

HM Customs and Excise:
The Misuse and Smuggling of Hydrocarbon Oils



REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 614 Session 2001-2002: 15 February 2002

executive summary

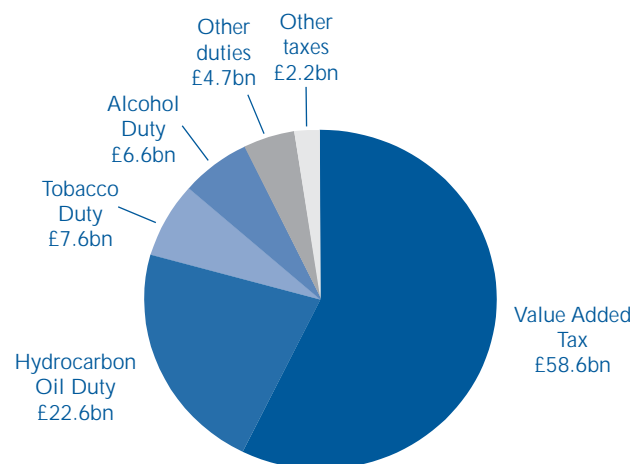
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The risks to the revenue

- 1 In 2000-01, HM Customs & Excise collected £102.3 billion in taxes and duties, net of repayments of £42.6 billion (**Figure 1**). This is equivalent to the amount needed to fund the Department of Health, the Ministry of Defence and the Home Office.
- 2 All taxes are subject to the risk of fraud and evasion by a variety of methods, ranging from false declarations to smuggling. Under their Service Delivery Agreement for the period 2001-04, Customs are producing threat assessments for all major business areas. Customs aim to use these assessments to measure the impacts of fraud and to develop strategies for tackling them.
- 3 Customs current priorities on law enforcement are tackling drug and tobacco smuggling. The Government published its strategy for *Tackling Drugs To Build a Better Britain* in 1998 and for *Tackling Tobacco Smuggling* in March 2000. The results from the first year indicate that Customs are on track to achieve their aim of putting tobacco smuggling into decline. In *Tackling Indirect Tax Fraud*, published in November 2001, Customs set out their estimates of revenue loss in the oils and alcohol sectors and from VAT missing trader fraud¹. It also sets out the Government's proposals for tackling fraud in these areas.

1 Figure 1 shows the total revenue collected by HM Customs & Excise in 2000-01



NOTE

All figures are net. Total VAT collected was £101.2bn, repayments totalled £42.6bn.

Source: HM Customs and Excise

¹ These frauds involve fraudsters obtaining VAT registration with Customs to acquire goods VAT free from other Member States. The fraudsters then sell on the goods at VAT inclusive prices and disappear without paying over the VAT paid by their customers to Customs.

- 4 We have reported on developments in Customs' counter fraud activities in the Comptroller and Auditor General's annual Standard Report on Customs collection of duties. The latest report, published with Customs' accounts for 2000-01, looks in particular at their work to combat Tobacco Fraud and a review of VAT registration. In July 2001, we published a separate report on the evasion of duties on alcohol through the diversion of duty-suspended products to the open market (HC 178, Session 2001-2002). And we have also commenced work on a wide ranging review of the way Customs, the Department of Work and Pensions and Inland Revenue tackle the major threat of external fraud against the public purse.
- 5 In this report, we look at the risks Customs face on hydrocarbon oils duty and how well they are tackling the illegal use of rebated fuel (fuel on which the duty is substantially lower than petrol and diesel because it will not be used in vehicles on the highway) and smuggling. Hydrocarbon oils, which accounted for £22.6 billion from duties in 2000-01, include fuels such as petrol, diesel and kerosene. Our methodology is set out in Appendix A. How Customs are organised to collect the duty and tackle fraud and smuggling is summarised in Appendix B.

Main Findings

- 6 Customs collect 80 per cent of hydrocarbon oils duty from the nine large oil refineries operating in the United Kingdom. The balance comes mainly from smaller refineries and businesses that trade in imported oils. When the final consumer purchases the fuel, Value Added Tax is also due. Together, hydrocarbon oils duty and VAT made up 80 per cent of the retail price of unleaded petrol (as of January 2002).
- 7 In November 2001, Customs estimated that in 2000 the revenue loss from frauds on petrol and diesel could be between £450 million and £980 million in the UK (**Figure 2**).
- 8 On the UK mainland, frauds on diesel in 2000 amounted to £450 million, up from £200 million in the previous year. Customs are concerned that fraud losses in the diesel sector could continue to grow if concerted action is not taken to tackle the problem. For Northern Ireland, the estimated revenue loss from fraud and legitimate cross border shopping on petrol and diesel was £380 million for 2000, up from £140 million in 1998. Customs estimate the total revenue from hydrocarbon oils duty in Northern Ireland is around £750 million.



