

Regulatory Impact Statement Aviation Security Service Review

Agency Disclosure Statement

1. This Regulatory Impact Statement has been prepared by the Ministry of Transport, based on information supplied by the Civil Aviation Authority and the independent project manager responsible for the Review of the Aviation Security Service (the Avsec Review). It provides an analysis of options to:
 - a. Ensure that the mechanisms for collecting the Aviation Security Service's (Avsec's) revenues are consistent with appropriate charging guidelines, and provide incentives to maximise the efficiency of the aviation security system.
 - b. Ensure that Avsec's reserves policy is flexible, transparent, and able to sustain 'business as usual' fluctuations in revenue
 - c. Set an appropriate passenger security charge for the next four years to recover actual costs as accurately as possible.
2. This Regulatory Impact Analysis provides analysis of a regulatory proposal to amend the passenger security charges, and significant non-regulatory proposals relating to Avsec's funding. It does not provide analysis on the full range of proposals that were considered as part of the Avsec Review. The Avsec Review had a broad focus and many of its recommendations are internal operational or policy decisions which are not expected to have a significant impact outside of government.
3. Options related to opening Avsec to competition, and charging for Avsec's services on a location-specific basis were ruled out of the scope of the Avsec Review and have not been referred to in this Regulatory Impact Statement.
4. The preferred options outlined in this Regulatory Impact Statement are expected to result in more equitable funding of Avsec, stronger incentives for efficiency, and more sustainable funding in the long term. The proposals will lead to a reduction of 12.4 percent in the international security charge and 21.3 percent in the domestic security charge by 2017, reducing the cost of air transport by \$1.51 per international passenger and \$0.98 per domestic passenger. However, the preferred option will impose costs on airports, which do not currently pay for aviation security services.
5. The proposals have been prepared based on the best available information and all revenue and expenditure projections have been thoroughly scrutinised. However, there are uncertainties around the projected passenger volumes and cost savings which have informed the proposed passenger security charges for the 2013/17 charges period.
6. The proposals will not impair private property rights, market competition, or the incentives on businesses to innovate and invest, or override any of the fundamental common law principles. The proposals are consistent with the government's commitments in the Government statement *Better Regulation, Less Regulation*.

Richard Cross, Senior Adviser
22 October 2013

Signature

Status Quo

The Aviation Security Service

7. Avsec is the Crown Agency responsible for the provision of aviation security services at New Zealand's six security designated airports (Auckland, Wellington, Christchurch, Queenstown, Dunedin, and Rotorua). Avsec conducts security screening of all international passengers and their hold stow baggage, and all domestic passengers on aircraft with 90 or more passenger seats, for prohibited and dangerous items. Avsec also provides a range of other functions to secure the areas in which the passenger and baggage screening is conducted, and to contribute to overall security at airports.
8. As a signatory to the International Convention on Civil Aviation (the Convention), New Zealand is required to have aviation security arrangements in place. The specific requirements are set out in Annex 17 to the Convention, which is maintained by the International Civil Aviation Organization. Avsec is audited by the Civil Aviation Authority, against New Zealand's domestic legislation, which is heavily influenced by the requirements of foreign regulators and standards and recommended practices promulgated by the International Civil Aviation Organization.

Passenger Security Charges

9. Avsec has an operating budget of around \$80 million per year, the vast majority of which is recovered from airlines through the passenger security charges. The passenger security charges are paid on a per-departing passenger basis, and are generally passed directly on to passengers in the price of an air ticket. Separate charges are in place for domestic and international passengers, reflecting the different security requirements applied to domestic and international travel.
10. The passenger security charges are set out in the Civil Aviation Charges Regulation (No 2) 1991. In accordance with guidance issued by the Treasury and the Office of the Auditor General, the charges are usually set for a three year period, on a full cost-recovery basis.
11. The charges also provide for a contingency reserve, which was introduced in 2007 to provide Avsec with the ability to absorb the impact of a significant external shock, or new aviation security requirements, which can be imposed at short notice following international security incidents.

The Avsec Review

12. Between 2007 and 2010, Avsec collected more revenue from passengers than was necessary, resulting in a large surplus. In order to reduce the accumulated surplus, the passenger security charges were set below cost in 2010, and reduced further in 2011, with the aim of reducing Avsec's reserves to a more sustainable level by 30 June 2013.
13. Avsec reached the target level of reserves three months earlier than planned, and signalled that it would need to reset the charges to fully recover costs earlier than had been anticipated. This situation led to the two-stage Avsec Review.
14. The first stage of the Avsec Review resulted in an increase in the passenger security charges, effective from 1 June 2013, to fund Avsec's operating costs and to begin rebuilding Avsec's depleted reserves. The charges are currently set at \$11.98 per departing international passenger (GST inclusive) and \$4.60 per departing domestic passenger (GST inclusive).

15. The second stage of the review, which is the focus of this Regulatory Impact Statement, is to help Avsec develop “a plan for a business model that will provide a durable charges structure, with expenditure based on robust revenue forecasts, and variances”.

