

## REGULATORY IMPACT STATEMENT

### PASSENGER SECURITY CHARGES REVIEW 2013

#### Agency Disclosure Statement

1. A Regulatory Impact Statement (this Statement) is required with respect to the proposals covered in the Cabinet paper. This Statement has been prepared by the Ministry of Transport in conjunction with the Aviation Security Service, a separate service within the Civil Aviation Authority.
2. From July 2011 passenger security charges (the charges) were reduced to lower-than-cost-recovery levels to eliminate, by 30 June 2013, a projected accumulated surplus of \$27 million<sup>1</sup>. The projected accumulated surplus will be eliminated by 30 June 2013, and increased charges are needed to fund the Aviation Security Service's normal operating costs.
3. The problem addressed by this Regulatory Impact Statement is to consider the minimum necessary increase in charges to provide stable funding for the Aviation Security Service from 1 June 2013 to 31 March 2014 (the review period).
4. The Aviation Security Service's projected costs, revenue variances and necessary cash reserves have been assessed as reasonable over the review period. Constraints on the selection of options include the need to implement new charges as soon as possible (1 June 2013) and the agreed review period.
5. The analysis recommends that charges increase from 1 June 2013 from \$8.00 to \$11.98 (GST inclusive) per departing international passenger, and from \$3.70 to \$4.60 (GST inclusive) per departing domestic passenger.
6. The Regulatory Impact Statement and associated supporting material have been assessed by the Ministry of Transport Regulatory Impact Statement Panel, and rated as 'meets' the quality assurance criteria.
7. The regulatory proposals recommended in this Statement are: required in the public interest; will deliver the highest net benefits of the practical options available; and are consistent with commitments in the Government statement "Better Regulation, Less Regulation."

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<sup>1</sup> All figures in this paper are exclusive of Goods and Services Tax (GST), unless otherwise stated.

## Status quo and problem definition

### Background

8. The Aviation Security Service is funded by international and domestic charges levied on airlines, on a per-departing passenger basis. The Aviation Security Service is a separate service within the Civil Aviation Authority, and is governed by the Civil Aviation Authority Board (the Board). The Aviation Security Service currently operates at six security-designated airports: Auckland, Rotorua, Wellington, Christchurch, Dunedin and Queenstown.
9. The Civil Aviation Charges Regulation (No. 2) 1991 (the Regulations) prescribes the charges. Airlines generally pass on the charge to passengers in the ticket price. Guidance from the Treasury and the 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.
10. In 2007, the charges were set to recover more than costs to allow the Aviation Security Service to establish contingency reserves (the reserves) of \$3 million (GST exclusive) from the domestic charge and \$4.5 million (GST exclusive) from the international charge. The reserves were intended to enable the Aviation Security Service to deal with the initial impact of a significant operational or financial risk associated with a terrorist event or international shock for up to 6 weeks.
11. Since 2007, the charges have changed five times (see Table 1). Amendments to the charges are made by way of an Order in Council amending the Regulations.

Table 1. Date new charges implemented	Reason for Change	International Charge		Domestic Charge	
		\$ GST inclusive	\$ GST exclusive	\$ GST inclusive	\$ GST exclusive
31 March 2007	Implementation of liquids, aerosols and gels screening for international flights	12.56	11.16	3.57	3.17
1 December 2007	Increased costs for capital expenditure on new equipment and premises at Auckland, Christchurch and Head Office	15.00	13.33	4.66	4.14
1 April 2010	Reduction of a projected accumulated surplus of \$42 million* by 1 April 2013	10.00	8.89	4.35	3.87
1 October 2010	Adjustment in GST from 12.5 percent to 15 percent	10.22	8.89	4.45	3.87
1 July 2011	Reduction of a projected accumulated surplus of \$27 million* by 30 June 2013	8.00	6.96	3.70	3.22

\* The projected accumulated surpluses exclude the \$7.5 million in contingency reserves

12. Cabinet agreed to reduce charges from 1 July 2011 to below cost-recovery levels to eliminate a projected accumulated surplus of \$27 million by 30 June 2013. At that time, Cabinet noted that officials would conduct a review during 2012/13 to increase charges from 1 July 2013 to fund the Aviation Security Service's normal operating costs and scheduled replacement of hold baggage screening equipment.
13. The projected accumulated surplus will be eliminated by 30 June 2013. However, the Board projects a \$10.5 million operating shortfall over the same period.

