

CHAPTER 2

THE GOVERNMENT OF THE HONG KONG SPECIAL ADMINISTRATIVE REGION

GENERAL REVENUE ACCOUNT

GOVERNMENT DEPARTMENT

Customs and Excise Department

**The Customs and Excise Department's efforts
to protect government revenue from dutiable commodities**

**Audit Commission
Hong Kong
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THE CUSTOMS AND EXCISE DEPARTMENT'S EFFORTS TO PROTECT GOVERNMENT REVENUE FROM DUTIABLE COMMODITIES

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THE CUSTOMS AND EXCISE DEPARTMENT'S EFFORTS TO PROTECT GOVERNMENT REVENUE FROM DUTIABLE COMMODITIES

Summary and key findings

A. **Introduction.** The Customs and Excise Department (C&ED) is responsible for the protection and collection of duties payable under the Dutiable Commodities Ordinance, which applies to four dutiable commodities (DCs), namely liquor, tobacco, hydrocarbon oil and methyl alcohol. In 2001-02, the C&ED collected over \$6.9 billion of duty revenue (para. 1.2).

B. **Audit review.** Audit has conducted a review to examine the C&ED's efforts to protect the Government's revenue from DCs and to ascertain whether there are areas for improvement in the C&ED's performance. As most (88%) of the duty revenue is from hydrocarbon oil and cigarettes, the audit has focused on these two DCs (para. 1.6). The major audit findings are summarised in paragraphs C to G below.

C. **General control on DCs.** Under the C&ED's existing licence and permit system, measures are generally in place to control the movement and storage of DCs (para. 2.9). However, Audit notes that there are two areas that require attention, namely:

- (a) **Implementation of the Open Bond System (OBS).** Most of the bonded warehouses are currently operated under the closed bond environment. In 2001, the C&ED conducted a pilot scheme for the OBS in five bonded warehouses. The implementation of the OBS will bring about benefits as well as risks. The C&ED's current plan is to implement the OBS in January 2003 and preparation work, which involves nine major tasks, is underway to address the risks. Audit considers that the C&ED needs to complete all the major tasks before implementing the OBS. Audit also considers that there is a need to review the operation of the OBS shortly after its implementation, so as to ensure that the risks of duty evasion under the OBS are properly managed (paras. 2.13 to 2.15); and
- (b) **Customs control on river trade vessels (RTVs).** Unlike ocean-going vessels, RTVs are not required to submit Pre-arrival Notices (PANs) to the Marine Department before entering Hong Kong. In June 2002, the Shipping and Port Control Regulations were amended to require RTVs to submit PANs. This new requirement, which the C&ED expects to come into effect later this year, will help the C&ED exercise control on the RTVs. However, given the large number of RTV movements and Hong Kong's long coastline, Audit considers that compliance monitoring and customs control will remain a significant challenge (paras. 2.19 to 2.23).

D. **Abuses of cigarette duty-free concessions.** Cigarette duty-free concessions have significant revenue implications. According to an estimate made by the Government in March 2002, local residents were bringing back 1.4 billion duty-free cigarettes (with a duty potential of \$1.13 billion) on return to Hong Kong every year. Audit's review indicates that improvements are

needed in the C&ED's procedures for preventing, detecting and deterring abuses of cigarette duty-free concessions. The audit focused on the Lo Wu Control Point through which a major part (80%) of the duty-free cigarettes are brought into Hong Kong (paras. 3.2 to 3.6). The main audit observations are:

- (a) ***Need to closely monitor duty-free sales.*** The licence conditions for operating duty-free shops impose obligations on the licensee to prevent abuses of duty-free concessions at source. However, these licence conditions are not being complied with and, as a result, there is little assurance that duty-free cigarettes are sold only to those who are entitled to duty-free concessions and in quantities that are within their entitlement (para. 3.12);
- (b) ***Need to increase customs checking.*** Due to the heavy passenger flow, customs control activities at the Lo Wu Control Point are conducted on a selective basis. Audit staff observed the activities at selected customs examination counters at the Lo Wu Control Point during June and July 2002 and found that only 0.88% of the travellers passing through the selected counters were intercepted for customs checking. In addition, Audit staff closely observed the activities of 32 travellers (who bought cigarettes at the duty-free shops in excess of the concession limit). The audit findings indicate that abusers of duty-free concessions could easily escape customs detection (paras. 3.17 to 3.24);
- (c) ***Need to enforce the 24-hour rule.*** A local resident is not entitled to any cigarette duty-free concessions unless he has stayed outside Hong Kong for at least 24 hours (the 24-hour rule). The C&ED has been concerned about the abuses of the 24-hour rule by day-trippers and has identified a number of measures to address the problem. However, Audit noted that, up to July 2002, none of these measures had been implemented (paras. 3.25 to 3.29); and
- (d) ***Need to rectify weakness in the C&ED's baggage examination procedures.*** The existing baggage examination procedures allow an abuser of duty-free concessions to escape penalty, even if he is intercepted at the customs examination counter for checking. All he needs to do is to declare to the customs officers that he is in possession of excessive cigarettes and pay the duty, or surrender the cigarettes to customs. As the cost of the cigarettes after duty is still lower than the price of cigarettes in the retail market, Audit considers that the existing C&ED procedures have little deterrent effect on the abusers of the duty-free concessions (paras. 3.30 to 3.33).

E. **Scope for improvements in the C&ED's audit on oil companies.** The C&ED's present approach to auditing oil companies is mainly transaction-based. Audit research indicates that, for large oil companies, the customs authorities of advanced countries usually adopt a system-based approach (SBA) to auditing them. As system-based audits are more effective in achieving the objective of customs audits, which is to obtain assurance on the companies' compliance with legislative requirements, Audit considers that there is a need for the C&ED to consider adopting the SBA in line with the practice of advanced countries (paras. 5.6 to 5.8).

F. **C&ED's efforts to combat illegal vehicle refuelling activities.** The C&ED has been taking various actions to combat illegal vehicle refuelling activities, including introducing legislative amendments, taking various enforcement actions (e.g. raiding illegal filling stations) and launching

reward schemes to solicit intelligence reports (paras. 6.6 and 6.7). While noting its achievements, Audit has found that the C&ED is facing the following problems which, if not satisfactorily resolved, could undermine the effectiveness of its enforcement efforts:

- (a) ***Illicit use of synthetic motor spirit (SMS).*** There are indications of a widespread misuse of rubber solvent and toluene for making SMS. Faced with enforcement difficulties against the illegal use of SMS as vehicle fuel, the C&ED is considering measures to control the sale and use of these chemicals. However, it could take a long time to implement such measures, which may involve legislative amendments (paras. 6.10 to 6.12);

- (b) ***Difficulties in closing down illegal detreating plants with underground tanks.*** Closing down an illegal detreating plant with an underground tank is a complicated matter. The difficulties in closing down such plants have undermined the C&ED's efforts in tackling illicit oil refuelling activities, because unscrupulous operators could re-open the plants after a raiding operation. In April 2002, an inter-departmental working committee, chaired by a senior C&ED officer, was set up to address the issue. Audit considers that there is a need for the C&ED to monitor the committee's progress to ensure that the problem is resolved as soon as possible (paras. 6.15 to 6.17); and

- (c) ***Illegal use of marked oil.*** In a review conducted in early 2000, the Independent Commission Against Corruption (ICAC) reported that the C&ED did not control the distribution of marked oil (which is exempted from duty) through the oil companies to the distributors, whose identities and sales volumes were not known, thus making it difficult for the C&ED to monitor their activities. Subsequent to the ICAC's review, the C&ED has taken various courses of action to tackle the illegal use of marked oil. These include, for example, visiting selected marked oil dealers and conducting an ad hoc verification exercise on end-users. According to the C&ED, the actions have been effective and there are indications that illegal oil dealers have refrained from buying marked ultra low sulphur diesel from the oil companies. Audit considers that continued efforts by the C&ED are necessary to sustain its achievement and keep the problem under control (paras. 6.19 to 6.26).

G. **Mainland diesel brought into Hong Kong by cross-boundary vehicles.** Under the current duty-free arrangement, cross-boundary goods vehicles are allowed to bring into Hong Kong Mainland diesel, which has a higher sulphur content than the diesel supplied in Hong Kong. The permitted quantities range from 100 to 300 litres for each goods vehicle, depending on its cylinder capacity. The Environment, Transport and Works Bureau considers that there are no strong environmental grounds for reducing the duty-free concessions at this time. The C&ED considers that the problem of illicit transfers of Mainland diesel from cross-boundary vehicles to local vehicles is under control. Audit considers that the risks of illicit transfers will remain, as long as the quantity brought into Hong Kong by cross-boundary vehicles (estimated to be 679 million litres a year) far exceeds their operational needs (estimated to be 236 million litres a year). There is a need for the C&ED to closely monitor the problem of illicit transfers and make sustained enforcement efforts to prevent a possible resurgence of the problem (paras. 7.2 and 7.9 to 7.15).

H. **Audit recommendations.** Audit has made the following main recommendations that the Commissioner of Customs and Excise should:

General control on DCs

- (a) before implementing the OBS, ensure that the C&ED is fully prepared and, in particular, has completed all the outstanding major tasks involved (para. 2.16(a));
- (b) review the operation of the OBS shortly (say 6 months) after its implementation, so as to ensure that the risks of duty evasion are properly managed (para. 2.16(b));
- (c) in consultation with the Marine Department, closely monitor the RTVs' compliance with the new legislative requirements and make the best use of the PANs for customs control purposes (para. 2.25(a));

Abuses of cigarette duty-free concessions

- (d) in the light of the audit observations, conduct an overall review of the C&ED's procedures for preventing, detecting and deterring the abuses of cigarette duty-free concessions (para. 3.34);
- (e) closely monitor the sales activities at the duty-free shops to ensure compliance with licence conditions (para. 3.34(a));
- (f) review the need for increased customs checking, so as to increase the chance of detecting abuses at the customs examination counters (para. 3.34(g));
- (g) in conjunction with the parties concerned, including the Immigration Department, take action to implement measures to effectively enforce the 24-hour rule on cigarette duty-free concessions as soon as possible (para. 3.34(h));
- (h) take urgent action to rectify the weakness in the baggage examination procedures, so as to ensure that adequate penalties are imposed on abusers caught at the customs examination counters and also to deter such abuses (para. 3.34(i));

C&ED's audit on oil companies

- (i) consider adopting the SBA in line with the practice of advanced countries (para. 5.11(a));

C&ED's efforts to combat illegal refuelling activities

- (j) draw up an action plan, with clear milestone dates, to monitor the progress of implementation of measures to control the sale and use of the ingredients for making SMS (para. 6.29(a));
- (k) draw up an action plan, with clear milestone dates, to monitor the progress of the inter-departmental working committee in resolving the problem of permanently closing down illegal detreating plants (para. 6.29(c));
- (l) make continued efforts to sustain the C&ED's achievement in controlling the use of marked oil, so as to keep the problem of its illegal use under control (para. 6.29(d));
- (m) conduct verification exercises on a regular basis to detect the potential misuse of marked oil (para. 6.29(e));

Illicit transfers of Mainland diesel

- (n) make sustained enforcement efforts to prevent a possible resurgence of the problem of the illicit transfers of Mainland diesel (para. 7.16(a)); and
- (o) consider the need to increase customs efforts on road-side checking of vehicles (para. 7.16(b)).

I. **Response from the Administration.** The Administration generally agrees with the audit recommendations.

PART 1: INTRODUCTION

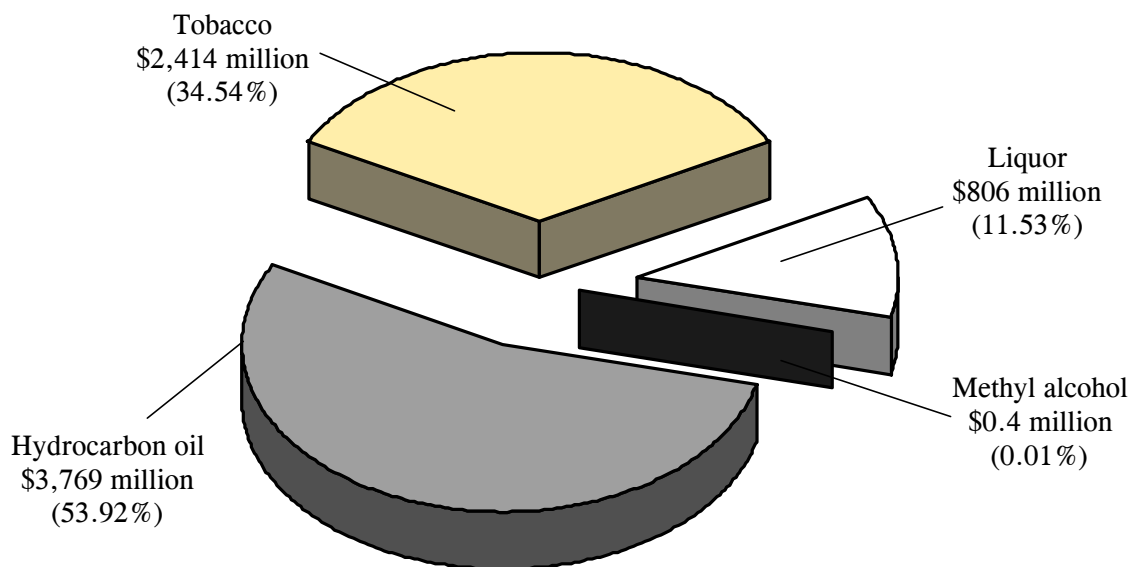
1.1 This PART describes the background to the audit and outlines the objectives and scope of the audit.

Background

1.2 The Customs and Excise Department (C&ED) is responsible for the protection and collection of duties payable under the Dutiable Commodities Ordinance (DCO — Cap. 109). At present, the DCO applies to four dutiable commodities (DCs), namely liquor, tobacco, hydrocarbon oil (Note 1) and methyl alcohol. Revenue from DCs is determined by the duty rates approved by the Legislative Council (LegCo) and the level of local consumption. (The duty rates in respect of tobacco and hydrocarbon oil are shown in Appendix A.) In 2001-02, the C&ED collected over \$6.9 billion of duty revenue, an analysis of which is shown in Figure 1 below.

Figure 1

Analysis of duty revenue collected in 2001-02



Source: C&ED's records

Note 1: Three types of hydrocarbon oil are chargeable to duty. They are light diesel, motor spirit and aircraft spirit.

Change in business environment

1.3 The growth in social and economic links with the Mainland in recent years and the continued development of the Pearl River Delta have resulted in steady increases in the number of cross-boundary travellers and vehicular traffic. For example, the total number of traveller arrivals at the Lo Wu Control Point had increased by 60% in the past five years, from 28.4 million in 1997 to 45.4 million in 2001. During the same period, the total number of vehicle arrivals at the three land border control points (Lok Ma Chau, Man Kam To and Sha Tau Kok) had also increased by 19%, from 4.8 million in 1997 to 5.7 million in 2001. The increase in the cross-boundary movements of people, cargo, aircraft, vehicles and vessels has made it more difficult for the C&ED to detect smuggling activities.

C&ED's role

1.4 The traditional role of the C&ED as an enforcement agency has expanded considerably in recent years. In a globalised business environment where technological developments are evolving, the business community expects customs to be also a trade facilitator, who will help them achieve "just-in-time" deliveries so that they can remain competitive in the market. The C&ED has to find the proper balance between its role as the enforcement agency to protect duty revenue, and as a trade facilitator to strengthen Hong Kong's competitiveness. To play these two roles effectively, the C&ED has been promoting the use of intelligence and risk management in its operations with the support of information technology.

Organisation of the C&ED

1.5 With an establishment of 5,163 posts (as at August 2002), the C&ED has five branches, namely the Administration and Excise Branch, the Boundary and Ports Branch, the Intelligence and Investigation Branch, the Trade Controls Branch and the Civil Secretariat (Note 2). The Administration and Excise Branch is responsible for all matters relating to DCs and for implementing policies in relation to such matters. The Boundary and Ports Branch and the Intelligence and Investigation Branch both play key operational roles in the protection of duty revenue. An organisation chart of the C&ED is at Appendix B.

Audit review

1.6 Audit has recently conducted a review to examine the C&ED's efforts to protect the Government's revenue from DCs and to ascertain whether there are areas for improvement in the C&ED's performance. As most (88%) of the duty revenue is from hydrocarbon oil and cigarettes, the audit has focused on these two DCs. The scope of the audit covers the following areas:

Note 2: *The estimated recurrent expenditure of the C&ED for the year 2002-03 amounts to \$1,970 million.*

- (a) the C&ED's general control on DCs prior to payment of duty (see PART 2 below);
- (b) the effectiveness of the procedures in preventing, detecting and deterring abuses of cigarette duty-free concessions (see PART 3 below);
- (c) the monitoring and measurement of performance in tackling cigarette smuggling (see PART 4 below);
- (d) customs audit on oil companies (see PART 5 below);
- (e) the problem of illegal vehicle refuelling activities and the C&ED's measures to tackle it (see PART 6 below); and
- (f) the Government's progress in reducing the quantities of diesel brought into Hong Kong by cross-boundary vehicles under the duty-free arrangement (see PART 7 below).

PART 2: GENERAL CONTROL ON DUTIABLE COMMODITIES

2.1 This PART examines the C&ED's general control on DCs prior to payment of duty.

Licence and permit control

2.2 Any person who imports, exports, or manufactures DCs must be the holder of an Import and Export licence, or a Manufacturer's licence issued by the C&ED. For the storage of DCs, licences are issued to three types of bonded warehouses, namely General Bonded Warehouse (GBW — Note 3), Public Bonded Warehouse (PBW — Note 4) and Licensed Warehouse (LW — Note 5).

2.3 The licences impose the terms and conditions on the conduct of business. Through these terms and conditions, the C&ED regulates the licensees in their dealings of DCs. To protect the revenue, licence holders may be required to deposit a security.

2.4 Any movement of DCs in or out of Hong Kong is subject to permit control. The C&ED issues three types of DC permits, namely:

- (a) **Removal permit (RP).** An RP is required when DCs are removed from an importing carrier to a bonded warehouse, between bonded warehouses, or from a factory to a bonded warehouse;
- (b) **Duty-paid permit (DP).** A DP is issued upon payment of duty. A DP is required when DCs are removed from an importing carrier, or a bonded warehouse, to a local retail outlet for sale; and
- (c) **Export permit (EP).** An EP is required when DCs are removed from a bonded warehouse to an exporting carrier, or from an importing carrier to an exporting carrier for re-export.

Control of DC movements

2.5 All DCs entering Hong Kong by land, air and sea must be covered by either an RP or a DP. On the other hand, DCs to be released from the bonded warehouses for export must be covered by an EP. Figures 2 and 3 below show the control procedures for the import and export of DCs respectively.

