Department for Environment, Food and Rural Affairs 2015-16

The Report of the Comptroller and Auditor General to the House of Commons

Introduction

The Department for Environment, Food and Rural Affairs (the Department) develops, implements and delivers policy relating to the environment, food and rural issues. It is also responsible for negotiating European agricultural and rural policy and related funding for the United Kingdom (UK) as long as the United Kingdom remains a member of the European Union (EU).

This report sets out my observations on the Department's handling of the Common Agricultural Policy (CAP), disallowance and the Basic Payment Scheme during 2015-16. It draws out successes and also areas of concern that will require further attention.

These are set in the context of the EU referendum on 23 June 2016 in which the people of the UK voted to leave the EU. At this time, the UK has not triggered the formal process or negotiations for exiting the EU. The outcome of these negotiations will determine what arrangements apply in relation to EU legislation and funding in future once the UK has left the EU. At this stage, therefore, the impact on such funding is unclear.

As the Annual Report and Accounts relate to the year ended 31 March 2016, the arrangements relating to EU agricultural and rural policy funding were not affected by the referendum. CAP is the EU framework of agricultural subsidies and rural development programmes. In 2015-16, the Department received funding of some £2.3 billion (2014-15 £3.1 billion) from the European Commission (the Commission) to deliver the CAP and other initiatives. CAP schemes affecting the 2015-16 financial statements can be split into two programmes: new CAP schemes for 2014-20 that started during 2015; and old CAP schemes for 2007-13 that were being wound up. Most payments administered by Defra in 2015-16 for the Commission are under new CAP 2014-20 schemes.

CAP Regulations and Disallowance

The CAP regulations are set by the EU following proposals made by the Commission and agreed by the European Parliament and European Council. Financial penalties, known as 'disallowance' penalties, are levied by the Commission when it considers actions taken by member states to control and administer CAP payments have not complied with regulations. 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.

Disallowance penalties are determined in light of the Commission's review of the relevant CAP scheme year and any further evidence provided by the member states in response. As this process of review and determination of the loss can take several years, penalties are not incurred in the financial year of scheme payments. The timing of the Commission's review and its outcome can therefore impact the value of disallowance in any given year.

I considered the Department's management of disallowance risk throughout CAP 2007-13 in my report '*Managing disallowance risk*' (HC 306), published in July 2015. This report explained what the CAP is, how the Department administers it in the UK and how disallowance penalties arise. It also considered the underlying causes of disallowance in England, future disallowance risk and how the Department manages this risk.

Qualified opinion on regularity - financial penalties arising from Commission-funded schemes

The Department administers the Commission funding for the CAP schemes. When disallowance penalties occur, the Commission reduces its funding for the schemes and the shortfall must be met directly from taxpayer funds. This shortfall is a loss to the UK Exchequer which is outside Parliament's intentions for the proper administration of European funding and I therefore considered the use of funds to pay disallowance penalties irregular.

The Department accrues penalties in their financial statements when either the Commission confirms a penalty or the Department decides not to contest it. At this point, the value of disallowance becomes certain and I consider it to be irregular. The Department also includes a provision in its financial statements for disallowance penalties which are probable but not yet confirmed.

In 2015-16, the value of disallowance penalties accrued in year was £65.8 million, which I consider material. I have therefore qualified my opinion on regularity on the 2015-16 financial statements. Disallowance is lower than in 2014-15, when £90 million was accrued, but this relates to multiple scheme years and the amount accrued in any one year does not represent the Department's performance in that year. Of the £65.8 million, the majority (£38.6 million) related to Single Payment Scheme payments, with smaller amounts (£13.3 million) from Rural Development, (£9.9 million) Cross Compliance penalties and the remaining (£4.0 million) other schemes.

The total value of cumulative disallowance penalties incurred under CAP 2007-13 is £661 million. The Commission has carried out a small number of audits on CAP 2014-20 schemes, but the related disallowance penalties have not yet been finalised.

Future financial penalties

Almost all payments in relation to the CAP 2007-13 schemes have been made but the Commission's reviews have not yet been finalised. The Department's current expectation is that disallowance penalties related to schemes under the CAP 2007-13 will not be fully calculated and settled until 2019-20.

In addition, Commission audits of CAP 2014-20 schemes are likely to result in further disallowance penalties upon conclusion. The Department is not able to predict future Commission audit findings and therefore the value of disallowance penalties that will arise. As a result, no liability is included in the financial statements.

Tackling disallowance and the CAP Delivery programme

Tackling disallowance has been an increasing challenge for the Department as the new 2014-20 CAP schemes are more complex than CAP 2007-13. They have more stringent control requirements and penalty calculations for multiple breaches of regulations are more severe. There is therefore a risk of higher disallowance penalties relating to the new schemes.

The Department's response to this challenge consists of two principle strands: the CAP Delivery Programme; and the Disallowance Strategy.