## **Problem definition**

14. The problem to be addressed by this Statement is to consider the necessary increase in charges to provide stable funding for the Aviation Security Service from 1 June 2013 to 31 March 2014 (the review period).
15. Also, the Aviation Security Service projects a \$10.5 million operating shortfall for the 2010-13 period. The size of the operating shortfall and the limited early warning to the Minister of Transport is of concern. The shortfall has identified an issue with the Aviation Security Service's future expenditure and revenue requirements; the quality and effectiveness of financial management; and options to adjust the business and funding model and the charges review process. This issue will be addressed separately in a (Stage Two) review during 2013, with implementation of any new charges arising from that review from 1 April 2014.

## **Objectives**

16. The government's objective for the Stage One review is to ensure the Aviation Security Service is appropriately funded to carry out its normal functions from 1 June 2013, while minimising additional costs to airlines (and indirectly, passengers), while ensuring the Aviation Security Service has sufficient reserves to manage revenue fluctuations during the review period.

## **Regulatory impact analysis**

### *Options*

17. Three options were assessed for new charges over the review period. Each of the options assumes a further resetting of charges from 1 April 2014 (as part of the Stage Two review), which will include a revised reserves policy.
18. The options are:
  - 18.1 Option One – No increase in charges, charges remain at \$8.00 international and \$3.70 domestic (GST inclusive).
  - 18.2 Option Two – Increase charges to reflect Aviation Security Service's real cost to the passenger. Reserves at the end of the review period would be the same as they were at the start of the period. The international and domestic charges would be \$11.72 and \$4.44 (GST inclusive) respectively.
  - 18.3 Option Three – Increase charges to reflect normal operating cost for the review period and partly replenish reserves from \$1.4 to \$3.0 million by end of the review period. The international and domestic charges would be \$11.98 and \$4.60 (GST inclusive) respectively.
19. The three options were assessed against the key criteria of financial impost on the airlines (and indirectly, passengers) and risks to the Aviation Security Service.
  - 19.1 Option One results in the Aviation Security Service becoming insolvent. It is not politically or practically viable.
  - 19.2 Option Two minimises the necessary charges increase at the expense of the Aviation Security Service's financial risk. It would limit the Service's ability to

manage possible variations in passenger numbers. The option provides the reserves at the end of the review period for up to 7 days of operating costs.

- 19.3 Option Three is preferred as the charges increase would replenish the reserves to a minimum level necessary to manage variations in passenger numbers. The option retains some financial risk, as reserves levels are projected to dip over the review period due to seasonal variations in passenger numbers. At the end of the review period, the reserves are projected to provide 14 days normal operating costs (\$3 million).

#### *How the proposed charges are calculated*

20. The increased charges are derived by:
- 20.1 Determining the Aviation Security Service's charges-related costs for the review period
  - 20.2 Allocating the costs (above) between international and domestic security services through Aviation Security Service's cost allocation methodology
  - 20.3 Forecasting passenger numbers for the review period
  - 20.4 Determining the processing cost on a per passenger basis
  - 20.5 Determining the desired reserves level at the end of the review period
  - 20.6 Allocating the reserves replenishment costs to each charge
  - 20.7 Determining the overall increase to each charge.