Problem definition

Problem 1: Avsec is exposed to a high risk of an over-recovery or under-recovery of the passenger security charges

16. Avsec has a strong international reputation, and its effectiveness as an organisation is not in question. However, there are a number of long-standing issues related to the sustainability of Avsec’s funding.
17. In accordance with guidelines issued by the Office of the Auditor General, Avsec’s passenger security charges are intended to be reviewed every three years. However, since their establishment in 2005, the charges have been reviewed seven times. Some of these charges reviews have been initiated in response to new international security requirements (for example, the requirement to introduce screening of Liquids, Aerosols and Gels on international flights in 2007). However, as shown in the table below, more recently a number of charges reviews have been initiated in response to an actual or projected over or under-recovery of the charges.

Table 2: Passenger Security Charges, 2005-2013

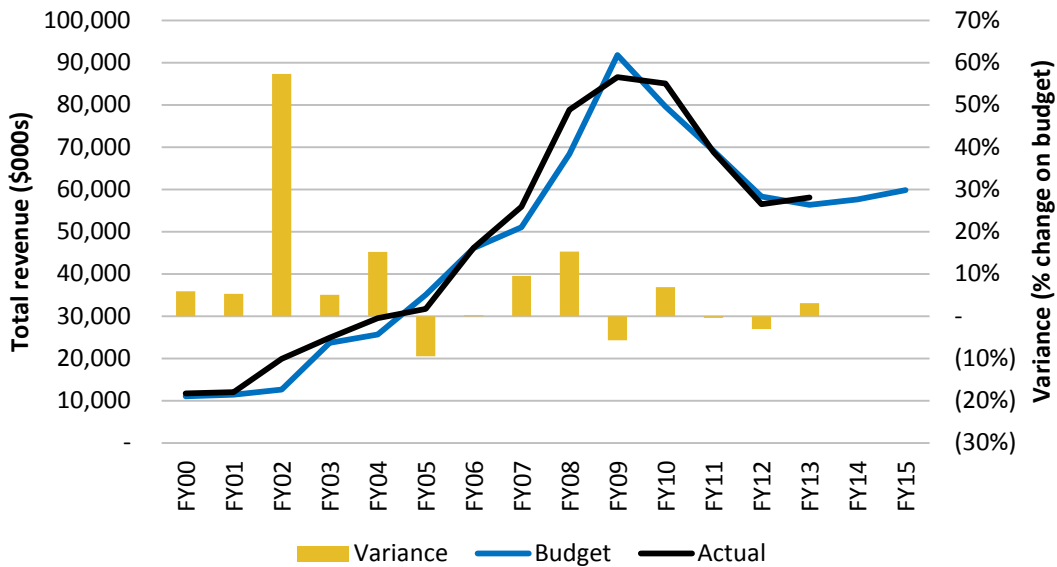
Date	Primary reason for charges review	International passenger charge \$ (GST inclusive)	Domestic passenger charge \$ (GST inclusive)
October 2005	Passenger security charges established.	8.31	3.57
March 2007	Implementation of liquids, aerosols and gels screening for international flights from 31 March 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
1 July 2011	Downward adjustment to account for cost savings and utilise Avsec’s accumulated surplus	8.00	3.70
1 June 2013	Stage one of Avsec Review: temporary adjustment to provide short term funding assistance, following a faster than expected utilisation of surpluses.	11.98	4.60

18. The aviation industry, in particular the Board of Airline Representatives New Zealand, is increasingly frustrated by the number of ‘unscheduled’ charges reviews which have taken place more recently. Reviewing the charges is a costly and resource intensive process for both government and industry.
19. The issue can be at least partly explained by the volatility of the aviation industry. The passenger security charge is applied on a per-departing passenger basis, and as a result, Avsec’s revenues are directly correlated with passenger volumes. Avsec is therefore heavily reliant on accurate passenger forecasts to inform its staffing levels and rostering.

Passenger volumes are inherently difficult to predict, as they can be impacted by economic factors, airline entry and exit, significant events, and seasonal variation.

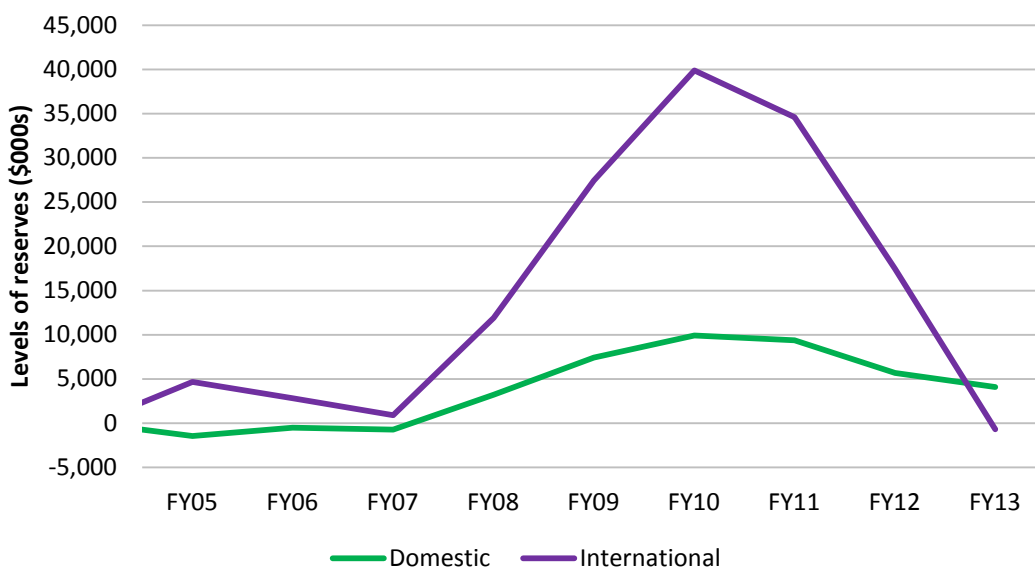
- For the past three years Avsec's passenger projections have been reasonably accurate. However, this has not always been the case. For example, in the year ended June 2008, Avsec's revenues were \$10.4 million (15 percent) higher than forecast (see below). In the five months between March and August 2013, international passenger volumes were tracking 4.2 percent ahead of forecast, suggesting that revenues for the current financial year may be significantly higher than expected.