Note 3: *GBWs are bonded warehouses sited at the shipping terminals and the Airport for the temporary storage of DCs unloaded by carriers for import, or pending loading for export.*

Note 4: *PBWs are bonded warehouses that have been licensed to provide public storage facilities for DCs.*

Note 5: *LWs are bonded warehouses licensed for the sole storage of DCs that are owned by the licensees of the warehouses.*

Figure 2

Control procedures for the IMPORT of DCs

By land

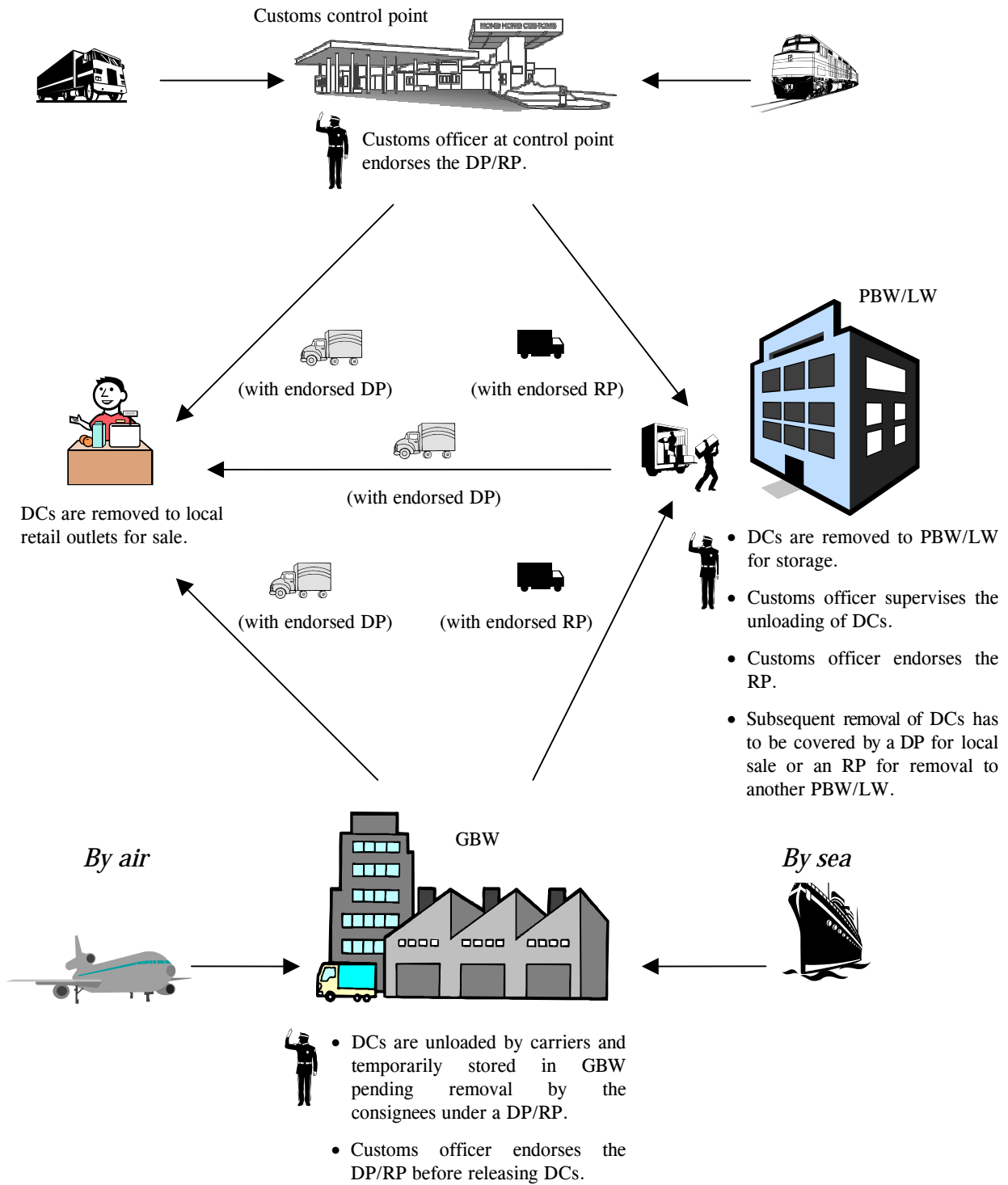
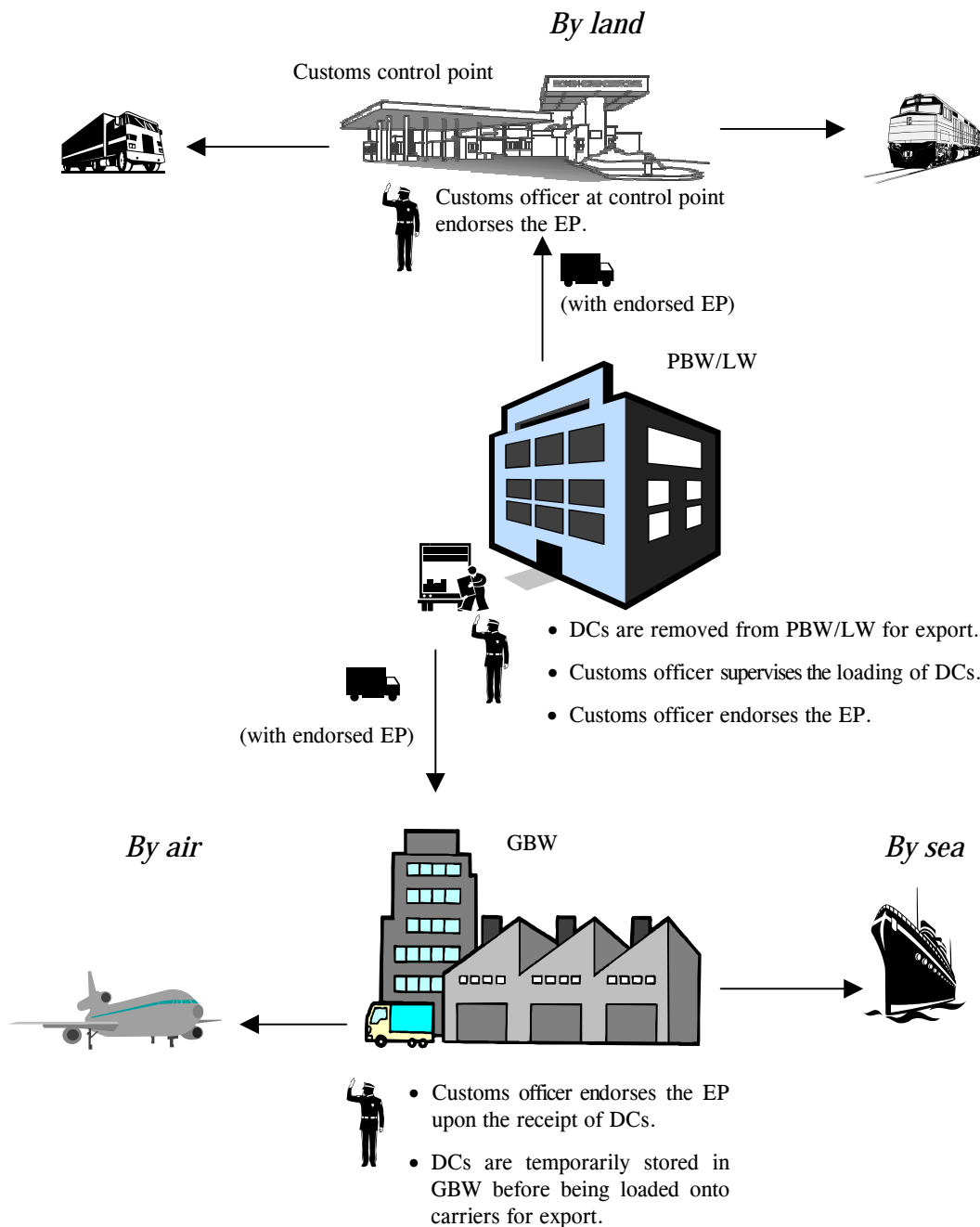


Figure 3

Control procedures for the EXPORT of DCs



Note: Additional requirements are imposed on the export of DCs:

- *the ship's officer/freight supervisor has to certify receipt of the goods for export on the relevant EP;*
- *landing certificates issued by the customs authority at the port of destination may be required; and*
- *for the export of hydrocarbon oil, EP holders have to report the shipment particulars to the C&ED two hours before the exporting ships leave the port.*

Bonded warehouse arrangements

2.6 The bonded warehouse is a duty-deferral facility. Owners of DCs may store their goods “under bond” in a customs controlled warehouse until they discharge the duty liability. Duty liability is discharged when the goods are duty paid or exported.

2.7 There are 57 bonded warehouses in Hong Kong, 48 of which are operated under a **closed bond system** for storing cigarettes and liquors. Under the closed bond system, customs officers are stationed at the warehouses to control the in-and-out movements of the DCs and keep track of the stock balances (Note 6). Periodically, customs officers conduct random physical stock checks. The warehouse licensees are required to submit weekly and monthly returns to the C&ED, showing the stock movements during the period and the stock balances. The C&ED will verify the particulars shown in the returns against the DC permits issued.

2.8 The remaining nine bonded warehouses are operated under an **open bond system (OBS)** for storage of hydrocarbon oil or breweries. Under the OBS, customs officers are not stationed at the warehouses to provide physical supervision of the warehouse operations.

Audit observations on the control environment

2.9 Audit notes that, under the existing licence and permit system, measures are in place to control the movement and storage of DCs. However, there are two areas that require attention, namely:

- (a) the implementation of the OBS (see paras. 2.10 to 2.15 below); and
- (b) customs control on river trade vessels (see paras. 2.19 to 2.24 below).

Consultancy study on the feasibility of the OBS

2.10 As mentioned in paragraph 2.7 above, most of the bonded warehouses are currently operated under the closed bond environment. In 1999, a consultancy was commissioned to study the feasibility of extending the OBS to all bonded warehouses in Hong Kong, taking into account overseas experience and practices (Note 7). The study confirmed the feasibility and benefits of

Note 6: *Under the closed bond system, warehouse operators are required to pay “customs attendance fees” to the C&ED to cover the staff costs of officers stationed at the warehouses.*

Note 7: *The consultancy noted that Australia, Canada, New Zealand, Singapore, the UK and the USA had already moved to open bond systems.*

introducing an OBS in Hong Kong. It confirmed that the extension of the OBS to the liquor and cigarette industries would reduce the traders' compliance costs, induce additional business opportunities and enhance Hong Kong's competitiveness in the international market.

2.11 The consultancy study also pointed out that in general, under the OBS environment, there would be an increase in revenue fraud, missing goods, thefts and mishandling of DCs upon the withdrawal of C&ED officers. Risks identified by the consultants include the following:

- Goods lost during bond-to-bond transfers
- Declared goods failing to arrive at warehouses
- Goods removed from warehouse stock, including the replacement of warehouse stock with sub-standard goods from the market
- Goods not packed in export containers
- Potential non-compliance with permit conditions
- Release of "duty not paid" stock to the market or to other bonded warehouses without permits if stock checks are not conducted frequently

2.12 The consultancy study concluded that the risks of revenue loss would be manageable if the C&ED put in place a comprehensive audit and risk-management system. In order to reduce the risks of revenue loss under the OBS environment, the consultancy study recommended that the C&ED should tighten the licensing, storage and record-keeping requirements for warehouse operators. It also recommended a structured audit methodology for checking the compliance of warehouse operators. As at July 2002, preparation work was underway to implement these additional requirements. Appendix C shows the progress of the C&ED's preparation work as at July 2002.

The OBS pilot scheme

2.13 During January to June 2001, the C&ED conducted a pilot scheme in five bonded warehouses to test the implementation of the OBS. The C&ED reported that feedback from the

participants was highly positive, and that no anomaly had been observed in the amounts of duty collected from the participating warehouses when compared to the trend in the same period in other bonded warehouses. As at July 2002, legislative amendments to support the full implementation of the OBS were in progress. Subject to the legislative amendments, the C&ED's current plan is to implement the OBS in January 2003.

Audit observations on the implementation of the OBS

2.14 **Major tasks before implementation of OBS.** The implementation of the OBS will bring about benefits as well as risks. The C&ED is fully aware of the risks involved and, in order to address the risks, preparation work is underway to tighten the licensing, storage, record-keeping and auditing requirements for warehouse operators. As shown in Appendix C, the preparation work involves nine major tasks and, as at July 2002, two of these tasks had been completed, six were in progress and one had yet to commence. **Audit considers that, before implementing the OBS, the C&ED needs to be fully prepared and, in particular, complete all the outstanding major tasks referred to in Appendix C.**

2.15 **Reduced supervision on the movements of DCs.** Under the closed bond system, the C&ED conducts 100% supervision on the loading and unloading operations (from bonded warehouses to containers and vice versa) of the warehouse operators because of the high risks involved (e.g. DCs may be removed without an appropriate permit). The C&ED intends, upon the implementation of the OBS in 2003, to reduce the level of supervision of these operations to about 10%. In this regard, Audit notes that, in the OBS pilot scheme carried out in 2001, the C&ED still maintained 100% supervision on the loading and unloading operations of the participating warehouses. This suggests that the possible impact of a reduced level of supervision has not been fully tested in the pilot scheme. **Audit considers that there is a need for the C&ED to review the operation of the OBS shortly after its implementation (say 6 months), so as to ensure that the risks of duty evasion are properly managed. In particular, there is a need to closely monitor the impact of the reduced level of supervision on the loading and unloading of DCs, so as to ensure that there is no revenue loss.** (Photograph 1 on the centre pages shows a customs officer supervising the unloading of DCs from a goods vehicle at a bonded warehouse.)

Audit recommendations on the implementation of the OBS

2.16 **Audit has recommended that the Commissioner of Customs and Excise should:**

- (a) **before implementing the OBS, ensure that the C&ED is fully prepared and, in particular, has completed all the outstanding major tasks referred to in Appendix C;**

- (b) **review the operation of the OBS shortly (say 6 months) after its implementation, so as to ensure that the risks of duty evasion are properly managed; and**
- (c) **in particular, closely monitor the impact of the reduced level of supervision on the loading and unloading of DCs, so as to ensure that there is no revenue loss.**

Response from the Administration

2.17 The **Commissioner of Customs and Excise** agrees with the audit recommendations. He has said that:

- (a) the progress of the nine major tasks listed in Appendix C is on schedule. Tasks 1 and 2 have been completed. Tasks 4, 6, 7 and 8 are in progress. Tasks 3, 5 and 9 are pending passage of the Dutiable Commodities (Amendment) Bill 2002. It is the C&ED's plan to complete all the tasks before the implementation of the OBS;
- (b) the Independent Commission Against Corruption (ICAC) will conduct a review of the OBS three months after Phase I (which excludes the distilleries) has been implemented. The C&ED will conduct its post-implementation review three months after full implementation (which includes the distilleries). A further review will be conducted three months after improvement measures identified in the first review have been implemented; and
- (c) the impact of the reduced level of supervision on the loading and unloading of DCs will be closely monitored (especially at the early stage of implementation) and will be carefully examined during the post-implementation reviews mentioned in (b) above.

2.18 The **Secretary for Financial Services and the Treasury** has said that:

- (a) the Government has taken on board the recommendations of the consultancy study to minimise the risk of revenue loss, and has put up proposals accordingly in the Dutiable Commodities (Amendment) Bill 2002, which is being examined by LegCo; and
- (b) he supports the C&ED's initiative on conducting reviews of the operation of the OBS shortly after its implementation.

Customs control on river trade vessels

2.19 River trade vessels (RTVs) refer to ships plying between Hong Kong and the ports along the Pearl River and the southern ports in the Mainland. In 2001, some 116,000 RTVs called at Hong Kong. Unlike ocean-going vessels, RTVs are not required by law to submit a Pre-arrival Notice (PAN) to the Marine Department before entering Hong Kong waters. Effective customs control of RTVs is constrained by a number of factors, including the following:

- (a) a vast number of RTVs enter and leave Hong Kong daily without submitting a PAN;
- (b) the long coastline of Hong Kong makes customs surveillance of RTVs very difficult;
- (c) RTVs are free to move within Hong Kong waters (Note 8) and not all are subject to customs attendance;
- (d) shipping schedules of RTVs are not always available (Note 9); and
- (e) while there is a bonded warehouse at the River Trade Terminal to control the movement of DCs before the completion of cargo clearance procedures, there is no bonded warehouse at the Public Cargo Working Areas.

2.20 Unlike ocean-going vessels, the C&ED cannot systematically select RTVs for inspection because RTVs are free to travel within the waters of Hong Kong without having to go through customs control points. The risk of DCs being smuggled into Hong Kong by RTVs is high. (Photograph 2 on the centre pages shows an RTV which was involved in smuggling a large quantity of illicit cigarettes into Hong Kong.)

2.21 In 1997, the ICAC completed a study on customs attendance on RTVs. Table 1 below shows the ICAC's two key recommendations and the C&ED's responses.

Note 8: *RTVs can berth at the River Trade Terminal, any of the eight Public Cargo Working Areas or any mid-stream buoys.*

Note 9: *Shipping schedules are only available for RTVs berthing at the River Trade Terminal and the Public Cargo Working Areas.*

Table 1

ICAC's recommendations on RTVs and C&ED's responses

ICAC's recommendation	C&ED's response
(a) The C&ED should create a computerised database to record schedules of RTV arrivals and departures. This database would form the basis of selection of vessels for examinations .	The C&ED agreed to the recommendation. However, it pointed out that it was difficult to collect information on the arrivals and departures of RTVs for maintaining the database, as many RTVs did not report their arrivals and departures.
(b) The C&ED should develop a management information system (MIS) to store operational data in relation to the shipping schedules of, and enforcement action on, individual RTVs. This information could be used for control and planning purposes in general and targeting inspections at "problem RTVs" in particular.	The C&ED agreed that a database containing comprehensive statistics on enforcement action taken against RTVs would be useful for analysis of smuggling trends and planning purposes. The C&ED would consider implementing this recommendation when additional resources were available.

Source: C&ED's records

Recent developments

2.22 In June 2002, the Shipping and Port Control Regulations (Cap. 313A) were amended to:

- (a) require vessels of any tonnage and RTVs to submit a PAN (see para. 2.19 above) to the Marine Department; and
- (b) require vessels to report their intended berth or anchorage on arrival in the PAN to facilitate the C&ED's planning for inspection assignments.

As at July 2002, the effective date of operation of the amended regulations had yet to be determined.