#### *Operating costs for the review period*

21. The operating expenditure for charges-funded activity during the review period is \$60.9 million (see Table 2 following). These costs reflect \$1.2 million in savings for the Stage One review period, mostly from: decreased personnel costs following redundancies; modest increases to staff remuneration consistent with state sector parameters; and a higher budget provision for leave contingencies.
22. In addition, due to recent European Union decisions, the Aviation Security Service now expects the costs associated with replacing hold stow baggage screening equipment to be significantly lower than projected during the 2011 Review, particularly the capital costs. Whilst the Aviation Security Service is still considering options for the most appropriate financing arrangements, including renewing a finance lease (the current arrangement), it expects the related future operating costs to be similar to current costs.

#### *Cost allocation*

23. The Aviation Security Service allocates costs to international, domestic, and other security services through a cost allocation methodology agreed with airlines in 2005, and used for previous charges reviews.
24. Indirect costs are allocated to activities based upon rostered duties, so specific allocations vary from year to year. Table 2 reflects actual and projected allocations, and the percentage share of total expenditure, for charges-funded activities over 2011–14 and the review period.

**Table 2 Charges-funded operational expenditure (\$ million GST inclusive)**

	2011/12 (Actual)	2012/13 (Projected)	2013/14 (Projected)	Review period (Projected)
International expenditure	50.3	51.8	49.4	41.5
Percentage share	67%	65%	65%	65%
Domestic expenditure	21.8	24.0	23.3	19.4
Percentage share	29%	30%	31%	30%
Other expenditure	3.3	3.4	\$2.8	2.9
Percentage share	4%	5%	4%	5%
<b>Total expenditure</b>	<b>75.5</b>	<b>79.3</b>	<b>75.6</b>	<b>63.8</b>
<b>Charges-funded expenditure</b>	<b>72.2</b>	<b>75.9</b>	<b>72.8</b>	<b>60.9</b>

*Totals may not add due to rounding.*

25. The Aviation Security Service manages fluctuations in the percentage allocations between international and domestic activities as part of business-as-usual. Given the potential impact of these fluctuations on the respective reserve balances during the review period, the Aviation Security Service advises that the Board will now review these percentage allocations at its regular meetings.

#### *Projected passenger numbers*

26. The Aviation Security Service projects 4.1 million international and 5.0 million domestic passenger departures over the review period. These projections, consistent with those advised in the Civil Aviation Authority's Statement of Intent for 2012–15, are calculated using a combination of historic patterns, updated by known changes to routes and capacity. The figures take into account other major factors such as the global economic outlook and the impact of the Christchurch earthquake on aviation, and are phased for seasonal travel fluctuations.
27. During consultation, the Board of Airline Representatives of New Zealand provided, from airports' recent pricing review, forecast international and domestic passenger numbers for Auckland, Wellington and Christchurch airports. The Service advises that this information is broadly in line with their forecast passenger numbers for the period.

#### *Calculation of the charges*

28. Table 3 shows how the international and domestic charges have been calculated for (the preferred) Option Three:

<b>Table 3</b> <b>Calculation of charges</b>	<b>Calculation method</b>	<b>International</b>	<b>Domestic</b>
a) Forecast cost of operations over review period	-	\$41,460,000	\$19,424,000
b) Funds necessary to replenish reserves	-	\$940,000	\$683,000
c) Projected passengers	-	4,068,000	5,027,000
d) Cost of processing a passenger	a/c	<b>\$10.19</b>	<b>\$3.86</b>
e) Cost of part-replenishment of reserve	b/c	<b>\$0.23</b>	<b>\$0.14</b>
f) Proposed charge (GST exclusive)	d + e	<b>\$10.42</b>	<b>\$4.00</b>
g) Proposed charge (GST inclusive)	f + 15%	<b>\$11.98</b>	<b>\$4.60</b>

## Impacts

29. Under Option Three, airlines are likely to include the full increased charges in ticket prices. The effect of increased charges on passenger travel is expected to be low. For example, an increase of \$3.98 against a \$500 international ticket is 0.8 percent. Similarly, a 90 cent increase in the price of a \$100 domestic fare would be 0.9 percent.
30. We are unable to estimate the specific impact for airlines, as they do not provide information on the numbers of screened passengers per airline. However, the Board of Airline Representatives of New Zealand did not raise any concerns with the increased charges during consultation.
31. The Aviation Security Service will receive an estimated \$16.1 million (GST inclusive) more for international and \$4.5 million (GST inclusive) more for domestic passenger departures over the review period. The cost will be spread over passengers and airlines because some tickets will be purchased in advance of 1 June 2013 at the existing charge.
32. There is no expected environmental or cultural impact from the increased charges.