Figure 1: Variance between Avsec's budgeted and actual revenue



- Discrepancies between forecast and actual passenger volumes can quickly accumulate, particularly when this coincides with a period in which Avsec's expenses are lower than expected. A period of higher than expected revenues and lower than expected expenditure between 2007 and 2011 resulted in a sudden and significant increase in Avsec's reserves (particularly the international reserves).

Figure 2: Avsec's reserves balance



22. It is unreasonable to expect perfect alignment between Avsec's revenues and expenditure. Some level of variability in Avsec's reserves is inevitable. Yet there is currently no established 'tolerance' for a small over-recovery or under-recovery in Avsec's financial management systems. Since 2007, Avsec has been permitted to carry a 'shocks' reserve of \$7.5 million (with \$4.0 million allocated to the international charge and \$3.5 million to the domestic charge) to allow it to manage the impact of a terrorist incident, natural disaster, or international event. However, this reserve is not intended to be used to absorb an over-recovery or under-recovery caused by 'business-as-usual' variations.

Problem 2: Airlines and passengers are paying for services for which they receive no direct benefit

23. Avsec provides a range of services which contribute to the overall outcome of protecting passengers and property from security threats. A number of parties, including airports, airlines, and the general public, benefit to some extent from New Zealand having a safe and secure aviation system which meets the expectations of the travelling public and our international trading partners. However, a 2004 Treasury-led Review of Passenger Clearance Services determined that passengers are the primary beneficiary of aviation security services, and should therefore meet the costs of providing those services.

24. This principle was confirmed by an independent review commissioned as part of the Avsec Review (the Castalia Report). However, the Castalia Report concluded that this only applies to services which are necessary for the protection of passengers and property from security threats. There are a number of services that Avsec provides which are peripheral to that objective. Specifically:

- Avsec is required to screen duty-free goods entering a sterile area before they are sold to passengers (and airline staff). Currently, all passengers are paying for this service regardless of whether or not they choose to purchase duty-free goods.
- Avsec currently issues around 60,000 temporary airport identity cards per year, primarily to external workers on the airport site with sponsorship from the airport company or an on-site service provider. There is currently no charge for this service (although there is a charge for issuing permanent identity cards). There is evidence that the current system is leading to exploitation of the temporary identity card facility, with a high proportion of multiple issues over short periods of time.
- Avsec currently screens any person entering a security enhanced area. While the majority are passengers and airline crew, between 10-25% of persons passing through a screening point are not travelling on an aircraft. This includes airport and retail staff, and the families of unaccompanied minors. At some airports, passengers travelling on smaller aircraft (which do not require security screening) are also being screened in order to access an airport lounge on the other side of the screening point. None of these groups are currently contributing towards the cost of security screening.

25. Avsec is also providing two services for which it has no clear legislative mandate – gatehouse duties (where Avsec controls entry and exit of persons at Auckland, Wellington, and Christchurch Airports), and airport escorts (for reasons other than security, such as VIP escorts or medical emergencies). Both of these functions are the responsibility of airports under Civil Aviation Rule Part 139, yet the costs of providing them are currently being met by passengers.

26. The total cost to Avsec of providing these services¹, and their contribution to the international and domestic passenger security charges, is summarised in the table below:

Table 1: estimated costs and charges contribution of certain Avsec services

Function	\$000s, excl. GST	Estimated contribution to international charge	Estimated contribution to domestic charge
Screening of duty-free goods	900	\$0.18	n/a
Issuing of temporary identity cards	389	\$0.05	\$0.02
Screening of airport staff and other non-revenue persons	1,252	\$0.23	\$0.02
Provision of gatehouse duties	1,860	\$0.26	\$0.09
Provision of non-security related escorts	6	(negligible)	(negligible)
Total	4,407	\$0.72 (6% of the total international charge)	\$0.13 (2.8% of the total domestic charge)

27. Under the current funding structure, passengers (through airlines) are cross-subsidising airports and retailers, by paying for services for which they receive no direct benefit. Airports and retailers are benefiting from Avsec's services without contributing to the cost, with no incentive to change their behaviour in order to improve the efficiency of the system.

