



## Red diesel and private pleasure craft

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At present barges, boats and other private pleasure craft may use 'red diesel' which is charged a much lower rate of excise duty than diesel fuel used in road vehicles: 9.69 pence per litre, compared with 50.35 pence per litre.<sup>1</sup> In 1992 Member States agreed EU-wide rules on charging excise duty, which only allowed for differential duty rates in very limited circumstances. A number of temporary derogations from this directive were made, one of which allowed the UK to continue to charge a reduced rate of duty on fuel used in private pleasure craft, up until 31 December 2006. Despite its efforts, the UK – along with some other Member States – were unable to persuade the European Commission that these derogations should be extended, and in Budget 2007 the Government confirmed it would implement the necessary changes on 1 November 2008: from this date, boat owners will pay the same rate of duty on the fuel they use as road users.<sup>2</sup> In August 2007 HM Revenue & Customs published a consultation document on how best to implement the new regime to minimise its impact on boat owners; comments are invited by 31 October.

This note sets out the current rules for using 'red diesel', before looking at the end of the derogation allowing its use in private pleasure craft, and the impact this may have.

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### A. The duty differential for red diesel

Diesel for agricultural use or other off-road use is subject to a substantially rebated rate of duty. At present "red diesel" as it is called is charged duty at 9.69 pence per litre (the technical term for this product is gas oil). This compares with a duty rate of 50.35 pence per litre charged on ultra low sulphur diesel – a duty differential of 40.66 pence.<sup>3</sup> When delivered from an oil warehouse normal 'white' diesel must have a red dye added to it, along with a chemical marker, before it can be sold as red diesel, so that its use can be detected.

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<sup>1</sup> Figure for ultra low sulphur and sulphur-free diesel. Duty rates on both the main road fuels and rebated fuels rose by 2 pence per litre on 1 October 2007 (HM Revenue & Customs Budget Note BN53, 21 March 2007).

<sup>2</sup> Private pleasure flying has enjoyed a similar duty rebate, which will also end on this date.

<sup>3</sup> Duty rates on all fuel categories over the past ten years are in HM Revenue & Customs, [Hydrocarbon oil duties factsheet](#), December 2006 (pp 11-14).

Red diesel can only be used in vehicles which are not generally used on the road, such as farmers' tractors, mowing machines, mobile cranes, unlicensed vehicles not used on public roads *and* privately owned boats (such as barges). A list of the 'excepted vehicles' that may use red diesel is in HM Revenue & Customs' guidance on the fuel that may be used legally in road vehicles.<sup>4</sup> In December 2004 the Government proposed certain changes to this list, "to ensure rebated oils are used only by appropriate vehicles, thereby helping to tackle oils fraud, protecting revenues and reducing damaging emissions."<sup>5</sup> Provision was made in the *Finance Act 2006* (section 8) to allow such changes to be made by Treasury order,<sup>6</sup> and secondary legislation to this effect was introduced in December 2006.<sup>7</sup>

Those categories of fuel charged a rebated rate of duty are set out in a Government consultation paper published in July 2003 (the paper examined the case for reforming the rate structure for rebated oils, to encourage the use of more environmentally friendly fuels); an extract is given below:

#### **Categories of rebated heavy oil**

Heavy oils are defined as "hydrocarbon oil other than light oil" - light oil being hydrocarbon oil of which not less than 90% by volume distils at a temperature not exceeding 210°C, or which gives off an inflammable vapour at a temperature of less than 20°C (a definition that includes petrol). The main heavy oils used as fuel are gas oil, fuel oil and kerosene. Heavy oils intended for use as fuel other than in road vehicles are subject to excise duty, but this is charged at a rebated rate. Full relief from duty is granted for a limited number of uses, including oil industry own use, commercial marine navigation, use in RNLI lifeboats and the heating of horticultural glasshouses.

Gas oil is heavy oil of which not more than 50% by volume distils at a temperature not exceeding 240°C and of which more than 50% by volume distils at a temperature not exceeding 340°C. The largest use of gas oil in the UK is as diesel road fuel, but more than a quarter is supplied for uses entitled to the rebated duty rate. To distinguish it from road fuel, rebated gas oil is marked with a chemical marker and a red dye. It is used as fuel for non-road vehicles, boats, trains and stationary engines, and for heating in industrial processes and in commercial, public sector and domestic buildings.

Fuel oil is heavy oil which contains in solution an amount of asphaltenes of not less than 0.5 %, or which contains less than 0.5% per cent but not less than 0.1 % of asphaltenes and has a closed flash point not exceeding 150°C. Composed of residual streams from petroleum refining operations, it is unsuitable for use in small diesel engines or boilers, but can be used for power generation and in larger furnaces and boilers. It is essentially a cheap bulk fuel.