## Reserves levels and sensitivity analysis

33. Table 4 compares the three options for the Stage One review. The new charges depend on the proposed replenishment of reserves. The table shows how the options affect reserves levels:

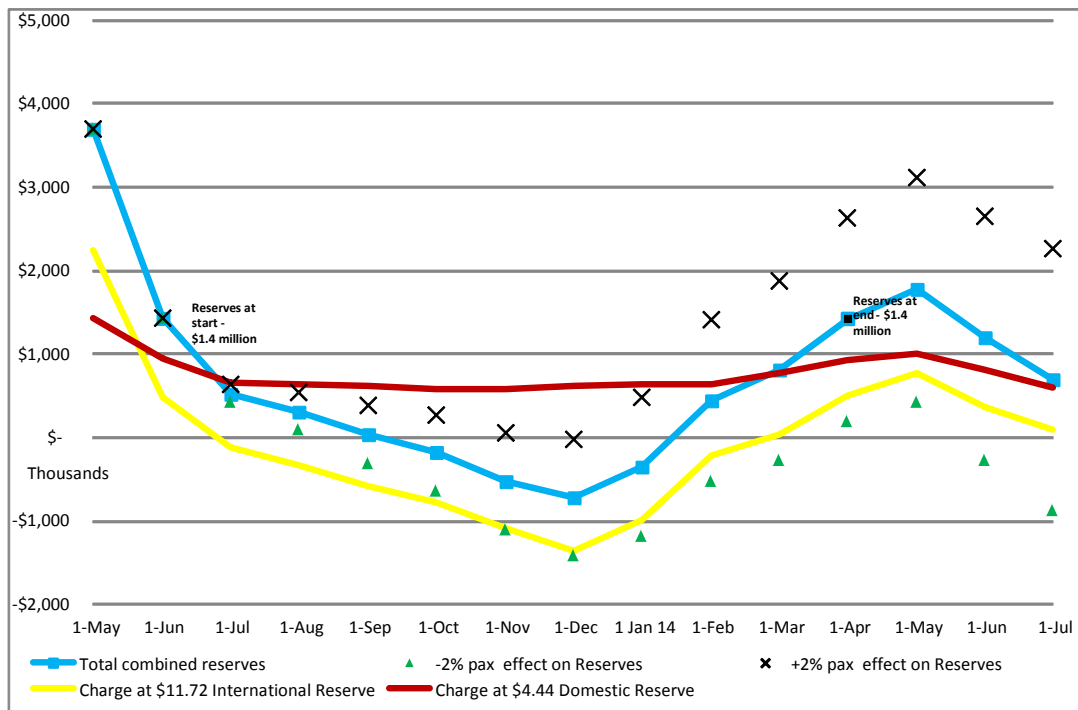
**Table 4 Options**

	Reserves at end of review period \$ m		Replenishment required \$ m		Increase to charges for this period (\$ GST inclusive)	
Option One – No increase in charges	Total International Domestic	-14.5 -12.7 -1.8	Nil (reserves eliminated)		Nil	
Option Two – Reserves maintained at 1 June 2013 levels	Total International Domestic	1.4 0.9 0.5	Nil		International Domestic	3.72 0.74
Option Three - Reserves partially replenished	Total International Domestic	3.0 1.6 1.4	Total International Domestic	1.6 0.7 0.9	International Domestic	3.98 0.90

34. The preferred option is to partially replenish the reserves. Full replenishment of the reserves to their authorised \$7.5 million total is not warranted because the scale and scope of the reserves will be reviewed in Stage Two.
35. Given the savings the Board already expects to deliver for the review period, the Aviation Security Service will have a limited ability to reduce or reprioritise expenditure further, if revenue is less than projected. Most of the Aviation Security Service's costs are staff related. Staff costs can be reduced in the long term. However, long term reductions to staff costs normally require additional short term expenditure to pay for redundancies. Without the ability to reduce costs over the review period, any changes to projected passenger numbers, and therefore charges revenue, will impact on the reserves levels.