Problem 3: Avsec's current passenger security charges are not aligned with projected passenger volumes and expenditure

28. The charges were established by Cabinet in March 2013, to provide short-term funding relief pending the outcome of the Avsec review.

29. The Avsec review team has undertaken a comprehensive assessment of Avsec's financial management. The Review has concluded that Avsec's projections of passenger numbers are more robust than they have been in the past, and Avsec is better placed to manage its personnel costs, which represent 75 percent of its costs. The review has also identified a number of initiatives that are expected to lead to cost savings and efficiency gains (discussed further in paragraph 60).

30. These initiatives are expected to lead to cost savings rising from \$1.0 million per year to \$2.2 million per year over a three year period from 2014/15. Avsec's management has also committed itself to further ongoing savings of \$0.5 million per annum compounding over the four years from 2014/15.

31. As a consequence, the current passenger security charges are no longer aligned with Avsec's best estimates of passenger volumes and expenditure over the four year charges period. Without a reduction in the passenger security charges, Avsec is likely to accumulate a surplus of approximately \$21 million over the period 2014-2017.

Objectives

32. The desired outcomes from the proposals outlined in this RIS are to:

- a. Ensure that Avsec's mechanisms for collecting revenue are consistent with appropriate charging guidelines, and provide appropriate incentives to maximise the efficiency of the aviation security system

¹ The Avsec Review identified a number of other costs imposed on Avsec by other users (for example, airlines changing departure gates at late notice prior to boarding) but these costs were considered immaterial, with administrative costs likely to outweigh any benefits of introducing a separate charge.

- b. Ensure that Avsec’s reserves policy is flexible, transparent, and able to sustain ‘business-as-usual’ variations in revenue
- c. Set an appropriate passenger security charge for the next three years to recover actual costs as accurately as possible.

Regulatory Impact Analysis

What should the basis for charging be?

33. Avsec does not have access to reliable data on passenger loadings in advance of flights, and makes its rostering decisions based on the number of scheduled departing flights (assuming an 82.5 percent passenger loading, plus a further four percent to account for non-passengers).
34. At smaller airports, where Avsec is often only required to screen one flight per day, Avsec’s cost structure is largely fixed. However, revenues can vary significantly based on the number of passengers actually travelling on the flight, and Avsec is effectively left bearing the risk of airlines not selling a proportion of the seats. This is demonstrated in the table below, which shows Avsec’s costs and revenues for screening a single Airbus A320 aircraft on a domestic route under different passenger loading scenarios:

Table 2: Example of Avsec costs and revenues for screening a domestic flight

No. of passengers	% of capacity	Avsec revenue	Avsec costs
85	50%	\$329	\$542
110	65%	\$426	\$542
140	82.5%	\$542	\$542
170	100%	\$658	\$542

35. At larger airports, Avsec’s cost structures are more complex. With numerous flights departing at different times of the day, and significant peaks and troughs in demand, rostering staff to match passenger throughput can be challenging. During peak hours at large airports, there is a significant variable cost component. However, low passenger loadings can still have an impact on Avsec’s revenues outside of peak operating hours.
36. The Avsec Review considered whether the impact of low passenger loadings could be shifted to airlines by charging on the basis of departing flights, with charges set on the number of available seats on the plane (rather than the number of seats sold on each flight). This would ensure that Avsec received a constant and predictable source of revenue regardless of actual passenger volumes.
37. Three different charging structures were considered:
- a) Charging airlines on a per-departing passenger basis (status quo)
 - b) A uniform charge to airlines per departing flight. The charge would be levied on a per flight per seat basis, meaning that aircraft with more seat capacity would be charged higher fees
 - c) A hybrid model based on a fixed charge with a variable component (a “two-part tariff”)
38. These options have been assessed against the following criteria:

- a) Their impact on Avsec’s ability to achieve greater alignment between revenue and expenditure
- b) Their impact on Avsec’s incentives to maximise its efficiency
- c) Their administrative complexity

39. An assessment of the options against these criteria is provided in the table below.

Table 3: Analysis of options for collecting Avsec’s revenue

Criteria	Option 1: charging airlines, on a per departing passenger basis (status quo)	Option 2: a uniform charge to airlines per departing flight	Option 3: a hybrid model based on a fixed charge with a variable component
Would it help Avsec to achieve greater alignment between revenue and expenditure?	No. Avsec’s revenues would continue to be dependent on passenger volumes, which are inherently volatile. There would be a high risk of an under or over-recovery.	Yes. The risk of low passenger loadings would be borne by airlines, which are better placed to manage the risk. Avsec would only be required to forecast the number of departing flights, which are more predictable than passenger numbers.	Partially. The impact of higher or lower than expected passenger numbers would be softened.
Would it incentivise Avsec to be more efficient?	Yes. Avsec would have strong incentives to reduce its costs by aligning its staffing levels with passenger throughput as accurately as possible.	No. As Avsec’s revenues would be fixed, there would be fewer incentives for Avsec to operate efficiently.	Partially, as some of Avsec’s revenues would remain dependent on passenger numbers.
Would it be complex to administer?	No, although it requires a continued focus on accurate passenger forecasting.	No, the charging system would be relatively straightforward. It would also remove the need for Avsec to forecast passenger numbers.	Yes, the costs would be slightly higher in determining the fixed and variable charges. Avsec would also be required to forecast both the number of passengers and flights.

