

**REGULATORY IMPACT STATEMENT
PASSENGER SECURITY CHARGES REVIEW 2011**

Agency Disclosure Statement

1. This Regulatory Impact Statement has been prepared by the Ministry of Transport (the Ministry) with information provided by the Aviation Security Service (Avsec).
2. It provides an analysis of options to reset the international and domestic passenger security charges (the charges) from 1 July 2011. This will be done by an Order in Council amending the Civil Aviation Regulations (No 2) 1991.
3. Due to lower than expected costs to implement new security requirements and an increase of actual projected passenger numbers, charges were set at a rate that led to an accumulation of excessive surpluses in Avsec's charges memorandum accounts.
4. Recent analysis shows that, despite a decrease in charges in April 2010, the accumulated surpluses would remain at \$27 million (excluding GST), excluding contingency reserves¹, by 30 June 2013. Therefore, further reductions are necessary in order to eliminate these projected accumulated surpluses by 30 June 2013.
5. Building on the results of the analysis done for the 2010 charges reduction, four options have been analysed. The preferred option is to reset the charges for the remaining 2 years of the 2010—13 charges period and then review the charges for 2013/14.
6. Analysis suggests that the charges would need to reduce to \$8.07 per departing international passenger, and to \$3.71 per departing domestic passenger², to eliminate the \$27 million (excluding GST) in projected accumulated surpluses. However, the preferred option is to reduce the charges to \$8.00 and \$3.70 respectively.
7. The suggested new charges will affect Avsec's budget, subject to variances in forecast expenditure and passenger numbers. Provided passenger numbers vary within their recent historical range, the consequence of variances in passenger forecasts is expected to affect revenue by no more than \$4 million over the 2 years.
8. Based on Avsec's passenger and expenditure forecasts, rounding the charges down to the nearest 10 cents (that is, setting the charges at \$8.00 and \$3.70 respectively) could result in an operating deficit of \$759,000 (excluding GST) over the 2011—13 period. However, this result is within the currently expected variances for charges revenue.
9. The Ministry is confident that the proposed reductions in security charges, based on current assumptions, will eliminate the \$27 million (excluding GST) in projected accumulated surpluses by 30 June 2013.
10. As the proposed charges for the next 2 years are lower than the revenue needed to fund the ongoing cost of Avsec's services, the charges will need to be increased from 2013/14.

¹ The contingency reserves have been set at \$4.5 million (excluding GST) and \$3 million (excluding GST) for international and domestic charges respectively. These reserves provide funding for Avsec to deal with the initial impact of a significant operational or financial risk associated with a terrorist event or international shock for up to six weeks.

² Cited figures include Goods and Services Tax (GST), except where otherwise stated.

11. The proposal will not impair private property rights, or the incentives for businesses to innovate and invest, or override any of the fundamental common law principles (as referenced in chapter 3 of the Legislation Advisory Committee's Guidelines on Process and Content of Legislation). The Rules are consistent with the government's August 2009 statement *Better Regulation, Less Regulation*.

Joanne Leung, Principal Economist
4 May 2011

Status quo and problem definition

Background

12. Avsec is funded by international and domestic passenger security charges levied on airlines, on a per-departing passenger basis. Avsec is a separate service within the Civil Aviation Authority (CAA), and is governed by the CAA Board. Avsec currently operates at seven security-designated airports – Auckland, Hamilton, Rotorua, Wellington, Christchurch, Dunedin and Queenstown.
13. The Civil Aviation Charges Regulation (No 2) 1991 sets out the basis on which the passenger security charges are made. Airlines generally pass the charges on to passengers in the ticket price. Guidance from the Treasury and Office of the Auditor-General gives a general expectation that charges should be set at no more than the amount necessary to recover costs, and to minimise the risk of under- or over-recovery.
14. Since 2005, the charges have changed four times (see Table 1). Amendments to the charges are made by way of an Order in Council amending the Civil Aviation Charges Regulations (No 2) 1991.