2 Figure 2 shows the revenue lost from the use of UK non-duty paid fuel in 2000

	Petrol £million	Diesel £million		Total £million
	<i>Fraud and legitimate cross border shopping</i>	<i>Fraud</i>	<i>Legitimate cross border shopping</i>	<i>Fraud and legitimate cross border shopping</i>
Mainland UK	150	450	900	1,500
Northern Ireland	150		230	380
Total	300		1,580	1,880

NOTE

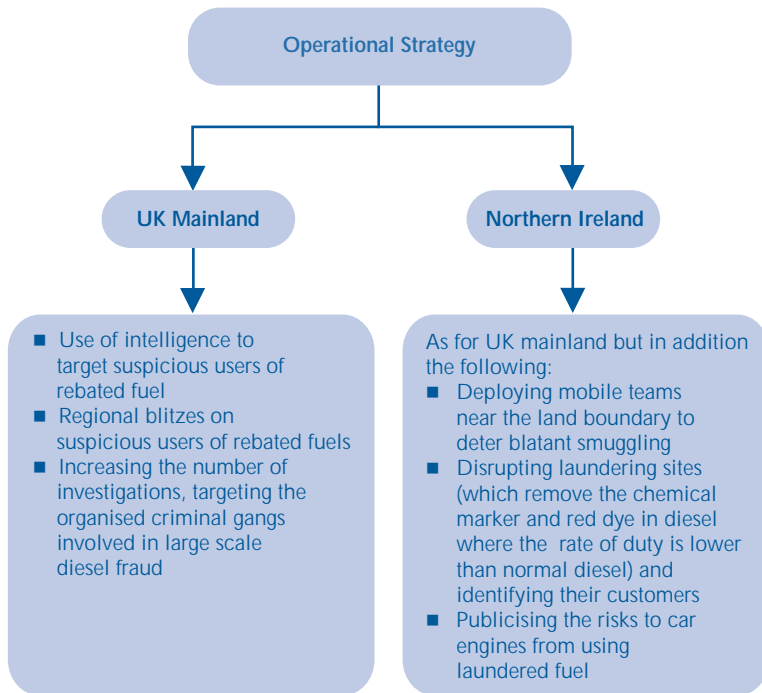
Customs estimate that £900 million is lost from legitimate cross border shopping for diesel which means that the maximum amount of fraud in the United Kingdom could be £980 million in 2000.

Source: HM Customs and Excise

- 9 Customs' developing strategy for tackling fraud on hydrocarbon oils duty is based on tackling misuse of rebated fuel and in addition in Northern Ireland disrupting the supply of smuggled fuel. The main elements of the strategy are summarised in **Figure 3**.
- 10 Customs believe that the smuggling of fuel is a material problem only between the Republic of Ireland and Northern Ireland. This is because of the long land border, the lower price of diesel and petrol in the Republic compared to the UK (for example on diesel there is a price difference of about 29 pence (38%) per litre, as of January 2002) and the presence of sophisticated criminal groups with experience in smuggling.
- 11 The illegal use of rebated fuel is also a problem in Northern Ireland, where in 2000-01 Customs found more laundering plants than on the mainland. Rebated fuels may only be used for off road purposes and attract significantly reduced rates of duty, for example red diesel (on which the duty is 3.13 pence per litre) is used principally in construction and agriculture, and marked kerosene (on which no duty is paid) is used in domestic heating. Laundering plants illegally remove the chemical markers and any dye from rebated fuels. The situation in Northern Ireland is inevitably affected by the political and civic situation in the Province.



