

The Auditor-General
Audit Report No.33 2005–06
Performance Audit

**Administration of Petroleum and Tobacco
Excise Collections:
Follow-up Audit**

Australian Taxation Office

Australian National Audit Office

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of Australia 2006

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Canberra ACT
2 March 2006

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Australian Taxation Office in accordance with the authority contained in the *Auditor-General Act 1997*. I present the report of this audit and the accompanying brochure to the Parliament. The report is titled *Administration of Petroleum and Tobacco Excise Collections: Follow-up Audit*.

Following its tabling in Parliament, the report will be placed on the Australian National Audit Office's Homepage—<http://www.anao.gov.au>.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian McPhee', is positioned above the printed name.

Ian McPhee
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

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Abbreviations

ANAO	Australian National Audit Office
ASIS	Australian Special Information Systems
ATO	Australian Taxation Office
Customs	Australian Customs Service
ECS	Excise Collections System
Excise BL	Excise Business Line
GST	Goods and Services Tax
HOTSA	Health of the System Assessment
SNC BL	Serious Non-Compliance Business Line

Summary and Recommendations

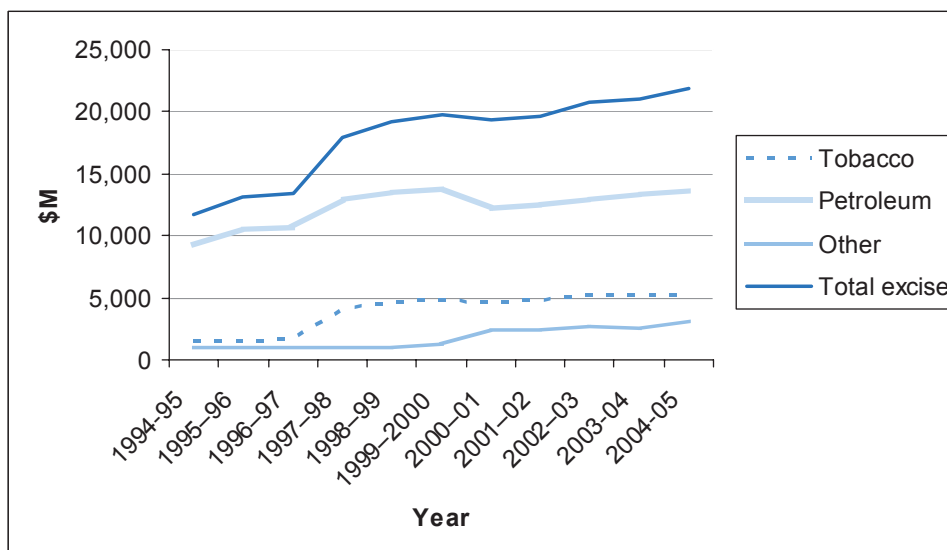
Summary

Background

1. Excise duty is levied on certain excisable goods manufactured or produced in Australia. Commodities subject to excise include petroleum, tobacco, alcohol (excluding wine) and crude oil. Excise duty rates for tobacco are increased biannually in line with movements in the consumer price index; however since 2001 indexation provisions have not applied to refined petroleum products, excluding oils and grease.
2. The Excise Business Line is the division within the Australian Taxation Office (ATO) that administers commodity-based revenue and business payment systems. The Excise Business Line has three key functions: collecting excise; paying certain grants and rebates; and regulating aspects of the industries from which excise is collected. In June 2005 the Excise Business Line employed 425 staff.
3. Under the principle of self-assessment, the calculation of excise duty is the responsibility of the manufacturer or dealer in excisable goods. The ATO provides advice and assistance to producers, manufacturers and dealers to calculate and meet their excise obligations. In 2004–05 the ATO collected \$21 888 million as excise revenue, accounting for 10 per cent of total revenue collections. Of this, \$13 608 million was for petroleum excise, \$5 220 million was for tobacco excise, and the remainder was for beer, spirits, and crude oil. Figure 1 shows the amounts of excise collected from 1994–95 to 2004–05.

Figure 1

Excise collections 1994–95 to 2004–05



Note: An excise surcharge on tobacco and petroleum was introduced in 1997 to replace various state business franchise fees. Surcharges were no longer payable following the introduction of GST. Excise collections for 2000–01 include some surcharge payments for clearances made in June 2000.

Source: ANAO analysis of information from Taxation Statistics.

4. During 2001–02 the Australian National Audit Office (ANAO) completed two separate audits of excise collection: one of petroleum excise and the other of tobacco excise. The audits followed the transfer of the excise function to the ATO from the Australian Customs Service in 1999. Overall, the ANAO concluded that the ATO was implementing effective administrative arrangements for collecting petroleum and tobacco excise. The ANAO also found that there was scope for the ATO to improve its administration of excise in the areas of supporting business systems, risk management and governance.

Audit objective

5. The objective of this follow-up audit was to examine the ATO’s implementation of the 20 recommendations in:

- *The Administration of Petroleum Excise Collections* (Audit Report No.17, 2001–02); and
- *The Administration of Tobacco Excise* (Audit Report No. 55, 2001–02),

having regard to any changed circumstances, or new administrative issues, affecting implementation of those recommendations. The audit also aimed to identify scope for improvement in the ATO's administration of petroleum and tobacco excise.

6. Follow-up audits are recognised as an important element of the accountability processes of Commonwealth administration. The Parliament looks to the Auditor-General to report, from time to time, on the extent to which Commonwealth agencies have implemented recommendations of previous audit reports. Follow-up audits keep the Parliament informed of progressive improvements and current challenges in areas of Commonwealth administration that have previously been subject to scrutiny through performance audits.

Conclusion and key findings

7. The ANAO concluded that the ATO had made good progress towards implementing the reports' recommendations. Seventeen of the reports' 20 recommendations have been fully implemented, and the remaining three have been substantially implemented. The ANAO noted that the ATO is finalising implementation of the three outstanding recommendations. Table 2 on page 14 presents a summary of the ANAO's assessment of the ATO's implementation of the reports' recommendations.

8. The ANAO identified several key issues relating to the ATO's administration of petroleum and tobacco excise. These concerned the need to review the memorandum of understanding between the ATO and the Department of the Environment and Heritage; the diversion of significant quantities of tobacco into the illegal market; the apparent involvement of criminal elements in the illegal tobacco market; the effectiveness of tobacco licensing as a compliance tool; the need for improvements in the Excise Collections System; and the development of a strategy directed at the consumers of illegal tobacco. The ANAO made three recommendations to achieve improved excise administration.

Petroleum excise administration

A memorandum of understanding between the ATO and the Department of the Environment and Heritage

9. Following passage of the *Fuel Quality Standards Act 2000* the Department of the Environment and Heritage assumed full responsibility for

fuel quality testing. In April 2005 the report of the independent statutory review of the *Fuel Quality Standards Act 2000* was tabled in Parliament. This report identified the need for a range of legislative and administrative improvements. The Department of the Environment and Heritage is responsible for advising the Government about the recommendations of the report.

10. The occurrence of a fuel quality incident may have implications for excise administration; conversely, the ATO's Excise Business Line may have information (of a non-taxation nature) that could help the Department of the Environment and Heritage administer the *Fuel Quality Standards Act 2000*. The ANAO considers that the ATO and the Department of the Environment and Heritage should review the current memorandum of understanding between the two agencies to improve their sharing of relevant information. Any exchange of information between the agencies would need to take place within the boundaries of the privacy and secrecy legislation governing how the two agencies collect and handle sensitive information.

Tobacco excise administration

Continued diversion of significant quantities of tobacco into the illegal market

11. The ATO's Compliance Program for 2005–06 identifies illegal tobacco operations as a key priority in the area of evasion and serious fraud. The ANAO concurs with the ATO that the risk of illegal tobacco operations is currently severe. A finding of this audit is that there are reasonable grounds to conclude that each year substantial quantities of tobacco continue to be diverted into the illegal market from Australia's tobacco plantations. Data limitations mean it is not possible to state accurately the precise amount of tobacco that is diverted each year.

12. Table 1 details the ATO's estimates of the quantities of tobacco grown, diverted to the illegal market, and seized by the ATO. The ANAO recognises that there is a range of uncertainties inherent in the ATO's estimates of the quantities of tobacco legally grown and illegally diverted. As a result of these uncertainties, the ATO is reluctant to use these estimates to evaluate the impact of its compliance activities on the illegal tobacco market.¹ The ANAO considers

¹ Except for the quantity of tobacco seized, the quantities are estimates only. These estimates are based on assumptions about the area of plantations harvested, the probable yield from those areas and a range of intelligence appraisals about quantities of tobacco that might have been diverted.

that it is important for the ATO to be able to evaluate the effectiveness of its compliance activities. In this light, the ANAO considers that the ATO could develop a suite of indicators, including qualitative ones, that, in conjunction with the quantitative estimates, would give a good guide to the effectiveness of the ATO's compliance strategies for illegal tobacco operations.

Table 1

Estimates of the quantities of tobacco grown, diverted to the illegal market, and seized by the ATO

	2000–01	2001–02	2002–03	2003–04	2004–05
Legally grown tobacco (kgs)	na	4 068 180	3 808 148	3 496 505	3 598 880
Estimate of diverted tobacco (kgs) ^{a, b}	na	243 000	295 000	313 000	347 000
Total seized illegal tobacco (cut and leaf) (kg) ^c	129 554	33 637	59 525	68 205	22 444

Note a: There are a range of uncertainties inherent in these estimates. Data limitations mean that it is not possible to accurately state the amount of tobacco diverted each year.

Note b: Estimates of the quantity of diverted tobacco are rounded to the nearest 1 000 kg.

Note c: The ATO advises that the decrease in the amount of tobacco seized from 2003–04 is attributable to the closure of tobacco plantations in north Queensland in 2003–04.

Source: ATO

Criminality in the illegal tobacco market

13. ATO research suggests that the profit takers, or organisers, in the illegal tobacco market are criminals actively involved in other forms of criminality such as drugs, money laundering, identity fraud, and car rebirthing as well as tobacco smuggling. ATO research shows that this type of highly organised involvement in the illegal tobacco market has intensified over the past three years. This is evidenced by, amongst other things, a degree of 'vertical integration' by, for example, criminal groups having an associate obtain a licence to grow tobacco.

14. The consequences of this criminal behaviour are serious. They include an adverse impact on the integrity of the taxation system as well as on the rule of law generally. The linchpin in the illegal tobacco market is the collection of groups that purchase illegal tobacco from farmers, process it into a form suitable for sale and distribute the manufactured product to retailers who sell it illegally.

15. During the audit, the ATO initiated multi-agency approaches, involving state and federal agencies, focussing strategically on the whole of the

illegal production and distribution chains. The ATO is also applying a whole-of-ATO approach to the tax affairs of people and entities identified through this operation.

Improving the effectiveness of tobacco licensing as a compliance tool

16. The ANAO found that since the previous audit, there has been an increased focus on using licensing as a compliance management tool. In 2001, the Excise Business Line decentralised the licensing function to the Industry Groups. As a result, the Fuel and Energy and Tobacco Industry Groups established dedicated licensing functions specific to their industries. The ANAO considers that developing a licensing framework will provide greater consistency across the Industry Groups when dealing with and developing excise licensing policy and strategies, and cross-promote efficiencies between the Industry Groups.

Need for improvement to the Excise Collection System

17. Audit Report No.55 of 2001–02 noted that the ATO used the Australian Customs Service's Licensing and Permissions System to administer excise collections, however it intended to develop its own Excise Collections System. In 2005 the ATO undertook a post implementation review of the new system. The report of this review found a significant budget overrun against the original business case. The review also found that the system deployment ran significantly over schedule, and did not include all of the original functionality. The ANAO found that this system could be improved in some important areas, however, the ATO intends to replace it by January 2008 as part of the *Easier, cheaper and more personalised program*.

Scope for the development of a strategy directed at the consumers of illegal tobacco

18. The Australian Institute of Health and Welfare estimates there are currently 290 000 Australian smokers who occasionally or regularly use illegal tobacco.² The Department of Health and Ageing advise that the proportion of smokers in Australia who use illegal tobacco is estimated to be fairly small. Unpublished data from the 2003 National Tobacco Campaign Evaluation Survey estimated that less than 5 per cent of smokers/recent quitters smoke illegal tobacco. Anecdotal evidence indicates that many consumers purchase

² One in five smokers in Australia has acknowledged awareness of illegal tobacco. Of them, 60 per cent admit to having smoked it. Australian Institute of Health and Welfare 2002, *2001 National Drug Strategy Household Survey Detailed Findings*, AIHW, Canberra.

illegal tobacco because it is cheaper than legal tobacco and/or because they believe it is 'natural', unadulterated and therefore a less harmful product than legal tobacco.³ The ANAO understands that a 100 gram pouch of illegal tobacco costs approximately \$13, whereas the equivalent amount of legal tobacco costs approximately \$36.

19. Expert advice commissioned by the Department of Health and Ageing showed that illegal tobacco grown in Australia presents serious additional health risks to those of legal tobacco, as it typically contains a number of contaminants.⁴ Illegal tobacco is often wet, sometimes to the extent that excess water has to be poured off. Twigs and pulp from raw cotton, hay, cabbage leaves and grass clippings are some of the vegetable matter that may be added to illegal tobacco in order to bulk up the weight for sale. The research reported a dense volume of fungal contamination in the samples examined. The illnesses caused by the fungal agents may range from allergic reactions, chronic bronchitis, asthma, aspergillosis, alveolitis, pneumonitis and lung cancer to Legionnaire's disease.

20. ATO compliance activity is currently directed at the supply side of the illegal tobacco market as consumers may not breach any law by purchasing illegal tobacco. Currently there are no initiatives directed at the demand side, with the exception of a fact sheet published by the Department of Health and Ageing. The ANAO considers that the ATO should engage with the Department of Health and Ageing so that a strategy directed at consumers of illegal tobacco might be developed. A targeted health education campaign directed at current and potential consumers of illegal tobacco may be warranted. Amongst other things, such a campaign could reduce the demand for illegal tobacco. Department of Health and Ageing advised that the underlying principle upon which the Australian Government's current tobacco control policy is based is '*there is no such thing as a safe cigarette*'. The ANAO notes that the goal of the National Tobacco Strategy 2004–2009 is '*to significantly improve health and to reduce the social costs caused by, and the inequity exacerbated by, tobacco in all its forms*' and that this includes illegal tobacco.

³ Bittoun, R 2002, 'Chop-chop' tobacco smoking', *Medical Journal of Australia*, 177, 686–687.

⁴ Bittoun, R. *The Medical Consequences of Smoking 'Chop-Chop'*, Discussion paper prepared for the Commonwealth Department of Health and Ageing, December 2004.