Table 1: International and domestic passenger security charges 2005 – 2010

Date	Reason for change	Charges per departing passenger \$ (GST inclusive)	
		International	Domestic
October 2005	Passenger security charges established.	8.31	3.57
March 2007	Implementation of liquids, aerosols and gels screening for international flights from 31 March 2007.	12.56	3.57
December 2007	Increased costs for capital expenditure on new equipment and premises at Auckland, Christchurch and Head Office.	15.00	4.66
April 2010	Over recovery of charges due to increase of passenger numbers and over-estimation of costs.	10.00	4.35
October 2010	GST increases from 12.5 percent to 15 percent.	10.22	4.45

15. From 2007, changes in expenditure and increases in passenger numbers and the associated revenue caused Avsec to recover passenger security charges in excess of its agreed contingency reserves.
16. In March 2010, the Ministry provided its analysis and recommendations on the following options to reset the charges and to eliminate the projected \$48 million (excluding GST) in accumulated surpluses (excluding the contingency reserves):
 - 16.1 Reset the charges over 3 years (recommended and adopted). This option was assessed to be fair and transparent and was able to meet the principle of cost-recovery within a reasonable timeframe.
 - 16.2 Eliminate the accumulated surpluses over a longer period (for example 6 years). This option was rejected because the prolonged holding of accumulated surpluses could have resulted in continuing inequities in the distribution of costs between current and future users.

- 16.3 Eliminate the accumulated surpluses over a shorter period (for example 12 months). This option was rejected because the fluctuations in the level of the charges would have been significant.
- 16.4 Retain a portion of the surpluses in a further 'contingency reserve'. This option was rejected due to a lack of transparency and the possibility of accumulating further excessive surpluses over time.
17. To eliminate a projected \$48 million (excluding GST) in accumulated surpluses (excluding contingency reserves of \$7.5 million (excluding GST)), the charges were reduced from \$15.00 to \$10.00 per departing international passenger and from \$4.66 to \$4.35 per departing domestic passenger in April 2010. Cabinet agreed the reduction on the basis that it would eliminate the projected accumulated surpluses of \$48 million (excluding GST) by 30 June 2013. At the same time, after hearing the Minister of Transport's (the Minister's) concern over projected cost increases, Cabinet directed an independent review of Avsec's planned cost structure. Cabinet was also advised that another review of charges would occur in 2011 should Avsec's projected costs need to be further reduced. Due to GST changing from 12.5 percent to 15 percent, the charges were increased in October 2010 to \$10.22 and \$4.45 for international and domestic passengers respectively.

Problem definition

18. The April 2010 reduction in charges was intended to eliminate the projected \$48 million (excluding GST) in accumulated surpluses by 30 June 2013. The independent review of Avsec's cost structure concluded that Avsec's November 2009 forecast, on which the last charges reduction was based, continued to overestimate staffing requirements, assumed excessive annual salary increases, and failed to take account of likely efficiency gains and cost savings.
19. In response to the independent review, the CAA Board critiqued and reduced Avsec's forecast costs and revenues. It was found that, should passenger security charges remain unchanged, the accumulated surpluses were still expected to stand at \$27 million (excluding GST, exclusive of the \$7.5 million (excluding GST) in contingency reserves) by 30 June 2013.
20. This level of accumulated surpluses violates the principle of setting charges at no more than the amount necessary to recover costs. This imposes undue costs on airlines and their customers relative to the services they receive. There is a risk that the surplus revenue problem will be seen as revenue gathering rather than cost recovery.

Objective

21. The government's objective is to eliminate the projected \$27 million (excluding GST) in accumulated surpluses by 30 June 2013, while minimising costs and price fluctuations and ensuring Avsec is appropriately funded to carry out its normal operations.
22. In accordance with the Treasury and the Office of the Auditor-General's (OAG) guidance, the charges are scheduled to be reviewed and reset every 3 years.
23. When Cabinet agreed the first reduction in passenger security charges in April 2010, the Minister indicated his intention to further reset the charges should there be evidence that the accumulated surpluses could not be eliminated by 30 June 2013.