Audit observations on customs control of RTVs

2.23 **Challenge remains.** Audit welcomes the above legislative amendment which will help the C&ED exercise control on the RTVs. However, given the large number of RTV movements

and Hong Kong's long coastline, compliance monitoring and customs control will remain a significant challenge. **Audit considers that there is a need for the C&ED, in consultation with the Marine Department, to closely monitor the RTVs' compliance with the new legislative requirements, and to make the best use of the PANs for customs control purposes.**

2.24 ***Need to implement ICAC's recommendations.*** Audit's enquiry indicated that, as at July 2002, the C&ED had not yet developed a computerised database/MIS on the RTVs, as suggested by the ICAC in Table 1 of paragraph 2.21 above. In Audit's view, the development of such a database/MIS will help the C&ED improve customs control on the RTVs (e.g. targeting some RTVs for inspection). **Given the risks of smuggling by the RTVs, there is a need for the C&ED to revisit the ICAC's recommendations and, resource permitting, accord priority to their implementation.**

Audit recommendations on customs control of RTVs

2.25 **Audit has recommended that the Commissioner of Customs and Excise should:**

- (a) **in consultation with the Marine Department, closely monitor the RTVs' compliance with the new legislative requirements and make the best use of the PANs for customs control purposes; and**
- (b) **consider according priority to the development of a computerised database and management information system to improve customs control on the RTVs.**

Response from the Administration

2.26 The **Commissioner of Customs and Excise** generally agrees with the audit recommendations. He has said that:

- (a) although the effective date of operation of the Shipping and Port Control (Amendment) Regulations 2002 has yet to be determined, a computer terminal of the River Trade Cargo Vessel Port Formality System (RTCVPFS — the Marine Department is the owner of this system) has been installed at the C&ED. Information on the PANs of RTVs, though not comprehensive, is now available to the C&ED. When the new Regulations come into operation later this year, the C&ED will have access to the shipping information (such as movement history, berths and shipping agents) on all RTVs. The C&ED will work closely with the Marine Department to monitor the RTVs' compliance with the new Regulations and make the best use of such data for customs control purposes; and
- (b) furthermore, the C&ED is enhancing its Customs Control System (CCS — see item 4 of Appendix C) to capture the enforcement records on RTVs. The C&ED believes that the enhanced CCS, together with the RTCVPFS, will provide an effective database to support customs control on RTVs.

PART 3: ABUSES OF CIGARETTE DUTY-FREE CONCESSIONS

3.1 This PART examines the effectiveness of the C&ED's procedures for preventing, detecting and deterring abuses of cigarette duty-free concessions.

Duty-free concessions for cigarettes

3.2 Before 5 July 2002, a local resident was allowed to bring in 100 duty-free cigarettes (Note 10), when he returned to Hong Kong after having been away for at least 24 hours. In his Budget Speech of March 2002, the Financial Secretary proposed to cut by 40% the quantities of duty-free cigarettes that local residents would be allowed to bring back on return to Hong Kong. **The Government estimated that local residents were then bringing back 1.4 billion duty-free cigarettes (with a duty potential of \$1.13 billion) every year.** Assuming that some local residents would purchase more cigarettes in Hong Kong to compensate for the reduction in duty-free concessions, the Government expected that more duties from cigarettes would be paid and this would bring about additional revenue. The new duty-free concession of 60 cigarettes for each local resident came into effect on **5 July 2002.**

3.3 For non-residents, no change was made and the duty-free concession for cigarettes remains at 200 cigarettes per person.

Price difference between cigarettes sold at duty-free shops and in the retail market

3.4 Duty-free cigarettes can be bought from duty-free shops located at the arrival halls of boundary control points (Note 11). Due largely to the duty-free concessions, the prices of the cigarettes sold at the duty-free shops are much lower than those in the retail market. For example, at the Lo Wu Control Point, cigarettes of some popular brands are sold at \$10 per pack (of 20 cigarettes) at the duty-free shops. Compared with \$32 in the retail market, a traveller can save \$22 (or 69%) for each pack of cigarettes bought at the duty-free shops. The savings will amount to \$66 for three packs (i.e. 60 cigarettes), \$110 for five packs (i.e. 100 cigarettes) and \$220 for ten packs (i.e. 200 cigarettes).

Note 10: *Under the DCO, the Commissioner of Customs and Excise may, by notice published in the Gazette, determine the quantity of DCs to be exempted from duty.*

Note 11: *There are duty-free shops at the arrival halls of the boundary control points at Lo Wu, the Hong Kong International Airport, Macau Ferry Terminal and China Ferry Terminal.*

Risk of abuse of duty-free concessions

3.5 The significant price difference between the cigarettes sold at duty-free shops and in the retail market provides a strong incentive for travellers to buy duty-free cigarettes, some of which may be brought into Hong Kong in breach of the duty-free concessions. Abuse of duty-free concessions may take the following forms:

- (a) local residents bringing back up to 60 cigarettes (or 100 cigarettes before 5 July 2002) **without** having stayed outside Hong Kong for at least 24 hours (hereinafter referred to as the “24-hour rule”);
- (b) local residents bringing back more than 60 cigarettes (or 100 cigarettes before 5 July 2002), irrespective of whether or not they have breached the 24-hour rule; and
- (c) non-residents bringing more than 200 cigarettes into Hong Kong.

Audit review of C&ED’s procedures

3.6 In view of the significant revenue implications of the cigarette duty-free concessions, Audit has recently conducted a review of the C&ED’s operations to assess the effectiveness of its procedures for preventing, detecting and deterring abuses. The audit has focused on the Lo Wu Control Point through which a major part (80%) of the duty-free cigarettes are brought into Hong Kong.

3.7 Audit staff paid a number of visits to the Lo Wu Control Point during June and July 2002. They acted as ordinary travellers during their visits and did not reveal their audit identity. This was to ensure that they obtained a true picture of the relevant activities. The audit covered the following areas:

- (a) sales activities at duty-free shops (paras. 3.8 to 3.16 below);
- (b) percentage of travellers checked at the C&ED’s customs examination counters (paras. 3.17 to 3.21 below);
- (c) Audit case studies on abuses of duty-free concessions (paras. 3.22 to 3.24 below);
- (d) the 24-hour rule for duty-free concessions (paras. 3.25 to 3.29 below); and

- (e) the C&ED's baggage examination procedures (paras. 3.30 to 3.33 below).

Sales activities at duty-free shops

3.8 For inbound travellers at the Lo Wu Control Point, duty-free shops are located both on the Mainland side and the Hong Kong side. Travellers can buy duty-free cigarettes from these shops after departure clearance on the Mainland side or before arrival clearance on the Hong Kong side. (Photograph 3 on the centre pages shows travellers buying duty-free cigarettes at the Arrival Hall of the Lo Wu Control Point.)

3.9 The duty-free shops on the Hong Kong side are operated under licences granted by the C&ED. **The licence conditions impose certain obligations on the licensee to prevent abuses of duty-free concessions at source.** The relevant licence conditions are as follows:

- (a) all dutiable liquor and tobacco must only be sold or supplied to arrival travellers at the Lo Wu Terminal. The licensee is required to **ascertain the status** of the travellers by inspecting their passports or travel documents;
- (b) the licensee is required to ensure that the quantities of dutiable goods sold to an arrival traveller **shall not exceed his/her entitled duty-free concession**, which shall be reduced by the quantities of duty-free goods the traveller brings into Hong Kong; and
- (c) the sales of dutiable goods will be covered by serially numbered invoices, which are to be kept for at least two years after their creation and ready for customs verification. The invoices shall contain, among other information, the **customer's name** and the quantity of goods sold.

Audit fieldwork on sales activities at duty-free shops

3.10 During the visits in June and July 2002 (see para. 3.7 above), Audit staff observed the sales activities at the two duty-free shops at the Arrival Hall of the Lo Wu Terminal Building. Audit staff also observed, in detail, 100 transactions of cigarettes while queuing as customers waiting to be served. Of these 100 transactions, 72 were observed before 5 July 2002 and 28 were observed on/after that date. Appendix D shows an analysis of these transactions.

3.11 Audit staff observed that, in general, the licensee **did not comply** with the licence conditions mentioned in paragraph 3.9 above. Audit staff reported the following observations:

General observations

- (a) a transaction was usually completed within a few seconds (see also para. 3.14 below). The sales staff did not make any attempt to ascertain the status of the customers by inspecting their passports or travel documents;
- (b) the sales staff did not ask their customers whether they were local residents or non-residents. Nor did they ask them whether they had stayed outside Hong Kong for at least 24 hours. **Without such information, the sales staff could not know whether a customer was entitled to any duty-free concession, or whether his duty-free concession had been exceeded;**
- (c) the sales staff did not ask the customers to give their names and did not record this information on the invoices, although spaces were provided specifically on the invoices for this purpose;

Specific observations on the 72 transactions before 5 July 2002

- (d) in these 72 transactions, 57 customers bought 100 cigarettes (i.e. five packs) and 15 customers bought 200 cigarettes (i.e. 10 packs) each. Audit staff noted that only on two occasions were the customers' requests challenged by the sales staff. On the two occasions, the customers' requests (one for 15 packs and another for 30 packs) were declined. The sales staff told the customers that they could only buy 10 packs at the maximum (Note 12). The customers took the advice and bought 10 packs each accordingly; and

Specific observations on the 28 transactions on or after 5 July 2002

- (e) in 18 of these 28 transactions, the customers each bought 60 cigarettes (i.e. three packs, which was the new duty-free concession effective from 5 July 2002). In the remaining 10 transactions, the quantity of cigarettes each customer bought ranged from 80 (i.e. four packs) to 300 (i.e. 15 packs). Audit staff noted that, although the sales staff frequently reminded the customers of the new duty-free concession, they rarely declined requests which exceeded the concession.

Note 12: *The sales staff did not explain why the sales limit was set at 10 packs. This was double the then duty-free concession (i.e. 5 packs) for local residents.*

Audit observations on sales activities at duty-free shops

3.12 ***Duty-free sales activities need closer monitoring.*** The licence conditions of the duty-free shops impose obligations on the licensee to prevent abuses of duty-free concessions at source. These licence conditions are not being complied with. As a result, there is little assurance that duty-free cigarettes are sold only to those who are entitled to duty-free concessions and in quantities that are within their entitlement. **Audit considers that there is a need for the C&ED to closely monitor the sales activities at the duty-free shops to ensure compliance with the licence conditions.**

3.13 ***Licence renewal process needs improvement.*** Licences for the operation of duty-free shops are subject to annual renewal. It is the C&ED's practice to carry out an annual inspection before giving approval for licence renewal. From the annual inspection reports, Audit notes that the annual inspections focus on a number of areas, including the storage condition, sanitary condition and security of the duty-free shops as well as the related warehouses. In addition, inspecting officers are required to assess the general effectiveness of control by the licensee and to carry out random physical stock checks of dutiable goods at the duty-free shops and warehouses. However, the annual inspection reports do not indicate that the inspecting officers have addressed the issue of duty-free sales at the shops. **Audit considers that, in the annual licence renewal exercise, special attention needs to be paid to the sales activities at the duty-free shops. Before renewing the licence, the C&ED needs to be satisfied that the licensee has fully complied with the relevant licence conditions.**

3.14 ***Sufficient time should be allowed for sales transactions.*** Apart from the licence conditions, the day-to-day operations of the duty-free shops at the Arrival Hall of the Lo Wu Control Point are governed by the "Guidelines and Procedures on Crowd Control System and Operating Arrangement", which address the need for crowd control and the control of passenger flow. According to these guidelines, in order to avoid the obstruction of passenger flow, the operator of the duty-free shops has to ensure that adequate sales staff are available so that each transaction can be completed in five seconds. Audit is concerned that the five seconds allowed for each transaction make it very difficult for the licensee to fully comply with the licence conditions (see para. 3.9 above). **Audit considers that there is a need for the C&ED, in consultation with the parties concerned (e.g. the Immigration Department and the Police), to review the 5-second requirement. It is necessary to strike a balance between the need to facilitate passenger flow, and the need to allow sufficient time for the licensee to complete a transaction in full compliance with the relevant licence conditions.**

3.15 ***Need to issue guidelines on the 24-hour rule.*** As reported in paragraph 3.26 below, at present the C&ED has practical difficulties in detecting abuses of the 24-hour rule. **Audit considers that there is a need for the C&ED to issue guidelines to help the licensee discharge his obligations in relation to the 24-hour rule.** The guidelines should state clearly what the licensee is expected to do in order to discharge his obligations.

3.16 ***Need to seek cooperation from the Mainland.*** Compliance with the licence conditions by the duty-free shops at the Lo Wu Arrival Hall is, by itself, insufficient to ensure that duty-free cigarettes are sold only to travellers who are entitled to the concessions and in quantities that are within their entitlement. This is because inbound travellers may choose to buy duty-free cigarettes at the duty-free shops on the Mainland side (see para. 3.8 above), which are not subject to the C&ED's control. **To help prevent the abuses of duty-free concessions at source, in Audit's view, there is a need for the C&ED to consider seeking the cooperation of the relevant Mainland authority to tighten the control on the sale of duty-free cigarettes on the Mainland side.**

Percentage of travellers checked at C&ED's customs examination counters

3.17 After immigration clearance, inbound travellers proceed to the customs examination counters for customs clearance. Upon intercepting a traveller for checking, the customs officer at the counter will:

- (a) ask the traveller if he has anything to declare (e.g. DCs, dangerous drugs, firearms and ammunition);
- (b) conduct a baggage inspection; and
- (c) arrange for X-ray scanning of any baggage or object which cannot be opened for a thorough examination or would likely be damaged upon opening.

3.18 Due to the heavy passenger flow, customs control activities at the Lo Wu Control Point are conducted on a selective basis. According to the performance data of the C&ED, 5.04 million inbound travellers were checked by customs during the financial year ended 31 March 2002 at the Lo Wu Control Point. This represented about 10% of the inbound travellers passing through that Control Point in that year.

Audit observations on the percentage of travellers checked

3.19 ***Audit fieldwork.*** During the visits paid in June and July 2002, Audit staff observed the activities at selected customs examination counters and, in particular, noted the number of inbound travellers intercepted for checking (Note 13) during the periods under observation. Audit staff reported that, during the periods under observation, there were 36,420 travellers passing through

Note 13: *The term "intercepted for checking" in this audit report refers to one or more of the actions mentioned in paragraph 3.17(a), (b) and (c) above.*

the selected counters and 322 (i.e. 0.88%) were intercepted for customs checking. On average, one traveller was intercepted every two minutes at each counter for customs checking. Further details are at Appendix E.

3.20 ***Need to improve accuracy of performance data.*** The small percentage of travellers intercepted for checking (i.e. 0.88%), as observed by Audit staff, is at variance with the C&ED's performance data which show that 10% of the travellers were checked (see para. 3.18 above). Upon Audit's enquiry, in August 2002, C&ED officers explained to Audit that the two percentages were not directly comparable. This was because the number of travellers checked, as shown by the C&ED's performance data, included not only the number of travellers intercepted for checking at the customs examination counters, but also the number of travellers processed through other means. These included the general and targeted surveillance of travellers' activities by plain-clothed officers and "dog-sniffing" operations (i.e. using specially trained dogs to detect smuggling and drug-trafficking activities) at the Control Point. However, Audit's enquiry indicated that customs officers performing customs checks through the various means at the Lo Wu Control Point were not required to prepare timely formal records on the number of travellers they had checked. Without such records, there is little assurance that the performance data are accurate because they are compiled on the basis of memory and guesstimates. **Audit considers that there is a need for the C&ED to draw up proper procedures for collecting, recording and validating the performance data, so as to ensure that they are accurate and reliable.**

3.21 ***Need to increase customs checking.*** Audit appreciates that the heavy passenger flow at the Lo Wu Control Point may pose a constraint on the extent of customs checks at the customs examination counters. However, the small percentage (i.e. 0.88%) of travellers checked at the counters, as observed by Audit staff, means that abuses of duty-free concessions have little chance of being detected. **Audit considers it necessary for the C&ED to review the need for increased customs checking, so as to increase the chance of detecting abuses at the customs examination counters.** The audit observations in paragraph 3.24 below are also relevant.

Audit case studies on abuses of duty-free concessions

3.22 During their visits in June and July 2002, Audit staff observed how effective the C&ED's spot checks were in detecting abuses of duty-free concessions. Audit staff performed the following procedures for inbound travellers after their departure clearance on the Mainland side:

- (a) identify those travellers who had bought more than 100 cigarettes (or more than 60 cigarettes for cases observed on or after 5 July 2002) at the duty-free shops;
- (b) observe whether such travellers were travelling alone and were not sharing the cigarettes purchased with other persons;

- (c) follow the travellers to the Hong Kong immigration booth and observe whether they were local residents by their use of Hong Kong Identity Cards for immigration clearance; and
- (d) follow the travellers to the customs examination counter, and observe whether customs officers intercepted them for checking.

3.23 Audit staff reported that there were plenty of travellers who fitted the description in paragraph 3.22(a) above. However, due to resource constraints, Audit staff could only perform all the above procedures on 32 travellers. The audit findings indicated that these 32 travellers had all abused duty-free concessions, but none of them was intercepted for customs checking at the customs examination counters (see Appendix F for details). Examples of the audit findings are given in Cases A to C below for illustration.

Case A

Case particulars

At about 5 p.m. on 8 June 2002, a man bought 800 cigarettes (i.e. 40 packs) from two different duty-free shops on the Mainland side. He put the cigarettes in a bag and walked towards the Hong Kong side. The man was travelling alone. An Audit officer followed him to the Lo Wu Arrival Hall. The man chose an immigration booth which was designated for Hong Kong residents only. The Audit officer followed him closely and saw clearly that he used a Hong Kong Identity Card for immigration clearance. At about 5:12 p.m. the man passed the customs examination counter. He was not intercepted for customs checking.

Audit comments

The man was a local resident. He was allowed to bring into Hong Kong 100 duty-free cigarettes, provided that he had stayed outside Hong Kong for more than 24 hours. While Audit had no information on the duration of his stay outside Hong Kong, the 800 cigarettes he brought in were well in excess of the duty-free concession. This was a clear case of abuse of the duty-free concession.

Case B

Case particulars

At about 6 p.m. on 14 June 2002, a woman bought 200 cigarettes (i.e. 10 packs) from a duty-free shop on the Mainland side. She was travelling alone. An Audit officer followed her to the Lo Wu Arrival Hall where she bought 60 cigarettes (i.e. 3 packs) more from a duty-free shop on the Hong Kong side. The Audit officer followed her closely to an immigration booth and saw clearly that she used a Hong Kong Identity Card for immigration clearance. At about 6:17 p.m. the woman passed the customs examination counter. She was not intercepted for customs checking.

Audit comments

The woman was a local resident. By bringing into Hong Kong 260 duty-free cigarettes, she had abused the duty-free concession.