Table 2

Summary of the ANAO’s assessment of the ATO’s implementation of the recommendations

Fully implemented	Substantially completed	Partially implemented	Limited progress	No progress
●	◐	◑	◒	○

No.	Topic of recommendation	ANAO assessment	Paragraph Reference
Petroleum			
1	Review excise risk register	●	3.2
2	Finalise memorandum of understanding with Customs	●	4.24
3	Develop petroleum licensing manual	●	4.10
4	Review excise licensing systems and processes	●	2.3
5	Implement an excise active compliance case management system	◑	2.16
6	Implement an excise investigations case management system	●	2.21
7	Implement comprehensive reporting on strategic/operational issues	●	4.42
8	Strengthen revenue collection controls with Customs	●	4.22
9	Quantify petroleum revenue trend factors	●	3.4
10	Excise fuel substitution strategy	●	3.6
11	Assess excise fuel substitution activities	●	3.10
12	Formalise fuel quality standards arrangements with Environment Australia	◑	4.26
Tobacco			
1	Tobacco Industry Group Business Plan: Articulate strategies, assess performance	●	4.12
2	Ensure compliance with legislation	●	3.15
3	Intelligence sharing with the Department of the Health and Ageing and other agencies	●	3.15
4	Excise intelligence capability: ensure staff skills are adequate	◑	3.45
5	Ensure excise intelligence systems meet business needs	●	2.27
6	Intelligence sharing with retailers, Customs, Australian Federal Police, and Road Transport Authorities	●	4.34
7	Finalise memorandum of understanding with Customs	●	4.24
8	Clarify roles of the Tobacco Industry Group and Investigations.	●	4.44

ATO Response

21. The Report recognises the ongoing challenges in the administration of excise with particular regard to those operating outside the system. The ATO appreciates that the report positively acknowledges the advances made in relation to improved intelligence systems, the establishment of the Serious Non Compliance Business Line to develop strategies around serious fraud and evasion and a shift to working across agencies in the administration of various acts and in investigating and tracing networks involved in illicit markets.
22. The report confirms 17 of the 20 recommendations from two earlier audits *The Administration of Petroleum Excise Collections* (Audit Report No.17, 2001–02) and *The Administration of Tobacco Excise* (Audit Report No.55, 2001–02) have been completed and that progress of the three remaining is well progressed.
23. The report recommendations give guidance with respect to improvement in strategies. The ATO has agreed to these recommendations and has proceeded with implementation.
24. The ATO's full response is provided in Appendix 1 of the Audit Report.

Recommendations

Set out below are the ANAO's recommendations aimed at improving the ATO's administration of excise collection. Report paragraphs references and the abbreviated ATO responses are also included. More detailed responses are shown in the body of the report. The ANAO considers that the implementation of each of the three recommendations is of equal priority.

Recommendation No.1
Para 3.41

The ANAO recommends that to help address demand for illegal tobacco, the ATO provide the Department of Health and Ageing with the relevant information to assist that Department review the scope for strategies directed at consumers.

ATO response: Agreed.

Recommendation No.2
Para 4.18

The ANAO recommends that to improve management reporting and decision-making, the internal management reports about excise administration be enhanced through increased use of measures of effectiveness to report performance, targets and progress against targets.

ATO response: Agreed.

Recommendation No.3
Para 4.32

The ANAO recommends that, having regard to the *Fuel Quality Standards Act 2000* and the role of the Department of the Environment and Heritage in administering that Act, the ATO review the memorandum of understanding between the two agencies to improve their sharing of relevant information.

ATO response: Agreed.

Audit Findings and Conclusions

1. Background and Context

This Chapter provides an overview of petroleum and tobacco excise in Australia, and the Australian Taxation Office's administration of excise collections. It discusses the findings of the previous Australian National Audit Office audits, and lists recent developments in excise administration. It also outlines the audit objectives and methodology.

Petroleum and tobacco excise in Australia

1.1 Excise duty is levied on excisable goods manufactured or produced in Australia.⁵ Commodities subject to excise include petroleum, tobacco, alcohol (excluding wine) and crude oil. Excise duty rates for tobacco are increased biannually in line with movements in the consumer price index. Since 2001 indexation provisions have not applied to refined petroleum products, excluding oils and grease. To determine the duty payable on excisable goods, the excise tariff rate is multiplied by the dutiable quantity. For petroleum, dutiable quantities are measured per litre, kilolitre, or kilogram. For tobacco products containing 0.8 grams of tobacco or less (for example, cigarettes and cigars), excise duty is calculated on a per-stick rate. The excise duty applied to other tobacco and cigars or cigarettes exceeding 0.8 grams is calculated per kilogram.

1.2 Table 1.1 breaks down the retail cost of petrol and cigarettes. It illustrates that the excise component of petrol accounts for approximately 34 per cent of the final cost to the consumer, and the excise component of a cigarette accounts for approximately 55 per cent.

⁵ The *Excise Act 1901* Section 4 (1) defines excisable goods as *goods in respect of which excise duty is imposed by the Parliament*. The *Excise Tariff Act 1921* imposes excise duty on certain types of goods produced or manufactured in Australia. The *Customs Tariff Act 1995* applies customs duty (equivalent to excise duty) to imported goods that would be subject to excise if manufactured domestically.

Table 1.1**Breakdown of the retail costs of petrol and cigarettes**

Excisable good	Approximate % of the final cost to the consumer			
	Excise	GST	Company/Retail	Manufacturer/Refinery
Petrol ^a	34	10	7	50
Cigarette ^b	55	10	13	22

Note a: Using average Sydney unleaded petrol price of 111 cents per litre (at April 2005). Numbers may not add to 100 due to rounding.

Note b: Based on a packet of 25 cigarettes costing RRP \$10.30 (at March 2005). The Excise rate at the time was 22.621 cents per stick.

Source: ATO

1.3 Through over 5 000 service stations, Australian refineries supply approximately 90 per cent of Australia's petroleum products. The price of refined petroleum products is largely determined by prices in the Asia-Pacific region. Therefore, the profitability of the Australian industry is largely determined by refining margins in Asia.⁶ Four major refiner-marketer companies (BP, Shell, Mobil, and Caltex) pay approximately 93 per cent of petroleum excise revenue. In addition, a number of small businesses store, produce and manufacture petroleum products for niche markets. The petroleum retail sector is currently undergoing significant change, as the supermarket chains have implemented discount schemes, and entered the retail market through commercial alliances.

1.4 Since the 1960s, the demand for tobacco leaf in Australia has declined significantly. This has been attributed to the 1995 industry deregulation, international price competition, and contraction of demand for the final product.⁷ As a result, there are now only two tobacco leaf buyers (manufacturers) in Australia, and tobacco leaf production only occurs in northeast Victoria (approximately 120 growers), and south Queensland (approximately six growers).⁸ The Tobacco Co-operative of Victoria Limited represents tobacco growers in Victoria.

⁶ See *Understanding petrol pricing in Australia* <www.accc.gov.au> for further information on petrol prices.

⁷ Domestic tobacco producers supply approximately 40 per cent of the tobacco manufactured in Australia. The Australian tobacco industry accounts for approximately two tenths of one per cent of the world's tobacco. Major producers are China, Brazil, India and the United States. In addition to significantly larger numbers of growers (for example, Brazil has approximately 30 000 tobacco growers), tobacco is cheaper on the international market. This makes export of Australian tobacco uneconomic.

⁸ At the time of the previous audits, tobacco was also grown in north Queensland.

Excise administration

1.5 Machinery of Government changes in November 1998 transferred administrative responsibility for the excise function to the Australian Taxation Office (ATO) from the Australian Customs Service (Customs). On 4 May 2001, the *Taxation Laws Amendment (Excise Arrangements) Act 2001* transferred responsibility for administration of excise legislation to the ATO.

1.6 The ATO is responsible for effectively managing and shaping systems that support and fund services for Australians, and give effect to social and economic policy through the taxation, superannuation, excise and other related systems.⁹ In 2004–05, the ATO collected almost \$215 000 million in revenue and employed 22 294 staff as at 30 June 2005. The Excise Business Line (Excise BL) is the division within the ATO that administers commodity-based revenue and business payment systems. The Excise Business Line has three key functions: collecting excise; paying certain grants and rebates; and regulating aspects of the industries from which excise is collected.¹⁰ The Excise BL operates under the compliance and operations sub-plans, and in June 2005 it employed 425 staff.

1.7 Under the principle of self-assessment, the calculation of excise duty is the responsibility of the manufacturer or dealer in excisable goods.¹¹ The ATO provides advice and assistance to producers, manufacturers and dealers to calculate and meet their excise obligations. In 2004–05 the ATO collected \$21 888 million as excise revenue, accounting for 10 per cent of total revenue collections. Of this, \$13 608 million was for petroleum excise, \$5 220 million was for tobacco excise, and the remainder was for beer, spirits, and crude oil. Figure 1 shows the amounts of excise collected from 1994–95 to 2004–05.

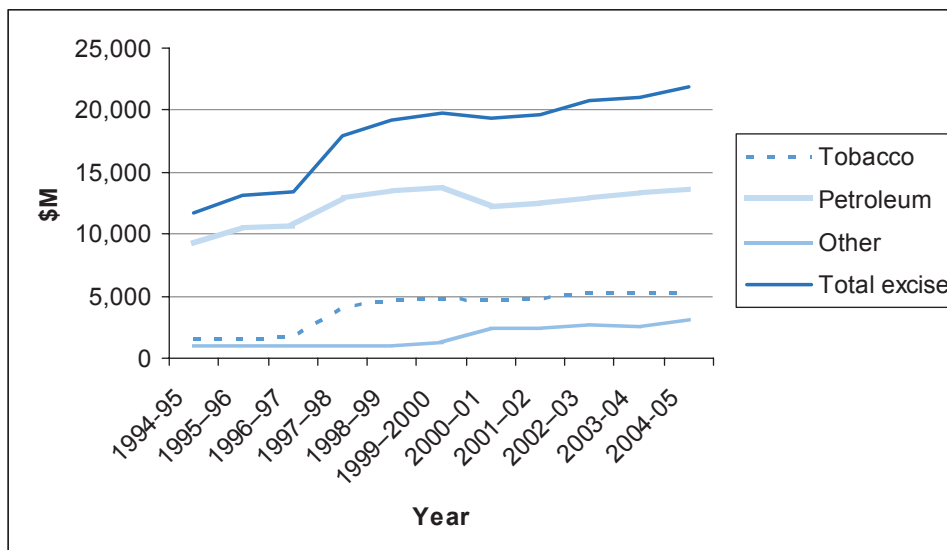
⁹ *Commissioner of Taxation Annual Report 2004–05*, p. 2.

¹⁰ Revenue is distributed through benefits such as the Energy Grants (Credit) Scheme, the Fuel Sales Grants Credit Scheme, Cleaner Fuel Grant Scheme, and the Product Stewardship for Oil Program.

¹¹ *Excise Duty Rates*, at <<http://www.ato.gov.au/large/content.asp?doc=/content/4085.htm&page=2&H2>>.

Figure 1.1

Excise collections 1994–95 to 2004–05



Note: An excise surcharge on tobacco and petroleum was introduced in 1997 to replace various state business franchise fees. Surcharges were no longer payable following the introduction of the GST. Excise collections for 2000–01 include some surcharge payments for clearances in June 2000.

Source: The ATO and ANAO analysis of information from Taxation Statistics.

ANAO Report No.17 of 2001–02 and ANAO Report No.55 of 2001–02

1.8 During 2001–02 the ANAO completed two separate audits of excise collection: one of petroleum excise and the other of tobacco excise. Overall, the ANAO concluded that the ATO was implementing effective administrative arrangements for collecting petroleum excise, and that it had arrangements for effectively administering tobacco excise.

1.9 The two reports contained a total of 20 recommendations directed at improving the ATO’s administration of petroleum and tobacco excise collections. These recommendations focused on three main areas:

- *improved governance*—including improved strategic planning, better internal organisational arrangements, and more robust external partnerships with several external agencies, such as the Australian Customs Service (Customs), the Department of the Environment and Heritage and the Department of Health and Ageing;

- *more efficient supporting business systems*—especially for licensing, case management and intelligence; and
- *improved risk management*—relating to managing fuel substitution and illegal tobacco.

Excise risks: fuel substitution and illegal tobacco

1.10 The ANAO audits in 2001–02 revealed two serious excise risks for the ATO to manage. One was the incidence of fuel substitution and the other was trade in illegal tobacco.

1.11 Audit Report No.17 reported that the excise loss from fuel substitution could be \$30 million per annum or higher. In a competitive retail market with narrow margins, the incentives for fuel substitution are high. Fuel substitution involves addition of products to petrol or diesel that attract a nil or concessional excise rate.

1.12 Fuel quality is regulated by the *Fuel Quality Standards Act 2000*, for which the Department of the Environment and Heritage has administrative responsibility. The *Fuel Quality Standards Act 2000* and excise legislation interact in various ways. For example, some fuel substitution that is an offence under the excise legislation, such as the diversion of heating oils into the diesel market, would result in a product that does not comply with the Diesel Standard, a determination made under the *Fuel Quality Standards Act 2000*. Conversely, activities that are lawful under the excise arrangements, such as the addition of ethanol to petrol, may violate the fuel quality standards mandated by the *Fuel Quality Standards Act 2000*.¹²

1.13 Illegal tobacco is tobacco that is grown and manufactured in Australia, and sold illegally to others, without excise being paid. Tobacco growers receive approximately \$700 per 1000 kilogram bale, while the excise and GST levied on the same bale is approximately \$30 000. This price disparity creates strong incentives to sell tobacco illegally. Anecdotal evidence suggests that growers may receive up to \$10 000 per 1000 kilogram bale on the black market.

1.14 While fuel substitution was a major concern at the time of the previous audit, the ATO has determined that no significant fuel substitution issues are

¹² In 2003 the Government set a 10 per cent cap on the level of ethanol that can be added to petrol under the *Fuel Quality Standards Act 2000*. The Department of the Environment and Heritage vehicle testing found petrol containing ethanol blends of 20 per cent or more may cause engine problems in some older vehicles. See <<http://www.deh.gov.au/atmosphere/fuelquality/standards/ethanol/labelling.html>>

currently identified, and that compliance with excise obligations is high.¹³ In contrast, the ATO has identified illegal tobacco as a continuing Compliance Program priority for 2005–06.¹⁴ Table 1.2 details the ATO’s current estimates of excise revenue loss due to illegal tobacco and fuel substitution.

Table 1.2

ATO estimates of excise revenue loss from fuel substitution and illegal tobacco 2000–01 to 2004–05

Revenue loss estimates	2000–01	2001–02	2002–03	2003–04	2004–05
	\$m	\$m	\$m	\$m	\$m
Fuel substitution ^a	30 +	19	8	8	8
Illegal tobacco ^{b, c}	n/a	63	79	86	98

Note a: Revenue loss from fuel substitution for 2003–04 and 2004–05 is based on the 2002–03 estimate. An ATO review is pending, however initial research indicates loss has not increased.

Note b: There are a range of uncertainties inherent in these estimates. Data limitations mean that it is not possible to accurately state the amount of tobacco diverted each year.

Note c: These estimates have been rounded to the nearest million dollars.

Source: ATO

Recent developments

ATO restructuring

Excise Business Line

1.15 The Excise BL was restructured in 2004. See Appendix 2 for the organisation structure of the Excise BL. It now consists of three streams: Business Delivery and Technical Services; Compliance Management; and Management and Business Services. Within the Compliance Management Stream, the two areas relevant to this audit are the:

- *Industry Groups*—the Fuel and Energy, Tobacco, and Alcohol Industry Groups manage the issues, risks and products specific to their industry. Their activities include processing licence and permission applications, monitoring and reporting on industry compliance and performance indicators, and managing strategic intelligence for their industry; and
- *Active Compliance*—responsible for delivering the Industry Groups’ risk management strategies through compliance treatment activities. This includes audit and non-audit strategies, and field and non-field

¹³ ATO, Compliance Program 2005–06. p. 28.

¹⁴ *ibid.* p. 90.

compliance products and services, ranging from advisory visits to desk reviews and comprehensive audits.

1.16 In 2001–02, the Excise BL had prime responsibility for excise administration. However, other Business Lines also have responsibility for some aspects of excise administration.