Regulatory impact analysis

Options

24. The following options were analysed.

- 24.1 Option 1: Maintain the status quo with no change in the level of charges.
- 24.2 Eliminate the accumulated surpluses by resetting the charges for a 2 year period and reset the charges to pay for normal cost-recovery and replacement of hold baggage screening equipment from 2013/14 to either:
 - Option 2a: eliminate the accumulated surpluses
 - Option 2b: eliminate the accumulated surpluses and round down to the nearest 10 cents (preferred)
- 24.3 Option 3: Eliminate the accumulated surpluses by resetting the charges for a 12 month period and reset the charges to pay for normal cost recovery from 2012/13 and then replacement of hold baggage screening equipment from 2013/14.
- 24.4 Option 4: Reset the charges for a 2 year period to reduce the accumulated surpluses to a level that provides some funding that contributes to the costs expected for the replacement of hold baggage screening equipment from 2013/14.

25. Forecasts indicate that at the current charges levels, general cost increases and volume changes over time will reduce the projected accumulated surpluses to around \$27 million (excluding GST) by 30 June 2013, but will not eliminate it as expected when the charges were reduced in April 2010. Under the status quo (Option 1), Avsec projects it will take until January 2016 to eliminate the accumulated surpluses. This option is not preferred as it incurs a risk of being seen as revenue gathering and will not achieve the government's intention to eliminate the accumulated surpluses by 30 June 2013.

26. The preferred option is to reset the charges for a 2 year period and round the charges down to the nearest 10 cents (Option 2b). Options 2a and 2b are both consistent with the Minister's intention to eliminate the projected accumulated surpluses by 30 June 2013, and will result in less fluctuation in passenger security charges over the next 2 years (to 30 June 2013). However, option 2b will incentivise tight control over costs and further savings by the CAA Board, given Avsec's past approach to allow generous margins in estimating its future costs.

27. Eliminating the accumulated surpluses over a 12 month period (Option 3) will result in significant variations in the level of charges and is therefore rejected. Based on Avsec's projections of expenditure and passenger numbers for the next 2 years, the estimated charges per departing international passenger would need to reduce to \$4.18 for 2011/12 and increase to \$11.84 for 2012/13. For departing domestic passengers, charges would be \$3.08 for 2011/12 and \$4.34 for 2012/13. This option would result in large changes in charges and an additional charges review not necessary for the preferred option.

28. The option (Option 4) to reset the charges for a 2 year period to reduce the accumulated surpluses to a level that provides some funding towards the replacement of hold baggage screening equipment from 2013/14 was considered. However, the option relied on information that is not yet available, including an accurate forecast of the cost of hold baggage screening equipment, and how the hold baggage screening equipment would be funded. Due to the unavailable information the option was not considered to be consistent with the Treasury and OAG guidance that indicates that charges should be set at no more than the amount necessary to recover costs.

Impacts of the preferred option

29. **Option 2a** (eliminate the accumulated surpluses): Based on Avsec's forecast costs and passenger numbers³, in order to eliminate the \$27 million (excluding GST) in accumulated surpluses by 30 June 2013, the passenger security charges would need to reduce by \$2.15 to \$8.07 per departing international passenger (Table 2), and by \$0.74 to \$3.71 per departing domestic passenger (Table 3).

30. **Option 2b** (eliminate the accumulated surpluses and round down to the nearest 10 cents): If the charges are rounded down to the nearest 10 cents, the new charges would be \$8.00 and \$3.70 per departing international and domestic passenger respectively. Based on Avsec's passenger and expenditure forecasts, rounding the charges down to the nearest 10 cents could result in an operating deficit of \$759,000 (excluding GST) by 30 June 2013.