Case C

Case particulars

At about 5:45 p.m. on 5 July 2002, a man bought 100 cigarettes (i.e. 5 packs) from a duty-free shop at the Lo Wu Arrival Hall. He was travelling alone. An Audit officer chatted with him outside the duty-free shop and asked him how he could buy five packs, given the new duty-free concession of only three packs. The man said that the sales staff only sold him three packs initially, but later sold him two more packs at his insistence. The man put two packs in his trouser-pockets, saying that it would help him avoid having trouble with customs. He then put the remaining three packs in a shopping bag provided by the duty-free shop. The Audit officer followed him closely to an immigration booth and saw clearly that he used a Hong Kong Identity Card for immigration clearance. At about 5:55 p.m. the man passed the customs examination counter. He was not intercepted for customs checking.

Audit comments

The man was a local resident. By bringing into Hong Kong 100 duty-free cigarettes, he had abused the duty-free concession. The man believed that by putting two packs in the trouser-pockets and carrying three packs in the shopping bag provided by the duty-free shop, he could avoid having trouble with customs.

Audit observations on the results of case studies

3.24 Of the 32 persons observed by Audit staff, all were found to have abused the duty-free concession. However, none of them had been intercepted for customs checking at the customs examination counters. The case studies indicate that abusers of the duty-free concession could easily escape customs detection. **The case studies reinforce the audit observations, referred to in paragraph 3.21 above, on the need for increased customs checking.**

The 24-hour rule for duty-free concessions

3.25 As mentioned in paragraph 3.5(a) above, breach of the 24-hour rule by local residents is a common form of abuse of duty-free concessions. Audit's analysis of the immigration data at the Lo Wu Control Point for two selected months (i.e. May 2000 and May 2001) indicates that 58% of the returning local residents had stayed outside Hong Kong for less than 24 hours. With a large number of day-trip travellers returning to Hong Kong every day, there is a high risk that many of them bring duty-free cigarettes into Hong Kong in breach of the 24-hour rule.

Difficulties in enforcing the 24-hour rule

3.26 The C&ED has been concerned about the abuse of the 24-hour rule by day-trippers. The problem was highlighted in a C&ED departmental paper of February 2000. According to that paper:

- (a) on 1 June 1991, the Commissioner of Customs and Excise imposed the 24-hour rule under which local residents returning to the territory after an absence of less than 24 hours would not qualify for duty-free concessions. This rule was increasingly abused by day-trippers or couriers with false claims of having been away for over 24 hours;
- (b) in formulating the 24-hour rule, the C&ED was aware of the difficulty in verifying the traveller's actual duration of stay outside Hong Kong. A degree of flexibility had been built into the enforcement of the rule. Customs officers would not question travellers on their duration outside Hong Kong if they had five (Note 14) or fewer packs of cigarettes. If, however, there appeared to be a reason for verification, the officers would have to rely on the date chop on the traveller's Home Visit Permit (HVP) which Hong Kong residents used for travelling to the Mainland. The date chop would indicate roughly, though not conclusively, when a Hong Kong resident had left Hong Kong for the Mainland;

Note 14: *Five packs (i.e. 100 cigarettes) were the then prevailing duty-free concession for local residents. As mentioned in paragraph 3.2 above, the concession has been reduced to three packs (i.e. 60 cigarettes) since 5 July 2002.*

- (c) the situation had been exacerbated since January 1999 with the introduction of the Home Visit Card (HVC). While there was a date chop on the HVP (Note 15), there was none on the HVC. With the HVC, customs officers did not have any quick and reliable means to verify or challenge a traveller's claim. Many people realised this new "benefit" of the HVC and had taken advantage of it. Consequently, more people were breaking the 24-hour rule by using the HVC;
- (d) customs officers could still check the departure date of a traveller through the Immigration Department, but the process required documentation work in both departments and might take days or even weeks. Moreover, the Immigration Department would not accede to the C&ED's requests lightly because of the requirements under the Personal Data (Privacy) Ordinance (PDPO — Cap. 486). Unless the Immigration Department was satisfied that the C&ED's requests were necessary with prima facie evidence that customs laws had been breached, the requests would most probably not be acceded to;
- (e) the revenue lost in this way was substantial. In terms of cigarettes which comprised the single largest item, the C&ED had estimated that the duty-free shops at the Lo Wu Control Point then sold about 2.1 million cigarettes every day (Note 16). Most of these cigarettes were believed to be carried into Hong Kong in breach of the duty-free concessions; and
- (f) as the HVP would eventually be replaced by the HVC, the 24-hour rule would be more and more difficult to uphold.

Remedial measures identified by the C&ED

3.27 The C&ED had identified a number of measures to address the problem. According to the February 2000 departmental paper, these included the following:

- (a) seeking access to the immigration database to detect abusers of the 24-hour rule;
- (b) requesting Immigration staff to alert C&ED staff of day-trippers, by routing them through a special channel;
- (c) requiring travellers who claim concessions to make a written declaration of the date of

Note 15: *Audit notes that the practice has since changed. Presently, Mainland immigration officers do not put a date chop on the HVP.*

Note 16: *This was the sales figure for 1999, including sales at the duty-free shops on both the Mainland side and the Hong Kong side. Audit notes that, for the financial year ended 31 March 2002, the quantity of cigarettes sold by these duty-free shops had increased to 3.7 million per day.*

departure, which can be used for subsequent verification and follow-up action (Note 17); and

- (d) abolishing cigarette duty-free concessions for local residents (Note 18).

Audit observations on difficulties in enforcing the 24-hour rule

3.28 **Lack of progress.** Audit noted that, as at July 2002, none of the measures identified in the February 2000 paper had been implemented. From the C&ED's records, Audit could not find any evidence indicating that the C&ED had pursued, with the Immigration Department, the options of data sharing and routing day-trippers through special channels. There was also no record indicating that the C&ED had pursued with the Department of Justice on the legal basis of requiring written declarations from travellers.

3.29 **Urgent need to implement effective enforcement measures.** Audit is concerned about the lack of progress in implementing effective measures to enforce the 24-hour rule which, according to the C&ED, is being abused increasingly by day-trippers (see para. 3.26(a) above). **Given the high risk of such abuses, Audit considers that there is a need for the C&ED to take action, in conjunction with the parties concerned (e.g. the Immigration Department), to implement measures to stem the abuses as soon as possible.**

C&ED's baggage examination procedures

3.30 After intercepting a traveller at the customs examination counter, and before conducting an examination, the customs officer asks the traveller if he has anything to declare. If the traveller declares possession of dutiable goods in excess of the duty-free concessions, he is required either to pay duty on these goods or to surrender them for confiscation.

3.31 If the traveller makes a false declaration, he may either be prosecuted or ordered to pay a penalty under the "Compounding Scheme" (Note 19). From the C&ED's records, Audit selected a typical case of compounding for illustration (see Case D below).

Note 17: *According to the February 2000 paper, this measure could be effective for deterring abusers of the 24-hour rule. The C&ED would take this forward with the Department of Justice to find out if there was sufficient legal basis for customs to impose such a requirement and if there were any implications for data privacy.*

Note 18: *According to the February 2000 paper, this was the C&ED's preferred option. According to that paper, this measure was consistent with the Government's anti-smoking policy and would increase government revenue substantially. However, objections could be expected from duty-free shops, or related commercial interests, on both sides of the boundary, as well as those enjoying the concessions at the time.*

Note 19: *Under the "Compounding Scheme", a person is required to pay a penalty equivalent to five times the duty payable plus a fine of \$2,000. If the value of duty exceeds \$10,000, or if the person has been compounded five times or more in the preceding two years, no more compounding is allowed and he will be prosecuted.*

Case D

Case particulars

At 12:05 p.m. on 24 February 2002, Customs Officer A selected an incoming Hong Kong resident for baggage examination at a customs examination counter of the Lo Wu Control Point. Prior to examination, Customs Officer A asked the man if he had anything to declare and he replied no. However, under the supervision of another customs officer, Customs Officer A subsequently found the man had 400 cigarettes in his possession. The man was immediately detained and informed of the offence that he had committed.

Penalty imposed

Since the man had left Hong Kong for less than 24 hours, he was not entitled to any duty-free concessions. Because he fulfilled the compounding criteria (see Note 19), he was asked to pay the compounding penalty of \$3,608 (i.e. 400 cigarettes @ \$0.804 per cigarette × 5 + \$2,000). The man paid the penalty on the spot and the cigarettes were returned to him.

Source: C&ED's records

Audit observations on C&ED's baggage examination procedures

3.32 ***Weakness in the C&ED's procedures.*** The existing procedures allow an abuser of duty-free concessions to escape penalty, even if he is intercepted at the customs examination counter for checking. **All he needs to do is to declare to the customs officers that he is in possession of excessive cigarettes and pay the duty, or surrender the cigarettes to customs.** In fact, C&ED records indicate that, of the 4,436 persons intercepted and found to possess excessive cigarettes during the 12-month period to June 2002, 4,244 (i.e. 96%) took advantage of this procedural weakness to escape penalty. In contrast, only 192 abusers (i.e. 4%) were prosecuted, or fined under the "Compounding Scheme", because they had made a false declaration.

3.33 ***Urgent need to rectify weakness.*** As the cost of the cigarettes after duty is still 14% lower than the price of cigarettes in the retail market (Note 20), Audit considers that the existing C&ED procedures have little deterrent effect on the abusers of duty-free concessions. **Audit considers that urgent action is needed to rectify the weakness, so as to ensure that adequate penalties are imposed on abusers caught at the customs examination counters and also to deter such abuses.**

Note 20: *Some popular brands of cigarettes are sold at \$10 per pack at the duty-free shops at the Lo Wu Control Point. Upon interception and declaration, an abuser has to pay a duty of \$16 and a licence fee of \$1.6 per pack, thus increasing the cost of his cigarettes to \$27.6 per pack. Compared with the price of \$32 per pack in the retail market, the total cost of the cigarettes is still 14% lower.*

Audit recommendations on C&ED's cigarette duty-free concessions

3.34 **Audit has recommended that the Commissioner of Customs and Excise should, in the light of the audit observations reported above, conduct an overall review of the C&ED's procedures for preventing, detecting and deterring the abuses of cigarette duty-free concessions. In particular, the Commissioner should:**

Sales activities at duty-free shops

- (a) **closely monitor the sales activities at the duty-free shops to ensure compliance with licence conditions (see para. 3.12 above);**
- (b) **in the annual licence renewal exercise, pay special attention to the sales activities at the duty-free shops. The C&ED should consider not renewing the licence unless it is satisfied that the licensee has fully complied with the relevant licence conditions (see para. 3.13 above);**
- (c) **in consultation with the parties concerned (e.g. the Immigration Department and the Police), review the 5-second requirement for each transaction. It is necessary to strike a balance between the need to facilitate passenger flow, and the need to allow sufficient time for the licensee to complete a transaction in full compliance with the relevant licence conditions (see para. 3.14 above);**
- (d) **issue guidelines to help the licensee discharge his obligations in relation to the 24-hour rule. The guidelines should state clearly what the licensee is expected to do in order to discharge his obligations (see para. 3.15 above);**
- (e) **consider seeking the cooperation of the relevant Mainland authority to tighten the control on the sale of duty-free cigarettes on the Mainland side (see para. 3.16 above);**

Percentage of travellers checked at customs examination counters

- (f) **draw up proper procedures for collecting, recording and validating the performance data of customs officers, so as to ensure that the data are accurate and reliable (see para. 3.20 above);**
- (g) **review the need for increased customs checking, so as to increase the chance of detecting abuses at the customs examination counters (see para. 3.21 above);**

The 24-hour rule for duty-free concessions

- (h) **in conjunction with the parties concerned, including the Immigration Department, take action to implement measures to effectively enforce the 24-hour rule as soon as possible (see para. 3.29 above); and**

Baggage examination procedures

- (i) **take urgent action to rectify the weakness in the baggage examination procedures, so as to ensure that adequate penalties are imposed on abusers caught at the customs examination counters and also to deter such abuses (see para. 3.33 above).**

Response from the Administration

3.35 The **Commissioner of Customs and Excise** generally agrees with the audit recommendations. He has said that:

Sales activities at duty-free shops

- (a) in consultation with the Department of Justice, the C&ED is now reviewing the licence conditions for the duty-free shops to ensure that they are effective and practicable. The C&ED will remind the licensee of his obligations to comply with the revised licence conditions and will conduct more checks at the sales counters to ensure compliance;
- (b) the C&ED's licensing office will take into account the compliance record of the duty-free shops when renewing the licences;
- (c) the 5-second requirement will be reviewed as part of the review exercise on licence conditions referred to in (a) above;
- (d) the C&ED is reviewing the licence conditions including those relating to the 24-hour rule. Guidelines will be issued where required;
- (e) according to international practice, there is generally no restriction on the quantity of duty-free sales to departing travellers at exit points, and duty-free shops at all exit points in Hong Kong are not required to set a limit on the quantity of sales to departing travellers. Nevertheless, the C&ED will continue to explore ways of obtaining assistance from the relevant Mainland authority to tighten the control of duty-free sales on the Mainland side. The C&ED believes that, with the assistance of the Immigration Department in enforcing the 24-hour rule and increased surveillance of travellers (see (j) and (l) below), it should be able to tighten the control of duty-free cigarettes brought in by travellers;

Percentage of travellers checked at baggage examination counters

- (f) the C&ED has now issued detailed procedures for collecting, recording and validating data relating to the processing of travellers;
- (g) currently, there are around 233,000 incoming travellers passing through various control points, including the Airport, each day. In line with international practice, the C&ED adopts a risk management approach in processing travellers;
- (h) the C&ED's enforcement priority is placed on the interdiction of dangerous drugs, arms and ammunition, counterfeit and pirated goods, and smuggled DCs, including cigarettes. The C&ED constantly reviews the percentage of checking for detecting various contrabands and abuses of duty-free concessions. Where necessary and resource permitting, the C&ED will increase the percentage of checking;

The 24-hour rule of duty-free concessions

- (i) with regard to the proposed requirement for written declarations of the date of departure from travellers (see para. 3.27(c) above), the C&ED has carried out a research on this issue and subsequently concluded that the proposal could not be pursued due to a lack of legal basis. The effectiveness of the proposal is also in doubt;
- (j) the C&ED has been exploring other practical measures to enforce the 24-hour rule. It is now liaising with the Immigration Department to work out a new mechanism, whereby the Immigration Department will provide instant feedback to the C&ED on the movement records of returning local residents, so that the C&ED can ascertain the duration of absence from Hong Kong of an intercepted traveller. A pilot run at the Lo Wu Control Point has been launched with positive results. It is anticipated that the new mechanism can be extended to all control points in future;

Baggage examination procedures

- (k) the existing legislation allows a traveller to pay duty on the declared excessive quantity of cigarettes. Once the duty on the declared quantity has been paid, the traveller should not be subject to penalty; and
- (l) in order to apprehend those travellers who do not declare excessive quantities of cigarettes, customs officers are deployed to conduct surveillance on arrival travellers at the duty-free shops and the Kowloon-Canton Railway concourse. Travellers under surveillance, after passing through the customs examination counters, will be intercepted at the concourse for inspection. They will be fined or prosecuted, if they are found to be in possession of undeclared excessive dutiable goods. Successful cases have been effected.

3.36 With regard to the enforcement of the 24-hour rule, the **Director of Immigration** has said that:

- (a) it is his understanding that, under the exemption clause of section 58(1)(c) of the PDPO, the C&ED may make applications to the Immigration Department for the provisions of movement records of specified individuals for the purpose of collection of any tax or duty;
- (b) after Audit had raised the issue, in August 2002, the C&ED approached the Immigration Department to explore the options mentioned in paragraph 3.27(a) and (b) above (i.e. data sharing and routing day-trippers through special channels). Since then, the two departments have been conducting a pilot run to support the enforcement of the 24-hour rule. In the pilot run, the C&ED is not given direct access to the immigration database. Instead, the Immigration Department provides the movement records of specified individuals to the C&ED upon request. The C&ED has found this arrangement effective;
- (c) to work out a practicable long-term arrangement, the C&ED, in liaison with the Immigration Department, is seeking advice from the Department of Justice and the Privacy Commissioner for Personal Data on the question of allowing the C&ED access to the immigration database, for the purpose of detecting abuses of the 24-hour rule. The two departments are also assessing the extent of checks required, and its implications on resource requirements and on the performance of immigration clearance at the control points; and
- (d) he will continue to work with the C&ED, within the confines of the law and data privacy protection principles, to help achieve the goal of protecting government revenue.

3.37 The **Secretary for Financial Services and the Treasury** has said that:

- (a) allowing duty-free tobacco (and wine) concessions for incoming travellers is a long-established policy of the Government. It is also a policy widely adopted by other governments in the world. The 24-hour rule has been effectively enforced until the Mainland authority's increased issue of the HVC and the subsequent cessation of the stamping of the HVP with arrival/departure dates in early 2002;
- (b) at a meeting in November 2001, the C&ED brought to the attention of the then Secretary for the Treasury the enforcement problems on duty-free concessions for local residents. The C&ED was asked to continue to monitor the situation and examine improvement measures; and
- (c) he welcomes the C&ED's latest initiative to tackle this problem in collaboration with the Immigration Department. He will consider the effectiveness of the improvement measures, in conjunction with the C&ED, and decide on the way forward.

PART 4: MONITORING AND MEASUREMENT OF THE C&ED'S PERFORMANCE IN TACKLING CIGARETTE SMUGGLING

4.1 This PART examines the monitoring and measurement of the C&ED's performance in tackling cigarette smuggling.

Background

4.2 It is the Government's aim to prevent and detect all forms of smuggling while facilitating the legitimate movement of travellers, cargo and mail. The significant difference in retail prices of cigarettes between Hong Kong and neighbouring areas provides a great incentive for the smuggling of cigarettes into Hong Kong for sale in the black market. Each year, the C&ED seized large quantities of illicit cigarettes while they were tran-shipped via Hong Kong or smuggled into the territory for local consumption. (Photograph 4 on the centre pages shows illicit cigarettes being concealed in a container.) Table 2 below shows the quantities of cigarettes seized in the past five years.

Table 2

Number of cigarettes seized in the past five years

Year	Smuggled into Hong Kong for local consumption	Tran-shipped via Hong Kong	Total	Duty potential
	(A)	(B)	(C)	(D)
			(C) = (A) + (B)	
	(in million)	(in million)	(in million)	(\$ million — Note)
1997	119	13	132	86
1998	104	1	105	80
1999	109	130	239	83
2000	117	17	134	90
2001	136	204	340	109

Source: C&ED's statistics

Note: The duty potential (D) is calculated by multiplying (A) by the appropriate duty rate (see Appendix A). Cigarettes tran-shipped via Hong Kong (B) have no revenue implications.

4.3 Apart from posing a threat to revenue, the prevalence of cheap smuggled cigarettes undermines the Government's health policy to contain the proliferation of tobacco use, especially among the young (Note 21).