Serious Non-Compliance Business Line

1.17 The Serious Non-Compliance Business Line (SNC BL) was created on 1 July 2003, and the Excise BL's investigations function was transferred to the SNC BL. See Appendix 3 for the organisation structure of the SNC BL. The SNC BL manages the ATO's significant tax evasion and fraud responsibilities. Amongst other things, the SNC BL combines intelligence analysis, complex audit and specialist investigative skills. The SNC BL assumed responsibility for managing the serious compliance risks associated with the illegal tobacco market. The Excise BL refers cases to the SNC BL for investigation and prosecution.

1.18 The ANAO noted that in April 2005, the Excise BL and the SNC BL signed a service level agreement, which defines their roles and responsibilities, and documents communications strategies the Business Lines use to manage excise risks. The ANAO considers separation of licensing and intelligence, active compliance and investigation activities, subject to appropriate planning, monitoring and communication, to be good governance.

Operations Business Line

1.19 Activities such as excise payment and product processing, pursuing debt, and enforcing lodgement obligations were transferred from the Excise BL to the Operations Business Line on 1 July 2005. Review of these activities was outside the scope of this audit.

GST Business Line

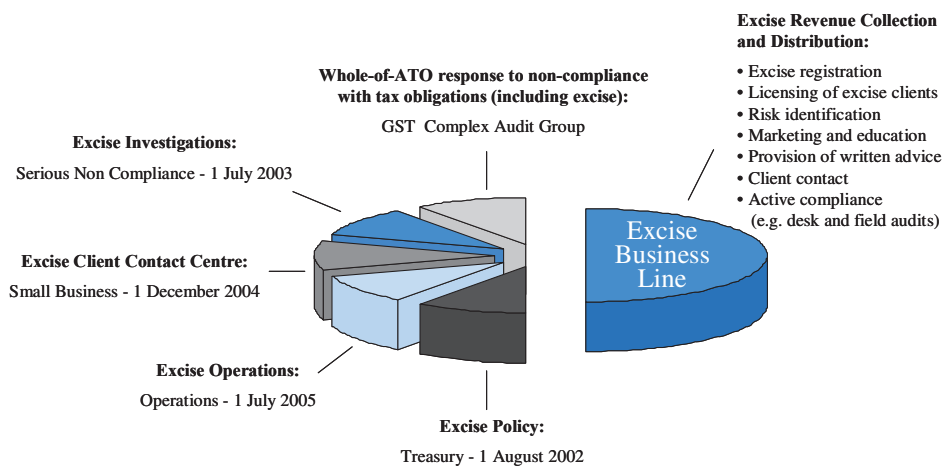
1.20 The Goods and Services Tax (GST) Complex Audit Group, within the GST Business Line, is responsible for the 'whole-of-ATO' response to non-compliance with tax obligations. This means that for certain people and entities who have not complied with a tax obligation, the GST Complex Audit Group gathers intelligence and conducts active compliance activities on all of their tax obligations. This includes excise, income tax, goods and services tax, business activity statements, etc.

Other areas with excise responsibilities

1.21 The Small Business Business Line answers excise-related telephone enquiries through a client contact centre. Treasury has undertaken legislative design activities since 1 August 2002. Figure 1.2 depicts the current delivery model for excise administration.

Figure 1.2

Excise delivery model



Source: ANAO analysis of ATO information

Change program

1.22 The ATO is currently undertaking a major program of work, called the *Easier, cheaper and more personalised program*.¹⁵ As part of this program, the ATO will replace multiple systems across the organisation with a single integrated ATO-wide system for administering taxes, superannuation, and excise. The new system will include whole-of-ATO functionality for client relationship management, case management, core processing, document and content management, and analytics. The new system is being released in stages. Release 1 occurred in the ATO’s call centres in September 2005. The ATO intends implementing the case management functionality in Release 2, scheduled for progressive implementation between April and December 2006. The ATO has advised that it plans to implement the core processing functionality in Release 3, scheduled for December 2007–January 2008.

¹⁵ For more information see *Revitalising the tax administration system: the Australian experience*. At: <<http://www.ato.gov.au/content/downloads/oeecd.pdf>>.

ANAO Audit Report No.20 of 2004–05

1.23 In 2004 the ANAO audited the ATO's management of the Energy Grants (Credits) Scheme. The Excise BL administers this scheme, and some of the findings and conclusions of that audit are relevant to excise administration. Audit Report No.20 of 2004–05 reported that the Excise BL had established reasonable planning, monitoring and reporting frameworks. These frameworks involve structured approaches to planning, a structured and regular system for performance monitoring, and well-structured and timely performance reports.

Fuel Quality Standards Act 2000

1.24 Following passage of the *Fuel Quality Standards Act 2000* the Department of the Environment and Heritage assumed full responsibility for fuel quality testing. The ATO no longer has any responsibility for, nor conducts, any fuel quality testing. In April 2005 the report of the Independent Statutory Review of the *Fuel Quality Standards Act 2000* was tabled in Parliament.¹⁶ This report identified the need for a range of legislative and administrative improvements. The Department of the Environment and Heritage is responsible for advising the Government about the recommendations of the report.

Reform to the Schedules of the *Excise Tariff Act 1921* and the *Customs Tariff Act 1995*

1.25 On 2 June 2005 the Minister for Revenue and Assistant Treasurer released an industry discussion paper entitled '*Review of the Schedule to the Excise Tariff Act 1921*'. The review will examine excise and customs tariffs to take into account the Government's excise reforms and the new business credit system that will replace all existing rebates and subsidies. It will also address a range of other '*redundant and unnecessarily complex provisions in the Schedules to the Excise Tariff Act 1921 and Customs Tariff Act 1995 which may also adversely affect other industries dealing in excisable products, such as the tobacco and alcohol industries*'. The discussion paper notes that the review is primarily an administrative review and is designed in part to reduce compliance costs for excise manufacturers, importers and administering authorities. The ATO

¹⁶ Fuel Quality Standards Act Review Panel with assistance from Economic Associates (Australia) Pty Ltd and SWB Consulting Pty Ltd, 2005, *Independent Statutory Review of the Fuel Quality Standards Act 2000*, Final Report.

advised that the excise tariff reforms could have significant implications for excise administration.

The audit

Audit objective

1.26 The objective of this follow-up audit was to examine the ATO's implementation of the 20 recommendations in:

- *The Administration of Petroleum Excise Collections* (Audit Report No.17, 2001–02); and
- *The Administration of Tobacco Excise* (Audit Report No.55, 2001–02),

having regard to any changed circumstances, or new administrative issues, affecting implementation of those recommendations. The audit also aimed to identify scope for improvement in the ATO's administration of petroleum and tobacco excise.

1.27 Follow-up audits are recognised as an important element of the accountability processes of Commonwealth administration. Parliament looks to the Auditor-General to report, from time to time, on the extent to which Commonwealth agencies have implemented recommendations of previous audit reports. Follow-up audits keep Parliament informed of progressive improvements and current challenges in areas of Commonwealth administration that have previously been subject to scrutiny through performance audits.

Audit methodology

1.28 The ANAO wrote to the ATO at the commencement of the audit, seeking information on the implementation of the recommendations from the previous audits. Following receipt of the ATO's response, the ANAO interviewed key ATO, Customs, Department of Health and Ageing and Department of the Environment and Heritage personnel. The ANAO also reviewed relevant systems, files, documents and statistical tabulations and analysis.¹⁷

¹⁷ The quantitative data in this audit was drawn from various sources indicated in the text. Unless otherwise shown, the data has been examined for reasonableness, but not audited.

1.29 This audit was undertaken in conformance with ANAO auditing standards and cost \$218 000.

Acknowledgements

1.30 The ANAO would like to thank ATO management and staff for their assistance in the conduct of the audit. In particular, we would like to thank staff for their time, effort and expertise contributed during the audit. The ANAO would also like to express appreciation to Customs, the Department of Health and Ageing, and the Department of the Environment and Heritage for their contribution to the audit.

Structure of report

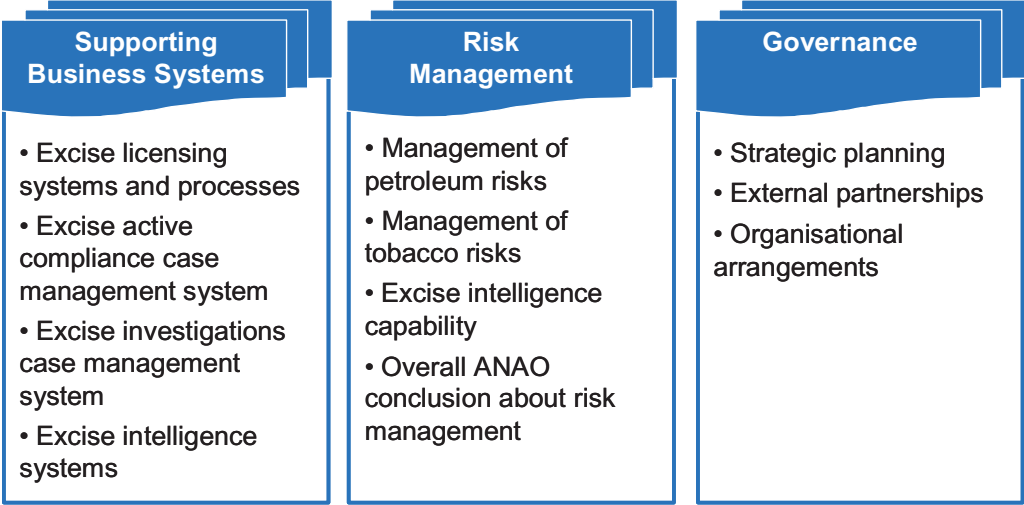
1.31 Each chapter presents:

- a brief background of the previous audit's findings;
- the recommendations from ANAO Report No.17 of 2001–02, and ANAO Report No.55 of 2001–02; and
- the findings of our follow-up audit.

1.32 To assist the reader, the recommendations have been grouped into themes, reflected in the three chapters that follow. Figure 1.3 depicts the structure and content of the report.

Figure 1.3

Structure of the report



2. Supporting Business Systems

This chapter discusses Recommendations No.4, 5 and 6 of Report No.17 of 2001–02, and Recommendation No.5 of Report No.55 of 2001–02. These recommendations concern the business systems that support excise administration.

Introduction

2.1 The activities the ATO undertakes in support of excise administration were outlined in the previous chapter, (see paragraphs 1.15 through 1.21). Audit Report No.17 of 2001–02 and Report No.55 of 2001–02 identified a number of improvements that could be made to enhance the business systems that support the revenue collection function of excise administration. These recommendations address:

- excise licensing systems and processes;
- case management systems for active compliance and investigations; and
- excise intelligence systems.

Excise licensing systems and processes

2.2 In order to produce, store, deal in, manufacture, or move under-bond excisable goods, an excise licence or permission is needed.¹⁸ Appendix 4 sets out the licences and permissions (for petroleum and tobacco) issued by the ATO, indicating the section of the *Excise Act 1901* under which these are issued. A licence holder must comply with the conditions of the *Excise Act 1901*. The legislation authorises the ATO to impose additional conditions on a licence.

Findings from Report No.17 of 2001–02

2.3 At the time of the previous audit, the Excise Licensing Group managed licences and permissions for the Excise BL. Applications for licences were processed using the Customs' Licensing and Permissions System; however, the ATO intended to develop licensing functionality as part of the new Excise Collections System (ECS). At the time the ATO advised that the cost of implementing the ECS would be \$2.711 million. The ANAO reviewed the

¹⁸ Excisable goods are under-bond when the excise duty on that good has not yet been paid.

efficiency and effectiveness of the Excise BL's licensing management systems, and determined that a number of initiatives to provide assurance on the consistency of decision-making had been introduced. Notwithstanding, the Excise Licensing Group relied on advice from the Industry Groups when assessing applications. The ANAO considered this double-handling in the licensing process inefficient and redundant. Further, the ANAO considered there were a number of measures the ATO could take to improve the efficiency of licensing processes, and to improve client service. As a result, the following recommendation was made.

Report No.17 of 2001–02 — Recommendation No.4

The ANAO recommends that the ATO review its petroleum excise licensing systems and processes. Specific areas that would benefit from this review are:

- establishing improved accountability arrangements and consultation mechanisms between the Petroleum Excise Industry Group and the Licensing Group, to achieve the optimum and value-added handling of licensing applications; and
- addressing the weaknesses of the current licensing systems and processes to achieve efficiencies and an increased client focus, both within and outside the ATO.

ATO response: Agreed.

ANAO's findings from the current audit

2.4 In 2001, the Excise BL decentralised the licensing function to the Industry Groups. As a result, the Fuel and Energy and Tobacco Industry Groups established dedicated licensing functions specific to their industries. The ANAO found that devolution of licensing to the Industry Groups has streamlined the application and approval process for new licences and permissions. The ANAO also found that the Industry Groups have implemented processes to manage the annual renewal of manufacturer licences. However, the ANAO considers that the ATO may benefit from developing a licensing framework to provide greater consistency across the Industry Groups with respect to excise licensing policy and strategies, and cross promote efficiencies between the Industry Groups.

2.5 Appendix 4 details the number of licences and permissions issued in 2004–05. The Fuel Energy Group advised that in 2004–05, 100 per cent of all licences and permissions were issued within the ATO's licensing service standards. The Tobacco Industry Group advised that 100 per cent of tobacco permissions and manufacturer licences were issued within the ATO's licensing

service standards. With respect to tobacco storage, producer or dealer licences, the ATO advised that it had only begun monitoring performance against standards for issuing these licences from 1 July 2005.

2.6 The ANAO also found that the ATO had implemented a number of measures to improve client service. This includes publication of information and forms on the ATO web site; establishment of a dedicated telephone, fax and email address for each Industry Group; and allocation of Key Client Managers to businesses. The ANAO further found that both Industry Groups had reviewed and improved licensing processes. In 2004 the Fuel and Energy Group undertook a project to re-issue licences using the ECS. As a result, clients were issued with a system-generated copy of their licence and/or permission, and the ATO was able to ensure the conditions attached to licences reflected their current operations. The Tobacco Industry Group also undertook a project in 2004 to review internal licensing processes.

Licensing as a compliance tool

2.7 The ANAO found that since the previous audit, there has been an increased focus on the use of licensing as a compliance management tool. The ANAO notes that the Tobacco Industry Group is currently in the process of undertaking a review of the conditions associated with licences. Consideration is being given to:

- developing standard sets of licence conditions to be applied to licence holders at different levels of risk;
- retaining the ability to add specific or unique conditions where necessary; and
- reviewing sanctions for non-compliance of licensing conditions.

2.8 The ANAO considers that the licence conditions should be concise, appropriate, and enforceable. It is important that the ATO ensures licence holders (particularly for those assessed as high risk licence holders) comply with all licence conditions, rather than relying on licence holders to notify ATO of any non-compliance. The ATO should also develop processes to routinely check that all licence holders are complying with all of their licence conditions, and enforce appropriate sanctions where they are not. The ATO advises that it now reviews all licence conditions on a regular basis.

Excise Collections System

2.9 The ATO undertook a post implementation review of the ECS in 2005. The report of this review found that the ATO developed a business case for the development of the ECS in March 2001, and estimated the cost of the project to be \$5.5 million. This business case was then revised in March 2003 following a time and budget overrun. The revised estimate of the project cost was \$21.51 million. The actual expenditure was less than proposed in the revised business case, following the ATO's decision to cease further development. Table 2.1 details the changing estimates of the cost of developing the ECS

2.10 The budget overrun was attributed to technology issues, such as inadequate staff skill levels, and a lack of acceptable standards, infrastructure, and the stability of the mid-range system platform.¹⁹ The post implementation review also found that the ECS deployment ran significantly over schedule. The original implementation date was 19 November 2001, however, the ECS was progressively implemented through a staged release; the initial release was on 1 July 2002, and release of the full system occurred on 1 July 2003.