Kerosene used as fuel for certain types of engine is charged duty at the gas oil rate. All other heavy oil, including kerosene used for heating, is entitled to a full rebate of duty, giving a nil effective duty rate. Kerosene is heavy oil of which more than 50% by

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<sup>4</sup> HM Revenue & Customs, [Notice 75: Fuel for road vehicles](#), December 2002 pp 12-14.

<sup>5</sup> Cm 6408 December 2004 p 147; HM Treasury / HM Customs & Excise, *Hydrocarbon oil duty: consultation on changes to excepted vehicle schedule*, December 2004.

<sup>6</sup> This was debated at the Committee stage of the Finance Bill on 9 May 2006: SC Deb (A) cc 76-82.

<sup>7</sup> SI 2006/93. The Order was debated by the Fifth Delegated Legislation Committee on 11 January 2007.

volume distils at a temperature of 240°C: it is a low sulphur oil used primarily as a domestic fuel.<sup>8</sup>

The paper says a little about the introduction of a duty differential on gas oil:

Hydrocarbon oil duty on light oil was introduced in 1928. In 1932 the duty was extended to heavy oils, including fuel oil and gas oil, but at a much lower rebated rate. From 1935 the full rate of duty was extended to gas oil used as fuel for diesel road vehicles, but gas oil and fuel oil used for other purposes has continued to be entitled to a partial rebate. In 1986 the rebated rate of duty on gas oil was increased from 0.77 ppl to 1.10 ppl, whilst that on fuel oil was held at 0.77 ppl. Fuel oil has subsequently continued to enjoy a lower rate of duty. Since 1986, the duty on gas oil and fuel oil has, for the most part, been increased broadly in proportion to increases on road fuels.<sup>9</sup>

Although the paper looked at whether the duty rate on rebated gas oil should be amended, to encourage the use of low sulphur gas oil, it did not question the underlying premise of this relief: that the duty charged on fuel used in vehicles that, by and large, make no use of the public road system, should be much lower than on fuel used by those which do – given that most of the wider costs to society from vehicle use come from the latter (including congestion, pollution, noise, accidents and damage to the road infrastructure.) No major changes have been made to the structure of this rebate since then.

In Budget 2004 the Government stated, “initial work suggested that there would be measurable environmental benefits from the introduction of low sulphur rebated oils in certain locations. Further discussion with the oil industry has highlighted the question of whether a differential alone would deliver these benefits or whether this should be coupled with regulatory changes.”<sup>10</sup> The following year it confirmed it would “keep under review whether any changes to the structure or administration of excise duty are required to ensure the availability of lower-sulphur gas oil for use in off-road machines.”<sup>11</sup>

Prior to the 2004 Budget, the differential between gas oil and ultra low sulphur diesel was 42.88 pence;<sup>12</sup> it is now 40.66 pence. Concern at high and volatile oil prices resulted in the main duty rates being frozen in 2004 and 2005,<sup>13</sup> while the rate on red diesel was increased in both years, to reduce the incentive for oils fraud.<sup>14</sup> In the 2007 Budget the Government announced duty rates for the next three years, confirming that the duty differential for rebated fuels would be maintained:

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<sup>8</sup> HM Revenue & Customs, [Hydrocarbon oil duty: consultation on duty differentials for more environmentally friendly rebated oils](#), July 2003 p 5. The review had been announced in *Budget 2003* (HC 500 April 2003 para 7.31).

<sup>9</sup> *Hydrocarbon oil duty*, July 2003 p 12

<sup>10</sup> *Budget 2004* HC 301 March 2004 para 7.35

<sup>11</sup> *Budget 2005* HC 375 March 2005 para 7.39

<sup>12</sup> The rates set on 1 October 2003 were 4.22 p (red diesel) and 47.1 p (low sulphur diesel).

<sup>13</sup> In both years, the Government had first proposed in the Budget that duty rates would rise in line with inflation in September, but then reversed this decision (Cm 6408 December 2004 para 7.32; Cm 6701 December 2005 paras 7.47-8)

<sup>14</sup> HC 301 March 2004 para 5.100-1; Cm 6701 December 2005 para 5.122

It is the Government's policy that fuel duty rates should rise each year at least in line with inflation as the UK seeks to reduce polluting emissions and fund public services. Budget 2007 sets out fuel duty rates for the next three years. Main fuel duty rates for 2007-8 will increase by 2 pence per litre (ppl), with these changes in rates deferred until 1 October 2007. Main fuel duty rates will then rise by 2ppl on 1 April 2008 and 1.84ppl on 1 April 2009. By 2009-10, main fuel duty rates will still remain 11 per cent lower in real terms than they were in 1999. In addition, the Government today announces an increase in duty for 2007-8 of 2ppl for rebated oils, also from 1 October, maintaining the differential between main and rebated fuel duty rates. ...