CAP Delivery Programme

The CAP Delivery Programme incorporates the procurement, development and implementation of new systems and processes to deliver the CAP 2014-20 schemes. Successful delivery of the Programme is critical to ensuring that the Department correctly applies scheme regulations to pay claimants accurately and efficiently; and minimises disallowance penalties going forward. Issues with the systems in 2015 resulted in a large proportion of paper-based claims rather than online claims, which led to more manual interventions and delays in payments made to farmers.

I reviewed the Department's implementation of the CAP Delivery Programme in my report '*Early review of the Common Agricultural Policy Delivery Programme*' (HC 606), published in December 2015. My conclusion stated that the CAP Delivery Programme had not provided value for money at that stage, and that '*significant challenges remain to make sure this year's payments are accurate, to prepare for future years, maximise Programme benefits and minimise disallowance penalties*'. The extent of disallowance arising as a result will only become apparent when the schemes are audited by the Commission.

The Department stabilised the programme in 2015, enabling the majority of farmers to be paid in December 2015. It also implemented a more staggered approach to system development and was able to reintroduce online applications for the Basic Payments Scheme in 2016.

Disallowance Strategy

The Department has developed a Disallowance Strategy which is currently awaiting ministerial approval. The strategy's objective is to minimise disallowance in a cost-effective way by:

- Further analysing the underlying causes of disallowance and identify future disallowance risks.
- Tackling the identified risks in the design of schemes (including through policy choices), by improving processes and systems, as well as by improving data quality (including mapping data).
- Working with the Commission and other Member States to reduce the legislative causes of disallowance.
- Minimising historic disallowance costs through negotiation, mitigating actions, conciliation and, where they have a good case, challenge through the European Courts.

Financial Management of EU funds

The Public Accounts Committee (PAC) held an inquiry on 23 February 2016 on Financial Management in the EU. This inquiry was informed by the NAO briefing '*Financial management of the European Union budget in 2014: a briefing for the Committee of Public Accounts*' (HC 799) published on 12 February 2016 and the Department was called to give evidence. The subsequent PAC report '*Financial management of the European Union budget in 2014*' (HC 730), published on 27 April 2016, highlighted the level of penalties paid to the Commission due to errors in how UK bodies have spent EU funds. It also highlighted the increasing complexities of the new CAP system.

The report's key findings were that EU rules and regulations for spending EU funds are complex and that the UK government has chosen to design programmes which have added to this complexity, driving up the risk of errors and penalties further. We also reported a distinct lack of urgency by UK government departments in tackling complexity and reducing the levels of penalties incurred.

Basic Payment Scheme

I reported in December 2015[1] that there were significant challenges remaining to make sure that 2015 Basic Payment Scheme payments made under the CAP 2014-20 were accurate. Alongside this, the Department set challenging targets for making timely payments to farmers.

The Department met its first two targets for timely payments, by making the 'majority' of payments by 31 December 2015 (>50%) and the 'vast majority' (>75%) by 31 January 2016. However, the target to make 'almost all' (92-95%) payments by 31 March 2016 was not met.

The Department has stated that it is initially reviewing the accuracy of 13,000 payments, representing payments to 15% of all claimants, where claimants may be due a further €100 or more. Inaccuracies have arisen where there are differences between claim forms and the Department's systems. My testing indicates that the most common cause for differences is where the Department has not yet updated its systems to include all information provided by the farmer. Where such differences arise the Department has not paid unmatched amounts, and has applied penalties related to the scale of these unmatched amounts. This reduces the risk of disallowance penalties, but delays full payments being made to farmers.

The Department is now completing its processing to confirm whether further amounts are due to farmers, and related penalties were justified. The 13,000 claims being reviewed include both claims known by the Department to have inaccuracies, and claims notified by farmers where they believe they have been underpaid. The Department has provided £25.3 million in its accounts as an estimate of payments due in relation to claims initially paid before 31 March 2016. The Department also believes that once the 13,000 claims have been reviewed, further payments in addition to the £25.3 million already provided may be required. The Department has not yet accurately estimated the value of these payments, but they will not be material to the Defra accounts.

[1] *Early review of the Common Agricultural Policy Delivery Programme* (HC 606)

Farmers will also be due to receive Financial Discipline Mechanism (FDM) refunds. The FDM allows for a small proportion of larger claims to be withheld annually to form a reserve that the Commission can use to respond to crises, with unspent funds refunded to farmers in the following year. Historically, refunds have been paid at the same time as the Basic Payment Scheme payments that they relate to. However, as a result of delays developing the appropriate functionality within the CAP Delivery Programme these have not yet been repaid. The Department expects to repay £16.9 million in respect of FDM refunds. Whilst these issues present challenges the Department must address, they do not impact on my opinion on the financial statements.

Conclusion

The Department continues to face a number of challenges to successfully manage disallowance in order to reduce the level of penalties incurred as well as ensuring the accurate transition from the old schemes to the new schemes. The potential exit from the EU does not reduce the need to tackle these challenges. I will continue to monitor progress in this area and will provide an update in my report on the Department's 2016-17 Annual Report and Accounts.

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