Preferred Option

40. The preferred option is the status quo (charging airlines on a per-departing passenger basis). While Avsec will remain exposed to a high risk of an over recovery or an under recovery, the current system creates positive incentives for Avsec to maximise the use of its resources to reduce costs. The Avsec Review concluded that there is considerable scope for Avsec to improve its efficiency within the current system, particularly at larger airports, by adapting its staffing levels when low passenger volumes are expected, and by working more effectively with stakeholders to improve its forecasting of passenger numbers.

What level of reserves should Avsec carry?

41. As mentioned previously, the aviation industry is highly volatile. The industry is exposed to external shocks. Terrorist incidents, financial crises, flu epidemics, and natural disasters which can have significant and often unpredictable impacts on passenger volumes at both a local and system-wide level. While Avsec’s current “shocks reserve” provides some flexibility to deal with unforeseen events, it does little to help Avsec to

manage the more routine variations in passenger volumes which are a reality of the environment Avsec is operating within.

42. The Avsec Review considered that Avsec requires three types of immediate financial capability, to manage revenue fluctuations within a charges period:
- **Working capital levels** to deal with daily fluctuations in cash balances, which can vary by up to \$6 million during any given month. Avsec's current balance sheet structure is just sufficient to manage these fluctuations.
 - **A reserve to allow for shocks.** Avsec currently has a provision for a 'shocks reserve' of \$7.5 million (consisting of \$4.5 million from international passenger charges and \$3 million for domestic passenger charges). This enables Avsec to operate for up to six weeks following a significant external shock or the imposition of a new security requirement, until a temporary or permanent capital injection, or other funding mechanism, can be provided².
 - **A reserve to allow for business as usual variations,** to enable Avsec to manage the effects of passenger volumes being higher or lower than forecast.
43. The Avsec Review initially considered two options for setting the level of reserves Avsec is permitted to carry:
- a. The status quo (a shocks reserve of \$7.5 million with no reserve for business-as-usual variations). This would require the reserves to be built up by \$3.7 million over the charges period as they are currently depleted³ following the previous under recovery of the charges. This equates to an increase of \$0.33 per international passenger and a decrease of \$0.05 per domestic passenger.
 - b. Establishing a 'business-as-usual' reserve of \$6 million to protect against a modest variation in passenger numbers within a charges cycle, and reducing the shocks reserve to \$6 million (due to the low likelihood of both reserves being called on at the same time). This would require the reserves to be built up by \$8.2 million over the charges period. This equates to an increase of \$0.57 per international passenger and an increase of \$0.01 per domestic passenger.
44. Maintaining the reserves at their current levels (\$3.8 million) is not considered a viable option as it would leave Avsec exposed to a high level of risk in the event of an external shock.
45. The Avsec Review also considered whether the issue could be addressed by reviewing the passenger security charges on a more regular basis (for example, annually). However, this option has a number of difficulties as reviewing the charges is resource intensive (for both industry and government), it would provide less certainty around future charges, and it would be inconsistent with public sector charging guidelines.

Preferred Option

46. Following consultation, option b) as described above was further refined. The preferred option is to establish a 'business-as-usual' reserve of \$4-6 million, and reduce the existing

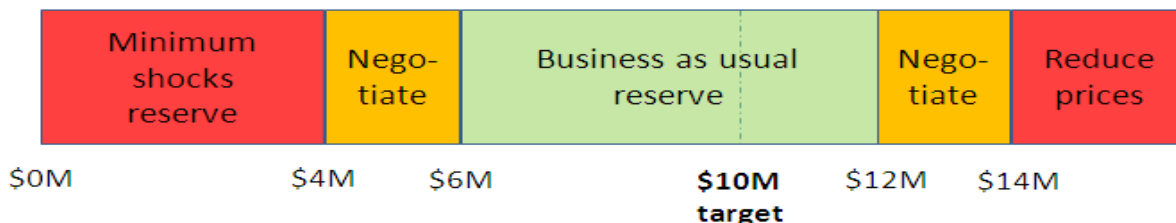
² The risk of a significant external shock occurring or a new security requirement being implemented is considered moderate over the four year charges period, and high over the long-term (10 years).

³ The total reserve balance at 1 July 2014 is projected to be \$3.7 million. This comprises a balance of -\$2.2 million in international reserves (due to a previous under recovery) and \$5.9 million in the domestic reserves (due to a previous over recovery). Under the status quo proposal, the international reserves would be built up to \$4.5 million and the domestic reserves would be run down to \$3.0 million by 2017.

shocks reserve to \$4-6 million. This would provide adequate protection against a modest variation in passenger volumes within a charges cycle, and mitigate the risk of an ‘unscheduled’ review being required. It also provides adequate funding to enable Avsec to manage the impact of an external shock.