Table 2: Estimation of international passenger security charges - 2011/12 and 2012/13

June years	ACTUAL	FORECAST			Total for 2 years
	2009/10	2010/11	2011/12	2012/13	2011-13
International passenger numbers	4,452,310	4,657,102	4,783,722	4,927,491	9,711,213
Costs of Aviation Security Service (excluding GST)					
International passenger screening	\$ 19,404,707	\$ 21,190,230	\$ 24,196,610	\$ 25,972,708	\$ 50,169,318
International foot patrols/searches	\$ 2,492,838	\$ 2,501,501	\$ 2,605,414	\$ 2,656,947	\$ 5,262,361
International hold baggage screening	\$ 13,814,763	\$ 14,563,956	\$ 14,887,188	\$ 14,906,495	\$ 29,793,683
Duty free screening	\$ 518,258	\$ 598,730	\$ 624,372	\$ 594,857	\$ 1,219,229
International mobile patrols	\$ 1,642,072	\$ 1,799,735	\$ 1,820,124	\$ 1,723,172	\$ 3,543,296
International aircraft search	\$ 351,025	\$ 382,375	\$ 385,522	\$ 394,579	\$ 780,101
International gatehouse duty	\$ 971,128	\$ 1,028,328	\$ 1,043,618	\$ 957,188	\$ 2,000,806
International explosive detector dog	\$ 1,214,862	\$ 1,174,419	\$ 1,162,281	\$ 1,173,741	\$ 2,336,022
International escorts and VIPs	\$ 9,838	\$ 11,795	\$ 10,302	\$ 23,372	\$ 33,674
International transit screening	\$ 1,805,464	\$ 1,937,879	\$ 1,906,602	\$ 1,803,350	\$ 3,709,952
Total gross expenditure	\$ 42,224,955	\$ 45,188,948	\$ 48,642,033	\$ 50,206,409	\$ 98,848,441
ADD: Loss of interest - run down of Memorandum accounts			\$ 266,000	\$ 540,000	\$ 806,000
LESS: Forecast surpluses 30 June 2011 from Memorandum accounts					-\$ 31,519,000
Estimated expenditure to be recovered from charges necessary to eliminate forecasted surplus (excluding GST)					\$ 68,135,441
Estimated cost per passenger (excluding GST)					\$ 7.02
Estimated cost per passenger (including GST)					
Option 2a – eliminate the accumulated surpluses					\$ 8.07
Option 2b – eliminate the accumulated surpluses and round down to the nearest 10 cents					\$ 8.00

³ Avsec has taken into account known and planned costs, costs of capital, the overall change in Avsec's cost structure brought about through efficiency gains, projected passenger growth, and the impact of inflation.

Table 3: Estimation of domestic passenger security charges - 2011/12 and 2012/13

June years	ACTUAL	FORECAST			Total for 2 years
	2009/10	2010/11	2011/12	2012/13	2011—13
Domestic passenger numbers	5,703,733	5,839,377	6,037,165	6,147,857	12,185,022
Costs of Aviation Security Service (excluding GST)					
Domestic passenger screening	\$ 14,877,047	\$ 16,141,283	\$ 17,059,826	\$ 17,045,609	\$ 34,105,435
Domestic foot patrols/area searches	\$ 1,766,370	\$ 1,771,995	\$ 1,864,137	\$ 1,781,761	\$ 3,645,898
Domestic mobile patrols	\$ 2,478,699	\$ 2,575,581	\$ 2,625,441	\$ 2,525,983	\$ 5,151,424
Domestic gatehouse duty	\$ 820,670	\$ 837,868	\$ 860,680	\$ 819,778	\$ 1,680,458
Domestic explosive detector dog	\$ 824,932	\$ 854,952	\$ 856,292	\$ 792,486	\$ 1,648,778
Domestic escorts & VIPs		\$ 1,438	\$ 1,446	\$ 1,334	\$ 2,780
	\$ 20,767,718	\$ 22,183,117	\$ 23,267,822	\$ 22,966,951	\$ 46,234,772
<u>ADD</u> : Loss of interest - run down of Memorandum accounts			\$ 114,000	\$ 229,000	\$ 343,000
<u>LESS</u> : Forecast surpluses 30 June 2011 from Memorandum accounts					-\$ 7,194,000
Estimated expenditure to be recovered from charges necessary to eliminate forecasted surplus (excluding GST)					\$ 39,383,772
Estimated cost per passenger (excluding GST)					\$ 3.23
Estimated cost per passenger (including GST)					
Option 2a – eliminate the accumulated surpluses					\$ 3.71
Option 2b – eliminate the accumulated surpluses and round down to the nearest 10 cents					\$ 3.70