Table 2.1

Excise Collections System cost estimates and actual costs

Estimate	Document	Date of estimate	\$m		
			Operating	Capital	Total
Resources	Draft excise project and systems resource estimates 2001-02	February 2001	2.711	–	2.711
Total planned expenditure	Business Case v1.0	March 2001	2.5	3	5.5
Revised total planned expenditure	Business Case Update	March 2003	7.5	14.01	21.51
Actual expenditure	Post Implementation Review Draft v0.03	July 2005	–	–	14.23

Source: ATO. ECS Post Implementation Review, July 2005, Draft version 0.03, pp. 17, 22

2.11 The ECS post implementation review further found that only 60 per cent of the original functionality was introduced. For example, a web-based entry point for online lodgements was not implemented. In addition, implementation of the ECS did not yield expected productivity gains, and system users currently employ a number of workarounds to overcome ECS

¹⁹ The development of the ECS was used by the ATO as a method to trial a new technology platform, as it was an environment with relatively low client and transaction numbers, and where a contingency was available.

functional limitations. Notwithstanding, the review determined that the non-financial benefits of the system were achieved. These included facilitating transfer of statutory responsibility for excise administration from Customs to the ATO, learning from the project about use of a new technology platform, integration with other ATO systems, and improved payment methods for clients.

2.12 The ATO intends to replace the ECS in Release 3 of the *Easier, cheaper and more personalised program*, scheduled for December 2007–January 2008. The ANAO suggests that when replacing the ECS licensing and permissions functionality, the ATO ensures the licensing requirements that are unique to the excise function are addressed. The ANAO understands there are other requirements that are unique to the excise function (such as calculation of excise duty payable, based on tariff rates). The new system will need to address these requirements. The ANAO considers it would be good practice to ensure all unique excise requirements are identified and included in the system specification. The ANAO notes that significant Excise BL resources are already involved in the design specification for the new system.

ANAO conclusion

2.13 The ATO has fully implemented this recommendation.

2.14 Devolution of the licensing function to industry groups has streamlined the application and approval process. The ATO has implemented a new licensing system—the ECS. An ATO review of this system found a significant budget overrun against the original business case, that the system was implemented late, and that not all of the original requirements were included. The ANAO found that this system could be improved in some important areas, however, the ATO intends to replace the ECS in by January 2008 as part of the *Easier, cheaper and more personalised program*.

Excise active compliance case management system

2.15 The excise collection scheme requires excise payers to comply with their obligations under the relevant excise legislation. The ANAO noted that the ATO's Compliance Model guides the compliance intervention made in response to compliance matters. The Compliance Model provides the framework through which the ATO understands the factors that influence

compliance behaviour, and subsequently selects the most appropriate compliance intervention for the circumstances.²⁰

Findings from Report No.17 of 2001–02

2.16 At the time of the previous audit, the Field Services Branch was responsible for the Excise BL's active compliance function. Within this branch, the Compliance Unit was responsible for active compliance activities, while the Investigations Unit managed cases involving fraud. The Compliance Unit used compliance kits created by the three Industry Groups to conduct compliance activities, and reported to the Industry Groups on completion of the tasks.

2.17 The ANAO noted that although some Compliance Unit staff accessed a working papers system called TeamMate, not all ATO sites used this system and the Petroleum Energy Industry Group (now the Fuel Energy Group) was not able to access it.²¹ Also, the compliance management function did not have access to an electronic case management system. This meant a number of recording systems were used, and integrated data could not be accessed in a timely manner. As a result, the following recommendation was made.

Report No.17 of 2001–02 — Recommendation No.5

The ANAO recommends that, to implement effective compliance management and reporting arrangements, the ATO take steps to establish a case management system to consolidate and rationalise the recording, updating, management and reporting of information relating to compliance activities.

ATO response: Agreed.

ANAO's findings from the current audit

2.18 The ANAO found that the Active Compliance branch currently uses two separate systems for managing case information: TeamMate and the Active Compliance Reporting System. Staff from Active Compliance and other Excise BL areas can access the TeamMate system and procedure manuals from the ATO intranet. Active Compliance case officers use the Active Compliance Reporting System as the primary system to record case management information such as client and activity details, time recording and financial

²⁰ For more information on the ATO's Compliance Model, see: <http://www.ato.gov.au/corporate/content.asp?doc=/content/5704.htm>.

²¹ TeamMate is used for managing active compliance working papers, and includes some workflow functionality. It electronically records audit documentation and processes, and links to electronic files relevant to the audit process (scanned documents may be attached in the system).

results. The ANAO noted that both systems have reporting functionality to assist with case planning and monitoring. However, team leaders continue to maintain separate Microsoft Excel spreadsheets to facilitate case management.

ANAO conclusion

2.19 The ATO has substantially completed this recommendation.

2.20 The Active Compliance branch continues to use two separate systems as well as stand-alone Microsoft Excel spreadsheets to manage active compliance cases. The ANAO notes that implementation of the case management functionality in the new enterprise solution (discussed in paragraph 1.22) is expected to fully address this recommendation.

Excise investigations case management system

Findings from Report No.17 of 2001–02

2.21 At the time of the previous audit, the Excise Investigations Unit was responsible for investigating instances of fraud (outside the ATO) that involved breaches of legislation in relation to excisable petroleum, tobacco and alcohol products.²² In addition, the Excise Investigations Unit prepared briefs of evidence for the Director of Public Prosecutions or the Australian Government Solicitor for consideration for criminal or civil prosecution.

2.22 The ANAO found that overall, the Excise Investigation Unit exhibited professional expertise when undertaking investigations or preparing evidence briefs. Officers had conducted themselves in accordance with the procedure manual, and the necessary security had been maintained. However, the ANAO also noted that the Unit did not have access to a case management system, and that manual records of cases were being maintained. As a result, the following recommendation was made.

²² The Commonwealth Fraud Control Guidelines (May 2002) defines fraud against the Commonwealth as '*Dishonestly obtaining a benefit by deception or other means*'. See http://www.ag.gov.au/aqd/WWW/criminaljusticeHome.nsf/Page/Fraud_Control for further information.

Report No.17 of 2001–02 — Recommendation No.6

The ANAO recommends that the ATO:

- implement and maintain an effective case management framework within the Excise Investigations unit including in the conduct of initial case planning and resource allocation, ongoing management and review of case progress and decisions to terminate cases; and
- consider implementation of an automated case management system within the Excise Investigations unit.

ATO response: Agreed.

ANAO's findings from the current audit

2.23 The ANAO found that in October 2002 the ATO developed a business case for an Excise, Special Audit, ATOFraud and Fraud Prevention and Control case management system. This business case determined that the existing ATO case management systems did not meet the unique requirements of fraud investigations.²³ As a result, the ATO decided to purchase ASISCaseManager from Australian Special Information Systems Pty Ltd (ASIS), an Australian software development company. The cost of ASIS software licensing and maintenance for the period June 2003 through July 2006, as reported on the ATO web site, was \$924 000.²⁴

2.24 The ASIS system was implemented in the SNC BL on 1 July 2004, and all cases open as at 30 June 2004 were migrated from Microsoft Excel spreadsheets into ASIS. The ASIS system is located on ATOProtect - a secure restricted access network. In December 2004 the SNC BL Executive decided ASIS would continue to be used as the SNC BL case management system for the short to medium term. However, in the longer term the SNC BL would use the *Easier, cheaper and more personalised program case management system*.

ANAO conclusion

2.25 The ATO has fully implemented this recommendation.

2.26 The ATO purchased ASISCaseManager and implemented it as the SNC BL case management system in 2004.

²³ Requirements unique to investigations include preparing and issuing warrants, seizure notices and briefs of evidence; recording and tracking evidence; complex legal proceedings; activity costings; photo arrays and security and secrecy requirements.

²⁴ ATO, Senate Order on Departmental and Agency Contracts, 1 July 2004 to 30 June 2005.

Excise intelligence systems

Findings from Report No.55 of 2001–02

2.27 Audit Report No.55 of 2001–02 determined that an effective intelligence framework is essential to the ATO’s administration of tobacco excise, given the illegal tobacco market, and the nature of excise legislation. An integral component of an intelligence framework is an intelligence system capable of storing, sorting, interrogating and analysing large amounts of intelligence, which can be accessed by, and disseminated to staff in a timely way. At the time of undertaking the previous audit, the ANAO found that the two components of the Excise BL’s intelligence systems were:

- intelligence databases—including various stand-alone investigations databases (Microsoft Excel spreadsheets), the TeamMate system, and the EXCIntelligence system;²⁵ and
- intelligence analysis tools—including IBase and Analysts Notebook.

2.28 The ANAO noted that, while the Tobacco Industry Group used EXCIntelligence, the Field Services Branch did not. In addition, there was duplication of information stored in the databases. The ANAO also found that the Excise BL did not hold sufficient numbers of licences for staff to make effective use of the available systems, and that staff using the intelligence tools had not been trained in their use. As a result, the following recommendation was made.

Report No.55 of 2001–02 — Recommendation No.5

The ANAO recommends that the Excise Business Line, in reviewing its intelligence information technology requirements, ensure that these are directed at meeting its business needs by:

- developing access to intelligence information; and
- effectively using intelligence analysis tools to collate and analyse information to strengthen the administration of tobacco excise.

ATO response: Agreed.

²⁵ EXCIntelligence is a web-based database that forms a subset of the ATOIntelligence application. It is the principal system for storing Excise intelligence information.

ANAO's findings from the current audit

2.29 The ANAO noted that Excise BL's intelligence capability was reviewed in 2003. A review of the EXCIntelligence system occurred in 2005. The ANAO found that Excise BL and SNC BL staff now use a number of supporting information technology tools, such as global positioning systems, aerial surveillance imaging, satellite imaging and the Fraud Intelligence Excise National Database System when undertaking active compliance, intelligence, and risk management activities. There has also been increased use of EXCIntelligence across the Excise BL. The ATO is currently in the process of further developing EXCIntelligence to improve the systems intelligence gathering and reporting capabilities.

2.30 The Tobacco Industry Group employed a strategic intelligence analyst to undertake tobacco research and intelligence analysis, including modelling the illegal tobacco market, risk identification and profiling. The ANAO considers that the ATO should expedite completion of the work in progress to model the illegal tobacco market.

2.31 The ANAO noted that any significant enhancements of information technology systems are on hold whilst the ATO's *Easier, cheaper and more personalised program*, initiatives are being finalised. The ANAO also noted that the new program would include an analytics capability.

ANAO conclusion

2.32 The ATO has fully implemented this recommendation.

2.33 The Excise BL reviewed its intelligence capability and the EXCIntelligence system. A strategic analyst has been appointed to undertake tobacco research and intelligence analysis, including modelling the illegal tobacco market, risk identification and profiling. Information technology tools are used to support active compliance, intelligence, and risk management activities.

3. Risk Management

This chapter discusses recommendations relating to the administration of excise risks. Recommendations No.1, 9, 10 and 11 of Audit Report No.17 of 2001–02 concern the management of petroleum risks, and Recommendations No.2 and 3 of Audit Report No.55 of 2001–02 concern the management of tobacco risks. Recommendation No.4 of Audit Report No.55 of 2001–02 relates to the Excise Business Lines' intelligence capability. The chapter ends with an overall conclusion about the ATO's management of the risks to the collection of excise.

Introduction

3.1 Through the ATO's compliance program, which consists of active enforcement, assisted self-regulation, and self-regulation and cooperation activities, the ATO aims to manage the risks inherent in a system of self-assessment. Activities the Excise BL undertakes to support the administration of the *Excise Act 1901* include risk identification and risk treatments. Risk treatments are activities undertaken to improve compliance with excise obligations. This includes registration/licensing of clients, marketing and education, provision of written advice, client contact, and active compliance (for example, desk and field audits). Audit Report No.20 of 2004–05 considered the Excise BL's risk management framework reasonable, structured and appropriate.²⁶

Management of petroleum risks

Excise risk register

Findings from Report No.17 of 2001–02

3.2 The ATO Risk Register is a risk database that stores intelligence information, and that all ATO Business Lines access. At the time of the audit, the Excise BL was responsible for a number of petroleum entries. The ANAO noted that the petroleum risk entries were incomplete. As a result, the ANAO made the following recommendation.

²⁶ Audit Report No.20 of 2004–05 *The Australian Taxation Office's Management of the Energy Grants (Credits) Scheme* was tabled in Parliament on 21 December 2004. The objective of the audit was to assess whether the ATO had established an administratively effective framework for managing the Energy Grants (Credit) Scheme, which the Excise BL administers. Some of the findings and conclusions of that report are, therefore, relevant to this audit.

Report No.17 of 2001–02 — Recommendation No.1

The ANAO recommends that the ATO conduct a rigorous review for completeness, accuracy and relevance of the Excise business line's petroleum entries on the ATO Risk Register.

ATO response: Agreed.

ANAO's findings from the current audit

3.3 The ANAO found that the ATO undertook a risk examination process in May 2001. The risks identified were consolidated into two key risks—licensed entities and fraud/illegal. The ATO subsequently reviewed petroleum risks in May–June 2002, and updated the ATO risk register. The ATO advised that a review of risks is conducted quarterly, and intelligence is added to risk analysis documents as it is gathered. Emerging risks are assessed as they arise. The Fuel and Energy Group and the Tobacco Industry Group manage the risks specific to their industries. Table 3.1 details the petroleum and tobacco risks currently recorded on the ATO Risk Register.

Table 3.1

Petroleum and tobacco risks

Commodity	Risks	
	Licensed entities	Fraud/illegal activity
Petroleum	Excise payers make errors, resulting in incorrect payment of excise.	Fuel substitution and blending.
	Late payments.	Fraudulent reporting and misdescription of excisable fuels.
Tobacco	Systems errors result in incorrect payment of excise.	Overproduction is illicitly manufactured and marketed.
	Late payment or late submission of returns.	Diversion of product into the illegal market from exports or imports.

Source: ANAO analysis of ATO information.

Quantification of petroleum revenue trend factors

Findings from Report No.17 of 2001–02

3.4 At the time of the audit, the (then) Petroleum Industry Group monitored excise collections on a weekly, monthly, and quarterly basis. From this monitoring, a number of reports were prepared for the Excise Executive. The ANAO considered that this reporting could be improved by detailing the reasons behind any significant variations in revenue trends. Therefore, the following recommendation was made.

Report No.17 of 2001–02 — Recommendation No.9

The ANAO recommends that, in monitoring and analysing revenue collection trends, the ATO should quantify, where possible, the impact of factors contributing to significant variations in revenue trends. This could result in a better understanding of the extent of impact associated with each factor, and would aid in improving future excise revenue estimates.

ATO response: Agreed.

ANAO's findings from the current audit

3.5 The Petroleum Industry Group has been restructured as the Fuel Energy Group to reflect the broader range of functions the group now administers. The ANAO found that the ATO has implemented an econometric model of the petroleum market and established a Strategic Intelligence Unit. This is a small team within the Fuel and Energy Group that researches economic and other factors that determine fuel clearances, and publishes regular reports for ATO management about the petroleum market and issues relevant to petroleum excise administration. The ANAO notes that this research contributes to more accurate forward estimates for fuel clearances and improved quantification of factors impacting fuel usage and revenue trends.