Modus operandi of illicit cigarette operators

4.4 **Import and distribution level.** Smugglers frequently use bogus companies to import illicit cigarettes from the Mainland or other Southeast Asian countries by making false declarations in the cargo manifests. Smugglers would hire a truck driver to collect the container and deliver the cargo to a designated place. When the truck is intercepted and the driver arrested, he would claim no knowledge of the nature of goods, making it difficult for the C&ED to trace the smugglers and charge them for offences.

4.5 **Retail level.** Illicit cigarettes are sold at busy spots such as markets or entrances of the Mass Transit Railway stations. After repeated raids by customs officers, the number of black spots has been reduced and operators have become more cautious. Instead of selling directly to the customers on the spot, pamphlets are distributed at public housing estates inviting customers to place orders by dialling a mobile phone number. Deliveries are made to the address of the customer. Recently, some housewives and unemployed persons were found selling illicit cigarettes in restaurants and canteens on a mobile basis.

The Anti-Illicit-Cigarette Task Force

4.6 After a significant increase of cigarette duty rate in 1991, cigarette smuggling has become a matter of concern. To tackle the problem, in 1994 the C&ED set up a dedicated Anti-Cigarette-Smuggling Task Force comprising 40 officers. The Task Force focused primarily on syndicated cigarette smuggling activities and investigation in storage and distribution networks. In 2000, after reviewing its enforcement strategy, the C&ED considered that there was a need to strengthen its enforcement action against street-level peddling activities and buyers of illicit cigarettes. As a result, the Task Force was expanded with the addition of 44 posts to form the Anti-Illicit-Cigarette Task Force (AICTF).

4.7 The AICTF, now comprising 84 officers, is dedicated to tackle all forms of cigarette smuggling activities. In 2001, the AICTF detected 975 cases of smuggling leading to the seizure of 325 million cigarettes.

Operations of other C&ED Commands

4.8 Other Commands of the C&ED are also involved in various tasks to prevent and detect smuggling activities. Such tasks include:

Note 21: *The Government's tobacco control policy is to discourage smoking, to educate the public, particularly the young, on the health risks involved, to contain the proliferation of tobacco use, and to protect the public from passive smoking to the maximum possible extent.*

- monitoring the import and export of goods;
- conducting checks on passengers, crew, cargoes, postal parcels, aircraft, vessels and vehicles; and
- conducting regular maritime and land patrols within Hong Kong's territorial boundaries.

Performance indicators used by the C&ED

4.9 The prevention and detection of smuggling is a Key Result Area under the Government's objective to keep Hong Kong safe and secure. The C&ED publishes a number of performance indicators through various channels, namely the Controlling Officer's Report (COR) of the Annual Estimates, the C&ED's Annual Review Reports and the C&ED's website. Table 3 below shows the published performance indicators.

Table 3

Performance indicators of C&ED's anti-smuggling activities

Performance indicator	COR (2002-03)	C&ED's Annual Review Report (2001)	C&ED's website (as at July 2002)
(a) Number of cases detected	✓	✓	✓
(b) Number of cigarettes seized	✓	✓	✓
(c) Number of vehicles seized	✓		
(d) Number of vessels seized	✓		
(e) Number of persons prosecuted		✓ (Note)	✓
(f) Number of persons compounded		✓	
(g) Number of black spots		✓	✓
(h) Black market prices for cigarettes			✓

Source: C&ED's records

Note: Only the number of persons arrested for buying illicit cigarettes was shown.

Audit observations on the publishing of performance indicators

4.10 As shown in Table 3 above, the C&ED publishes a total of eight performance indicators through various channels. These are all useful performance indicators. Items (a) to (g) are output indicators, which inform the public of the C&ED's efforts and outputs in tackling cigarette smuggling. On the other hand, item (h), the black market prices for cigarettes, is an outcome indicator informing the public how successful the C&ED's anti-smuggling efforts are. The more successful the C&ED's anti-smuggling efforts are, the less will be the supply of illicit cigarettes and the higher will be their prices.

4.11 The COR is an important document through which the Government accounts for its expenditure to the public and LegCo. However, Audit notes that only four of the above eight indicators are shown in the COR. **In Audit's view, there is a need for the C&ED to consider including all the eight indicators in the COR.** This will help the public and LegCo better assess the performance of the C&ED in tackling cigarette smuggling.

Audit observations on the impact of duty-free sales on smuggling activities

4.12 It is generally recognised that the sale of duty-free cigarettes is a major factor affecting the size of the black market for illicit cigarettes. The more duty-free cigarettes are sold, the smaller will be the size of the black market, and vice versa. In this regard, there are two recent developments which could significantly reduce the sales of duty-free cigarettes. One is the reduction, by 40%, of the cigarette duty-free concession for local residents from 5 July 2002 onwards. The other is the implementation of tighter control measures, as recommended by Audit in PART 3 of this report, to stem the abuses of duty-free concessions. These developments may lead to a greater demand for illicit cigarettes and increased smuggling activities.

4.13 Audit notes that, of the 84 posts for the AICTF (see para. 4.7 above), 44 were created as from April 2000 on a temporary basis for a period of three years. These temporary posts may be deleted in April 2003. Audit is concerned about the possible reduction of anti-smuggling resources in the face of a possible increase in cigarette smuggling activities. **Audit considers that there is a need for the C&ED to monitor closely the impact of the developments (referred to in para. 4.12 above) on smuggling activities, and take it into account when reviewing the resources to be deployed to anti-smuggling activities.**

Audit recommendations on monitoring and performance measurement

4.14 **Audit has recommended that the Commissioner of Customs and Excise should, building on the existing performance indicators, make continued efforts to improve the**

Photograph 1

**A customs officer supervising the unloading
of DCs from a goods vehicle at a bonded warehouse**
(para. 2.15 refers)



Source: Photograph taken by Audit staff

Photograph 2

**An RTV involved in smuggling a large quantity
of illicit cigarettes into Hong Kong**
(para. 2.20 refers)



Source: C&ED's records

Photograph 3

**Travellers buying duty-free cigarettes at the
Arrival Hall of the Lo Wu Control Point**
(para. 3.8 refers)



Source: C&ED's records

Photograph 4

Seizure of illicit cigarettes that were concealed in a container
(para. 4.2 refers)



Source: C&ED's records

Photograph 5

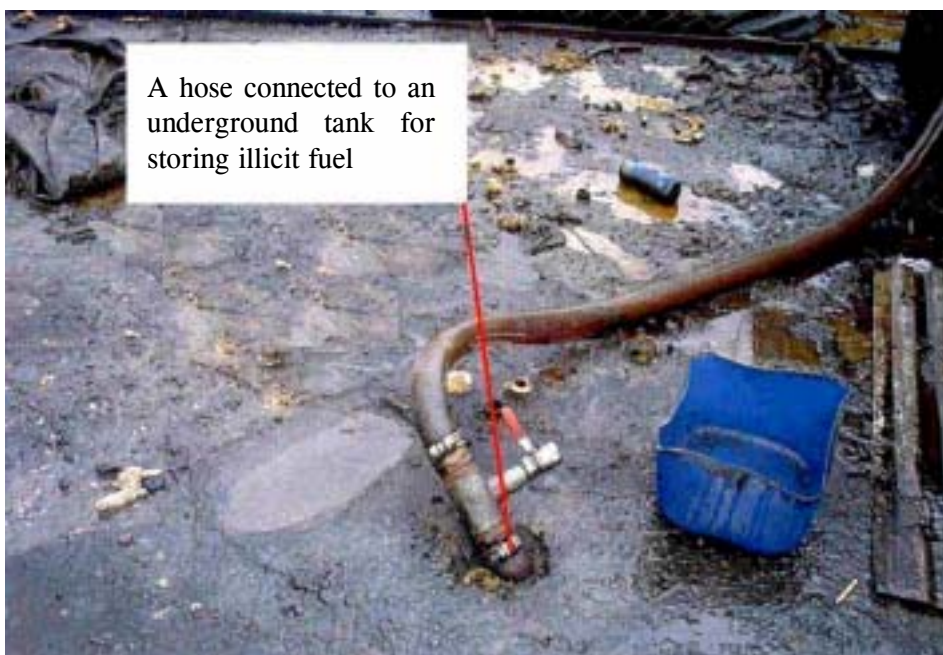
A motor vehicle refuelling at an illegal filling station
(para. 6.10 refers)



Source: C&ED's records

Photograph 6

**A scene at an illegal detreating plant
with an underground storage tank**
(para. 6.15 refers)



Source: C&ED's records

Photograph 7

Inbound goods vehicles awaiting customs clearance at the Lok Ma Chau Control Point

(para. 7.3 refers)



Source: C&ED's records

Photograph 8

Customs officers conducting road-side checking on vehicles

(para. 7.15 refers)



Source: C&ED's records

monitoring and measurement of the C&ED's performance in tackling cigarette smuggling. In particular, he should:

- (a) **consider including in the COR all the eight performance indicators now published by the C&ED through various channels, so as to help LegCo and the public better monitor the C&ED's performance in tackling cigarette smuggling (see para. 4.11 above);**
- (b) **closely monitor the impact of the recent developments (referred to in para. 4.12 above) on smuggling activities; and**
- (c) **take into account the impact of the recent developments (referred to in para. 4.12 above) on smuggling activities when reviewing the resources to be deployed to the C&ED's anti-smuggling activities.**

Response from the Administration

4.15 The **Commissioner of Customs and Excise** agrees with the audit recommendations. He has said that:

- (a) in consultation with the Financial Services and the Treasury Bureau (FSTB), he will consider including other performance indicators (as shown in Table 3 of para. 4.9 above) in the COR;
- (b) the C&ED will continue to closely monitor the illicit cigarette market and constantly revise its enforcement strategy to stamp out illicit cigarette activities at all levels; and
- (c) the C&ED and the FSTB are reviewing the role of the AICTF and will ensure that adequate resources are available to combat the smuggling of illicit cigarettes.

4.16 The **Secretary for Financial Services and the Treasury** has said that he will consider any proposal from the C&ED to include more performance indicators in its COR, and will deploy adequate resources to tackle cigarette smuggling activities.

PART 5: CUSTOMS AUDIT ON OIL COMPANIES

5.1 This PART examines the C&ED's approach to auditing oil companies.

Duty on hydrocarbon oil

5.2 In 2001-02, the C&ED collected \$3.8 billion from hydrocarbon oil which consisted of motor spirit, light diesel and aircraft spirit. Duties on motor spirit and light diesel represented 78.6% and 21.3% respectively of the total duties collected from hydrocarbon oil.

Relevant legal provisions

5.3 The legal provisions governing the duty on hydrocarbon oil are broadly as follows:

- (a) **Duty.** Under the DCO, the import and manufacturing of three types of hydrocarbon oil, namely light diesel, motor spirit and aircraft spirit, for local consumption are chargeable to duty. The supply and purchase of dutiable hydrocarbon oil for which duty has not been paid is prohibited;
- (b) **Import and export control.** To facilitate the levy of duty on fuel, imports and exports of fuel are subject to a licensing system under the DCO. Suppliers must hold import/export licences and bonded warehouse licences for the import/export and storage of hydrocarbon oil; and
- (c) **Marked oil.** Also known as "red oil" or industrial diesel, marked oil (Note 22) is exempted from duty and is designated for marine and industrial use only. Legitimate users include factories, restaurants, construction sites, fishing boats, small crafts and ocean going vessels. It is an offence to supply or use marked oil as fuel in motor vehicles, except for three specific types of vehicles (Note 23).

Note 22: *Marked oil refers to the diesel to which a prescribed marker and additive in red colour has been added by oil companies for distinguishing it from dutiable diesel. There are mainly two types of marked oil in Hong Kong. The first type is blended from light diesel with a higher sulphur content (0.5% by weight). It is mainly used for marine and industrial purposes. The second type is blended from light diesel with ultra low sulphur content (0.005% by weight). It is mainly used by franchised bus companies and the Government.*

Note 23: *They are franchised public buses, buses operated by the Kowloon-Canton Railway Corporation within the North-west Transit Service Area, and vehicles not registered under the Road Traffic Ordinance (Cap. 374) and solely for industrial use.*

C&ED's audit procedures

5.4 **OBS.** The import, storage and sale of fuel oil are handled by five oil companies holding special import, manufacturer and warehouse licences. The C&ED has adopted an OBS (see para. 2.8 above) to control the storage and release of dutiable fuel oil. Under the OBS, oil companies are given full autonomy in managing the stock inventory of raw materials and dutiable goods. Oil companies are also permitted to remove dutiable fuel oil from licensed premises for local consumption and export, without the supervision of customs officers. However, under the DCO, oil companies are required to submit monthly stock returns to the C&ED, showing detailed stock movements of the oil.

5.5 **C&ED's audit procedures.** To ensure that the oil companies comply with the legislative requirements, a team of C&ED officers, comprising nine officers, performs customs audits on the oil companies. The team performs the following main audit tasks:

Document checks

- (a) conduct preliminary checks on all monthly returns submitted by the oil companies to identify any self-manifest mistakes or irregularities;
- (b) conduct on-site verification of selected monthly returns against the oil companies' records and documents. In general, two monthly returns are selected for each audit;

Physical checks

- (c) conduct physical stock checks at oil depots against book stock. In general, physical stock checks are conducted twice every year on selected oil types;
- (d) collect samples of oil products for analysis by the Government Chemist;
- (e) supervise the re-filling of dye-marker at oil depots, the repairing or cleaning of the marked oil blending systems, and tank cleaning operations at oil depots;
- (f) conduct surprise checks at oil depots to ensure that there are no unauthorised alterations or repair works to the marked oil blending systems; and
- (g) conduct surprise checks on customs seals affixed to marked oil blending systems to ensure that they have not been tampered with.

Audit research of practices of advanced countries

5.6 Audit recently conducted a research into the practices of other advanced countries for conducting customs audits of oil companies. Audit has found that for large oil companies, where reliance is placed on their self-compliance, the customs authority concerned usually adopts a system-based approach (SBA) to auditing the companies. The objective of the SBA is to obtain an assurance on the integrity of the information supplied to customs, through an evaluation of the companies' records, practices, processes and systems. This, in turn, enables the customs authority to obtain an assurance on the companies' compliance with legislative requirements. The SBA consists of the following key steps:

- Preliminary activity and planning (including systems description and verification)
- Analytical checking and initial assessment
- Control identification and verification
- Compliance testing and control evaluation (Note 24)
- Substantive testing (i.e. checking of records and transactions)
- Treating issues arising from the audit
- Audit reporting

Audit observations on the C&ED's audit procedures

5.7 The C&ED's audit approach, as described in paragraph 5.5 above, is mainly transaction-based. It focuses on the checking of selected transactions. Audit's review of the C&ED's audit working papers indicates that little emphasis is placed on the documentation and verification of the oil companies' systems, and on the identification and evaluation of controls.

5.8 In Audit's view, transaction-based audits are simple and easy to perform. However, system-based audits are more effective in achieving the objective of customs audits, which is to obtain assurance on the companies' compliance with legislative requirements. **There is a need for the C&ED to consider adopting the SBA in line with the practice of advanced countries.**

Note 24: *In a system-based audit, an auditor must consider the nature of the auditee's business and evaluate the systems of internal control to determine the nature, extent and timing of the audit procedures to be used.*

5.9 In this regard, Audit notes that members of the C&ED's audit team are customs officers and not professional auditors. As such, they may not have the necessary expertise for conducting system-based audits. **Therefore, if it is decided to implement the SBA, staff re-profiling and training of the C&ED's audit team will be necessary, so as to ensure that sufficient audit expertise is available for its successful implementation.**

Other areas for improvement

5.10 Audit has also identified the following areas for improvement in the C&ED's audits of oil companies:

- (a) **Preliminary checks on monthly returns (see para. 5.5(a) above).** In conducting monthly preliminary checks on oil companies' returns, customs officers are expected to review the returns to identify any self-manifest mistakes or irregularities and to make enquiries on the significant ones. As the C&ED has not laid down any guidelines on how the customs officers should review the returns, the effectiveness of the preliminary checks depends very much on the experience and judgement of individual officers;
- (b) **Monthly returns verification (see para. 5.5(b) above).** For each audit, the C&ED's audit team would select two monthly returns for verification on-site. Audit noted from the working papers that there was no documentation on how the selection was made. There was also no documentation to indicate whether or not the selection was based on risk assessment;
- (c) **Physical surprise stock checks (see para. 5.5(c) above).** Customs officers would contact the oil companies by phone before visiting the companies for stock checks. There was, therefore, no surprise element. The audit team would select some oil types for stock checks, but there was no documentation on how the selection was made; and
- (d) **Compliance with licence conditions.** Under their licence conditions, the oil companies are required to notify the C&ED of any change in their systems, books and records used for operating the licences. Audit noted that the licence conditions had not always been complied with. For example, in one case, the oil company had computerised the process of calculating the oil quantities to be shown in its monthly returns. However, this was only found out by the C&ED's audit team upon visiting the company.

Audit recommendations on customs audits of oil companies

5.11 **Audit has recommended that the Commissioner of Customs and Excise should:**

Adopting SBA

- (a) **consider adopting the SBA in line with the practice of advanced countries (see para. 5.8 above);**
- (b) **if it is decided to implement the SBA, review the needs for staff training and staff re-profiling of the C&ED's audit team, so as to ensure that sufficient audit expertise is available for the successful implementation of the SBA (see para. 5.9 above);**

Other areas for improvement

- (c) **draw up guidelines/checklists to help the C&ED's audit team identify high risk areas when conducting preliminary checks on the oil companies' monthly returns. This will enable them to perform their tasks more effectively, in particular for those less experienced staff (see para. 5.10(a) above);**
- (d) **require the audit team to show clearly in the audit working papers:**
 - (i) **how monthly returns are selected for detailed verification on-site (see para. 5.10(b) above);**
 - (ii) **how different types of oil are selected for stock checks (see para. 5.10(c) above); and**
 - (iii) **whether the selections in (i) and (ii) above are based on risk assessment;**
- (e) **build in a surprise element in conducting stock checks (see para. 5.10(c) above); and**
- (f) **remind the oil companies of the need to keep the C&ED informed of any change in their systems, books and records used for operating their licences, and monitor their compliance with this requirement (see para. 5.10(d) above).**

Response from the Administration

5.12 The **Commissioner of Customs and Excise** agrees with the audit recommendations. He has said that:

Adopting SBA

- (a) the SBA concept has been taken on board in designing the proposed OBS (see para. 2.12 above). The Dutiable Commodities (Amendment) Bill 2002, now being studied by LegCo, requires licensees to provide details of their systems and procedures to the C&ED for consideration in licence application and control purposes. This control system is actually based on the SBA concept. The Bill applies to all types of DC warehouses, including oil companies. The C&ED, in consultation with FSTB, will review the control measures on hydrocarbon oil upon implementation of the Bill;
- (b) the C&ED will gather the audit experience of the customs authorities abroad to devise its audit system and review the needs for staff training and staff re-profiling;

Other areas for improvement

- (c) guidelines were drawn up in August 2002 for reference of the C&ED's audit team in conducting monthly preliminary checks on the oil companies' returns;
- (d) from September 2002 onwards, documentation on file will be required to show how monthly returns from the oil companies are selected for on-site verification;
- (e) since August 2002, the C&ED's audit team has been required to document all risk factors considered in selecting different types of oil for stock checks, and to build in a surprise element in conducting stock checks; and
- (f) when oil companies renew their licences, they will be further reminded of the requirement to keep the C&ED informed of any change in their systems, books and records used for operating the licences.