The Government's recent policy has been to maintain the differential between rebated oils and main road fuel duty rates in support of the oils fraud strategy. While the Government recognises the impact that increases can have on heavy users of rebated oils, it is also aware that the duty on rebated oils does not currently recognise the environmental costs of the fuel. In the light of these considerations, the Government will maintain the differential between rebated oils and main road fuels for 2007-08, and in the subsequent two years will increase rebated oils rates by the same proportions as main road fuels in those years.<sup>15</sup>

## **B. EU duty harmonisation and red diesel**

The UK's discretion in setting duty rates on all excisable goods – hydrocarbon oils, alcohol and tobacco – is limited with respect to EU-wide agreements on the harmonisation of duty rates. The first of these agreements was adopted in October 1992, and took effect from 1 January 1993. In the case of mineral oils, the relevant directives were directive 92/82/EEC, which established the minimum rates of duty that Member States could charge, and its companion directive 92/81/EEC which defined those oils to be charged duty. In October 2003 both directives were replaced by directive 2003/96/EC of 27 October 2003, known as the 'Energy Products Directive.'

Under Article 8(2) of the 1992 mineral oils directive, provision was made for Member States to charge a lower rate or no duty on oil used for certain purposes, including oil used "exclusively in agricultural and in horticultural works, and in forestry and inland fisheries." Similarly, under Article 8(3) Member States could charge a rate below the standard minimum if oils were used for, amongst other things, "vehicles intended for use off the public roadway or which have not been granted authorization for use mainly on the public highway."<sup>16</sup> In general these provisions are retained in the Energy Products Directive (EPD).

Although minimum duty rates are set for all mineral oils,<sup>17</sup> Article 8(2) of the EPD allows States to charge rates far below these for certain "industrial and commercial purposes", including "agricultural, horticultural or piscicultural works, and in forestry", and "vehicles intended for use off the public roadway or which have not been granted authorisation for use

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<sup>15</sup> HC 342 March 2007 paras 7.36, 5.134

<sup>16</sup> The rate could be no lower than 18 ECU per 1,000 litres (under Article 5(2) of 92/82/EEC). This is roughly equivalent to 1.2 pence per litre.

<sup>17</sup> These minimum rates are set out in table A to Annex I of 2003/96/EC. The minimum standard rate for gas oil is set at 302 Euro per 1,000 litres (around 20.4 pence per litre).

mainly on the public roadway.”<sup>18</sup> As a consequence, the UK may continue to charge duty on red diesel at substantially lower rate for use, say, by farmers in their tractors.

The position of red diesel used for private pleasure craft is slightly different. Article 8(1) of the 1992 mineral oils directive established that fuel used in “navigation within Community waters (including fishing) *other than in private pleasure craft*” should be exempt from duty (*emphasis added*). Article 8(2) provided the option for States to apply a partial or full exemption for fuel used for “navigation on inland waterways other than for private pleasure craft.” Both provisions are retained in the Energy Products Directive: in Articles 14(1)(c) & 15(f). In this context the term ‘private pleasure craft’ is defined as, “any craft used by its owner or the natural or legal person who enjoys its use either through hire or through any other means, for other than commercial purposes and in particular other than for the carriage of passengers or goods or for the supply of services for consideration or for the purposes of public authorities.”<sup>19</sup>

However, Article 8(4) of the 1992 mineral oils directive permitted individual countries to provide further exemptions or reductions of duty on mineral oils, if unanimously agreed. In the UK’s case a concession allowed for rebated gas oil to continue to be used “for navigation in private pleasure craft” (under Article 1(12) of Council Directive 92/510/EEC). Annex II of the Energy Products Directive gives a long list of reduced rates and exemptions which Member States apply at present, which includes the UK’s derogation for leisure marine use (para 15 of this Annex covers the UK). Under Article 18(1) of the EPD, States may continue to apply these derogations, but that “subject to a prior review by the Council, on the basis of a proposal from the Commission, this authorisation expires on 31 December 2006” unless another date is specified in Annex II. As with all tax legislation any amendment to these rules would have to be agreed unanimously.

To recap: under the relevant European agreements (the Energy Products Directive), fuel used by private pleasure craft is taxable at the same rate as the equivalent road fuel. The United Kingdom has a derogation that allows private pleasure craft to use rebated red diesel, up to 31 December 2006. Any extension of this derogation, or any others allowed in the directive, would require the unanimous agreement of the Council.

Finally, although red diesel may be purchased at quaysides, marinas and on inland waterways, under a separate scheme the duty paid by the fishing industry on marine fuel used for navigation within community waters is fully repayable, so that it is, in effect, duty free. Guidance is published by HM Revenue & Customs.<sup>20</sup> This is *not* affected by the potential loss of the UK derogation set out above. Indeed, specific provision is made in the Energy Products Directive that Member States should exempt from duty “fuel for the purposes of navigation within Community waters (including fishing), other than private pleasure craft.”<sup>21</sup>

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<sup>18</sup> Table B to Annex I sets the minimum rates that may be charged in these circumstances: for gas oil the rate is 21 Euro per 1,000 litres (around 1.4 pence per litre).