Excise fuel substitution strategy: compliance and investigation activities

Findings from Report No.17 of 2001–02

3.6 Report No.17 of 2001–02 found that the ATO was addressing the issue of fuel substitution through targeted investigations, including fuel testing. The ANAO made the following recommendation to ensure the Excise BL received maximum benefit from fuel testing activities.

Report No.17 of 2001–02 — Recommendation No.10

The ANAO recommends that, as part of its fuel substitution strategy, the ATO should supplement its compliance and investigation activities with measures such as:

- specifying detailed client compliance requirements to assist in assessing compliance and enabling appropriate and timely remedial action by the Petroleum Excise Industry Group; and
- updating and finalising the draft fuel testing procedures to ensure maximum leverage for the Excise Business Line from its fuel testing activities.

ATO response: Agreed.

ANAO's findings from the current audit

3.7 The ANAO noted that the Fuel and Energy Group uses the licence as a means of managing compliance risks. Permissions are reviewed on a risk-based priority to ensure that issue and conditions are appropriate. The quantity restrictions on permissions are continually monitored and deliveries are compared to the limits. All new applications and variations must be supported by a business case to ensure legitimate end-use. The Fuel and Energy Group monitors licensee behaviour against licence conditions, often on a weekly basis. The ANAO found that the ATO generally acts upon compliance concerns at the earliest opportunity.

3.8 Remission certificates enable licensed entities to deal in concessional or excise-free products. The ATO advised that annual renewal of remission certificates ensures certificates are not issued to entities that no longer have a legitimate use for concessional products.²⁷ Remission certificate caps are monitored monthly and form part of the monthly monitoring report.

3.9 A memorandum of understanding, dated December 2004, governed the relationship between the ATO and the Department of the Environment and Heritage in relation to fuel sampling, however this expired on 30 June 2005.²⁸ Table 3.2 details the results from the fuel testing the ATO undertook under a service level agreement with the Department. The total number of samples drawn during the life of the service level agreement was 1 475, and 115 (8 per cent) of the samples were found to be outside the standard. The

²⁷ There is demand for excise-free products as they are used in illegal fuel substitution.

²⁸ The memorandum of understanding between the ATO and the Department of the Environment and Heritage is discussed further in Chapter 4, *Governance*.

Department of the Environment and Heritage is responsible for the investigation and resolution of fuel standards matters. The Department of the Environment and Heritage advised that fuel samples found to be non-compliant with a fuel standard have been examined by the Department with a view to prosecution action under the *Fuel Quality Standards Act 2000*.

Table 3.2

Results of fuel testing 2001–02 to 2004–05

State	2001–02			2002–03			2003–04			2004–05		
	Samples taken	No. Non-compliant	% Non-compliant	Samples taken	No. Non-compliant	% Non-compliant	Samples taken	No. Non-compliant	% Non-compliant	Samples taken	No. Non-compliant	% Non-compliant
NSW	86	8	9	218	12	0.5	322	31	10	343	53	15
VIC	97	0	0	127	2	0.2	137	2	0.2	145	7	5

Source: ATO

Assessment of excise fuel substitution activities

Findings from Report No.17 of 2001–02

3.10 The ANAO considered that the ATO should systematically assess, on an ongoing basis, fuel substitution activities. This would require the ATO to determine the extent of the problem, undertake cost-benefit analyses of different revenue loss targets, and formulate strategies to address the issues. Therefore, Report No.17 of 2001–02 made the following recommendation.

Report No.17 of 2001–02 — Recommendation No.11

The ANAO recommends that to consolidate its fuel substitution strategy the ATO should systematically assess its exposure to fuel substitution activities with a view to fully determining the extent of the problem and formulating appropriate strategies to address the issue. This would include:

- identifying all the possible substitutes for diesel and petroleum;
- determining the possible revenue implications or potential exposure to revenue loss if any of the identified substitutes are used; and
- reviewing existing strategies or developing new strategies to limit exposure to revenue loss.

ATO response: Agreed in principle.

ANAO's findings from the current audit

3.11 The ANAO found that the ATO actively manages the risk of illegal fuel substitution through the use of non-taxed or concessionally taxed products. Further, the ATO uses a range of sound quantitative measures to support risk management. Table 1.2 in the *Background and Context* chapter details the ATO's estimates of excise revenue loss due to petroleum substitution. The ANAO found that the ATO has identified possible fuel substitutes. The ATO has continued to monitor the volumes of these products released into the market and their uses.

3.12 The ANAO found that ATO actions to manage the risk of fuel substitution have significantly reduced the problem. These actions include referral of cases for prosecution to the Commonwealth Director of Public Prosecutions; the attachment of specific conditions to relevant licences, and the close monitoring of compliance with those conditions; immediate contact with the licensee at the first sign of a possible problem; and a more sophisticated and effective intelligence system for the detection of possible compliance problems.

3.13 Fuel substitution was a major concern at the time of the earlier audit. Fuel substitution seems to have been opportunistic, rather than systemic criminal behaviour responding to incentives and opportunities. The relatively high proportion of tax embedded in the retail price provides a strong incentive for those without regard to the law to evade excise. Rapidly escalating costs of petroleum-based products may stimulate opportunistic non-compliant behaviour. The ANAO notes that managing these risks requires constant vigilance and prompt, effective action from the ATO. Nevertheless, because it is opportunistic, it is amenable to ATO's compliance actions. If appropriate compliance action is taken at the earliest opportunity, larger-scale evasion may be curtailed. The enactment of the *Fuel Quality Standards Act 2000* and the establishment of a capacity in the Department of the Environment and Heritage dedicated to the administration of the Act have also contributed to the amelioration of the risk of fuel substitution.

ANAO conclusion

3.14 The ANAO found that the ATO has fully implemented Recommendations No.1, 9, 10 and 11 of Report No.17 of 2001-02.

Management of tobacco risks

Illegal tobacco

Findings from Report No.55 of 2001–02

3.15 Report No.55 of 2001–02 identified illegal tobacco as a major risk to excise revenue. In 1999 the ATO developed an Illicit Tobacco Strategy. This strategy aimed to minimise illegal activity in order to protect revenue, not disadvantage the legitimate industry, and safeguard the community. The ANAO considered that the ATO had developed a strategic approach to managing tobacco excise risks; however, the following recommendations were made to enhance the ATO's risk management practices.

Report No.55 of 2001–02 — Recommendations No.2 and 3

The ANAO recommends that, the ATO review its strategy to manage risks relating to illicit tobacco and to include contact with Australian tobacco retailers as an integral part of ensuring compliance with excise legislation.

ATO response: Agreed.

The ANAO recommends that, to develop better informed risk assessments and to more accurately quantify the revenue leakage resulting from the trade of chop-chop in Australia, the ATO should consider developing effective working relationships with the Department of Health and Ageing and other appropriate Commonwealth agencies. This would provide added information relevant to ascertaining the nature and size of the chop-chop market.

ATO response: Agreed.

ANAO's findings from the current audit

3.16 The ANAO found that the ATO liaises with retailer representative organisations through regular industry meetings. Additionally, the ATO has worked closely with major tobacco manufacturers on media campaigns. The Tobacco Industry Group conducted a mail out to 39 000 tobacco retailers in August 2003, followed by a targeted client education and visitation program.

3.17 The ANAO noted that as a result of an ATO initiative, the Australian Bureau of Statistics has recorded the quantity of cigarette papers and tubes

separately since 1 July 2002.²⁹ This information improves the reliability and validity of the estimates of the quantity of illegal tobacco in the marketplace.

3.18 The ANAO considers that the ATO has established effective working relationships with the Department of Health and Ageing and other appropriate Commonwealth agencies, which facilitates intelligence gathering in relation to the illegal tobacco trade.

3.19 The ANAO considers that the ATO has made significant progress in modelling the legal and illegal tobacco markets. The initiatives the ATO has taken to model the tobacco markets bring together a wide range of relevant data. They also make clear the assumptions behind the modelling of these markets. The ATO is finalising computer-based mathematical models of the tobacco markets that are capable of using incomplete data and data of variable quality. They are also capable of representing relationships between relevant variables that are not exact, but are characterised by uncertainties. These models have the capacity to make a wide range of relevant reliable and valid ‘what if’ assessments. The ANAO noted that further work is needed to complete the models and validate the quality of data.

3.20 Table 3.3 details the ATO’s estimates of excise revenue loss due to illegal tobacco, and the value of illegal tobacco it has subsequently seized.

Table 3.3

Illegal tobacco

Estimate	2000–01	2001–02	2002–03	2003–04	2004–05
	\$m	\$m	\$m	\$m	\$m
Estimated excise value of diverted tobacco ^{a, b}	n/a	63	79	86	98
Excise value of seized domestic tobacco (leaf + cut) ^c	33	9	16	19	6

Note a: There are a range of uncertainties inherent in these estimates. Data limitations mean that it is not possible to accurately state the amount of tobacco diverted each year.

Note b: These estimates have been rounded to the nearest million dollars.

Note c: These estimates have been rounded to the nearest million dollars.

Source: ATO.

²⁹ Cigarette papers are small sheets or leaves of paper that are sold for rolling one's own cigarettes either by hand or with a rolling machine. The paper is a long rectangle with a narrow strip of glue or gum along one of the long edges. Consumers use cigarette tubes to make cigarettes by inserting fine cut tobacco into the hollow tube, usually with the aid of a small machine or injector. The tube generally has a filter tip attached, which consists of a plug of crimped acetate tow and a filter wrap made from paper. The tube may be treated with a chemical such as citrate or phosphate to facilitate a fast or slow burn rate. Cigarette tubes are generally white, although the portion covering the filter may be white or tan hue. The ANAO understands that all cigarette papers and tubes sold in Australia in the retail market are imported.

Continued diversion of tobacco into the illegal market

3.21 The ATO's Compliance Program for 2005–06 identifies illegal tobacco operations as a key priority in the area of evasion and serious fraud. The ANAO concurs with the ATO that the risk of illegal tobacco operations is currently severe. A finding of this audit is that there are reasonable grounds to conclude that each year substantial quantities of tobacco continue to be diverted into the illegal market from Australia's tobacco plantations. Data limitations mean it is not possible to state accurately the precise amount of tobacco diverted each year. Recent media coverage speculates that illegal tobacco trading has increased in volume and value and that ATO actions to curtail it have been ineffective.³⁰

3.22 Table 3.4 details the ATO's estimates of the quantities of tobacco grown, diverted to the illegal market, and seized by the ATO. The ANAO recognises that there is a range of uncertainties inherent in the ATO's estimates of the quantities of tobacco legally grown and illegally diverted. The ANAO notes that as a result of these uncertainties, the ATO is reluctant to use these estimates to evaluate the impact of its compliance activities on the illegal tobacco market. The ANAO considers that it is important for the ATO to be able to evaluate the effectiveness of its compliance activities. The ANAO considers that the ATO could develop a suite of indicators, including qualitative ones, that, in conjunction with the quantitative estimates, would give a good guide to the effectiveness of the ATO's compliance strategies for illegal tobacco operations.

³⁰ For example: Win TV, Sunday, *Tobacco wars*, 5 June 2005; and British American Tobacco Australia, *Illegal tobacco haul rewards new policy focus*, 30 August 2005.

Table 3.4**Estimates of the quantities of tobacco grown, diverted to the illegal market, and seized by the ATO**

	2000–01	2001–02	2002–03	2003–04	2004–05
Legally grown tobacco (kgs)	na	4 068 180	3 808 148	3 496 505	3 598 880
Estimate of diverted tobacco (kgs) ^{a, b}	na	243 000	295 000	313 000	347 000
Total seized illegal tobacco (cut and leaf) (kg) ^c	129 554	33 637	59 525	68 205	22 444

Note a: There are a range of uncertainties inherent in these estimates. Data limitations mean that it is not possible to accurately state the amount of tobacco diverted each year.

Note b: Estimates of the quantity of diverted tobacco are rounded to the nearest 1 000 kg.

Note c: The ATO advises that the decrease in the amount of tobacco seized from 2003–04 is attributable to the closure of tobacco plantations in north Queensland in 2003–04.

Source: ATO

3.23 The ANAO noted that internal ATO governance reporting does not typically include estimates of the impact of ATO compliance activity on the proportion of Australian tobacco diverted into the illegal market. The ANAO considers there is scope for improving performance reporting to the ATO Executive about the illegal tobacco market, by using measures of effectiveness when reporting performance of the ATO's compliance strategies.

3.24 ATO strategic decision-making may also be enhanced by knowing the total Commonwealth revenue foregone as a result of diversion of tobacco into the illegal market. This revenue loss occurs because tax is not paid on the additional trading activity that would have occurred had the tobacco not been illegally diverted. The ANAO considers that the ATO should estimate the total revenue cost to the Commonwealth of the illegal tobacco market in order to better understand the problem, and to better inform ATO strategic decision-making. Components of the total revenue cost would include loss of excise and GST, as well as loss of other tax revenue as a result of growers', manufacturers' and retailers' lost income.

3.25 The ANAO considers that an accurate estimate of the full cost to the Australian community of the continuation of the illegal tobacco market would improve whole-of-government decision-making about combating the illegal tobacco market. One component of the full cost is the total revenue cost previously mentioned. The two other components are:

- the health and social costs associated with the additional health problems caused by consumption of illegal tobacco; and

- the additional annual expense that the Commonwealth and state governments incur as a result of administering compliance enforcement and monitoring regimes.

Participants in the illegal tobacco market

3.26 The ANAO notes that since the excise function was transferred to the ATO, the ATO's objective has been to put an end to the systemic diversion of Australian tobacco to the illegal tobacco market and to eliminate the criminal element from the trade in tobacco products. The ANAO found that the ATO has pursued strategies to achieve these objectives, especially since the SNC BL was established in 2003. The ATO takes a strategic approach to combating the risk from illegal tobacco activity.³¹

3.27 The ANAO understands that differentiation between the four major groups involved in the illegal tobacco market is important to achieving significant compliance improvements. These groups are:

- licensed farmers;
- retailers;
- highly organised profit takers and/or organisers of the illegal tobacco market; and
- consumers of illegal tobacco.

Different compliance strategies are needed for each group.

Licensed farmers

3.28 The ANAO found that since the previous audit the ATO has increasingly focused on using licensing as a compliance management tool. Table 3.5 and Table 3.6 provide information on the number of current tobacco licence holders and licences, as well as the applications for tobacco licences from 2002–03 to 2004–05.

³¹ Commissioner of Taxation Annual Report 2003–04, pp. 151–53.

Table 3.5**Current tobacco licence holders and licences 2004–05**

Tobacco licence	Licence holders	Licences
Manufacture licence	4	4
Storage licence	15	33
Producer licence	159	199
Dealer licence	9	11

Source: ATO

Table 3.6**Tobacco licence applications 2002–03 to 2004–05**

Tobacco licence	2002–03	2003–04	2004–05
Manufacture licence	6	1	1
Storage licence	12	4	3
Producer licence	13	26	40
Dealer licence	2	7	5

Source: ATO

3.29 The ATO has a range of compliance responses it can initiate against non-compliant licensed tobacco farmers. For the least serious compliance breaches, the ATO may provide general education or information sessions for growers and their taxation agents to acquaint them with their obligations under excise and tax legislation. In a similar spirit, ATO officers may visit licence holders from time to time to help them understand particular aspects of their licences and obligations under excise and tax legislation. When the ATO detects possible breaches of licence conditions, licence holders may receive written advice from the ATO about the possible breach of excise legislation. The ATO will usually advise the licence holder of ways to rectify the possible breach and of the consequences of not so doing.