36. Actual passenger numbers for the last two financial years (2010–12) were 3.3 percent less than forecast<sup>2</sup>. As this negative variance was due to a range of significant factors and given the shortened review period (10 months compared to 3 years), the Ministry and the Aviation Security Service have agreed that a 2 percent variance is appropriate for a sensitivity analysis.
37. Analysis on reserves levels for options two and three are provided in the charts below. The charts reflect steeply dropping reserves levels until 1 June, when new charges reduce the rate of fall. Over the review period, reserves dip to a minimum in December, only rising again to targeted levels by 31 March 2013.
38. Chart one shows how option two effects reserves. Charges are set at \$11.72 and \$4.44 for international and domestic charges respectively. Total combined reserves go into a deficit from October to January reaching a maximum deficit of \$0.73 million in December. A 2 percent negative variance extends the deficit period from September to March with a maximum deficit of \$1.4 million.

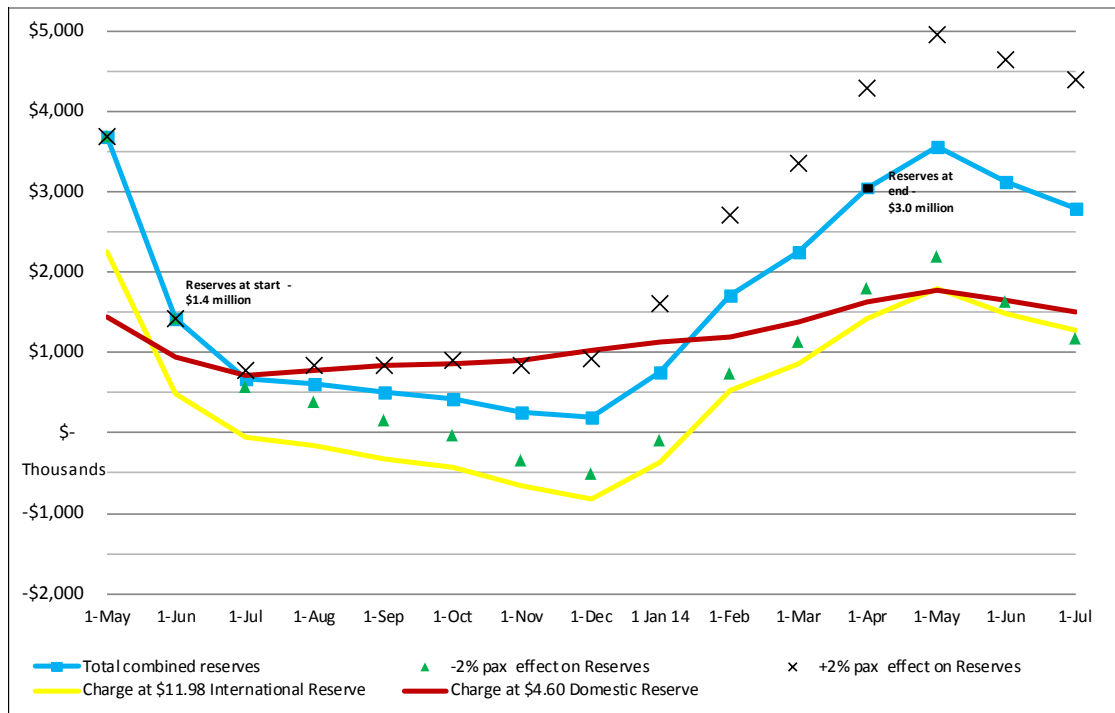
**Chart 1. Option Two. Effect on domestic and international reserves with revised charges of \$11.72 & \$4.44 implemented from 1 June 2013**



39. Chart two shows option three's effect on reserves. Charges are set at \$11.98 and \$4.60 for international and domestic charges respectively. Total combined reserves avoid going into deficit and reach a minimum of \$0.2 million. A 2 percent negative variance creates a deficit period from October to January with a maximum deficit of \$0.5 million in December.