PART 6: ILLEGAL VEHICLE REFUELLING ACTIVITIES

6.1 This PART examines the problem of illegal vehicle refuelling activities in Hong Kong and the C&ED's measures to tackle it.

Types of illicit vehicle fuel

6.2 There are three main types of illicit fuel, namely:

- (a) ***Dutiable light diesel and motor spirit.*** These are dutiable light diesel and motor spirit on which the full duty prescribed by law has not been paid. They mainly come from illegal imports or light diesel purported to be for export but illicitly diverted into the local market;
- (b) ***Marked oil.*** This is the illegal use of marked oil as fuel in motor vehicles (see para. 5.3(c) above); and
- (c) ***Detreated oil.*** This is marked oil with the colouring substance and marker removed, or impeded, to facilitate illegal sale in the black market.

Financial incentive for illegal vehicle refuelling activities

6.3 The main reason for engaging in illegal vehicle refuelling activities is financial gain. Lucrative profits can be reaped from selling illicit fuel. According to the C&ED's records, a medium-sized illegal filling station can earn a net profit of \$4,500 per day by selling an average of 3,000 litres of illicit light diesel.

6.4 On the demand side, the price difference provides an incentive for drivers to take the risk of using illicit fuel. As at June 2002, the pump price for legally supplied ultra low sulphur diesel (ULSD) was \$5.88 per litre, while light diesel was sold in the black market at about \$4 per litre.

Concerns arising from the sale and use of illicit fuel oil

6.5 Apart from the loss of revenue, illegal vehicle refuelling activities and use of illicit fuel in motor vehicles give rise to the following concerns:

- (a) over-storage or mishandling of illicit fuel is a fire hazard. Illegal vehicle filling stations set up in residential areas pose a serious threat to public safety;
- (b) the sulphur content of illicit diesel can be several times that of the ULSD currently sold in Hong Kong, thus causing more air pollution; and
- (c) alleged triad involvement in the sales of illicit fuel oil could jeopardise law and order in Hong Kong.

C&ED's actions

6.6 The C&ED has been taking various actions to combat illegal vehicle refuelling activities, including the following:

- (a) **Amendments to the DCO.** The DCO has been amended to facilitate the enforcement and prosecution work of the C&ED (Note 25). The C&ED considers that the problem of transferring diesel from cross-boundary vehicles to other vehicles has died down as a result of the legislative amendment on statutory limit of sulphur content. The driving licence disqualification clause has served as an effective deterrent in curbing the demand for illicit diesel. Most drivers have refrained from using illicit diesel after one conviction (Note 26);
- (b) **Enforcement actions.** The Marine & Land Enforcement Command of the C&ED, with a total staff of over 300, undertakes the main day-to-day operational work against illicit fuel activities in the territory. Its duties include the raiding of illicit filling stations, checking road vehicles for illicit fuel and surveillance of coastal areas, waterfronts and black spots to detect smuggling activities. It also conducts in-depth investigation and surveillance of syndicates involved in the smuggling and supply of illicit fuel. From time to time, the C&ED would mobilise customs officers of other units to conduct large-scale operations to suppress the supply and use of illicit oil. The C&ED also conducts joint

Note 25: *The DCO was amended in July 2000 and February 2001. The amendments seek to help the C&ED to prove the offences of supply or use of illicit fuel by shifting the burden of adducing evidence to the suspect. Furthermore, the maximum fine for offences relating to marked oil has been increased from \$200,000 to \$1,000,000, and repeated offenders convicted of illicit fuel offences can be disqualified from holding their driving licences for specified periods.*

Note 26: *Up to March 2002, seven offenders had been disqualified from holding their driving licences by the court.*

operations with other enforcement departments such as the Fire Services Department (FSD) and the Police. Appendix G shows the performance data of the C&ED in relation to combating illicit oil activities for 2000 and 2001; and

- (c) **Other actions.** The C&ED has launched reward schemes, jointly with the major oil companies, to encourage informers to provide information that may lead to the seizure of illicit fuel. Other actions include the launching of intensive media campaigns to publicise the adverse consequences of using illicit fuel, and the setting up of hotlines to solicit intelligence reports.

6.7 The C&ED considers that the above actions have contained the problem of illegal refuelling activities in the territory. As the illicit fuel business is regarded as a menace to society and a threat to public security, the C&ED considers that there is a need for continued efforts to clamp down the illicit activities.

Problems that could undermine the C&ED's enforcement efforts

6.8 Audit has recently conducted a review of the C&ED's efforts to combat illegal vehicle refuelling activities. While noting its achievements, Audit has found that the C&ED is facing various problems which, if not satisfactorily resolved, could undermine the effectiveness of its enforcement efforts. The audit findings are reported under the following headings:

- (a) illicit use of synthetic motor spirit (see paras. 6.10 to 6.12 below);
- (b) difficulties in closing down illegal detreating plants with underground tanks (see paras. 6.13 to 6.17 below); and
- (c) control of duty-free marked oil (see paras. 6.18 to 6.26 below).

6.9 Furthermore, Audit has found that there is scope for improvement in the C&ED's performance measurement and reporting. The audit findings are reported in paragraphs 6.27 and 6.28 below.

Illicit use of synthetic motor spirit

6.10 According to the C&ED's statistics, since early 2002, there has been an increase in the seizure of illicit motor spirit. (Photograph 5 on the centre pages shows a motor vehicle refuelling at an illegal filling station.) The number of cases detected in the first six months of 2002 was 371,

which more than tripled the number of cases (i.e. 115) detected in the same period of 2001. Synthetic motor spirit (SMS — Note 27) was found in most of the cases. According to a discussion paper of the C&ED dated June 2002, there are difficulties in taking enforcement action against the illegal use of SMS, as follows:

- (a) there are strict liability offences specified in the legislation against the drivers of motor vehicles using marked oil or detreated oil. However, there is no similar provision against the driver of a vehicle if SMS is found in its fuel tank; and
- (b) vehicles using SMS may not be readily identified by customs officers conducting fuel checks on vehicles on the road as there is no equipment available to differentiate between SMS and petrol from legitimate sources. Such drivers can only be caught when they are engaged in the act of refuelling at illegal filling stations.

6.11 Based on the C&ED's information, SMS is locally produced at a cost of \$3 per litre and sold in the black market at \$6 per litre. Compared with the legitimate pump price of motor spirit at \$10.75 (including a duty of \$6.06) per litre, there is a strong financial incentive for drivers to use SMS regardless of the possible adverse effects on the vehicle engine. The price difference also provides a good profit margin for the illegal operators. In the June 2002 discussion paper, the C&ED made an assessment of the extent of the illegal use of the SMS. According to that paper:

- (a) in the first four months of 2002, oil companies sold about 10 million litres of rubber solvent and toluene for local consumption, which were the ingredients for making SMS. However, the C&ED's enquiries with traders revealed that there was no factory/industry in Hong Kong which used a substantial quantity of such chemicals;
- (b) the C&ED was aware that there were a few chemical companies which had bought drums of such chemicals and repacked them into small tins for local use as cleansing agent and solvent. It was estimated that each month, 20,000 to 30,000 litres of such chemicals would be sufficient for local industrial use; and
- (c) assuming that 90% of the locally consumed rubber solvent and toluene were being illegally used for making SMS, about 27 million litres a year of illicit fuel were supplied to the black market (Note 28).

Note 27: *SMS is blended by mixing rubber solvent with either toluene or xylene. These ingredients can be bought readily from the oil companies without any control. The mixture is colourless. In order to deceive the users, dyestuffs and lubricants are usually added to the mixture to make it resemble the colour of motor spirit from legitimate sources.*

Note 28: *Upon enquiry, in September 2002, the C&ED advised Audit that the figure of 27 million litres (10 million litres in 4 months to 12 months to 90%) of rubber solvent and toluene, quoted in the C&ED paper of June 2002, was a very rough estimate. The C&ED was conducting an in-depth study to get a more accurate assessment of the illicit use of these chemicals.*

Based on (c) above, Audit has estimated that the potential revenue loss arising from the use of illicit SMS is about \$163 million a year (27 million litres @ \$6.06 per litre).

Audit observations on illicit use of synthetic motor spirit

6.12 Audit is concerned that there are indications of a widespread misuse of rubber solvent and toluene for making SMS, and that the C&ED is facing difficulties in its enforcement against such misuse. Audit notes that the C&ED is considering measures to control the sale and use of these chemicals, but it could take a long time to implement such measures, which may involve legislative amendments. **Audit considers that there is a need for the C&ED to draw up an action plan, with clear milestone dates, to monitor progress and to ensure that appropriate measures are implemented as soon as possible. Meanwhile, continued efforts are necessary to stem the operations of illegal filling stations through increased surveillance and raids.**

Difficulties in closing down illegal detreating plants with underground tanks

6.13 According to the C&ED, three types of establishment are involved in illegal fuel activities, namely illegal filling stations, detreating plants with tanks installed on the ground and detreating plants with underground storage tanks.

6.14 The C&ED considers that the problem of illegal filling stations is under control as a result of its vigorous enforcement actions. The C&ED also considers that it has no difficulties in closing down detreating plants with tanks installed on the ground.

6.15 In order to evade detection, some detreating plants have installed their storage tanks, filters, pipes and hoses underground, leaving only the inlet and the outlet visible above the ground. The C&ED has encountered difficulties in closing down these plants. It has also found that the costs of removing the underground storage tanks are high. The C&ED is concerned that, if the underground tanks are not removed after a raid, unscrupulous operators will re-open the plants and run illicit fuel activities again. In April 2002, an inter-departmental working committee, chaired by a senior C&ED officer, was set up to address the issue. (Photograph 6 on the centre pages shows a scene at an illegal detreating plant with an underground storage tank.)

Audit observations on difficulties in closing down illegal detreating plants with underground tanks

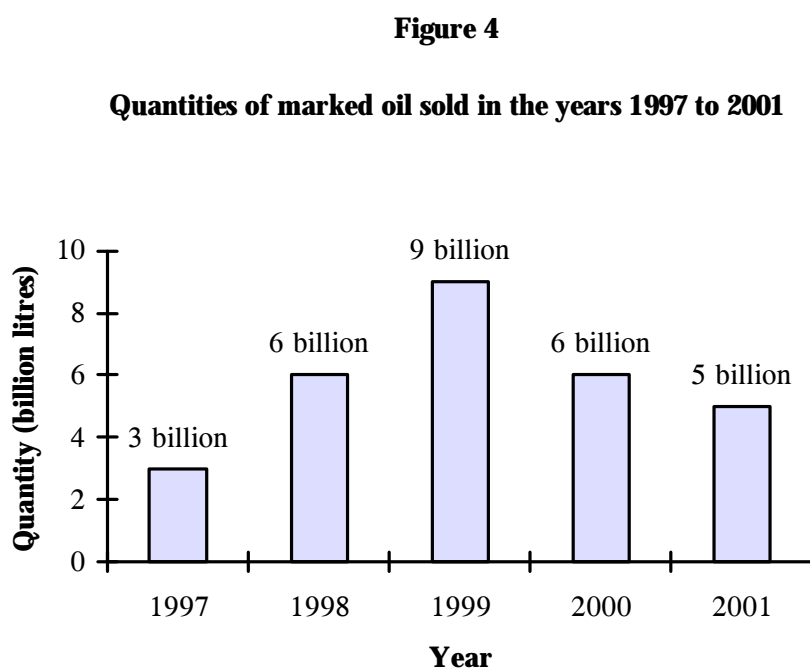
6.16 Audit is concerned that the difficulties faced by the C&ED in closing down and removing the detreating plants with underground tanks have undermined the C&ED's efforts in tackling illicit

oil refuelling activities. In one case, for example, the C&ED had since 1998 conducted 35 raids on the illegal detreating plant. However, as at July 2002, the C&ED believed that the plant was still operating actively.

6.17 Given the complexity of the issue, Audit considers that the setting up of an inter-departmental working committee to deal with the issue is a step in the right direction (Note 29). **To ensure that the problem is resolved as soon as possible, Audit considers that there is a need for the C&ED to draw up an action plan, with clear milestone dates, to monitor the committee's progress.**

Control of duty-free marked oil

6.18 **Quantity of marked oil sold.** As mentioned in paragraph 5.3(c) above, marked oil, which is exempted from duty, is designated for marine and industrial use and for the use of specific types of vehicles (e.g. franchised public buses). The quantities of marked oil sold by oil companies have been substantial, as shown in Figure 4 below.



Source: C&ED's records

Note 29: *The closing down of an illegal detreating plant involves the formulation of removal procedures, identification of risks associated with the removal, and confirmation of estate rights. To deal with such a complicated task, the committee has representatives from the Buildings Department, Environmental Protection Department, Police, Lands Department, Highways Department and FSD.*

6.19 **The ICAC's study.** In early 2000, the ICAC conducted a study on the C&ED's systems and procedures in the enforcement against illegal sale and use of diesel. In its report of April 2000, the ICAC noted that:

- (a) there had been a steady increase in the turnover of marked oil in recent years, from three billion litres in 1997 to nine billion litres in 1999. Even if a small percentage of this quantity was sold for illegal use, the ill-gotten gains for the illegal operators could be substantial. There was, therefore, a great incentive for the illegal reselling of marked oil (Note 30);
- (b) the C&ED's operations against illegal sale of marked oil were mainly directed at the retail level (i.e. raiding operations were targeted at retail black spots). Despite some successful raids and sizable seizures, the problem persisted; and
- (c) there were, however, no attempts to address the problem at source. The C&ED did not control the distribution of marked oil through the oil companies to the distributors whose identities and sales volumes were not known, making it difficult for the C&ED to monitor their activities except through public complaints.

6.20 **The ICAC's recommendation.** The ICAC considered that the entire system of controlling the sale and use of marked oil would need a rethink. The ICAC recommended that the C&ED should conduct an overall review of the marked oil system.

6.21 **Actions taken by the C&ED.** Subsequent to the ICAC's review, the C&ED has taken various courses of actions to tackle the illegal use of marked oil. The main actions are shown in Table 4 below.

Note 30: *Illegal reselling refers to the purchases by operators of marked oil in bulk from the oil companies and reselling it to illegitimate users.*

Table 4

Actions taken by the C&ED to tackle the illegal use of marked oil

Time	C&ED's actions
(a) From February 2001 onwards	Oil companies are required to show, in their monthly returns, a detailed breakdown (by levels of sulphur contents) of the deliveries of marked oil. The customers' names and delivery addresses have to be shown.
(b) April 2001	Customs officers visited some selected marked ULSD dealers, who were registered customers of the oil companies, to understand their operations.
(c) June 2001	<p>The C&ED urged oil companies to record, on each delivery order, the exact delivery address (for marked oil of 0.035% and 0.005% sulphur content).</p> <p>The C&ED conducted a survey, through the oil companies, to collect end-users' information (e.g. business/delivery addresses, daily consumption and purposes of use). It built up a database of marked ULSD end-users.</p>
(d) From July 2001 onwards	<p>To prevent illegal oil dealers from buying large quantities of marked ULSD by vessels, from July 2001 onwards oil companies are required to notify the C&ED 12 hours in advance of delivery. The information provided include: delivery date and quantities; purposes of use; and the name of the vessel. Six hours before delivery, the C&ED will approve or disapprove the delivery orders. Oil companies are further required not to blend marked ULSD for marine delivery without the C&ED's approval.</p> <p>The C&ED reviews regularly purchases of marked ULSD, based on copies of oil companies' delivery orders. Verbal explanations are sought on excessive purchases.</p>
(e) June 2002	The C&ED conducted an ad hoc verification exercise on 48 end-users. The exercise focused on the use of marked ULSD. Customs officers visited the end-users at their business addresses and conducted sample checks of the marked oil they were using. The result of the exercise indicated that there was potential misuse of marked oil among 35 of those 48 end-users.
(f) July 2002	The C&ED conducted a follow-up exercise on the 35 cases of potential misuse. The result indicated that further actions were required on 11 of those cases. These suspected end-users were put on either the C&ED's " Stop List " (which means that customs officers would be stationed at the depots of the oil companies and intercept all deliveries of marked oil to these end-users), or " Watch List " (which means that the cases would be closely monitored and investigation actions would be taken if necessary).

Source: C&ED's records

6.22 ***C&ED's evaluation of actions taken.*** The C&ED considers that the above actions have been effective for tackling the illegal use of marked oil. There are indications that illegal oil dealers have refrained from buying marked ULSD from the oil companies. The quantity of duty-paid diesel has increased and, conversely, the quantity of marked oil sold by oil companies has decreased.

Audit observations on control of duty-free marked oil

6.23 ***Continued efforts needed.*** Audit notes that the C&ED has taken various actions to tackle the illegal use of marked oil and that, according to its own evaluation, the actions are effective for tackling the problem. **Audit considers that continued efforts by the C&ED are necessary to sustain its achievement and keep the problem under control.**

6.24 ***Need for regular verification exercises.*** Audit notes that the ad hoc verification exercise, referred to in items (e) and (f) of Table 4 of paragraph 6.21 above, were effective for identifying potential misuse of marked oil. **To sustain such efforts, Audit considers that there is a need for the C&ED to conduct similar exercises on a regular basis.**

6.25 ***Overseas experience.*** Audit's research indicates that other countries have also encountered similar difficulties in controlling duty-free marked oil. For example, in the UK, the customs authority estimated that there was a revenue loss of £450 million from diesel fraud in 2000. As part of its anti-oil-fraud strategy, the UK customs authority proposed to introduce a system for the approval and registration of dealers in controlled oil, known as the "Registered Dealers in Controlled Oil System". Under this system, anyone wishing to sell or deal in controlled oil will need to be approved. Distributors (i.e. oil companies and dealers) are given the obligations to take reasonable steps to check that sales of marked oil are made only to customers who intend to put them to an approved use. This system will be implemented with effect from April 2003.

6.26 ***Need to keep in view overseas experience.*** Audit notes that there are, at present, no similar requirements in Hong Kong to control marked oil dealers. **Audit considers it necessary for the C&ED to keep in view the developments in the UK and the need for implementing a similar system in Hong Kong.**

Performance indicators used by the C&ED

6.27 The C&ED reports annually in the COR the number of seizure cases and the quantity of illicit fuel oil seized as indicators of the C&ED's performance in combating illegal vehicle refuelling activities. In addition, the C&ED publishes a number of other performance indicators (e.g. the number of illegal detreating plants and number of illegal filling stations smashed) in its Annual Review Reports and website. Details are shown in Appendix H.