3.30 There is a range of administrative actions the ATO can take in response to more serious non-compliant behaviour. It can, for example, add further conditions to a licence or it can suspend or cancel a licence. Section 105 of the *Excise Act 1901* provides that an authorised officer may at any time check the stock of tobacco leaf of any producer or dealer. If a deficiency cannot be satisfactorily accounted for, the producer or dealer must pay duty on the amount of tobacco leaf found to be deficient. The duty is calculated as if the

tobacco had been manufactured into excisable goods and entered into home consumption on the day on which the deficiency was found. The *Proceeds of Crime Act 1987* provides a scheme to trace, restrain and confiscate the proceeds of crime against Commonwealth law.³²

3.31 The ANAO found that the ATO has acted, or is considering taking action, along the lines of all compliance responses reviewed above.

3.32 In support of compliance activity, the ATO conducts a range of surveillance, monitoring and enforcement activities. The latter is carried out in conjunction with state and territory police forces.

Retailers

3.33 The ATO can use a range of compliance responses against tobacco retailers who undertake non-compliant activity. For the least serious breaches, the ATO may provide general education or mail out information to tobacco retailers and their taxation agents to remind them of their obligations under excise and tax legislation. Further, ATO officers will visit some retailers to:

- provide advice on the penalties for buying or selling illegal tobacco;
- gather information on products sold (roll-your-own papers, tubes, etc.);
- determine if they have been approached to buy or sell illegal tobacco;
- assess whether their business has been affected by illegal tobacco; and
- provide ATO contact details for them to volunteer further information.

3.34 If an ATO compliance officer finds illegal tobacco on a retailer's premises, the officer will issue a Penalty Infringement Notice and confiscate the tobacco. Penalty Infringement Notices are currently set at \$2 200. The Taxation Commissioner's Annual Report for 2004–05 states that 34 notices amounting to \$74 800 were issued as an alternative to prosecution. The ANAO found that the ATO has acted, or is considering taking action, along the lines of all of the compliance responses reviewed above.

Whole-of-ATO response to address non-compliance with tax obligations

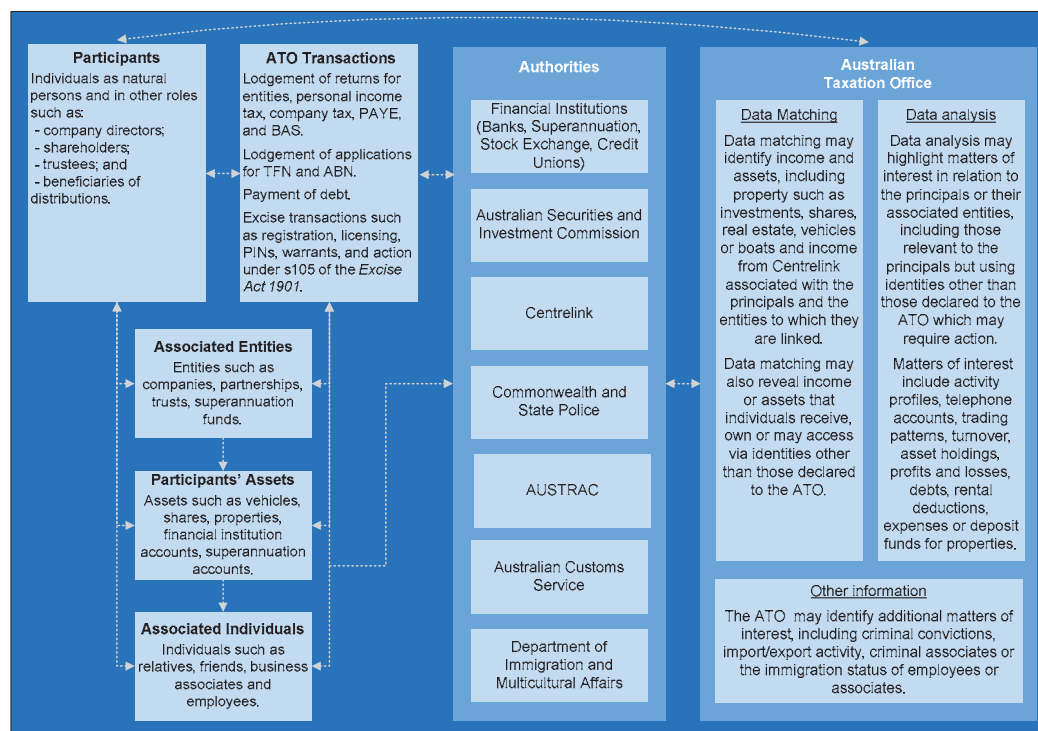
3.35 The ATO has a whole-of-ATO project underway to ascertain the extent to which people associated with the illegal tobacco market (growers, retailers

³² The objects of this Act are to deprive people of the proceeds and benefits derived from the commission of offences against the Commonwealth/Territories; to provide for forfeiture of property used or in connection with offences; and to enable law enforcement authorities to trace proceeds, benefits and property.

etc) comply generally with tax legislation. This project considers related compliance issues, such as payments made by Centrelink and obligations to state government authorities. The framework of this approach is illustrated in Figure 3.1. The ANAO considers there is scope for wider application of the whole-of-ATO view of people involved in the illegal tobacco market.

Figure 3.1

Information sources and linkages used by whole-of-ATO approach



Source: ANAO analysis of ATO information

Profit takers and/or organisers of the illegal tobacco market

3.36 ATO research suggests that the profit takers, or organisers, in the illegal tobacco market are criminals actively involved in other forms of criminality such as drugs, money laundering, identity fraud, and car rebirthing as well as tobacco smuggling. ATO research shows that this type of highly organised involvement in the illegal tobacco market has intensified over the past three years. This is evidenced by, amongst other things, a degree of ‘vertical integration’ by, for example, criminal groups having an associate obtain a licence to grow tobacco. The consequences of this criminal behaviour are serious, and include an adverse impact on the integrity of the taxation system

as well as on the rule of law generally. The linchpin in the illegal tobacco market is the collection of groups that organise to purchase illegal tobacco from farmers, process it into a form suitable for sale and distribute it to retailers to sell illegally. This underlines the importance of enforcement activity to counter the broad and organised activity identified by the relevant authorities.

3.37 During the audit, the ATO initiated multi agency approaches, involving state and federal agencies, focussing strategically on the whole of the illegal production and distribution chains. The ATO is also applying a whole-of-ATO approach to the tax affairs of people and entities identified through this operation.

Consumers of illegal tobacco

3.38 The Australian Institute of Health and Welfare estimates there are currently 290 000 Australian smokers who occasionally or regularly use illegal tobacco.³³ The Department of Health and Ageing advise that the proportion of smokers in Australia who use illegal tobacco is estimated to be fairly small. Unpublished data from the 2003 National Tobacco Campaign Evaluation Survey estimated that less than 5 per cent of smokers and recent quitters smoke illegal tobacco. Anecdotal evidence indicates that many consumers purchase illegal tobacco because it is cheaper than legal tobacco and/or because they believe it is 'natural', unadulterated and therefore a less harmful product than legal tobacco.³⁴ The ANAO understands that a 100 gram pouch of illegal tobacco costs approximately \$13, whereas 100 grams of legal tobacco costs approximately \$36.

3.39 Expert advice commissioned by the Department of Health and Ageing showed that illegal tobacco on the market that has been grown in Australia presents serious additional health risks to those of legal tobacco, as it typically

³³ One in five smokers in Australia has acknowledged awareness of illegal tobacco. Of them, 60 per cent volunteer to having smoked it. Australian Institute of Health and Welfare 2002, *2001 National Drug Strategy Household Survey Detailed Findings*, AIHW Canberra.

³⁴ Bittoun, R 2002, 'Chop-chop' tobacco smoking', *Medical Journal of Australia*, 177, 686–687. The ANAO notes that Dr Bittoun focussed only on the health effects of Australian grown but illegally manufactured and sold tobacco, not smuggled tobacco products, the other main source of illegal tobacco.

contains a vast array of contaminants.³⁵ Illegal tobacco is often wet, sometimes to the extent that excess water has to be poured off. Twigs and pulp from raw cotton, hay, cabbage leaves and grass clippings are some of the vegetable matter that may be added to illegal tobacco in order to bulk up the weight for sale. The research reported a dense volume of fungal contamination in the samples examined. The illnesses caused by fungal agents range from allergic reactions, chronic bronchitis, asthma, aspergillosis, alveolitis, pneumonitis, and lung cancer to Legionnaire's disease.

3.40 ATO compliance activity is currently directed at the supply side of the illegal tobacco market as consumers may not breach any law by purchasing illegal tobacco. Currently there are no initiatives directed at the demand side, with the exception of a fact sheet published by the Commonwealth Department of Health and Ageing.³⁶ The ANAO considers that the ATO engage with the Department of Health and Ageing so that the two agencies might examine opportunities to better inform current and potential consumers of illegal tobacco of the serious health risks associated with consuming illegal tobacco. A targeted health education campaign directed at current and potential consumers of illegal tobacco may be warranted. Amongst other things, a campaign could reduce the demand for illegal tobacco. The Department of Health and Ageing advised that the underlying principle upon which the Australian Government's current tobacco control policy is based is *'there is no such thing as a safe cigarette'*. The ANAO notes that the goal of the National Tobacco Strategy 2004–2009 is *'to significantly improve health and to reduce the social costs caused by, and the inequity exacerbated by, tobacco in all its forms'* and that this includes illegal tobacco. The Department of Health and Ageing further advised that while there are health issues specific to the use of illegal tobacco, people who use this material are still susceptible to health risks associated with smoking tobacco. Most people who smoke illegal tobacco also smoke lawfully manufactured and sold tobacco. They are therefore in the

³⁵ Bittoun, R *The Medical Consequences of Smoking 'Chop-Chop'*, Discussion paper prepared for the Commonwealth Department of Health and Ageing, December 2004 website address: <<http://www.health.gov.au/internet/wcms/publishing.nsf/Content/health-mediarel-yr2005-cp-pyn029.htm>>. The ANAO notes that Dr Bittoun focussed only on the health effects of Australian grown but illegally manufactured and sold tobacco, not smuggled tobacco products, the other main source of illegal tobacco). The Department of Health and Ageing has advised that there is limited research available on the specific health effects of smoking illicit tobacco.

³⁶ On February 2005 the Department of Health and Ageing released a Fact Sheet about illegal tobacco. See: <<http://www.health.gov.au/internet/wcms/publishing.nsf/Content/health-publth-strateg-drugs-tobacco-chop-chop.htm>> for more information.

target group for the National Tobacco Strategy 2004–2009 and the current education campaign activity.

Recommendation No.1

3.41 The ANAO recommends that to help address demand for illegal tobacco, the ATO provide the Department of Health and Ageing with the relevant information to assist that Department review the scope for strategies directed at consumers.

ATO Response

3.42 Agreed. The ATO will provide information regarding the amount of tobacco being diverted to the illegal market along with information regarding seizures to the Department of Health and Ageing for consideration in the development of community messages around the effects of tobacco smoking on health.

Department of Health and Ageing Comment

3.43 The Department would be happy to receive any relevant information the ATO can provide in order to support the Department's responsibilities under the *National Tobacco Strategy 2004–2009*.

ANAO conclusion

3.44 The ATO has fully implemented Recommendation Nos.2 and 3 of Report No.55 of 2001–02.

Excise intelligence capability

Staff skills

Findings from Report No.55 of 2001–02

3.45 Report No.55 of 2001–02 found that the intelligence gathering and analysis skills of excise staff varied considerably. At the time the ATO acknowledged that specific intelligence training would be needed for some staff. The ANAO considered that all staff involved in gathering and analysing tobacco-related intelligence should undertake specialised intelligence training.

Report No.55 of 2001–02 — Recommendation No.4

The ANAO recommends that the ATO evaluate its tobacco excise intelligence capability to help ensure that staff have the skills necessary to effectively gather and analyse strategic, operational and tactical intelligence.

ATO response: Agreed.

ANAO's findings from the current audit

3.46 The ATO's serious non-compliance intelligence capability now resides in the SNC BL. The SNC BL is building its intelligence capability to deliver strategic, operational and tactical intelligence in the areas of serious fraud and evasion. As well, the ANAO supports the initiatives underway in the Excise BL to complete the Excise BL's intelligence framework and improve intelligence capability. Other initiatives that would contribute to fully addressing this recommendation include:

- completing the modelling of the tobacco markets (legal and illegal);
- upgrading the data used by the models and integration of the project; and
- purchasing associated specialist software and training of additional staff in its use.

ANAO conclusion

3.47 The ATO has substantially completed Recommendation No.4 of Report No.55 of 2001–02.

Overall ANAO conclusion about risk management

3.48 The ANAO found that when managing excise risks, the ATO has made significant progress since the previous audit. The Excise BL's capacity to manage risks is enhanced by two specific improvements. One is use of petroleum and tobacco market modelling, and the other is use of licences to manage compliance.

3.49 The ATO considers that the risk of fuel substitution is currently moderate. The ANAO notes that effective management of the risk requires constant vigilance. Fuel substitution may arise from opportunistic behaviour trying to exploit unexpected or sudden developments. Nevertheless, because it is opportunistic, it is amenable to ATO compliance actions.

3.50 The ATO considers that the risk of illegal tobacco operations is currently severe. Tobacco continues to be diverted from Australian plantations into the illegal tobacco market, despite the ATO's intensive compliance activity.

3.51 Once the tobacco market modelling is completed, the ATO should be better able to monitor and evaluate industry compliance by using ratios of illegal tobacco grown and/or seized compared to the total quantity grown.

3.52 If successful in the medium term, the specialist group established to combat the organised criminal activity currently operating in the illegal tobacco market, augmented by the whole-of-ATO approach, may reduce this risk.

3.53 The ANAO considers there is scope to moderate demand for illegal tobacco. This may be achieved by a well-targeted campaign that brings to the attention of current and potential consumers of illegal tobacco the serious additional health risks.

4. Governance

This chapter discusses Recommendations No.2, 3, 7, 8 and 12 of Report No.17 of 2001–02, and Recommendations No.1, 6, 7 and 8 of Report No.55 of 2001–02. These recommendations concern governance of excise administration, including strategic planning, external partnerships and organisational arrangements.

Introduction

4.1 Public sector governance refers to the way in which an organisation is managed, including structure, culture, policies, strategies and management of stakeholder relationships. The objective of public sector governance is to ensure the organisation achieves overall outcomes in a way that enhances confidence in the organisation, its decisions and actions.³⁷ Audit Report No.17 of 2001–02 and Audit Report No.55 of 2001–02 raised a range of governance issues that are followed up in this chapter.

4.2 The ANAO found that a number of changes to the ATO governance framework have occurred since the previous audits. Areas in which significant change to the ATO's governance has occurred are in the ATO's:

- *planning framework*—including the ATO's sub-plan approach;
- *reporting arrangements*—including the ATO Health of the System Assessment (HOTSA) process;³⁸
- *external relationships*; and
- *structure*—including creation of the Serious Non-Compliance Business Line.

The current structure of the ATO is discussed in Chapter 1, *Background and Context*. Other areas in which significant changes have taken place are discussed in more detail below.

³⁷ ANAO, 2003, *Public Sector Governance, Volume 1*. Better Practice Guide, Framework, Processes and Practices, p. 6.

³⁸ HOTSA reports are designed to assess potential risks across eleven core aspects of management. These are referred to as compliance pillars or key success factors. These key success factors range from the level of revenue collected through to system design and sustainability issues.