<sup>19</sup> Under Article 14(1)(c) of 2003/96/EC

<sup>20</sup> [Notice 263: Marine voyages - excise duty relief for mineral \(hydrocarbon\) oil](#), May 2004

<sup>21</sup> Under Article 14(1)(c) of 2003/96/EC. See also, HC Deb 21 July 2005 c 2031W.

## C. Concerns about private pleasure craft

In spring 2004 the concerns of boat owners about the potential loss of the red diesel derogation began to be raised in the House. In April Bob Spink put down an EDM calling on the Government “to find a way to prevent the anticipated trebling of the price of marine diesel which could occur over the next three years as a result of the EU Directive to restructure the taxation of diesel and the expiry of the United Kingdom's derogation at the end of 2006.”<sup>22</sup> During the Committee stage of the Finance Bill on 27 April 2004, when the House considered the increase in the rate of duty on red diesel announced in Budget 2004, Andrew Tyrie asked “the leisure boat industry also benefits from an EU derogation from harmonisation of fuel duty for a transitional period, so is the hike part of the preparation for the removal of that derogation?”<sup>23</sup> Responding to the debate, the then Economic Secretary John Healey said:

The hon. Member for Chichester also asked about the derogation for leisure marine use. The derogation expires on 31 December 2006, and we have an opportunity to try to renegotiate it if we wish. We shall consider the approach that we shall take in the run-up to that date, and we will ensure that we consult widely before we settle on our approach. I emphatically make it clear that the rate change proposed this year is not, as the hon. Member for Chichester suggested, a harbinger of further increases for the leisure boat industry in the run-up to the expiry of the derogation in 2006.<sup>24</sup>

The issue was raised in a series of PQs at this time: apparently there are no official figures for the numbers of private pleasure craft, “but the British Marine Federation has estimated that there are approximately 451,000 private pleasure boats in the UK, although this figure includes all types of boats, not just those using red diesel.”<sup>25</sup> Similarly, “lack of robust data available means no reliable assessment has to date been made of potential revenue gains for the Exchequer from the loss of the UK's derogation from the European Energy Products Directive, which enables private boat users in the UK to purchase rebated gas oil.”<sup>26</sup> A further EDM in February 2005 attracted 59 signatures.<sup>27</sup>

In July 2005 the Royal Yachting Association and the British Marine Federation published a paper on this issue in conjunction with the Inland Waterways Association and the Federation of Petroleum Suppliers; it made the case for retaining this derogation as follows:

The derogation should not be viewed as a subsidy for very affluent people who own large boats. This high value sector of the market is important to wealth creation and is internationally mobile. This is borne out by the fact that the UK's largest power boat builders export in excess of 90% of their output. The derogation is a domestic market issue. [Research by the RYA] ... demonstrates that boating in the UK is a middle-income family pursuit. The reality is that it will be the family that may have saved for

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<sup>22</sup> EDM 993 of 2003-04, *EU directive on marine diesel taxation*, 19 April 2004. The motion attracted 15 signatures. Roger Williams tabled an amendment to read, in the second line, “marine diesel in particular, but also diesel for fuelling canal boats and recreational fishing and pleasure boats ...” – which only the Member himself signed (EDM 993A1 of 2003-04).

<sup>23</sup> HC Deb 27 April 2004 c 821

<sup>24</sup> HC Deb 27 April 2004 c 826

<sup>25</sup> HC Deb 18 October 2004 c 544W

<sup>26</sup> HC Deb 27 October 2004 c 1297W. see also, HC Deb 14 October 2004 c 344W

<sup>27</sup> EDM 693 of 2004-05, *Pleasure boats and red diesel*, 8 February 2005.

many years to achieve their dream of owning a boat, who will be priced off the water. We do not believe that there will be an overall net gain to the Exchequer if the derogation is removed. The potential for any increase in duty revenues will be negated by the loss of other taxes if participation in boating and related discretionary spend reduces and marine businesses face a downturn.<sup>28</sup>

In the *Pre-Budget Report* in December 2005 the Government stated that it was “minded to apply for an extension” of this derogation, and would “issue an initial regulatory impact assessment on the effects of ending the derogation for private pleasure craft” to be “used as the basis for further information gathering and discussions.”<sup>29</sup> This assessment was published alongside the 2006 Budget; the document set out the issue as follows:

The UK is one of five Member States with derogations under the Energy Products Directive permitting the use of red diesel in private pleasure craft, the others being Ireland, Belgium, Finland and Malta. The derogations held by Member States under this Directive are due to expire at 31 December 2006. If a Member State wishes to renew a derogation, a formal request must be made to the European Commission; the procedure is then for the Commission to make a proposal to the EU Council of Ministers, where approval requires unanimous consent. The Commission has expressed the view that, unless Member States can show that renewal is in the interest of reducing distortion of competition, promoting the better operation of a single market or protecting the environment, derogations should not be renewed.<sup>30</sup>