47. The figure below demonstrates how this option would be applied in practice:

Figure 3: proposed Avsec reserves policy



48. The business-as-usual reserve would not be fixed, but would fluctuate with seasonal trends and other business cycle influences. If passenger volumes are significantly higher than projected, and total reserves looked likely to exceed \$12 million, Avsec would begin consultations with industry and government stakeholders to reduce the charges. Conversely, if passenger volumes were significantly lower than projected, and the business-as-usual reserve looked likely to go below zero, Avsec would begin consulting on proposals to increase the charges.

49. Avsec would be permitted to utilise a portion of the \$6 million shocks reserve as an interim measure while a price increase was being negotiated. However, the shocks reserve would not be permitted to drop below \$4 million (except in the case of a significant external shock).

50. For budgeting purposes, the ‘targeted’ level of reserves would be \$10 million (comprising the \$6 million shocks reserve and \$4 million of business as usual reserves). This reflects the fact that a reduction in the charges is typically less controversial and easier to implement than an increase in the charges.

Who should pay for Aviation Security Services?

51. The rationale of funding Avsec by charging passengers (through airlines) is well understood and accepted by industry. However, the Avsec Review considered whether it would be appropriate to charge other users for certain Avsec services where it is clear that passengers are not the direct beneficiaries of that service, and where passengers are not responsible for the risk that is being protected against.

52. The table below provides an analysis of the primary beneficiaries for the three services for which a separate charge is being considered:

Table 4: Analysis of primary beneficiaries for specific Avsec services

Description of activity or service provided	Primary beneficiary
Issuing temporary identity cards to external workers on the airport site, under sponsorship of the airport company or an on-site service provider.	The person receiving the temporary identity card, or the sponsoring organisation, which benefit from the ability to access the secure airport environment. In some cases passengers may benefit (for example when the person receiving the temporary identity card performs a role that is necessary for the safe and secure operation of the aircraft). However, in most cases, safety and security related roles will be performed by staff with permanent identity cards.
Screening duty-free and other goods available for sale in sterile areas of international airports	Airports and retailers, which benefit from the opportunity to sell products beyond the screening point. Some passengers will also benefit where they choose to purchase goods from a duty-free retailer.
Screening of airport and retail staff and other non-revenue persons, including families of unaccompanied minors and passengers passing through the screening point when travelling on services which do not require security screening.	The person being screened (or their employer), unless that person is performing a role that is necessary for the safe and secure operation of an aircraft.

53. The Avsec Review considered two options for recovering the costs of the services described above:

- a. Retaining the status quo: passengers would continue to meet the full cost of Avsec’s operations through the passenger security charge.
- b. Charging other users for specific services: passengers would continue to meet the majority of Avsec’s costs, with other services charged to the primary beneficiaries where it is administratively efficient to do so.

54. These options have been assessed against the following criteria:

- Their alignment with the primary beneficiary and the source of the risk which the specific service aims to protect against
- The extent to which they would maximise incentives to improve overall efficiency
- The complexity of administering the charging mechanism

An assessment of the two options against these criteria is provided in the table below.

Table 5: Analysis of options for recovering the costs of certain Avsec services

Criteria	Option 1: retaining the status quo (funding 'non-core' services through the passenger security charge)	Option 2: charging other users for specific services
Would the cost of providing the services be met by its primary beneficiaries and/or the risk exacerbators?	No, passengers would continue to pay for services for which they may receive no direct benefit (although some passengers may receive benefit from some services).	Yes, all services would be funded by their direct beneficiaries and those who introduce the risk which Avsec is protecting against.
Would it maximise incentives to improve overall efficiency?	No. As some individuals would receive a service without paying for it, there would be nothing to incentivise the efficient use of resources.	Yes. By charging users for the costs they incur on Avsec, there would be strong incentives for individuals to change their behaviour.
Would it be complex to administer?	No. The current mechanism is straightforward with all costs recovered through a single charge.	In some cases, introducing new charges for specific services would be relatively straightforward (such as charging for airport identity cards), but in other cases it may be impractical to charge the primary beneficiary of the service (for example, it would be difficult to keep track of and invoice airport and retail staff and other non-revenue persons passing through the screening point).

Preferred option

55. The preferred option is to charge other users for specific services where the primary beneficiary can be clearly identified and it is administratively efficient to do so. This includes:

- Introducing a charge of \$7.95 (GST inclusive) to sponsoring organisations for the issue of temporary airport identity cards. The majority of those using temporary identity cards are conducting business on the airport site for which passengers receive no direct benefit. Charging the organisations responsible is expected to improve overall efficiency by reducing exploitation of the temporary identity card system.
- Introducing a charge of \$86.25 per hour (GST inclusive) to airport companies to recover the cost of screening duty-free goods⁴. This will ensure that the cost is met by those who benefit (airports and retailers who profit from the opportunity to sell the goods, and the passengers who choose to purchase them). A charge to airports is the most efficient way of collecting this revenue as it can easily be passed on to retailers when negotiating their lease.
- Introducing charges of \$5.91 and \$2.79 (both GST inclusive) respectively for screening airport and concessionaire staff into the international and domestic screened areas. This would be charged to airports based on a formula negotiated with them and based on the number of permanent identity card holders. Airports would then make the decision whether, how and to whom these charges would be passed on.