Planning framework

4.3 The ATO's planning framework incorporates three views of the organisation: market segments; corporate capabilities; and revenue products and special focus areas.³⁹ Information about risks, organisational priorities and strategies from these views input into the ATO's planning processes. The high-level planning documents relevant to excise administration are the ATO's:

- *Outcome and Outputs Framework*—establishes the ATO's corporate direction, impacts to be achieved and specifies the products and services it has undertaken to deliver to the community;
- *Strategic Statement*—provides direction and a framework for the ATO's activities over the three-year period, 2003–05. The ATO's business intent as outlined in the Strategic Statement, is *To optimise collections and make payments under the law in a way that instils community confidence that the system is operating effectively*;
- *Plan*—collectively the ATO's five sub-plans form the ATO Plan. The ATO's sub-plans articulate the strategies, priorities, risks and performance measures the ATO uses to manage performance in relation to outcomes to be achieved and outputs to be produced. Activities associated with managing excise are funded under the Compliance and Operations Sub-Plans;
- *Excise Line Delivery Plan*—this annual plan sets out the contribution the Excise BL will make to the sub-plan, and provides the direction and framework for activities it will undertake during the year. Within the Excise BL, each business unit then develops its own plan; and
- *Serious Non-Compliance National Plan*—identifies priorities, risks, strategies, resourcing and outputs for the SNC BL over a five-year period.

³⁹ Market segments include large businesses, small to medium enterprises, micro businesses, individuals, and not-for-profit and government. Revenue products are excise, goods and services tax, income tax, and superannuation, while examples of special focus areas are aggressive tax planning, and the cash economy. Corporate capabilities include active compliance, provision of written advice and client contact, amongst others.

Reporting arrangements

4.4 Performance monitoring and reporting are important aspects of governance. The ANAO noted that the Excise BL and the SNC BL are subject to the governance reporting requirements common to the whole ATO, including:

- annual reporting such as the HOTSAs process; and
- quarterly and monthly governance reporting.

4.5 These reports provide a comprehensive picture of the numbers of activities and time and cost considerations by project, focus area, market and product. Various groups and forums within the ATO receive these reports, including the Excise BL Executive, Active Compliance Steering Committee, ATO Productivity Committee, market committees, capability leaders, the plenary governance forum, and the ATO Executive.

4.6 Audit Report No.20 of 2004–05 *The Australian Taxation Office's Management of the Energy Grants (Credits) Scheme* reported that the Excise BL had established reasonable planning, monitoring and reporting frameworks. These frameworks involve structured approaches to planning, a structured and regular system for performance monitoring, and well-structured and timely performance reports (despite the reporting framework being complex).

External relationships

4.7 A memorandum of understanding between the ATO and Customs governs the working relationship between the two agencies and was signed on 9 January 2004.

4.8 Following passage of the *Fuel Quality Standards Act 2000* the Department of the Environment and Heritage assumed full responsibility for fuel quality testing.⁴⁰ The ATO no longer has any responsibility for, nor conducts, any fuel quality testing. Further, excise legislation provides no head of power for the ATO to pursue fuel quality issues.

4.9 A draft memorandum of understanding between the ATO and the Australian Federal Police provides a framework of cooperation for investigating taxation cases and related matters involving money laundering and other criminal activity. A memorandum of understanding between the ATO and the Victorian Police formalises monitoring of tobacco growing in the Myrtleford area of Victoria.

⁴⁰ The December 2004 memorandum of understanding that governed the relationship between the ATO and the Department of the Environment and Heritage, in relation to fuel sampling, expired on 30 June 2005.

Strategic planning

Findings from Report No.17 of 2001–02

Petroleum excise licensing policy and procedures manual

4.10 Audit Report No.17 of 2001–02 found that the Excise BL did not have a consolidated and up-to-date licensing and procedures manual to support petroleum excise administration. This resulted in a lack of strategic direction in administering the licensing function, a heavy reliance by licensing staff on the then Petroleum Energy Industry Group for advice, and an increased possibility of personal interpretation in the licensing process. The following recommendation was made.

Report No.17 of 2001–02 — Recommendation No.3

The ANAO recommends that the ATO develop a comprehensive petroleum excise licensing policy and procedures manual that provides operational guidance, within the necessary strategic management context, for administering the licensing function.

ATO response: Agreed.

ANAO's findings from the current audit

4.11 The ANAO found that the Excise BL has developed a licensing policy and procedures manual, which is electronically embedded within the Excise Collection System.

Findings from Report No.55 of 2001–02

Tobacco Industry Group Business Plan strategies and objectives

4.12 At the time of the previous audit, the ANAO found that the then Tobacco Excise Industry Group had not adequately developed strategies and performance measures in its business plans. The ANAO considered this prevented the ATO from fully using all available resources. As a result, the ANAO made the following recommendation.

Report No.55 of 2001–02 — Recommendation No.1

The ANAO recommends that, as part of a continuous improvement process, when developing the Business Plan for 2002–03, the Tobacco Excise Industry Group articulate clearly appropriate strategies and measures aimed at achieving the objectives identified in the Business Plan and assess its performance against those objectives.

ATO response: Agreed.

ANAO's findings from the current audit

4.13 The ANAO found that the ATO has placed governance of the Excise BL on the same footing as the ATO's other business lines and that integration of the excise function into the ATO is complete. The ANAO noted that the ATO has developed a corporate planning Practice Statement.⁴¹ The ANAO reviewed the *Excise Line Delivery Plan 2004–05*, the *Tobacco Industry Group Business Plan 2004–05* and the draft *Excise Line Delivery Plan 2005–06*. The ANAO considers that these plans comply with the ATO's design criteria for plans, as detailed in the Practice Statement.

Performance monitoring and reporting

4.14 While the ATO has placed governance of the Excise BL on the same footing as the ATO's other business lines, the ANAO considers that performance monitoring and reporting could be further improved by more extensive use of measures of effectiveness, such as ratios, to set targets and report performance against the targets. As a general rule, where performance is being measured quantitatively, it is preferable to use the ratio of the actual quantity obtained from the measurement to the total quantity in that category (if available) rather than simply the actual quantity obtained. Using ratios in this way enables evaluation of achievement against set performance targets. Such targets would be expressed in terms of achieving a nominated percentage of the total quantity in the category. In other areas of activity where reliable and valid measures of quantity are not readily available, such as in relation to the illegal tobacco market, the ATO will need to develop good measures of effectiveness to use in governance of the excise function.

⁴¹ The Practice Statement applies to all ATO plans, and requires them to align with the ATO's higher level plans; detail how activities will deliver on one or more of the sub-plan outputs; document the purpose of the plan; define the client group for which the program is responsible; list the risks to be managed and their mitigation strategies; and define what is to be achieved during the relevant period, how this is to be achieved, performance measures to assess their achievement and associated accountabilities.

4.15 The ANAO notes that obtaining reliable and valid estimates of the quantities necessary for setting targets and monitoring and evaluating performance against those targets might not be practical in all circumstances. Nevertheless, there are some key variables that are of greatest relevance to overall performance. As reported elsewhere (for example, Chapter 3), the ATO is working on systems that would yield this information in the future. As noted in Chapter 3, the ANAO considers that the ATO needs better measures of the effectiveness of compliance strategies directed at the illegal tobacco market.

4.16 By using ratios to set targets and report performance against targets, the ATO Executive could get a more complete understanding of what is being achieved and at what cost. In addition, the Executive could be better informed about gaps in achievement, the cost of closing those gaps and any opportunity costs associated with additional achievement. In this regard, information about the extent to which objectives remain to be achieved and the cost of doing so supports improved strategic decision-making. For example, it is often essential to make trade-offs between the extent to which objectives can be achieved given actual and opportunity costs. Since several business lines administer important excise functions, information using ratios to report performance could be considered necessary for good governance of the function.

4.17 The ANAO considers that the ATO effectiveness in reducing the illegal tobacco market requires ongoing evaluation of the likelihood of tobacco continuing to be diverted from Australian plantations into the illegal market.

Recommendation No.2

4.18 The ANAO recommends that to improve management reporting and decision-making, the internal management reports about excise administration be enhanced through increased use of measures of effectiveness to report performance, targets and progress against targets.

ATO Response

4.19 Agreed. The ATO acknowledges the benefits of articulating effectiveness measures in the strategic planning process and in evaluating treatment strategies.

4.20 The ATO has recently expanded its compliance strategies from a concentrated focus on diversion of illicit tobacco from farms to include the identification of networks used in its production, distribution and sales. The

ATO will review its effectiveness measures to encompass the development of this approach and consider effectiveness measures from a cross tax product perspective.

ANAO conclusion

4.21 The ATO has fully implemented Recommendation No.3 of Report No.17 of 2001–02 and Recommendation No.1 of Report No.55 of 2001–02.

External partnerships

Findings from Report No.17 of 2001–02 and Report No.55 of 2001–02

Excise revenue collection control arrangements with Customs

4.22 At the time of the previous audit, Customs collected excise on behalf of the ATO. Noting that the ATO was at least a year away from implementing the Excise Collection System, Report No.17 of 2001–02, recommended strengthening the ATO's controls over collection processes.

Report No.17 of 2001–02 — Recommendation No.8

The ANAO recommends that, in order to provide the necessary assurance on the integrity and effectiveness of the excise revenue collection function, the ATO should strengthen existing controls relating to excise revenue collection arrangements with Customs.

ATO response: Agreed.

ANAO's findings from the current audit

4.23 The ANAO found that as a result of implementing the Excise Collection System, all excise administration is now within the ATO.

ATO and Customs memorandum of understanding

4.24 Both previous audits identified the need for a memorandum of understanding between the ATO and Customs. As a result, the ANAO made the following recommendations

Report No.17 of 2001–02 — Recommendation No.2 and Report No.55 of 2001–02 — Recommendation No.7

The ANAO recommends that, to effectively administer the excise collection function and to maintain a cooperative and effective working relationship, the ATO and Customs should finalise a memorandum of understanding on mutual interests and responsibilities in excise administration.

ATO and Customs response: Agreed.

The ANAO recommends that, to help develop an efficient and effective approach to joint compliance and to minimise compliance costs for the tobacco industry, the ATO and Customs agree on the joint compliance working arrangements for tobacco audits, and incorporate them into the Memorandum of Understanding currently being developed between the ATO and Customs.

ATO and Customs Response: Agreed.

ANAO's findings from the current audit

4.25 The final schedule to the memorandum of understanding (Schedule 2 Excise) was signed and effective on 9 January 2004. The ANAO noted there are good working relationships between the two agencies under the memorandum of understanding.

Formal arrangements with Environment Australia regarding fuel quality standards

4.26 Report No.17 of 2001–02 identified the need for a memorandum of understanding between the ATO and the agency then known as Environment Australia, (now the Department of the Environment and Heritage) about implementing fuel quality standards. The ANAO therefore made the following recommendation.

Report No.17 of 2001–02 — Recommendation No.12

The ANAO recommends that the ATO formalise its arrangements with Environment Australia on the implementation of fuel quality standards, to enable both agencies to maximise their benefits from fuel testing initiatives.

ATO response: Agreed.

ANAO's findings from the current audit

4.27 The ATO no longer has responsibility for, nor conducts, any fuel quality testing. Further, excise legislation provides no head of power for the ATO to pursue fuel quality issues.

4.28 Following passage of the *Fuel Quality Standards Act 2000*, which now regulates fuel quality, the Department of the Environment and Heritage assumed full responsibility for fuel quality testing. The ATO and the Department of the Environment and Heritage concluded a memorandum of understanding for the transition period during which the ATO continued with fuel testing under the direction, and on behalf, of the Department. This memorandum of understanding governed, amongst other things, the fuel testing regime, including issues about fuel quality, which the ATO conducted, on a user pays basis, on behalf of the Department. The ATO ceased fuel testing activity during 2004–05.

4.29 The Act was amended in 2004 by inserting section 67A, which enables certain information gathered under the Act to be shared with the Commissioner of Taxation ‘for use in relation to grants described in the *Energy Grants (Cleaner Fuels) Scheme Act 2004*’.

4.30 In April 2005 the report of the independent statutory review of the *Fuel Quality Standards Act 2000* was tabled in the Parliament. This report identified the need for a range of legislative and administrative improvements, including broadening section 67A to include *Excise Act 1901* matters. The Department of the Environment and Heritage is responsible for advising the Government about the recommendations of the report.

4.31 The *Fuel Quality Standards Act 2000* and excise legislation interact in various ways. For example, some fuel substitution that is an offence under the excise legislation, such as the diversion of heating oils into the diesel market, would result in a product that does not comply with the Diesel Standard, a determination made under the *Fuel Quality Standards Act 2000*. Conversely, activities that are lawful under the excise arrangements, such as addition of ethanol to petrol, may violate the fuel quality standards mandated by the *Fuel Quality Standards Act 2000*.⁴² As a result, the ANAO understands that incidents that relate to either fuel substitution in relation to either excise or fuel standard matters may inevitably be of concern to both agencies. Therefore, the occurrence of a fuel quality incident may have implications for excise administration; conversely, the ATO’s Excise BL may have information (of a non-taxation nature) that could help the Department of the Environment and

⁴² In 2003 the Government set a 10 per cent cap on the level of ethanol that can be added to petrol under the *Fuel Quality Standards Act 2000*. The Department of the Environment and Heritage vehicle testing found petrol containing ethanol blends of 20 per cent or more may cause engine problems in some older vehicles. See <<http://www.deh.gov.au/atmosphere/fuelquality/standards/ethanol/labelling.html>>.

Heritage administer the *Fuel Quality Standards Act 2000*. The ANAO considers that the ATO and the Department of the Environment and Heritage should review the memorandum of understanding between the two agencies to improve their sharing of relevant information. Any exchange of information between the agencies would need to take place within the boundaries of the privacy and secrecy legislation governing how the two agencies collect and handle sensitive information.

Recommendation No.3

4.32 The ANAO recommends that, having regard to the Fuel Quality Standards Act 2000 and the role of the Department of the Environment and Heritage in administering that Act, the ATO review the memorandum of understanding between the two agencies to improve their sharing of relevant information.

ATO Response

4.33 Agreed. The ATO has progressed the review of the memorandum of understanding with the Department of Environment and Heritage. The information shared will include the methodology used in the development of compliance activities around fuel testing and also the results of fuel testing to ensure clients are eligible to claim fuel tax credits.

Formal intelligence sharing

4.34 Report No.55 of 2001–02 identified the need for improved intelligence capability, including formal intelligence sharing arrangements with a range of authorities. Accordingly, the ANAO made the following recommendation.

Report No.55 of 2001–02 — Recommendation No.6

The ANAO recommends that, to develop a more effective tobacco intelligence capability, the Excise Business Line consider establishing and maintaining formal intelligence sharing arrangements with:

- tobacco retailers;
- Customs;
- Australian Federal Police and State police forces; and
- State Road Traffic Authorities.

ATO response: Agreed with qualification.

ANAO's findings from the current audit

4.35 Most of the activity to which this recommendation relates is now within the SNC BL.

4.36 The ANAO accepts that intelligence sharing with retailers has practical limitations and noted that the tobacco retail sector as a whole provides the ATO with useful intelligence about the illegal tobacco market. There may be merit in the ATO obtaining retail data from tobacco manufacturers to help administer the *Excise Act 1901*, especially to better target compliance activities in the tobacco retail sector.