<sup>2</sup> Civil Aviation Authority's Statement of Intent for 2011–14

**Chart 2. - Option Three. Effect on domestic and international reserves with revised charges of \$11.98 & \$4.60 implemented from 1 June 2013**



40. The Aviation Security Service has some ability to manage seasonal deficits by using funds from working capital.
41. A positive 2 percent variance in passenger numbers over the Stage Two review period would increase the total level of reserves at 31 March 2014 to \$4.3 million. This level falls within established reserves levels of \$7.5 million. As the Stage Two review will consider the nature, use, and level of these reserves, the charges can be reset from 1 April 2014 to alter the reserves levels as needed.
42. A negative 2 percent variance in passenger numbers would reduce the total reserve levels at 31 March 2014 to \$1.8 million. This would not create any cash flow or solvency issues for the Aviation Security Service.

*Impact of presold tickets*

43. Airlines pay the charges when passengers travel, but many passengers purchase their tickets in advance. Accordingly, when charges were reduced in 2010 and 2011, airlines received the financial benefit of presold tickets that included the higher charges.
44. The Stage One review proposes increased charges, with airlines incurring a financial loss on any tickets sold before 1 June 2013. The Board of Airline Representatives of New Zealand was advised of this during consultation, and did not raise any concerns.

**Consultation**

45. The Minister of Transport agreed to a brief consultation process with the Board of Airline Representatives of New Zealand only, rather than a broader industry group including airports and tourism stakeholders. This was due to the urgency of the



Stage One review, that increased charges had already been signalled in 2011, and that airlines are directly affected by the proposal.

46. The Board of Airline Representatives of New Zealand received the discussion document on 21 November and had 10 working days to comment. During this time, the Aviation Security Service met with them twice, and presented the results of the reforecasting exercise.
47. The Board of Airline Representatives of New Zealand supported the proposal for a two-stage review and the recommended charges. It also expressed a very strong interest in the Stage Two review, and in the Aviation Security Service having time to identify opportunities for further efficiencies.

### **Conclusion and recommendations**

48. Maintaining the status quo (Option One), results in the Aviation Security Service becoming insolvent. It is not politically or practically viable.
49. To allow the Aviation Security Service to fund its normal operations, and to part-replenish reserves from 1 June 2013, the Ministry recommends that:
  - 49.1 the international passenger security charge be increased from \$8.00 to \$11.98 (GST inclusive)
  - 49.2 the domestic passenger security charge is increased from \$3.70 to \$4.60 (GST inclusive).

### **Implementation**

50. Amend the Civil Aviation Charges Regulations (No 2) 1991 to increase the charges. New charges are intended for implementation by 1 June 2013.

### **Monitoring, evaluation and review**

51. The Board will continue to oversee the financial performance of the Aviation Security Service and receive regular reporting on revenue, expenditure, and the reserves balances. The Board will also continue to monitor whether related assumptions are holding true and consider appropriate action to manage any variances. The Minister of Transport has reiterated his expectation that the Board advise him promptly on the latter.
52. The Aviation Security Service also provides a monthly report on the above financial information, and on key performance indicators, to the Ministry of Transport. The Ministry will continue to discuss this report with the Aviation Security Service and advise the Minister on any emerging issues.
53. The Stage Two review will look at the above matters to consider both the level of charges to apply from 1 April 2014 and the related mechanisms for managing revenue and expenditure pressures.