Audit observation on performance indicators

6.28 Similar to the observations on cigarette smuggling (see para. 4.11 above), Audit considers that the performance indicators shown in Appendix H are useful indicators. **In Audit's view, there is a need for the C&ED to consider including all these indicators in the COR, so as to help the public and LegCo better assess the C&ED's performance in combating illegal vehicle refuelling activities.**

Audit recommendations on the C&ED's actions to combat illegal vehicle refuelling activities

6.29 **Audit has recommended that the Commissioner of Customs and Excise should:**

Illicit use of SMS

- (a) **draw up an action plan, with clear milestone dates, to monitor the progress of implementation of measures to control the sale and use of rubber solvent, xylene and toluene, which are the ingredients for making SMS (see para. 6.12 above);**
- (b) **make continued efforts to stem the operations of illegal filling stations through increased surveillance and raids (see para. 6.12 above);**

Difficulties in closing down illegal detreating plants with underground tanks

- (c) **draw up an action plan, with clear milestone dates, to monitor the progress of the inter-departmental working committee in resolving the problem of closing down illegal detreating plants with underground tanks permanently (see para. 6.17 above);**

Control of duty-free marked oil

- (d) **make continued efforts to sustain the C&ED's achievement in controlling the use of marked oil, so as to keep the problem of its illegal use under control (see para. 6.23 above);**

- (e) **conduct verification exercises on a regular basis to detect the misuse of marked oil (see para. 6.24 above);**
- (f) **keep in view the developments of the “Registered Dealers in Controlled Oil System” in the UK, and the need for implementing a similar system in Hong Kong (see para. 6.26 above); and**

Performance indicators used by the C&ED

- (g) **consider including in the COR all the useful performance indicators now published by the C&ED through various channels, so as to help the public and LegCo better assess the C&ED’s performance in combating illegal vehicle refuelling activities (see para. 6.28 above).**

Response from the Administration

6.30 The **Commissioner of Customs and Excise** agrees with the audit recommendations. He has said that:

Illicit use of SMS

- (a) the C&ED has been monitoring the situation closely and has been examining various measures to tackle the problem of the illicit use of SMS. An action plan will be worked out as soon as practicable;
- (b) meanwhile, vigorous enforcement actions will continue. The C&ED will conduct more joint operations with other departments and carry out close surveillance of known syndicates to stem illicit fuel activities at all levels;

Difficulties in closing down illegal detreating plants with underground tanks

- (c) according to the C&ED’s up-to-date intelligence, there are three illegal detreating plants with underground storage tanks. Two of them have been found inoperative with the pipelines of their storage tanks disconnected, after the C&ED’s repeated enforcement actions;

- (d) there are some difficulties in removing the remaining detreating plant due to legal and structural safety problems. The inter-departmental committee, led by the C&ED, has been exploring various measures to resolve the problem (see para. 6.15 above). An action plan will be drawn up in three months' time to monitor all actions;

Control of duty-free marked oil

- (e) the C&ED will continue to take various control measures to prevent the illegal use of marked oil. It will also conduct verification exercises (similar to the one mentioned in items (e) and (f) of Table 4 of para. 6.21 above) on a regular basis to detect illegal users;
- (f) the C&ED will examine the control system in the UK (referred to in para. 6.25 above), after its implementation in April 2003, to see whether it is feasible for application in Hong Kong. When considering the matter, he will take into account the need to strike a balance between trade facilitation and revenue protection; and

Performance indicators used by the C&ED

- (g) in consultation with the FSTB, the C&ED will consider including other performance indicators (as shown in Appendix H) in the COR.

6.31 The **Secretary for Financial Services and the Treasury** has said that he would consider any proposal from the C&ED to include more performance indicators in its COR.

PART 7: FUEL OIL DUTY-FREE CONCESSIONS FOR CROSS-BOUNDARY VEHICLES

7.1 This PART examines the Government's progress in reducing the quantities of diesel brought into Hong Kong by cross-boundary vehicles under the duty-free arrangement.

Quantities of duty-free diesel allowed for cross-boundary vehicles

7.2 Prior to 1991, fuel in the fuel tanks of vehicles arriving from the Mainland for use in these vehicles was exempt from duty. Due to the higher retail price of diesel in Hong Kong, the C&ED found that many goods vehicle drivers tried to exploit the duty-free arrangement by enlarging the fuel tanks of their vehicles to bring into Hong Kong large quantities of diesel for resale. To counter this illegal act, the Dutiable Commodities Regulations (Cap. 109A) were amended in 1991 to restrict the allowed duty-free quantities of diesel according to the cylinder capacity of a goods vehicle. Permitted quantities range from 100 to 300 litres of diesel, as shown in Table 5 below:

Table 5

Quantities of duty-free diesel allowed for cross-boundary goods vehicles entering Hong Kong

Cylinder capacity of vehicle	Quantity allowed
Below 3,000 c.c.	100 litres
3,000 to 10,000 c.c.	200 litres
Over 10,000 c.c.	300 litres

Source: Dutiable Commodities Regulations

Note: The maximum quantity allowed is roughly equal to three-quarters of the capacity of the fuel tank of a goods vehicle.

7.3 The above duty-free concessions for goods vehicles have remained in force since 1991. As for other motor vehicles (e.g. passenger coaches and private cars), the fuel in the fuel tank for use in that vehicle has continued to be duty exempted. (Photograph 7 on the centre pages shows inbound goods vehicles awaiting customs clearance at the Lok Ma Chau Control Point.)

The Public Accounts Committee's concerns

7.4 In 1997, Audit conducted a review of the Government's measures taken to monitor and control air pollution. In its Report of February 1998, the Public Accounts Committee (PAC) expressed concern that the Government's control on the sulphur content of vehicle diesel was undermined by the illegal trade in diesel and the inflow of large quantities of high sulphur content diesel under the duty-free arrangement. The PAC recommended that the Government should:

- (a) continue to closely monitor the environmental impact of the inflow and consumption of vehicle diesel with high sulphur content; and
- (b) tighten the control of the inflow of high sulphur content diesel under the duty-free arrangement.

The Government's response to the PAC's recommendations

7.5 The Government keeps the PAC informed, through the Government Minutes and Annual Progress Reports, of its progress in implementing the PAC's recommendations. The progress reported during the years 1998 to 2002 is shown in Table 6 below.

Table 6

Progress reported to the PAC

Source document	Reported position
(a) Government Minutes (April 1998 and May 1999) Annual Progress Reports (October 1998 and 1999)	The Environmental Protection Department (EPD) had been monitoring closely the environmental impact of vehicle diesel with high sulphur content. The Administration was studying the feasibility of reducing the quantities of duty-free vehicle diesel carried by goods vehicles arriving from the Mainland.
(b) Government Minute (May 2000)	The Administration intended to reduce the sulphur content of diesel supplied in Hong Kong to not more than 0.035% in January 2001. It had agreed with the Guangdong Provincial Government to establish a working group to look into the feasibility of harmonising the motor diesel specifications between Guangdong and Hong Kong.
(c) Annual Progress Report (October 2000)	In July 2000 a concessionary duty on ULSD (i.e. 0.005% sulphur content) was introduced to encourage vehicles to switch to environmentally cleaner fuel. The Administration was considering ways to reduce the amount of diesel not meeting Hong Kong's standards carried by cross-boundary vehicles into Hong Kong.
(d) Government Minute (May 2001)	All petrol filling stations in Hong Kong had been supplying ULSD since August 2000. All franchised buses had also switched to ULSD since February 2001. The Administration was reviewing the suggestion to further reduce the maximum amount of diesel that could be carried into Hong Kong from the Mainland by cross-boundary diesel vehicles in their fuel tanks. The Administration would take into account the effect of enhanced enforcement actions against illegal vehicle refuelling activities and other new measures that were being considered against such activities.
(e) Annual Progress Report (October 2001)	The Administration planned to make ULSD the statutory standard for motor diesel. The Administration was reviewing the need for further restricting the amount of diesel that could be carried into Hong Kong from the Mainland by cross-boundary vehicles, in the light of the effectiveness of the existing control over the use of illicit fuel.
(f) Government Minute (May 2002)	ULSD had become the statutory standard for motor diesel from April 2002. Rigorous enforcement actions against the use of illicit fuel had taken effect. The Administration would keep in view the need for further restricting the amount of fuel that could be carried into Hong Kong by cross-boundary vehicles, in the light of the effectiveness of the control measures.

Source: Government Minutes and Annual Progress Reports to the PAC

The Task Force to Improve Air Quality

7.6 In May 2000, a Task Force to Improve Air Quality, chaired by the then Secretary for the Environment and Food (Note 31), was set up to coordinate inter-departmental efforts in the implementation of measures to reduce vehicle emissions and to monitor the effectiveness of the measures. At two meetings in September 2000 and January 2001, the Task Force studied a proposal to restrict the quantity of Mainland diesel that was allowed to be carried by cross-boundary goods vehicles into Hong Kong. According to the Task Force's January 2001 discussion paper:

- (a) **High sulphur content of Mainland diesel.** Motor diesel available in the Mainland had a sulphur content of between 0.3% and 0.5% by weight (Note 32). This was significantly higher than the statutory upper limit of 0.035% (Note 33) in the Air Pollution Control (Motor Vehicle Fuel) Regulations and the sulphur content of 0.005% of ULSD which was the only type of diesel available at petrol filling stations in Hong Kong. A vehicle using Mainland diesel could emit up to 25% more particulates (and 5% more nitrogen oxide) than one using ULSD;
- (b) **Current duty-exempt level.** The maximum duty-exempt level (see para. 7.2 above) was roughly equal to three-quarters of the fuel tank capacity of a vehicle. Legal action was instituted against drivers of cross-boundary goods vehicles detected with diesel in excess of this limit when entering Hong Kong; and
- (c) **Significant price difference.** The pump price of motor diesel in the Mainland was between RMB 2.60 and RMB 3 per litre, compared with \$5.94 per litre in Hong Kong. This made refuelling in the Mainland up to the limit attractive. It was legal for these vehicles to bring into Hong Kong diesel up to the maximum duty-exempt level as long as the diesel remained in their fuel tanks for their own consumption, but it was illegal to transfer the diesel to another vehicle or to sell it in Hong Kong. However, some drivers still disregarded the law. It was expected that the latest amendments to the DCO (see para. 6.6(a) above) would enhance the deterrent against such illegal activities.

Note 31: *The Task Force was made up of representatives from various then Bureaux and Departments including the Transport Bureau, Finance Bureau, Planning and Lands Bureau, Economic Services Bureau, EPD, C&ED and Transport Department.*

Note 32: *With effect from January 2002, the Mainland has revised its motor diesel standard. The sulphur content of motor diesel now sold in the Mainland must not exceed 0.2%. A proposal to further reduce the sulphur content to 0.05% is also being considered.*

Note 33: *With effect from April 2002, ULSD has been adopted as the statutory standard for motor diesel in Hong Kong. The sulphur content of ULSD is 0.005%.*

7.7 The Task Force considered a number of options in the light of information on the pattern of operation of cross-boundary vehicles. At its meeting on 20 January 2001, the Task Force considered that the environmental benefits of the options should be assessed in detail in the light of the effectiveness of the new amendments to the DCO. The Task Force also considered that the possible reaction of the transport trade should also be assessed in more detail.

7.8 At another meeting on 22 June 2001, noting a member's comment that there had been an increase in the use of licit fuel, the Task Force decided that the issue should be reviewed in three months' time. However, as far as Audit could ascertain, up to July 2002, the matter had not been brought up to the Task Force again for further deliberations.

Audit's enquiry with the Environment, Transport and Works Bureau

7.9 In August 2002, Audit made enquiry with the Environment, Transport and Works Bureau (ETWB) about:

- (a) the progress of the Task Force in pursuing options to reduce the duty-free concessions (see para. 7.10 below); and
- (b) the quantities of Mainland diesel consumed in Hong Kong (see paras. 7.11 to 7.13 below).

Progress of the Task Force in pursuing options to reduce the duty-free concessions

7.10 With regard to paragraph 7.9(a) above, the ETWB has informed Audit that although the matter has not been brought back to the Task Force for discussion, the ETWB (and the former Environment and Food Bureau) have been following it up with the C&ED.

Quantities of Mainland diesel consumed in Hong Kong

7.11 With regard to paragraph 7.9(b) above, Audit notes that every year, about 4.5 million goods vehicles arrive from the Mainland. If these vehicles all took full advantage of the current duty-free concessions, Audit has estimated that they could have brought in a maximum of 1,112 million litres of Mainland diesel in 2001. In response to Audit's enquiry, the ETWB and the C&ED have informed Audit that:

- (a) **Quantity brought into Hong Kong.** The amount of Mainland diesel brought into Hong Kong should not be as high as 1,112 million litres because the majority of cross-boundary vehicles do not bring in the maximum quantities allowed. According to a recent survey conducted by the C&ED, 80% of the incoming goods vehicles had only 50% of their tanks filled, and the rest mostly had less than 50% of their tanks filled. Based on the result of this survey, the C&ED has estimated that the amount of Mainland diesel brought into Hong Kong by cross-boundary vehicles is about **679 million litres** a year. Not all of this quantity is consumed in Hong Kong. Most of the Mainland diesel brought into Hong Kong which is not used up here, will be carried back to the Mainland for consumption; and
- (b) **Quantity consumed in Hong Kong.** According to the ETWB's assessment, cross-boundary vehicles consume only about **236 million litres** of Mainland diesel a year in Hong Kong. This assessment is based on the assumption that, on average, each incoming cross-boundary vehicle will travel 110 kilometres (km) within Hong Kong before leaving for the Mainland again. The assumption, in turn, is based on the fact that the common destinations of the cross-boundary vehicles are about 30 to 55 km from the three crossing points (Man Kam To, Sha Tau Kok and Lok Ma Chau) and that such vehicles, being business vehicles, will not tour around for no purposes.

7.12 From the above, it can be seen that the estimated quantity brought into Hong Kong by the cross-boundary vehicles (i.e. 679 million litres a year) far exceeds their operational needs (i.e. 236 million litres a year). Thus, the question arises as to whether there is scope for reducing the duty-free concessions, without adversely affecting the operations of the cross-boundary vehicles. On this question, the ETWB is of the view that the existence of some scope for reducing the concessions is insufficient to justify a reduction, and that there are no strong environmental grounds for reducing the concessions at this time. The ETWB has informed Audit that:

Environmental impact

- (a) according to the ETWB's estimate, under the best case scenario (i.e. where no Mainland diesel is allowed to be brought into Hong Kong), there could be an overall reduction of 2% to 4% of particulate emissions (and 0.5% to 1% of nitrogen oxide emissions) from the entire vehicle fleet in Hong Kong. However, this is infeasible mainly because of the difficulties in providing the required supporting facilities to allow cross-boundary vehicles to dump the Mainland diesel in their fuel tanks before entering Hong Kong, and to be refuelled with Hong Kong diesel immediately after their entry into Hong Kong. Such difficulties would be insurmountable, given the already congested environment of the border crossing points and the heavy cross-boundary traffic;

- (b) according to the ETWB's preliminary estimate, the concession limit has to be set at a level less than one-tenth of the fuel tank capacity, if it is to bring about any appreciable environmental gains. This will result in a reduction of 0.8% to 1.6% of particulate emissions (and 0.2% to 0.4% of nitrogen oxide emissions) from the entire vehicle fleet in Hong Kong (see para. 4 of Appendix I);

Possible reaction of the transport trade

- (c) the possible reaction of the transport trade is another factor to be considered. When the current limit was introduced in 1991 (see para. 7.2 above), there was strong reaction from the transport trade;
- (d) in order to bring about any appreciable environmental gains, the concession limit has to be set at a significantly lower level and this would cause insurmountable difficulties (see (a) and (b) above). It is envisaged that the transport trade would strongly object to any proposal of setting the duty-free concession limit at such a low level;
- (e) the transport trade has been adversely affected by the downturn in economy and its sentiments are extremely volatile. Its reaction to any proposal to lower the duty-free limit should not be underestimated and should be carefully handled;

ETWB's main concern is illicit transfers of Mainland diesel

- (f) the major benefit of limiting the amount of Mainland diesel to be brought by cross-boundary vehicles into Hong Kong is to prevent the illicit transfers of Mainland diesel from such vehicles to local vehicles in Hong Kong. The ETWB has been regularly monitoring the effectiveness of the control measures taken by the C&ED to combat the use of illicit fuel; and
- (g) a decision on this matter should be taken carefully and on solid justifications, taking into account the enhanced effectiveness of the enforcement actions taken by the C&ED on the use of illicit fuel in Hong Kong. The ETWB considers that, so long as the situation regarding the use of illicit fuel remains under effective control, there appears to be no strong environmental grounds for further reducing the concessions.

7.13 In addition, the C&ED has assured Audit that the problem of illicit transfers is not serious and is under control. The C&ED has informed Audit that:

- (a) the Government has put in sustained efforts to combat the illicit transfers of Mainland diesel; and
- (b) the C&ED believes that the problem of transferring diesel to other vehicles has died down as a result of legislative amendments and enforcement actions (see para. 6.6 above). This belief is supported by intelligence reports, the small quantities of Mainland diesel seized (Note 34), and the fact that the consumption of duty-paid diesel has remained stable despite a switch by taxis to using liquefied petroleum gas from diesel (Note 35).

Audit observations on the risks of illicit transfers

7.14 Audit notes that the ETWB's main concern, in considering whether or not to reduce the duty-free concessions, is the risks of illicit transfers of Mainland diesel from cross-boundary vehicles to local vehicles. Audit also notes the C&ED's assurance that the problem of illicit transfers of Mainland diesel is under control. **However, Audit considers that the risks of illicit transfers will remain, as long as the estimated quantity brought into Hong Kong by cross-boundary vehicles (i.e. 679 million litres a year) far exceeds their operational needs (i.e. 236 million litres a year).**

7.15 In this connection, Audit notes that there has been a drop in the number of vehicles selected for road-side checking by the C&ED in 2002. In the first six months of 2002, the C&ED had selected 1,190 vehicles for road-side checking. This represented a decrease of 33%, compared with 1,779 vehicles checked in the same period of 2001. **As road-side checking is an effective means of detecting and deterring the illicit transfers of Mainland diesel, Audit considers it necessary for the C&ED to increase its efforts on such checking.** (Photograph 8 on the centre pages shows customs officers conducting road-side checking.)