31. As the proposed passenger aviation security charges for the next 2 years are lower than the ongoing cost of Avsec's services, it is expected that the level of charges will need to increase from 2013/14..
32. Airlines are likely to pass on to customers the proposed reduction in passenger security charges. As the size of the temporary price change is small, the Ministry does not expect any change in travel patterns as a result.
33. Airlines would receive a small benefit from the reduced charges due to the transition time during which airlines have already received the current charges on prepaid tickets from customers but only pay Avsec the new charges from 1 July 2011. However, it would be administratively complex to refund the balance of charges to passengers, as passengers purchase tickets through a number of agents with electronic payment systems that may not retain the payment information through which a refund could be made.
34. Countering the small benefit above, there would be some communication cost to airlines associated with the price changes. However, this cost is likely to be insignificant.
35. There is no fiscal, environmental and cultural impact as a result of a change in the level of the charges.

Sensitivity analysis

36. There is ongoing uncertainty around passenger numbers and the impact on forecast revenue. The Ministry has analysed the likely impacts on the level of charges if passenger numbers vary by between one and three percent.
37. Table 4 shows that a three percent change in passenger forecasts will affect the level of charges by around \$0.24 per international passenger and \$0.10 per domestic passenger (that is, the differences between the baseline charge levels and the new charge levels at a +/- three percent change in passenger forecasts). The one to three percent range is typical of the variance between projected and actual passenger volumes in recent years. In 2009/10, the forecast passenger growth was 1.34 percent lower than actual.

Table 4: Effects on charges from changes in passenger forecasts

	Changes in passenger forecast from baseline				
	-3%	-1%	baseline	+1%	+3%
Charge per passenger	Required charges per departing passenger				
International	\$8.32	\$8.15	\$8.07	\$7.99	\$7.83
Domestic	\$3.82	\$3.75	\$3.71	\$3.68	\$3.61

38. Based on the proposed charge levels of Option 2a, the effects of a three percent change in passenger forecast on revenue (and the level of operating surpluses or deficits) are around \$2 million (excluding GST) for international passengers and \$1.2 million (excluding GST) for domestic passengers (Table 5a). Provided passenger numbers vary within their recent historical range, the consequence of variances in passenger forecasts is expected to be no more than \$3.2 million (excluding GST).

Table 5a: Effects on revenue (and associated operating surpluses or deficits) from changes in passenger forecasts under option 2a

Based on charges rates of \$8.07 (international) and \$3.71 (domestic)	Changes in passenger forecast from baseline				
	-3%	-1%	baseline	+1%	+3%
	Estimated surpluses/(deficits) over the 2 years to 30 June 2013— exclusive of GST*				
International	(\$2.04m)	(\$0.68m)	-	\$0.68m	\$2.04m
Domestic	(\$1.18m)	(\$0.39m)	-	\$0.39m	\$1.18m
Total surpluses/(deficits)	(\$3.23m)	(\$1.08m)	-	\$1.08m	\$3.23m

* Figures may not sum to total due to rounding

39. Based on the proposed charge levels of Option 2b, there will be an operating deficit of \$759,000 (excluding GST) over 2011—13. This result is within the expected variances in the passenger forecasts. The effects of a three percent change in passenger forecast on revenue (and the level of surpluses or deficits) are around \$2.6 million (excluding GST) for international passengers and \$1.4 million (excluding GST) for domestic passengers (Table 5b). Provided passenger numbers vary within their recent historical range, the consequence of variances in passenger forecasts is expected to be no more than \$4 million (excluding GST).