Should the derogation be lost, pleasure boat owners could still use rebated fuel to provide heat and light on their boats; similarly, fuel suppliers could still provide red diesel for use in commercial craft. However, both groups would be faced with significant costs in installing additional fuel tanks:

If boat owners wished to continue to use red diesel, they would have to add an extra tank: one for fuel to propel the boat, and another for fuel for other purposes such as cooking, heating and lighting. The cost would vary depending on the size and design of the boat, but it is estimated to be in the region of £750 for a typical inland cruiser ... Given that the proportion of inland boat owners on low or reduced incomes is far greater than for boat owners as a whole, the costs of fitting a new tank would have a disproportionate effect on the inland waterways sector, including inland tourism ...

Although [suppliers choosing to provide both rebated and unrebated fuel] would not suffer any loss of trade, [they] would face additional costs for installing new tanks and pumps for the second fuel. The estimated cost of adding a tank is £20,000 (consisting of £12,000 for the tank, £6,000 for the pump and £2,000 for installation). In addition, installation of ULSD would also have a potential opportunity cost in that space in marinas is often limited and the space taken by additional tanks could, for example, have been used as berthing for a boat. There would also ... be potential additional costs in terms of providing extra security for the fuel.<sup>31</sup>

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<sup>28</sup> RYA et al., *Seeing red: campaign for the retention of the current derogation on red diesel*, July 2005 p 23. At: <http://www.rya.org.uk/NR/rdonlyres/8F854BF5-A87E-4BF6-9D65-B713BE04404C/0/RedDieselBriefingSeeingRed.pdf>. The magazine *Motor Boat Monthly* also ran a campaign on the issue: <http://www.ybw.com/mbm/redalert/>

<sup>29</sup> Cm 6701 December 2005 para 7.50

<sup>30</sup> *Partial regulatory impact assessment for hydrocarbon oils duty*, March 2006 paras 21.4-5

<sup>31</sup> *op.cit.* paras 21.19, 21.21, 21.31

The Government concluded that in its view “the balance of advantage lies with retaining the derogation. Its removal would cause market distortion and would have significant compliance costs for both the industry and the Government.”<sup>32</sup> Two short extracts are reproduced below: first, on the issue of market distortion:

The removal of the derogation could cause market distortions in encouraging many UK boat owners to base their boats in other Member States. The RYA survey indicates that 51% of respondents said they would consider keeping their boat abroad if the derogation were not renewed.<sup>33</sup> Within that group, a greater proportion of owners of more expensive motorboats would be likely to remove their boats, while less well off boat owners who might be unable to afford to resite their boats would be hit harder. In addition, there would be further market distortions as cross border shopping for fuel would be more attractive (e.g. it would be more attractive to go to the Channel Islands, France or Ireland to restock with cheaper fuel than it is at present). The boat owners who would be likely to move their vessels abroad typically use much more fuel than average - about 5,000 litres a year. The UK would therefore lose the largest consumers of fuel overseas, and this could lead to a reduction in the revenue raised.<sup>34</sup>

Second, on the impact that losing the derogation would have on compliance costs:

At present, suppliers of rebated fuels are registered by HMRC in their Registered Dealers of Controlled Oils scheme (RDCO). This places requirements on dealers to maintain records of purchasers of rebated fuels and the purpose to which they are put in order that misuse can be more easily detected. The net effect of removing the derogation would be that some of those currently registered under the RDCO scheme would stop supplying rebated fuels and therefore there would be a small compliance saving for these suppliers. However, there would be additional assurance costs for HMRC in those instances where suppliers decided to supply rebated and unrebated fuels alongside each other. Since this would greatly increase the possibility of misuse or fraud, HMRC assurance would therefore have to be much tighter than if just one fuel were being supplied.

Prevention of misuse would also be made much harder for HMRC if boat owners installed two tanks. Records could show that a boat filled up with both fuels, but whether or not the rebated fuel was being used properly could not be established from this information alone. At present, pleasure boats are a low fraud risk for HMRC in that they are entitled to use red diesel. If that entitlement were removed, pleasure boats in the UK would become an additional fraud threat and HMRC would have to spend more resources in ensuring that red diesel was not misused. HMRC estimates that it would need five extra staff to check compliance at a cost of approximately £250,000 a year. It would also have to invest in additional testing equipment for sampling fuel from boats. In addition, it would be difficult for HMRC to establish clearly whether there had been fraud. A boat might legitimately have traces of red diesel in its engines subsequent to the removal of the derogation for a number of reasons that would make prosecution difficult.<sup>35</sup>

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<sup>32</sup> *op.cit.* para 21.70,

<sup>33</sup> [*Seeing red*, July 2005 p 8]

<sup>34</sup> *op.cit.* paras 21.54-5

<sup>35</sup> *op.cit.* paras 21.34-38



The issue was the subject of a short debate in the Lords on 22 May 2006. Lord Berkeley, who instigated the debate, argued that extending the derogation was unsound:

Surely those who can afford a half-million-pound gin palace to go across the Channel and fill up with 3,000 litres [of diesel] ... can afford to pay the same rate of duty as motorists do in this country. Does [the Minister] also accept that it is nothing to do with the boat-building industry in this country deserving help? The French boat-building industry is very much bigger and, in France, if you have a pleasure boat, you have to pay the full duty on all the fuel that you put in.<sup>36</sup>

Other Lords also raised doubts about the Government's position: Lord Stoddart pointed out that "there are millions of poor people driving motor cars who are paying 60p in every litre in taxation", and Lord Newby asked about "environmental benefits that would accrue if people using motorboats paid a reasonable amount of duty on their fuel."<sup>37</sup> Speaking for the Government Lord McKenzie responded to these two points as follows:

The RIA sets out the rationale behind the decision, which relates to the cost to boat owners not only of fuel but of putting in new tanks—because they would potentially have two sources of fuel. There is also the impact on fuel suppliers and small businesses and the cost of compliance. This is not just about very rich people who have very big boats. There are around 349,000 boats in the UK, and many of those are owned by middle-income families and, in the inland waterways network, families generally on less than average income ...

The environmental issues do not necessarily all point in one direction. Part of the issue is that if the availability of rebated oils was to be abrogated, there would be a risk of a move toward greater use of petrol engines, particularly on some smaller boats. There is an issue about the availability of fuelling points, because new investment would be needed if two sources of fuel were going to be provided. If there were fewer of those points, there could be difficulties with longer journeys and more fuel being carried, with all the implications associated with that.<sup>38</sup>

On 3 July 2006 the European Commission published a review of all the derogations to the Energy Products Directive due to expire at the end of the year.<sup>39</sup> The Commission argued that there was no justification for an extension to the derogation on fuel used by private pleasure craft:

Most Member States enjoying derogations have had enough time by now to adapt to the new situation given that fuel used by private boats has been taxable in principle since 1993 and that phasing-out of the derogation was initiated by the Commission in 2000. It should also be pointed out that very often the tank facilities for pleasure boats and commercial ships are located separately (e.g. a marina on one side and commercial ports on the other) ... The Commission can accept ... that there might be additional administrative burdens and compliance costs associated with the shift to the new tax treatment ... However, if such arguments were to be accepted, it would mean that the derogations would have to be maintained forever thus contradicting the

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<sup>36</sup> HL Deb 22 May 2006 c 571

<sup>37</sup> HL Deb 22 May 2006 c 572

<sup>38</sup> HL Deb 22 May 2006 c 571-2

<sup>39</sup> COM(2006) 342 final, 3 July 2006

general policy principle that derogations must be time-limited and must aim at overcoming initial difficulties encountered with implementation of new legislation.<sup>40</sup> There might also be a risk of fraud related to dual-use of the same fuel on one boat (which might in particular be the case for inland waterway boats). However, it can be argued that similar risks of fraud exist in other sectors where one type of fuel is used by the same person for different purposes thereby triggering different rate of excise duty (e.g. in farming). In any event, the experience of Member States not benefiting from any derogation in the matter could be helpful in this respect.

As regards the argument about tank tourism [that is, consumers purchasing fuel from another Member State to avoid paying the full duty rate in their own country], it must be pointed out that only six Member States presently apply the derogation. From the internal market point of view, if any distortions do exist, then they are most likely to be caused by the existence of the derogation itself rather than by its expiry. Finally, although the expiry of the derogation might lead to an increase in prices, this is the necessary consequence of the assimilation of the activity in point with comparable activities.<sup>41</sup>

On 17 October 2006 the then Financial Secretary, John Healey, confirmed that the UK had submitted its application to the Commission, as well as applications to continue derogations for fuel used in private air navigation and for waste oil reused as fuel. The Minister said, "We believe that removing this derogation would provide no significant revenue or environmental benefits to the UK, would undermine other EU objectives and could pose significant compliance costs for business and fuel users":

Gordon Brown, the Chancellor of the Exchequer, announced in the 2006 Budget that the UK would formally apply to the European Commission to renew these derogations. Now that the application has been made, the next step is for the European Commission to respond to our application for renewal, along with those being submitted by other EU Member States ... The UK's three derogations allow for reduced duty rates of 6.44ppl as opposed to 47.1ppl for rebated gas oil ('red diesel') for use in private pleasure craft; of 28.1ppl for aviation gasoline used in private aircraft as opposed to 56.2ppl for leaded petrol; and for waste oil reused as fuel, which has no duty, as opposed to 6.44ppl. The three derogations collectively cost the UK less than £25m a year.<sup>42</sup>

In the *Pre Budget Report* on 6 December the Government confirmed that the Commission had declined to renew the derogation on private air navigation, and that as a result, it would "consider options for legislating the change so as to ensure a suitable period of transition and to minimise the longer-term compliance burden."<sup>43</sup> At Treasury Questions the next day the Financial Secretary announced that the Commission had also rejected the UK's request to renew the derogation for private boats:

Thirty-four separate derogations from the directive are held by member states. None has yet been approved by the Commission and 14 have been rejected so far. Late

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<sup>40</sup> [The Commission refers to this argument in an earlier section of the report on the case for preserving a derogation held by some countries to allow rebated fuel to be used in aircraft for 'private pleasure flying; for clarity this extract incorporates this text (para 2.2.1).]