3 Figure 3 shows how Customs have developed their strategy for tackling frauds on oils duty (as at November 2001)



NOTE

Customers' strategy may change as a result of proposals set out in Tackling Indirect Tax Fraud

- 12 Customs believe that smuggling to the mainland is limited at present, due to the difficulties in transporting oil in sufficient quantities without it being noticed and the relatively low profit margins compared with other types of fraud, such as tobacco or drug smuggling, and indeed other types of oils fraud. Where it does happen, however, there are also health and safety risks, for example to ferry passengers, if oil is transported in extra tanks which have not been properly secured. Although the normal tanks of vehicles can be filled with cheaper fuel on the continent, it is an offence to then remove this fuel later on for use in other vehicles in the UK. This is known as decanting.
- 13 Customs see the illegal use of rebated fuels in road vehicles as the main risk they face on hydrocarbon oils duty on the UK mainland. Customs have undertaken a number of intelligence led operations on the mainland and in Northern Ireland to track duty - rebated supplies from the point of production through the distribution system to detect and disrupt illicit consumption.
- 14 Red diesel and kerosene are chemically marked so that Customs can detect illegal use by testing samples from fuel tanks. We found that contrary to Customs guidance, staff have placed too much reliance on sight tests to detect the obvious presence of the dye in red diesel.
- 15 Fraudsters can use laundering techniques to remove the markers from red diesel and kerosene, or mix red diesel with other agents to mask the dye, making the use of sight tests alone an ineffective method for detecting the illegal use of fuel. The chemicals used to launder fuel often remain in the fuel which can cause serious damage to engines.





- 16 Specialist companies have developed sophisticated portable tests that may allow Customs' staff to carry out more accurate tests to confirm that rebated fuel is being used illegally. The Legitimate Oil Pressure Group consider that it might be easier for Customs to detect those retail sites in Northern Ireland which are selling smuggled fuel if all normal duty paid fuel in Northern Ireland is chemically marked, but this would need to be looked into further.
- 17 Since 1999-2000, when Customs started to develop their strategy for tackling frauds on hydrocarbon oils duty in Northern Ireland, the amount of fuel seized by Customs there has doubled and the number of vehicles seized involved in smuggling has more than tripled. But filling stations in Northern Ireland selling illicit fuel, of which there are estimated to be over 400 involved to some extent, are often back in business after Customs have seized fuel from them. The Northern Ireland region of the Petrol Retailers Association is concerned that if Customs are not more effective their members will continue to go out of business.
- 18 I provided my initial findings, conclusions and recommendations to Customs in June 2001. In November 2001, Customs published *Tackling Indirect Tax Fraud* which includes their outline strategy for tackling frauds on hydrocarbon oils duty and their estimates of revenue losses.

Main Conclusions and Recommendations

- 19 As part of their overall change in approach to tackling fraud, Customs published their estimates of the revenue losses on hydrocarbon oils duty. These estimates will assist them in identifying areas where the duty is at risk and to develop their response. They are working further on their estimates as in Northern Ireland, in particular, these include legitimate cross border shopping. The Government has outlined in *Tackling Indirect Tax Fraud* what Customs are currently doing to tackle oils fraud and possible new initiatives currently being considered. I believe that these should include an assessment of the risks and resources. Some of the key elements under consideration by Customs include:
- An authorisation scheme for the distributors of tied oils and rebated fuels;
 - A simultaneous strengthening of the obligations on distributors to take reasonable steps to check that sales of such fuels are made only to customers who intend to put them to an approved use;
 - Improved chemical and colour markings of rebated fuel to deter misuse;
 - Increased numbers of intelligence-led checks and investigations;
 - Tougher penalties against those engaged in the supply of fuels for illicit purposes, or for those found using such fuel in road vehicles; and
 - A targeted publicity campaign designed to highlight the danger of fuel misuse and the penalties for people caught misusing.
- 20 As part of Customs' continuing work to develop their strategy they are also:
- Looking at whether the distribution of their resources between drugs, tobacco and other frauds is the optimum;
 - Considering outcomes-based targets for hydrocarbon oils duty;
 - As part of the Organised Crime Task Force in Northern Ireland, working with other public sector agencies on ways to tackle the supply and sale of illicit fuel in Northern Ireland;

- Developing their intelligence data to provide anti-smuggling teams with profiles of vehicles and individuals that are most likely to be smuggling oil; and
- Ensuring that their road fuel testers comply with departmental guidelines, that require them to carry out full chemical tests on all fuel samples, taking into account other relevant factors.

21 In addition, I believe Customs should:

- Examine whether it would be cost effective to chemically mark all duty paid fuel in Northern Ireland. This could act as a deterrent to smugglers and launderers of fuel;
- Give fresh guidance to road fuel testing units to ensure that current penalties and sanctions are used to best effect in order to act as a sufficient deterrent to others; and
- Assess the effectiveness of measures taken by other European Union Member States in the oils fraud sector.



Milk tanker seized by HM Customs and Excise in February 2002 which was being used to transport laundered fuel on the UK mainland. These tankers are unsuitable for transporting oil.

Source: National Audit Office