4.37 The ANAO noted that a formal memorandum of understanding governs the ATO–Customs relationship. The ANAO noted good working relationships between the two agencies. The ANAO expects these interactions to strengthen, given that demand for illegal tobacco appears to significantly exceed supply from Australian plantations. In the absence of demand abating and if the ATO's compliance activity reduces the domestic supply of illegal tobacco, operators in the illegal market may attempt to procure illegal tobacco from abroad.

4.38 The ANAO noted that since the SNC BL was established, the ATO has developed strong intelligence sharing arrangements with the Australian Federal Police and State police forces. For example, there is a formal memorandum of understanding between the ATO and the Victorian Police in relation to tobacco growing in the Myrtleford area of Victoria. As well, the relationship between the ATO and the New South Wales Police has been recently established and may warrant a formal memorandum of understanding.

4.39 The ANAO noted that the ATO has appropriate access to relevant State Road Traffic Authority data and accepts that intelligence sharing arrangements with these authorities has practical limitations.

ANAO conclusion

4.40 The ATO has fully implemented Recommendation No.2 and No.8 of Report No.17 of 2001–02, and Recommendation No.6 and No.7 of Report No.55 of 2001–02.

4.41 The ATO has substantially completed Recommendation No.12 of Report No.17 of 2001–02. The ANAO considers that a memorandum of

understanding between the ATO and the Department of the Environment and Heritage would improve sharing of relevant information between the agencies.

Organisational arrangements

Findings from Report No.17 of 2001–02

Reporting between the Excise Investigations Unit, Field Services Branch management and the Petroleum Industry Group

4.42 Notwithstanding the need to maintain security for intelligence and investigation information, the ANAO considered that the two-way flow of information between the then Petroleum Industry Group and the then Investigations Unit would contribute to more effective management of excise arrangements. As a result, the ANAO made the following recommendation.

Report No.17 of 2001–02 — Recommendation No.7

The ANAO recommends that the ATO implement comprehensive and regular reporting on progress with investigation cases and on strategic and operational issues of importance, between the Excise Investigations Unit, Field Services Branch management and the Petroleum Excise Industry Group.

ATO response: Agreed.

ANAO's findings from the current audit

4.43 A service level agreement between the Excise BL and SNC was completed before the audit. The Excise BL receives regular formal and informal case updates from the SNC BL. The ANAO noted that at the time of the audit, the SNC BL was considering only a small number of petroleum cases, and the work referred by the Excise BL was almost all for illegal tobacco.

Findings from Report No.55 of 2001–02

Clarify the roles of the Tobacco Industry Group and the Investigations Unit

4.44 At the time of the previous audit, the ANAO considered that more clearly defining the roles and responsibilities of the Tobacco Industry Group and the then Excise Investigations Unit would eliminate duplication of information and analysis effort, ensure an effective intelligence capability, and allow the Excise BL to better achieve tobacco excise investigations outcomes. Consequently, the following recommendation was made.

Report No.55 of 2001–02 — Recommendation No.8

The ANAO recommends that, to better achieve its tobacco excise investigation outcomes, the Excise Business Line clarify the role of the Tobacco Industry Group and the Excise Investigations Unit in:

- planning and prioritising investigations activities; and
- sharing relevant information and intelligence.

ATO response: Agreed with qualification.

ANAO's findings from the current audit

4.45 The functions of the then Excise Investigations Unit have been transferred to the SNC BL. The ANAO considers the relationship between the SNC BL and the Excise BL is working well and there are good professional working relationships between ATO officers at a range of levels. The ANAO also noted that ATO procedures were tightened significantly after an internal fraud incident in 2004.

ANAO conclusion

4.46 The ATO has fully implemented Recommendation No.7 of Report No.17 of 2001–02, and Recommendation No.8 of Report No.55 of 2001–02.



Ian McPhee
Auditor-General

Canberra ACT
2 March 2006

Appendices

Appendix 1: ATO Response



Australian Government
Australian Taxation Office

SECOND COMMISSIONER OF TAXATION

Mr Peter White
Executive Director
Performance Audit Services

Australian National Audit Office
GPO Box 707
CANBERRA ACT 2601

3 February 2006

Dear Mr White

**Performance Audit – Administration of Petroleum and Tobacco Excise Collections:
Follow-up Audit**

Thank you for providing a copy of the proposed audit report on the ATO's activities following on from two earlier audits *The Administration of Petroleum Excise Collections* (Audit Report No.17, 2001-02) and *The Administration of Tobacco Excise* (Audit Report No55, 2001-02).

It is pleasing to see that the ANAO have confirmed that seventeen of the twenty recommendations made in the earlier audits have been fully implemented and that the remaining three recommendations have been substantially completed. The report also acknowledges plans are in place and well progressed to finalise the implementation of these recommendations as well.

Thank you for your constructive and co-operative approach to this review. I would like to commend to you the work of your auditors, Richard Mackey and Kirsty Stuart who were very professional in their approach.

The ATO's formal response to the report is enclosed at attachment A in accordance with Sec 19 of the *Auditor-General Act 1997* and our comment for inclusion in the brochure accompanying the report is enclosed at attachment B.

Should you wish to discuss this matter further please contact Kath Quigley on (07) 3853 4701.

Yours sincerely,

Jennie Granger
Second Commissioner
Australian Taxation Office

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Attachment A

Recommendation No. 1
Para 3.41

The ANAO recommends that to help address demand for illegal tobacco, the ATO provide the Department of Health & Aging with the relevant information to assist that Department review the scope for strategies directed at consumers.

ATO Response Agreed.

The ATO will provide information regarding the amount of tobacco being diverted to the illegal market along with information regarding seizures to the Department of Health and Ageing for consideration in the development of community messages around the effects of tobacco smoking on health.

Recommendation No. 2
Para 4.17

The ANAO recommends that to improve management reporting and decision-making, the internal management reports about excise administration be enhanced through increased use of measures of effectiveness to report performance, targets and progress against targets.

ATO Response Agreed.

The ATO acknowledges the benefits of articulating effectiveness measures in the strategic planning process and in evaluating treatment strategies.

The ATO has recently expanded its compliance strategies from a concentrated focus on diversion of illicit tobacco from farms to include the identification of networks used in its production, distribution and sales. The ATO will review its effectiveness measures to encompass the development of this approach and consider effectiveness measures from a cross tax product perspective.

Recommendation No. 3
Para 4.30

The ANAO recommends that, having regard to the *Fuel Quality Standards Act 2000* and the role of the Department of the Environment and Heritage in administering that Act, the ATO review the memorandum of understanding between the two agencies to improve their sharing of relevant information.

ATO Response Agreed.

The ATO has progressed the review of the memorandum of understanding with the Department of Environment and Heritage. The information shared will include the methodology used in the development of compliance activities around fuel testing and also the results of fuel testing to ensure clients are eligible to claim fuel tax credits.

Attachment B**Administration of Petroleum and Tobacco Excise Collections: Follow-up Audit**

The Report recognises the ongoing challenges in the administration of excise with particular regard to those operating outside the system. The ATO appreciates that the report positively acknowledges the advances made in relation to improved intelligence systems, the establishment of the Serious Non Compliance business line to develop strategies around serious fraud and evasion and a shift to working across agencies in the administration of various acts and in investigating and tracing networks involved in illicit markets.

The report confirms 17 of the twenty recommendations from two earlier audits *The Administration of Petroleum Excise Collections* (Audit Report No.17, 2001-02) and *The Administration of Tobacco Excise* (Audit Report No55, 2001-02) have been completed and that progress of the three remaining is well progressed.

The report recommendations give guidance with respect to improvement in strategies. The ATO has agreed to these recommendations and has proceeded with implementation.

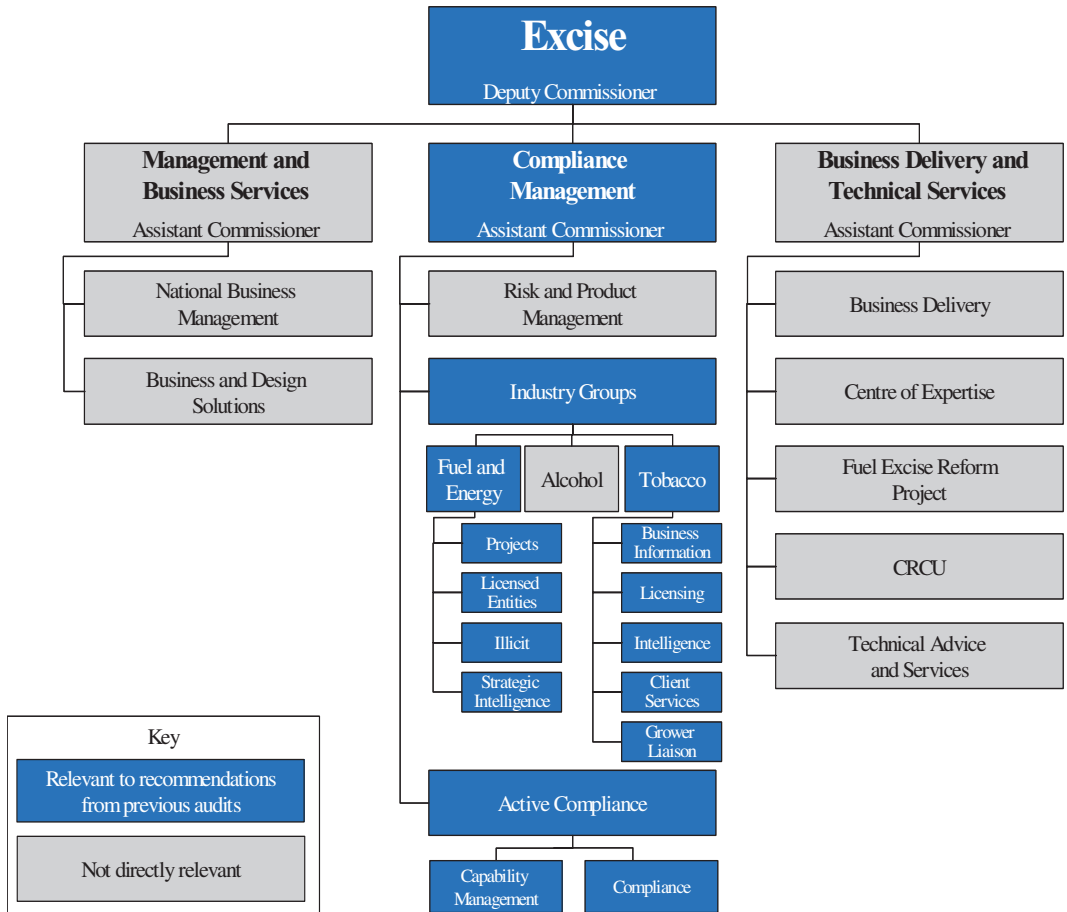
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Appendix 2: Excise Business Line Organisation Chart

Figure A.1 depicts the organisation structure of the Excise BL as at 3 September 2005. Areas relevant to the audit are highlighted in blue.

Figure A.1

Organisation structure of the Excise BL



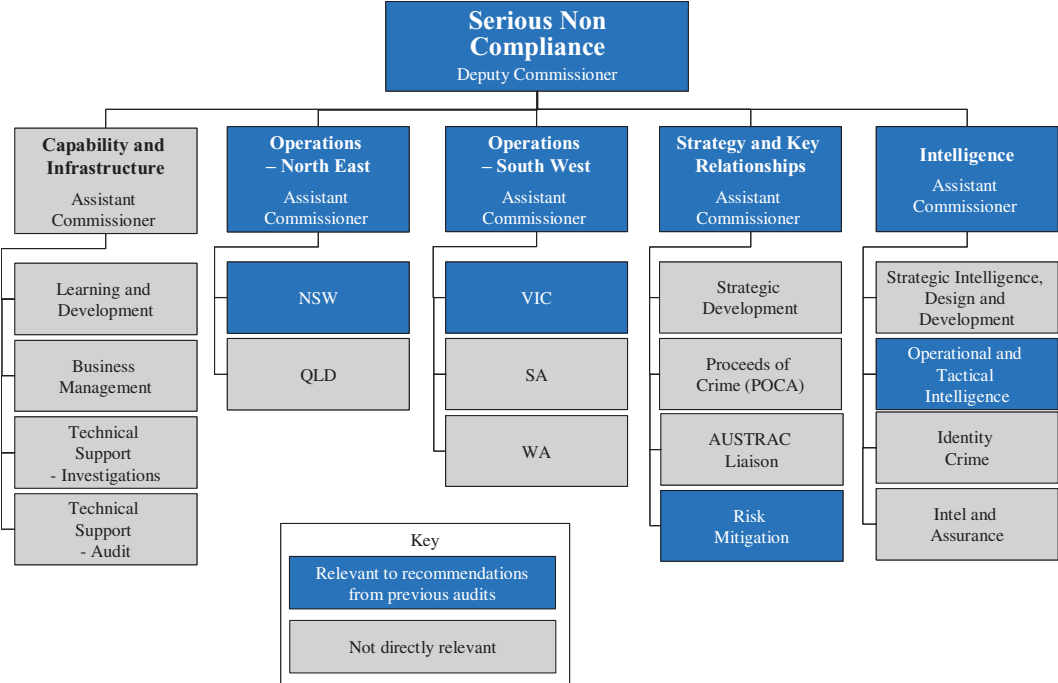
Source: ANAO depiction of ATO material.

Appendix 3: Serious Non Compliance Organisation Chart

Figure A.2 depicts the organisation structure of the SNC BL as at 3 September 2005. Areas relevant to the audit are highlighted in blue.

Figure A.2

Organisation structure of the SNC BL



Source: ANAO depiction of ATO material.

Appendix 4: Excise Licences and Permissions

Table A.1 sets out the licences and permissions (for petroleum and tobacco) issued by the ATO, indicating the section of the *Excise Act 1901* under which these are issued.

Table A.1

Excise licences and permissions

Licences	Excise Act 1901	Annual renewal	Issued for tobacco	Issued for petroleum	Purpose
Manufacturer	Part IV	✓	✓	✓	Authorises the manufacture of specific excisable products on the premises specified on the licence.
Storage	Part IV		✓	✓	Allows the licence holder to store specified under-bond goods on licensed premises.
– Duty Free Operator	s.61(D) s.61(E)		✓		Authorises the licence holder to sell under-bond excisable goods to relevant travellers.
Producer	Part IV		✓		Authorises the licence holder to produce tobacco seed, plant or leaf on the premises specified on the licence. The producer may sell their products to licensed manufacturers or dealers.
Dealer	Part IV		✓		Authorises the licence holder to buy or sell tobacco seed, plant or leaf to other licensed manufacturers, producers or dealers.
Permissions					
Periodic Settlement Permission	s.61C		✓	✓	Grants authority to deliver specified excisable goods into home consumption without paying the excise duty. For example, permission holder lodges excise returns and pays excise duty weekly by 4.00 pm Monday for goods delivered the previous week.
Continuing Movement	s.61A s.44		✓	✓	Authorises the continuous or ongoing movement of specific under-bond products between specified places/licensed premises.
Single Transaction	s.61A s.44		✓	✓	Authorises a one-off movement of specific under-bond products between specified places/licensed premises.

Source: ATO

Table A 2**Petroleum and tobacco licences and permissions issued 2004–05**

Licence/permission	No. issued	
	Petroleum	Tobacco
Manufacturer Licence		
- New	44	0
- Renewal	378	4
Storage Licence	5	1
- With Duty Free Operator Permission	–	4
Producer Licence	–	15
Dealer Licence	–	7
Periodide Settlement Permission	11	0
- PSP for Diplomats and Consular Officials	–	1
Continuing Movement Permission	36	47
Single Transaction Permission	30	14

Source: ATO

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