56. It does not include introducing charges for other non-revenue persons passing through screening points, as it would be administratively complex to identify and invoice these individuals. Instead, Avsec will work with airlines and airports to minimise the impact that

⁴ Based on the resource and overhead costs of manning a duty-free screening point for one hour

these groups have on Avsec's operations. The volume of non-revenue persons passing through screening points will be closely monitored, and the decision will be reviewed if there is evidence that the incidence is increasing, and charging might be effectively introduced.

57. Introducing the charges described above will enable a reduction of \$0.62 in the international passenger charge and \$0.09 in the domestic passenger charge.
58. The Avsec Review also considered options for the provision of gatehouse duties and airport escorts which are not directly related to security. A review of the Civil Aviation Rules confirmed that these are both clearly defined as being the responsibility of airport companies under Rule Part 139. As legislative amendment was outside the scope of the Avsec Review (other than where it relates to funding), the only viable option is for Avsec to stop undertaking these roles. This will reduce Avsec's annual expenditure by \$1.1 million, which equates to a reduction of \$0.18 in the international passenger charge and \$0.06 in the domestic passenger charge. Airports will be required to provide this service at their expense. Airport companies would still be able to contract Avsec to perform these functions on a contract-for-service basis.

What should the new passenger security charges be?

59. Passenger security charges are calculated based on Avsec's assumed passenger volumes and expenditure over the four year charges period. Avsec's passenger and expenditure forecasts for the period between 2013/14 and 2017/18 are summarised below.

Passenger Volumes

60. Avsec's passenger projections are based on the known capacity of all flights, adjusted based on an assumed 82.5% load factor. These figures are then reviewed on a flight-by-flight and airport-by-airport basis. The projections are further refined through consultation with the Board of Airline Representatives New Zealand, and a review of public statements and Airport submissions to the Commerce Commission, as well as historical trends. The projections for the next charges period are as follows:

Table 6: Actual and projected passenger numbers, 2009/10 to 2016/17

Passengers	Actual numbers				Projected (budgeted) numbers			
	2009 /10	2010 /11	2011 /12	2012 /13	2013 /14	2014 /15	2015 /16	2016 /17
International passengers	4,452	4,582	4,776	4,760	4,891	5,008	5,155	5,307
Domestic passengers (on flights which require screening)	5,704	5,497	5,641	6,006	6,096	6,349	6,557	6,772

Expenditure

61. As part of the Avsec Review, Avsec's future cost and revenue projections and their underlying assumptions were thoroughly scrutinised. The conclusion of this process was that while Avsec has been relatively efficient from an operational perspective, there are significant efficiency savings yet to be realised. The Avsec Review identified the following measures which are expected to achieve cost savings over the next three years:

- Investing in improvements to the QUINTIQ rostering system, and a small number of business analysts to strengthen Avsec’s corporate capacity to use information more strategically, and develop further efficiency savings over the medium term
- Employing more staff in the ‘screener’ class, to perform duties which are do not require fully trained Aviation Security Officers
- Reducing staff numbers at screening points during off-peak times
- Generating efficiencies by rostering less staff at screening points in off-peak hours. While small queues may develop, this will reduce idle time without significantly impacting the passenger experience
- Reducing the vehicle fleet by 20 percent
- Possible centralisation of some checked-in baggage screening and workforce rostering tasks

62. The investments and cost savings that are expected to result from these initiatives are summarised in the table below. While the exact level of the cost savings has been estimated, they are considered reasonable and achievable.

Table 7: Identified investments and cost savings

Proposed investments and efficiency gains (\$000s, excl GST)	Financial year			Outyear
	2014/15	2015/16	2016/17	2017/18
Investments in the QUINTIQ rostering system and related analytical capability	+520	+520	+390	+390
Savings – specific efficiency gains	-1,010	-1,510	-2,210	-2,510
Savings – medium term efficiencies	-490	-980	-1,460	-1,950
Net annual savings	-980	-1,970	-3,280	-4,070

63. Avsec’s future expenditure projections (summarised below) take these cost savings into account.

Table 8: Actual and projected expenditure, 2012/13 – 2016/17

Expenditure (\$000s)	Actual	Projected			
	2012/13	2013/14	2014/15	2015/16	2016/17
Personnel & employment costs	58,864	59,441	58,987	58,977	58,575
Operating costs	13,883	12,946	13,816	14,986	15,167
Equipment costs	4,867	4,373	4,044	3,854	3,912
Total operating expenditure	77,614	76,760	76,847	77,817	77,654

Preferred option

64. Based on the passenger and revenue projections described above, Avsec has calculated that under the status quo (with no changes to Avsec’s funding or its reserves policy), the passenger security charges would need to be set at \$12.21 per international passenger and \$3.90 per domestic passenger (GST inclusive). In order to improve the alignment between the charges and anticipated passenger volumes and expenditure, the charges

would be reduced annually throughout the charges period. By 1 April 2017, the charges would be reduced to \$11.10 per international passenger and \$3.59 per domestic passenger.