<sup>41</sup> COM(2006) 342 final, 3 July 2006 para 2.2.2

<sup>42</sup> HM Treasury press notice 76/06, 17 October 2006

<sup>43</sup> Cm 6984 December 2006 para 5.141

yesterday afternoon, it was confirmed to me that the Commission had decided not to renew the UK's application for a fresh derogation for private boats ...

We put the strongest possible case to the Commission, and we prepared that case in close co-operation with, and with contributions from, many of the organisations affected. We could have done little more to press the case. I have personally spoken with and written to the Commissioner on the issue, but there is no further stage in the process. First, we need to discuss the implications of the Commission's decisions. Secondly, we will consult widely on implementing the directive. Thirdly, we will have to legislate, and implement the changes. I made it clear to the Commissioner that it is important to allow the UK a suitable period in which to translate the Commission's decision into the implementation of the changes required. The Commissioner acknowledged that point, and we will work with the boating associations on that in the coming months.<sup>44</sup>

In their report on the Commission's response, the European Scrutiny Committee asked the Government "what scope there is for it (and like-minded Member States) to try to persuade the Commission to change its mind?"<sup>45</sup> John Healey wrote to the Committee in February, setting out the Government's thoughts on the matter:

The Financial Secretary to the Treasury (John Healey) emphasises that the Commission has the right of initiative in bringing forward legislative proposals authorising derogations from the Directive. He then says that the Government sees no possibility of changing the Commission's decision in this matter, reporting that:

- the Government submitted clear and complete evidence to support extension of the derogations, developed with close cooperation from the relevant industry bodies;
- the case was also raised personally and in writing with the responsible Commissioner;
- in reaching its decision the Commission was fully aware of the reasons the Government wished to continue the derogations;
- there is nothing further the Government (or other Member States) could add that would persuade the Commission to reverse its decision; and
- there is no further stage in the process under Article 19 of the Directive.

The Minister comments further that technically Member States may appeal to the Court of First Instance of the European Court of Justice against a Commission decision on any of the grounds set out in Article 230 EC. But, he says, in this case:

- it would be very hard to argue that the Commission's decision is not clearly and properly reasoned;
- the Court would be highly unlikely to find against the Commission's decision in an area where it had clear right of initiative, unless it had obviously abused its discretion in reaching this decision;
- even if that were the case — and there are no grounds for thinking it is — the Commission would be obliged only to change the process by which it had reached its decision and would not be obliged to take an affirmative decision instead of a negative one; and
- there appears little prospect of a successful appeal and the Government does not intend to challenge the Commission's decision.

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<sup>44</sup> HC Deb 7 December 2006 cc 429-30

<sup>45</sup> *Sixth Report*, 26 January 2007 HC 41-vi 2006-07 p 13

The Committee concluded that, “regrettably, there is nothing more that can be done to secure continuation of these derogations.”<sup>46</sup>

## D. Recent developments

In Budget 2007 the Government confirmed it would remove the reduced rate of duty for fuel used by private pleasure boating on 1 November 2008, “after further consultation with industry about the best way to minimise the longer-term compliance burden on the sectors concerned.”<sup>47</sup> In August 2007 HM Revenue & Customs published a consultation document on how best to implement the new regime to minimise its impact on boat owners.<sup>48</sup> In the introduction the department noted that “Ministers have said that we would look for ways of implementing the new regime which would both minimise the impact, and ensure that any additional compliance burden was as small as possible”:

We, therefore, need to bear in mind that any proposed system must be proportionate to the revenue at risk and should recognise that

- Private pleasure craft will continue to be able to use red diesel legitimately for purposes other than propulsion;
- Private pleasure craft will be free to use red diesel bought from the Channel Islands;
- Red diesel bought at the current rate will remain in tanks for long periods, and traces will remain even longer; and
- There is a need to minimise any restriction on boat owners’ ability to travel because of non – availability of fuel.<sup>49</sup>

The department sets out two principal options: to allow boat owners to continue to use red diesel, but pay the full rate of duty – or, to switch to unmarked full duty-paid fuel:

The benefit of continuing to use marked fuel is that the supply infrastructure is already in place, and existing equipment and tankage can continue to be used. Fuel would continue to be available to pleasure craft throughout the UK, and there would be no restraint on pleasure cruising as a result of pleasure craft being unable to refuel. It would, however, have resource and cost implications for HMRC who would need to devise a compliance and enforcement regime, and would create compliance burdens for fuel suppliers and/ or boat owners, depending on how the scheme was administered. Specifically, legislation would need to be introduced to tighten laws around the use of marked fuel to make it an offence to use this as road fuel irrespective of the rate of duty paid. This scheme also has EU implications as in some member states the use of marked fuel in pleasure craft is not permitted. This, however, has always been the situation.<sup>50</sup>

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<sup>46</sup> *Tenth Report*, 6 March 2007 HC 41-x 2006-07 pp 67-8

<sup>47</sup> HC 342 March 2007 para 5.135; HM Revenue & Customs Budget Note BN70, 21 March 2007

<sup>48</sup> A similar consultation exercise is being carried out simultaneously on the implementation of new procedures following the expiry of the derogation that allowed the UK to apply a reduced rate of excise duty on aviation gasoline (Avgas) and exempt aviation turbine fuel (Avtur) from excise duty used for private pleasure-flying.

<sup>49</sup> HM Revenue and Customs, *Energy Products Directive – expiry of the derogation for private pleasure boats: consultation on the options for change*, 1 August 2007 p 4. At present, this is available at:

[http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE\\_PROD1\\_027786](http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_027786)

<sup>50</sup> *Energy Products Directive ...*, 1 August 2007 pp 8-9

Although it would be much simpler from an administrative point of view for boat owners simply to use duty-paid fuel, there are serious difficulties with this option:

Typically, suppliers of fuel to the boat industry provide only one type of diesel fuel – rebated red diesel. This is used both by commercial and private pleasure craft, and in addition, depending on their location, some suppliers may also supply fuel for use in agriculture and plant machinery. It should be noted that the removal of the derogation has no effect on commercial use: commercial craft will continue to be free to use red diesel, and commercial marine craft will continue to be eligible for full duty relief under Marine Voyages Relief.

Fuel sites are typically located in harbours, at marinas, on floating barges and on towpaths, and in many areas are few and far between. Supplying a second stream of fuel would involve substantial additional costs for suppliers, and would require new storage space for which planning permission is likely to become increasingly difficult. Boat owners fear that many of the suppliers with a wide customer base (commercial and agriculture) will simply opt to continue to provide only rebated fuel. There is anecdotal evidence that suppliers are already taking this decision. Smaller suppliers who cater for private pleasure craft only, faced with the not insignificant additional cashflow and security costs of supplying unrebated fuel, may just close. In either case the end effect would be to reduce the already limited number of fuel stations that service private pleasure craft. The likelihood of being able to refuel in fewer locations (particularly in remote areas) is a very real concern for boat owners, who fear that certain parts of the country (such as the Scottish highlands and islands) will, in effect, become out of bounds for pleasure craft, simply because it will be impossible to refuel other than with red diesel ...

[Furthermore] if boat owners were required to purge their tanks of red diesel in reparation for taking in unmarked ULSD it is estimated that this would cost between £500 and £1000. Even then, this would be unlikely to remove all traces of the rebated marker, which could be expected to contaminate fresh fuel for some time. If tanks are not cleaned red diesel would continue to be present in a tank for significantly longer (up to 5 years has been quoted by some stakeholders). There are also the environmental implications of tank cleaning and the risk of fuel entering and polluting the waterways.

To complicate matters further, the Channel Islands are not affected by the Commission's decision and so will continue to supply rebated fuel for private pleasure craft, and UK boat owners will be able to fill up with rebated fuel supplied there. There will therefore be instances where, although red diesel will no longer be permitted to be sold in the UK as fuel for private pleasure boats, there will continue to be legitimate reasons for its presence in the main running tanks of boats.<sup>51</sup>

For these reasons, the department favours the first of these options, requiring the supplier to collect duty on sales to private pleasure craft. An alternative arrangement would be a self regulated scheme, where boat owners could purchase fuel at the rebated rate and then pay the balance of duty (on a frequency to be determined), and respondents are also asked for their views on this.

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<sup>51</sup> *Energy Products Directive ...*, 1 August 2007 pp 6-7, 12

The department also makes some comments on the amounts of money it expects to raise from the end of this derogation:

We estimate that the revenue gain from the expiry of the boat derogation is in the area of £10 to £15m a year. It follows that this is the maximum additional revenue at risk from private boating if, for example, boat owners were allowed to continue using red diesel but misused the scheme by (depending on the option adopted) misleading RDCO suppliers as to nature of their boat (ie commercial/ domestic), failing to submit returns or submitting false repayment claims. HMRC's enforcement effort must be proportionate to this risk. Taken in the context of a total yield of £24bn (05/06) from oils, the private pleasure craft industry would account for 0.06% of the total revenue.<sup>52</sup>

Comments on the paper are invited by 31 October.

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<sup>52</sup> *Energy Products Directive ...*, 1 August 2007 pp 13-14