Note 34: *According to the C&ED, of the 263,000 litres of light diesel seized in 2001, only 3,388 litres (or 1.3%) contained sulphur content in excess of the prescribed standard of 0.035%, which suggests that they were sourced from the Mainland. The C&ED also advised that it had not found any illicit transfer of fuel by cross-boundary vehicles throughout 2001.*

Note 35: *According to the C&ED, the quantity of duty-paid diesel increased from 684 million litres in 1999, by 10%, to 754 million litres in 2000. In 2001, the quantity of duty-paid diesel was 747 million litres, representing a small decrease of 0.9% compared with 2000, despite the switching of some 10,000 taxis to using liquefied petroleum gas. These figures reflect the good progress in curbing revenue loss from illicit fuel activities.*

Audit recommendations on minimising the risks of illicit transfers

7.16 **Audit has recommended that the Commissioner of Customs and Excise should:**

- (a) **closely monitor the problem of illicit transfers of Mainland diesel and make sustained enforcement efforts to prevent a possible resurgence of the problem; and**
- (b) **in particular, consider the need to increase customs efforts on road-side checking of vehicles, so as to increase the chance of detecting the illicit transfers of Mainland diesel and to deter such activities.**

Response from the Administration

7.17 The **Commissioner of Customs and Excise** agrees with the audit recommendations. He has said that:

- (a) the C&ED will closely monitor the situation and make sustained enforcement efforts to prevent a possible resurgence of the problem of illicit transfers of Mainland diesel; and
- (b) as the problem of illicit transfers has died down, the C&ED has flexibly redeployed its resources to combat other illicit fuel activities. Nevertheless, the C&ED will closely monitor the situation and will consider increasing customs efforts on road-side checking when the situation warrants.

7.18 The **Secretary for the Environment, Transport and Works** has said that:

- (a) she will continue to monitor closely the effectiveness of the C&ED's enforcement actions against the illicit transfers of Mainland diesel; and
- (b) she will consider the need for reducing the duty-free concessions on environmental grounds, in the light of the effectiveness of the enforcement actions.

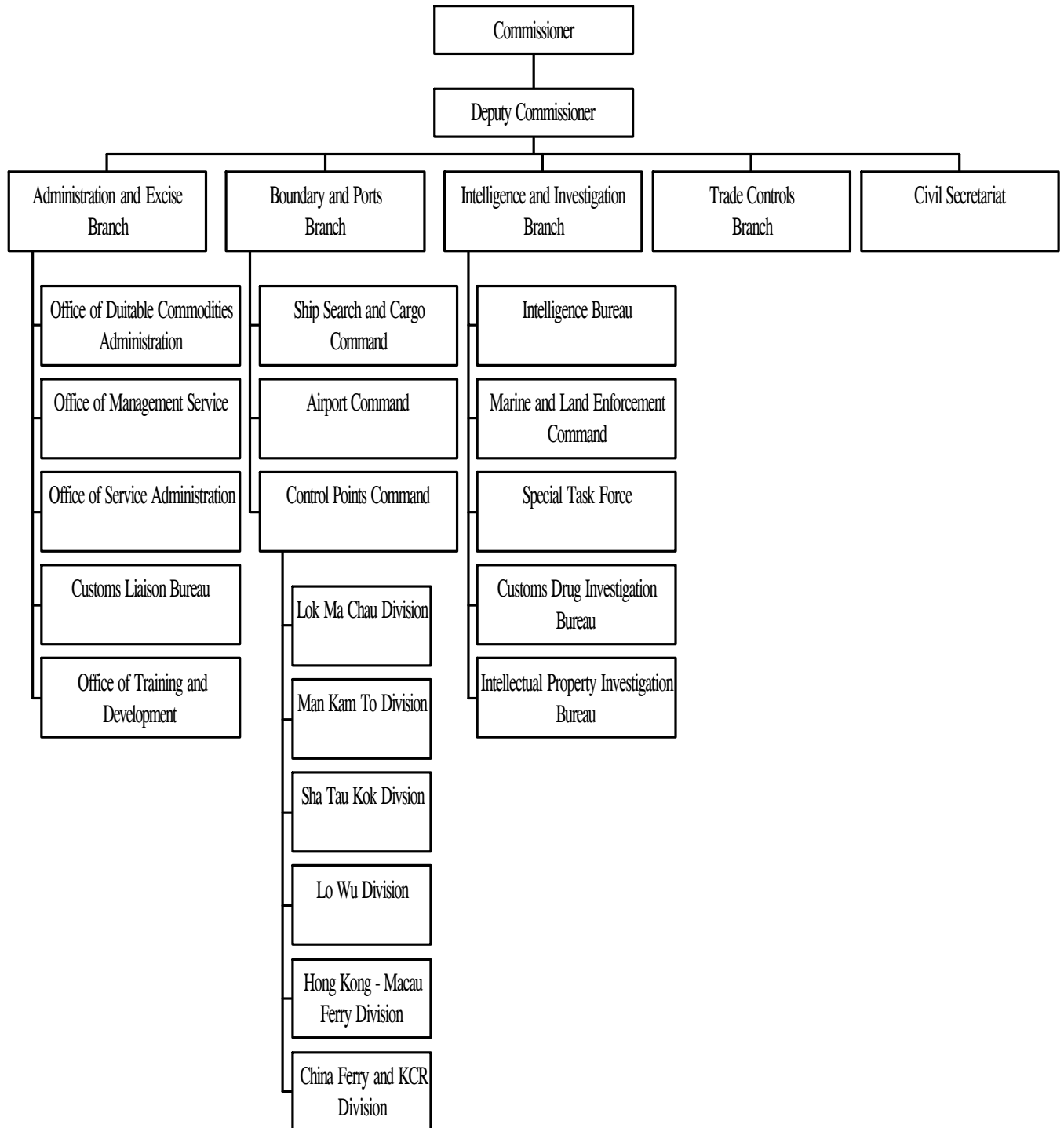
Duty rates on tobacco and hydrocarbon oil from 1997 onwards

Tobacco	Effective date		
	12.3.1997	18.2.1998	7.3.2001
Cigarettes (\$ per 1,000)	\$723	\$766	\$804
Cigar (\$ per kg)	\$930	\$986	\$1,035
Chinese prepared tobacco (\$ per kg)	\$177	\$188	\$197
Other manufactured tobacco (\$ per kg)	\$875	\$928	\$974

Hydrocarbon oil	Effective date						
	12.3.1997	20.6.1997	18.2.1998	3.4.1998	23.6.1998	7.7.2000	1.1.2001
(\$ per litre)							
Aircraft spirit	\$6.14	\$6.14	\$6.51	\$6.51	\$6.51	\$6.51	\$6.51
Motor spirit (leaded)	\$6.82	\$6.82	\$7.23	\$6.82	\$6.82	\$6.82	\$6.82
Motor spirit (unleaded)	\$6.06	\$6.06	\$6.42	\$6.06	\$6.06	\$6.06	\$6.06
Light diesel	\$3.06	\$2.89	\$3.06	\$2.89	\$2.00	\$2.00	\$2.89
Ultra low sulphur diesel	—	—	—	—	—	\$1.11	\$1.11

Source: C&ED's records

Organisation chart of the C&ED as at July 2002



Source: C&ED's records

**C&ED's major tasks
 for the implementation of the OBS**

Major tasks	Position as at end of July 2002 (Target completion month)
1. Revision of licence and permit conditions to cope with the OBS	Completed
2. Commissioning of industry awareness programmes	Completed
3. Preparation of the Warehouse Guides to cope with the OBS	In progress (Final draft completed, but awaiting C&ED management's approval)
4. Enhancement to the Customs Control System (CCS — Note 1) to cope with the OBS	System testing in progress (November 2002)
5. Establishment of the Excise Compliance and Audit Division for the OBS	Departmental Establishment Committee papers under preparation (December 2002)
6. Revision of relevant C&ED Standing Procedures	In progress (December 2002)
7. Revision of the Excise Control Division Work Manuals	In progress (December 2002)
8. Revision of relevant C&ED forms	In progress (October 2002)
9. Commissioning of in-house training for C&ED officers	Not yet commenced (Note 2)

Source: C&ED's records

Note 1: The CCS is a computer system to record the movement and the up-to-date inventory of DCs in each warehouse.

Note 2: In-house training will start upon the passing of the legislative amendment (see para. 2.13 of the report).

Appendix D
(para. 3.10 refers)

**Analysis of the sales transactions observed by Audit staff
at the duty-free shops on Hong Kong side (in June and July 2002)**

Date	60 cigarettes per transaction	80 cigarettes per transaction	100 cigarettes per transaction	120 cigarettes per transaction	200 cigarettes per transaction	300 cigarettes per transaction	Total number of transactions
A. Transactions observed before 5 July 2002 (concession: 100 cigarettes)							
01/6/02			3		1		4
08/6/02			15		3		18
09/6/02			3				3
13/6/02			3		4		7
14/6/02			6		4		10
15/6/02			6				6
19/6/02			9				9
22/6/02			4		2		6
28/6/02			8		1		9
Subtotal			57		15		72
B. Transactions observed on or after 5 July 2002 (concession: 60 cigarettes)							
05/7/02	5		1				6
06/7/02	3						3
07/7/02	2				1		3
11/7/02	4		2				6
14/7/02	2		2			1	5
20/7/02	2				1		3
21/7/02		1		1			2
Subtotal	18	1	5	1	2	1	28
Total	18	1	62	1	17	1	100

Source: Transactions observed by Audit staff during visits in June and July 2002

**Audit observations in June and July 2002
on travellers intercepted for customs checking**

Date	Day	Duration of Audit observation			No. of travellers passed the customs counters	No. of travellers intercepted for customs check	% of travellers intercepted for customs check
		Start time	End time	Time in minutes			
01/6/02	Saturday	1:25 p.m.	1:50 p.m.	25	1,786	2	0.11 %
08/6/02	Saturday	4:20 p.m.	4:50 p.m.	30	1,004	12	1.20 %
08/6/02	Saturday	5:05 p.m.	5:20 p.m.	15	1,783	1	0.06 %
08/6/02	Saturday	5:25 p.m.	5:50 p.m.	25	446	8	1.79 %
08/6/02	Saturday	6:30 p.m.	6:45 p.m.	15	802	4	0.50 %
09/6/02*	Sunday	1:54 p.m.	2:16 p.m.	22	546	3	0.55 %
13/6/02	Thursday	6:13 p.m.	6:28 p.m.	15	488	16	3.28 %
14/6/02	Friday	9:25 a.m.	9:40 a.m.	15	1,725	6	0.35 %
14/6/02	Friday	6:25 p.m.	6:55 p.m.	30	1,991	30	1.51 %
14/6/02	Friday	7:16 p.m.	7:46 p.m.	30	1,820	30	1.65 %
14/6/02	Friday	7:53 p.m.	8:10 p.m.	17	884	4	0.45 %
15/6/02*	Saturday	3:25 p.m.	3:50 p.m.	25	1,719	5	0.29 %
19/6/02	Wednesday	3:10 p.m.	3:50 p.m.	40	1,549	7	0.45 %
19/6/02	Wednesday	3:59 p.m.	4:30 p.m.	31	2,024	8	0.40 %
22/6/02	Saturday	1:15 p.m.	1:30 p.m.	15	1,212	12	0.99 %
22/6/02	Saturday	1:35 p.m.	2:05 p.m.	30	1,043	8	0.77 %
28/6/02	Friday	5:40 p.m.	6:05 p.m.	25	600	12	2.00 %
28/6/02	Friday	6:10 p.m.	6:25 p.m.	15	350	9	2.57 %
28/6/02	Friday	6:25 p.m.	6:55 p.m.	30	1,652	27	1.63 %
28/6/02	Friday	7:05 p.m.	7:25 p.m.	20	1,528	9	0.59 %
05/7/02	Friday	6:05 p.m.	6:35 p.m.	30	1,078	10	0.93 %
05/7/02	Friday	6:42 p.m.	6:57 p.m.	15	977	10	1.02 %
06/7/02	Saturday	6:40 p.m.	7:10 p.m.	30	1,880	20	1.06 %
11/7/02	Thursday	6:55 p.m.	7:15 p.m.	20	1,262	12	0.95 %
14/7/02*	Sunday	5:04 p.m.	5:34 p.m.	30	1,477	15	1.02 %
20/7/02	Saturday	7:00 p.m.	7:30 p.m.	30	3,331	29	0.87 %
21/7/02*	Sunday	3:12 p.m.	3:42 p.m.	30	1,463	13	0.89 %
				Total:	<u>36,420</u>	<u>322</u>	0.88%

* General holiday

Source: Observed by Audit staff during their visits in June and July 2002

**Audit observations in June and July 2002
on travellers who abused the duty-free concession**

Traveller	Date	Time passing through the customs examination counter	Quantity of cigarettes
1	01/6/02	1:20 p.m.	200
2	08/6/02	2:05 p.m.	More than 200
3	08/6/02	3:55 p.m.	More than 200
4	08/6/02	4:15 p.m.	200
5	08/6/02	5:10 p.m.	200
6	08/6/02	5:12 p.m.	800
7	08/6/02	5:15 p.m.	200
8	08/6/02	6:12 p.m.	200
9	09/6/02	12:42 p.m.	200
10	13/6/02	6:04 p.m.	200
11	13/6/02	6:10 p.m.	400
12	14/6/02	9:20 a.m.	400
13	14/6/02	6:17 p.m.	260
14	14/6/02	6:50 p.m.	300
15	14/6/02	7:08 p.m.	200
16	15/6/02	3:13 p.m.	200
17	19/6/02	3:05 p.m.	140
18	19/6/02	3:07 p.m.	200
19	19/6/02	3:45 p.m.	200
20	22/6/02	1:08 p.m.	200
21	22/6/02	1:10 p.m.	200
22	28/6/02	5:35 p.m.	200
23	28/6/02	5:35 p.m.	200
24	28/6/02	6:15 p.m.	200
25	28/6/02	6:18 p.m.	200
26	05/7/02	5:55 p.m.	100
27	11/7/02	6:38 p.m.	100
28	11/7/02	6:50 p.m.	100
29	14/7/02	4:50 p.m.	120
30	14/7/02	5:00 p.m.	300
31	20/7/02	6:52 p.m.	120
32	21/7/02	3:10 p.m.	100

Source: Observed by Audit staff during their visits in June and July in 2002

- Note:*
- (1) The observations above include travellers who purchased cigarettes from duty-free shops on both the Hong Kong side and the Mainland side.*
 - (2) All the above passengers used Hong Kong Identity Card and travelled alone. They were not intercepted for customs checking at the customs examination counters.*

Appendix G
(para. 6.6(b) refers)

Performance data of the C&ED in combating illicit oil activities

	Year 2000		Year 2001	
	Quantity	No. of cases	Quantity	No. of cases
	('000 litres)		('000 litres)	
Marked oil seized	3,248	503	820	176
Detreated marked oil seized	768	369	313	113
Light diesel seized	329	251	263	286
Petrol seized	185	319	231	351
Illegal detreating plants smashed	530	38	342	31
Illegal filling stations neutralised	—	598	—	487
Black spots for illicit fuel activities	—	110	—	35
Vehicles found using illicit fuel	—	508	—	365

Source: C&ED's records

Appendix H
(para. 6.27 refers)

**Performance indicators on combating illegal vehicle refuelling activities
(published by the C&ED through various channels)**

Performance indicators	COR (2002-03)	C&ED's Annual Review Report (2001)	C&ED's website (as at July 2002)
(a) Number of cases detected	✓	✓	✓
(b) Quantity of illicit fuel seized	✓	✓	✓
(c) Number of illegal detreating plants smashed		✓	
(d) Number of illegal filling stations neutralised		✓	✓
(e) Number of black spots for illicit fuel		✓	✓
(f) Number of cases with driving licence disqualified		✓	✓

ETWB's estimation of potential environmental benefits brought by reducing the duty-free diesel concessions for cross-boundary vehicles

1. Given that the common destinations of the cross-boundary vehicles in Hong Kong are about 30 to 55 km from the three border crossing points and internal freight movements are handled by local goods vehicles, the ETWB has estimated that a cross-boundary vehicle will require diesel of about 1/6 of the fuel tank size to complete a round-trip in Hong Kong before crossing over to the Mainland again without refuelling. The estimation is as follows:

Cylinder capacity of vehicle	Estimated fuel consumption rate	Amount of fuel required to complete a round-trip in Hong Kong (Note)	Amount of fuel required in terms of fraction of the fuel tank size
	(litre/km)	(litre)	
Below 3,000 c.c.	0.14	15	1/9
3,000 – 10,000 c.c.	0.33	36	1/7
Above 10,000 c.c.	0.63	69	1/6

Note: The calculations are based on a round-trip journey of 110 km, which is corresponding to a distance that doubles the furthest distance between the common destinations and the three crossing points.

2. A control scheme will not, therefore, bring about any genuine environmental gains if the duty-exempt limit is set above 1/6 of the fuel tank size.

3. In practice, drivers of cross-boundary vehicles will top up the fuel tank in Hong Kong only where necessary and sufficient for the onward journey back to the Mainland due to the price differential between Hong Kong and the Mainland. So any environmental benefits should be calculated on the amount of clean fuel to be consumed in Hong Kong, i.e. the difference between the duty-exempt limit set and the actual amount of fuel required to make the trip back to the Mainland.

4. For illustration purpose, if the duty-exempt limit is set at 1/10 of the fuel tank size, a vehicle will need to refuel about 1/15 (i.e. the difference between 1/6 and 1/10) of the fuel tank in Hong Kong in order to complete a round-trip journey before re-entering the Mainland. In that case, 40% of the fuel consumed in Hong Kong will be the cleaner ULSD. On a pro rata basis, the potential environmental benefits that can be brought by the control scheme will be 0.8% to 1.6% reduction of particulate emissions and 0.2% to 0.4% of nitrogen oxide emissions from the whole vehicle fleet in Hong Kong (i.e. 40% of the reductions that can be brought by the best case scenario where no Mainland diesel is allowed to be brought into Hong Kong).

Acronyms and abbreviations

AICTF	Anti-Illicit-Cigarette Task Force
CCS	Customs Control System
C&ED	Customs and Excise Department
COR	Controlling Officer's Report
DC	Dutiable commodity
DCO	Dutiable Commodities Ordinance
DP	Duty-paid permit
EP	Export permit
EPD	Environmental Protection Department
ETWB	Environment, Transport and Works Bureau
FSD	Fire Services Department
FSTB	Financial Services and the Treasury Bureau
GBW	General bonded warehouse
HVC	Home Visit Card
HVP	Home Visit Permit
ICAC	Independent Commission Against Corruption
km	Kilometres
LegCo	Legislative Council
LW	Licensed warehouse
MIS	Management information system
OBS	Open bond system
PAC	Public Accounts Committee
PAN	Pre-arrival Notice
PBW	Public bonded warehouse
PDPO	Personal Data (Privacy) Ordinance
RP	Removal permit
RTCVPFS	River Trade Cargo Vessel Port Formality System
RTV	River trade vessel
SBA	System-based approach
SMS	Synthetic motor spirit
UK	United Kingdom
ULSD	Ultra low sulphur diesel