Table 5b: Effects on revenue (and associated operating surpluses or deficits) from changes in passenger forecasts under option 2b

Based on charges rates of \$8.00 (international) and \$3.70 (domestic)	Changes in passenger forecast from baseline				
	-3%	-1%	baseline	+1%	+3%
	Estimated surpluses/(deficit) over the 2 years to 30 June 2013– exclusive of GST*				
International	(\$2.61m)	(\$1.25m)	(\$0.58m)	\$0.09m	\$1.45m
Domestic	(\$1.36m)	(\$0.57m)	(\$0.18m)	\$0.21m	\$0.99m
Total surpluses/(deficits)	(\$3.96m)	(\$1.83m)	(\$0.76m)	\$0.31m	\$2.44m

* Figures may not sum to total due to rounding

40. While the passenger projections were done prior to the Christchurch and Japan earthquakes, the CAA Board decided that the effect on passenger numbers was not clear enough to warrant a change in projections. The CAA Board agreed that Avsec would keep a watching brief on any changes in passenger numbers from the events, and that Avsec would be able to manage any related funding pressures within its existing budget.

Consultation

41. Written submissions were received from nine submitters based on Option 2a (that is, eliminate the accumulated surpluses): Air New Zealand, Auckland International Airport, the Aviation Industry Association, the Board of Airline Representatives New Zealand Incorporated (BARNZ), International Air Transport Association, the New Zealand Airports Association, the New Zealand Public Service Association, the Tourism Industry Association of New Zealand and Wellington International Airport.
42. Avsec's major industry stakeholder, BARNZ, welcomed the proposed temporary reduction in charges, as it believes eliminating the accumulated surpluses is a priority. BARNZ expressed concern about possible lower-than-expected passenger numbers, but on balance agreed with the proposed charges levels.
43. All submitters supported reducing passenger security charges except the New Zealand Public Service Association, which opposed the forecast reduction in Avsec's staff costs. The Aviation Industry Association submitted that the charges should be set at an even lower rate of \$5.85 and \$3.17 per departing international and domestic passenger respectively, to reduce the accumulated surpluses more quickly than proposed and avoid the risk that the present charges are considered a tax. The Ministry of Transport believes the present charges are not a tax because they are currently set below Avsec's baseline costs for normal operations.

Conclusion and recommendations

44. To maintain the status quo with no change in the level of charges means that the intention to eliminate the accumulated surpluses by 30 June 2013 cannot be achieved. Instead, it would take until January 2016 to eliminate the accumulated surpluses. On the other hand, to eliminate the accumulated surpluses over a 12 month period would result in two further charges reviews within 2 years and significant variations in the level of charges over time, and result in inequities in the distribution of costs between current and future users.

45. Therefore, in order to eliminate the accumulated surpluses within the next 2 years, the Ministry recommends under option 2b that the:

- 45.1 international passenger security charge be decreased from \$10.22 to \$8.00
- 45.2 domestic passenger security charge be decreased from \$4.45 to \$3.70

Implementation

46. Amend the Civil Aviation Charges Regulations (No 2) 1991 to reduce the level of passenger security charges. New charges are to be implemented on 1 July 2011.

Monitoring, evaluation and review

47. In June 2010, three new members were appointed to the CAA Board. The strengthened and more focussed CAA Board, combined with the independent review of costs, has precipitated change in Avsec itself. The CAA Board has strong oversight and will report transparently and openly on Avsec's budgets, underlying assumptions, progress and issues. From April 2011, Avsec is reporting against the new performance indicators every 6 months to BARNZ, quarterly to the Ministers of Transport, and monthly to Avsec's management, the CAA Board, and the Ministry.

48. The Ministry will review the level of charges in 2012/13 with a view to changes from 2013/14.