65. However, the charges will also be impacted by the other proposals outlined in this RIS. The impact of each proposal on the passenger security charges is demonstrated in the table below:

Table 9: Impact of policy proposals on the passenger security charges

Proposal	Impact on international charge		Impact on domestic charge	
	1 April 2014	1 April 2017	1 April 2014	1 April 2017
Baseline (charges set based on anticipated passenger numbers and expenditure with no changes to the funding of specific services or the reserves policy)	12.21	11.12	3.90	3.71
Avsec stops performing gatehouse duties (or performs this duty under contract to airports)	-0.18	-0.18	-0.06	-0.06
Avsec introduces a charge for issuing temporary identity cards	-0.06	-0.06	-0.03	-0.03
Avsec charges airports for screening airside retail operations	-0.52	-0.52	-0.03	-0.03
Avsec establishes a 'business-as-usual' reserve of \$6 million, and re-establishes the existing 'shocks-reserve' to \$4-6 million by 30 June 2017	+0.22	+0.13	+0.01	+0.03
Proposed passenger security charges	11.67	10.49	3.79	3.62

66. The preferred option, taking account of the proposals outlined in this RIS, is therefore to reduce the passenger security charges on 1 April 2014 to \$11.67 per international passenger, and \$3.79 per domestic passenger (initial reductions of 2.6 percent and 17.6 percent, respectively). The charges would be automatically reduced on an annual basis throughout the three year charges period as follows:

Table 10: Proposed passenger security charges, 2014-2017

	1 April 2014	1 April 2015	1 April 2016	1 April 2017
International passenger security charge	11.67	11.50	11.19	10.49
Domestic passenger security charge	3.79	3.68	3.62	3.62

67. There is some uncertainty around all of the assumptions on which the proposed passenger security charges are based. As a result, there remains some risk of an over-recovery or under-recovery. Under the new reserves policy, Avsec would be able to withstand a 16% variance in domestic passenger numbers, an 8% variance in international passenger numbers, or a 5 percent variance in expenditure over the four year charges period (or a mix of the three) before needing to initiate discussions on a charges increase.
68. No other options would achieve the necessary alignment between projected passenger numbers and expenditure. While a single, one-off reduction to the charges was considered, this was ruled out because it would not rebuild the reserves to a safer level,

or align with the staggered nature of the cost savings which are expected to accumulate over the charges period.

Consultation

69. As part of the Avsec Review, an Industry Reference Group was formed to provide feedback and suggestions to the Review team. This group included representatives of the Board of Airline Representatives New Zealand, Air New Zealand, the Qantas Group, the New Zealand Airports Association, and the Aviation Community Advisory Group.
70. A consultation document was prepared and provided to all interested parties, and public consultation meetings were held in Auckland, Wellington, and Christchurch. A total of sixteen submissions were received. The three major international airports (Auckland, Wellington, and Christchurch) and the New Zealand Airports Association strongly opposed the proposals to introduce charges to airports. Other stakeholders supported this proposal, including the Board of Airline Representatives New Zealand, the Qantas Group, and Air New Zealand
71. A number of changes were made to the proposals as a result of consultation. Most notably, the proposal to charge all non passenger groups passing through screening points was reconsidered, with Avsec instead proposing a charge only for retail staff, and to work with airlines and airports to reduce the impact that the other groups have on Avsec's operations. The proposed changes to the reserves policy were also refined further in response to issues raised during consultation.
72. The Treasury and the Civil Aviation Authority have been consulted on the proposals in this Regulatory Impact Statement. The Department of Prime Minister and Cabinet has been informed.

Conclusions and Recommendations

73. The proposals outlined in this RIS will result in more equitable funding of aviation security services, with greater alignment between those who impose costs on Avsec and those who benefit from Avsec's services.
74. As a result of the proposed charges to airports and other cost savings, it will be possible to reduce the passenger security charges from 1 April 2014, with further annual reductions until 1 April 2017, whilst simultaneously building additional reserves to improve Avsec's financial sustainability.

Implementation

75. An amendment to the Civil Aviation Charges Regulations (No 2) 1991 is required in order to bring the new passenger security charges into effect.
76. New regulations will be introduced to allow Avsec to charge for the issue of temporary identity cards, and to charge airports on an hourly basis for screening of duty-free goods and on a per-person basis for the screening of retail staff.
77. The new reserves policy will take effect from 1 April 2014, with the reserves built up to their target level over the next three financial years to 30 June 2017.
78. The compliance costs (to both industry and government) associated with the proposals outlined in this RIS are expected to be modest and largely administrative. These costs are expected to be outweighed by the reduced resource costs associated with reviewing the charges on a regular basis.

Monitoring and evaluation

79. Avsec will report regularly to the Civil Aviation Authority Board, the Ministry of Transport, and the Minister of Transport, with updated passenger and expenditure projections, and reserves balances. The Ministry of Transport will continue to monitor the performance of Avsec and encourage improvements in the rigour applied to its performance reporting.
80. The passenger security charges are scheduled to be reviewed again in 2017. At that time, the effectiveness of the policy decisions outlined in this Regulatory Impact Statement will also be evaluated.