spending review settlement with HM Treasury, the Department obtained ring-fenced funding for disallowance penalties. This ring-fence consisted of £90 million per year from 2011-12 until 2014-15, with a further £40 million for 2015-16. This fund cannot be used for any purpose other than disallowance without HM Treasury's approval.

3.31 Because of this ring-fencing, the Department does not itself directly benefit financially from any reduction in disallowance that it achieves as a result of its investment. The Department's accounting officer has a duty to consider the wider implications for public finances of the cost of disallowance and has prioritised its investment choices accordingly. The Department should continue to do so even when its direct incentives are limited by the current ring-fencing arrangements.

Constraints to managing disallowance

3.32 Although the Department has an ambition to reduce overall disallowance, it does not expect to be able to reduce it to zero for the foreseeable future. The Department cited two reasons why it is likely to tolerate some disallowance risk:

- the cost of avoiding disallowance may sometimes be higher than the disallowance avoided; and
- where it has policy choices, the Department balances affordability and deliverability against future disallowance risk while taking account of potential policy outcomes, for example to achieve better environmental outcomes.

3.33 Despite their efforts, the Department and the RPA believe that further increases in disallowance are likely in the early years of CAP 2015–20 for the following reasons:

- **CAP 2015–20 is more complex than the scheme it replaces**
  Some aspects of the reformed CAP, such as mandatory crop rotation and other greening requirements, have never been implemented before. The Department believes it is inevitable that the UK's interpretation of the rules will differ from the Commission's.

- **The introduction of more stringent flat-rate penalties**
  Under CAP 2005–14, multiple failures of a similar nature were capped at the flat rate of the most serious offence (usually 5%). Under the new regime, the Commission can apply flat-rate penalties of up to 10% if there are multiple failures, for example if three key controls are found to be deficient.

- **The Commission's stated intention 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 arising that the Commission may conclude more quickly.

- **An increase in the number of controls**
  Many of the key control headings from CAP 2005–14 have now been disaggregated into their constituent components. This means there are now more controls to fail and a higher risk of disallowance.

- **An increased focus on pillar 2**
  Only between 3 and 4 per cent of the total disallowance since 2006 is attributed to pillar 2. The European Court of Auditors recently recommended that the Commission should pay more attention to pillar 2 as it has found that errors are increasing in that area.

Appendix One

Our audit approach

1 This report examines past causes of disallowance, the risks of future disallowance arising from CAP reform and what the Department is doing to manage these risks. It is intended primarily as a description of the facts. We did not set out to draw a conclusion about value for money.

2 Our main evidence sources were:

- semi-structured interviews with officials from the Department, the RPA, the UK Co-ordinating Body and the German federal co-ordinating body;
- a review of key documents from the Department, the RPA and the UK Co-ordinating Body, including strategies, risk registers, plans and board minutes;
- review and analysis of other literature, including a range of recent documents relating to disallowance risk;
- a call for evidence on disallowance from various European paying agencies (to which only the Dutch responded); and
- a review of the Department's Disallowance Assessment Reporting Tool (DART), which was carried out by our data modelling experts.

Appendix Two

Current action plans in England

Action plan	The Department's and the RPA's primary actions
The Land Parcel Identification System (LPIS) action plan addresses four specific issues identified by the European Commission's auditors: • the extent the LPIS could be updated; • the integration of commons land; • the eligibility status of woodland; and • the integration of the LPIS into new IT developed to deliver the CAP after 2014 (CAP Delivery programme).	Procured a new aerial photography supplier. Established a commons layer in Rural Land Register. Updated mapping protocol with eligibility criteria for woodland. Rolled out rapid field visits where existing mapping information is indeterminate. Introduced manual and automated processes to update the LPIS.
The Fruit and Vegetable Producer Organisation Scheme action plan addresses deficiencies concerning: • recognition criteria for eligibility; • controls for operational programmes; • general quality of controls for approval, monitoring and claim-handling; and • on-the-spot checks.	Refined programme approval processes. Reviewed the operational framework and administrative procedures. Reviewed controls, policy and processes for scheme documentation. Reviewed on-the-spot and desk checks.
The Rural Development Programme for England (RDPE) action plan concerns two specific deficiencies identified by Commission audits: • claim periods for agri-environment agreement were not aligned with pillar 1; and • insufficient verification of livestock stocking density options.	From 2015 onwards, set a single start date of 1 January for all agri-environment agreements. Realigned claim periods for existing agreements. Communicated changes to affected agreement holders. Carried out retrospective cross-checks of livestock databases. Revised guidance for inspectors. Carried out a programme of rapid field visits between March and June 2015 to check animal numbers.

Appendix Three

Implementation decisions review

Issue	The Department's considerations	Final decisions taken
Hedges		
Farmers with more than 15 hectares of arable land must maintain at least 5% as an ecological focus area (EFA). Hedges were offered as an EFA option in England from 2015 onwards.	The Commission set a requirement for member states' Land Parcel Identification System (LPIS) to hold data on all EFA features by 2018. As such, additional investment in the LPIS was viewed as inevitable and necessary by the Rural Payments Agency (the RPA). Until LPIS achieves the required functionality, the RPA risks disallowance for making payments based on unverified data. If the RPA instead waited for the hedge data to be digitised then disallowance could be incurred for late payments instead.	Bring forward LPIS update with a rapid procurement exercise, prioritising hedges in arable areas. Make full use of the payment window (December to June) to allow maximum time for digitisation. Align validation of claims with data as these become available, to check as many as possible before payment is made.
Three-crop rule		
New greening rules require farmers with 10 hectares or more of arable land to grow at least two or more crops on their land during the claim year. To control this requirement, member states must set a cropping period in which crops are in the ground and available for inspection.	The cropping period in England should be short for agronomic reasons and the National Farmers Union (NFU) lobbied extensively on this point. The Commission expects 5% of the population to be checked. This is equivalent to 2,000 inspections, which the RPA estimated would take three months to carry out with current resources. Tension between the longer cropping period required by the Commission to control the measure, and the reality of the farming year was highlighted by NFU, which wanted a shorter cropping period.	Set the shortest possible cropping period manageable within the RPA's current resources (1 May to 30 June). Exceptions made for crops typically sown late or with very short growing periods (eg maize, or potatoes), provided the RPA is notified beforehand. Remote-sensing and geo-tagged photos submitted by claimants were explored. However, the Commission stated crops must be inspected while in the ground.

Issue	The Department's considerations	Final decisions taken
Active farmer test		
Under CAP reform, direct payments will not be made to claimants carrying out certain activities (eg airports, railways, waterworks, etc) unless they meet one of three 're-admission criteria'. Member states could define 2 of these criteria: whether agricultural activities are 'significant', and whether agriculture is the claimant's principal business activity.	Potential risk of disallowance if the Commission disagrees with how re-admission criteria have been defined. The need to minimise the risk that genuine farmers may be caught by the test (eg those who have diversified activities).	Regulations interpreted as clearly and narrowly as possible to avoid ambiguity and potential disallowance. Farmers can claim agriculture as principal business activity if agricultural receipts are at least 40% of total receipts. A farmer's agricultural activity is considered 'significant' if the agricultural holding is at least 36 hectares. A third non-discretionary criterion provides re-admission if a farmer's direct payment is more than 5% of non-agricultural receipts.

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