



04 April 2011

INFORMATION FOR THE CONSULTATION ON THE REVIEW OF THE DOMESTIC AND INTERNATIONAL PASSENGER SECURITY CHARGES 2011

1. Purpose

- 1.1 To consult with the Board of Airline Representatives New Zealand (Inc) (BARNZ), the airline industry and Government departments on a proposal to review the current domestic and international passenger security charges. This document will be discussed in detail at formal consultation meetings, which will occur prior to the due date for written feedback (Wednesday 20 April 2011).
- 1.2 This consultation proposes that the new charges be lowered for the next two years to \$8.07 GST inc (\$7.02 GST exc) for the international passenger security charge and \$3.71 GST inc (\$3.23 GST exc) for the domestic passenger security charge.

2. Background

- 2.1 Under the Civil Aviation Act 1990, Avsec is responsible for the screening and searching of departing international passengers and their baggage for prohibited and dangerous items, liquids, aerosols and gels; airport access control; airport worker screening; patrolling of security-designated airports; and the searching of aircraft. Avsec also screens domestic passengers and their hand baggage on domestic aircraft of 90 seats or more. Avsec is also responsible for continually reviewing security techniques and processes relating to the protection of civil aviation, as well as providing security services to the Commissioner of Police and to any government agency when requested by the Minister as long as aviation security is not compromised.
- 2.2 Avsec currently operates at seven security-designated airports – Auckland, Hamilton, Rotorua, Wellington, Christchurch, Dunedin, and Queenstown.

Passenger security charges

- 2.3 The Civil Aviation Charges Regulation (No 2) 1991 sets out the basis on which the passenger security charges are made.
- 2.4 Under the direction of Cabinet, Avsec is required to set fees that meet the full costs of the services provided (ie it should not set charges at a level that deliberately generates a surplus or a loss). Guidance on this is provided by the Treasury's Costing and Charging Guidelines and the International Civil Aviation Organisation's Policies on Charges for Airports and Air Navigation Services.
- 2.5 In adopting this approach, Avsec manages its financial risk by avoiding setting charges too low or too high. Avsec aims to set charges for a three-year period. This is consistent with "Charging Fees for Public Sector Goods and Services" (2008), produced by the Office of the Auditor-General and "Guidelines for Setting Charges in the Public Sector" (2002) produced by the Treasury. By setting charges over a multi-year period, Avsec expects that the charges will balance out.
- 2.6 Surpluses and deficits do arise and are tracked against forecasts through Avsec's memorandum accounts, with the aim of balancing revenue and expenditure over time,

and bringing transparency to the charging system. The use of memorandum accounts also assists in avoiding re-setting the charges too often.

Over-recovery of charges

- 2.7 In April 2010 passenger security charges were reduced from \$15 to \$10 GST incl (\$13.33 to \$8.89 GST excl) for the international and \$4.66 to \$4.35 (\$4.14 to \$3.87 GST exc) for the domestic, with a proposed review after three years. The charges were set at a level that covered the cost of the services and contemplated the utilisation of all accumulated surpluses (excluding reserves) built up previously over the charge period. Despite running in deficit since the charges were set, the accumulated surpluses are not being eroded as quickly as was originally expected due to higher passenger volumes (and revenues) and lower operational costs.
- 2.8 Avsec has forecast at 30 June 2011 an accumulated surplus of \$37.9m (comprising \$31.5m from the international passenger security charges, \$7.2m from the domestic passenger security charges and -\$0.781m from other fees and charges). This is exclusive of the \$4.5m international and \$3.0m domestic passenger security charge reserve¹. This is also \$9.661m higher than forecast in the 2010/13 Statement of Intent.
- 2.9 As a result of Avsec's accumulated surplus being larger than originally intended or needed, the Government has agreed that the review of the charges should commence now with the new charges coming into effect on 01 July 2011 for a two-year period. This will return Avsec to a true cost of service model.

Consultation paper

- 2.10 This paper is intended to be the basis for consultation with industry and government departments. The reduction in the charges is viewed as a technical pricing adjustment to apply for a two year period through to 30 June 2013 and, accordingly, is limited in scope to a price adjustment only. Consultation will not extend to the range of services provided under the charges, as these have not changed. In addition, the proposed security charges have been developed utilising cost allocation methodologies, agreed with industry in October 2005. These, also, have not changed.

3 Reviewing and Resetting the Passenger Security Charges

Summary

- 3.1 The proposed passenger security charges have been calculated in line with the Government's previously signalled intention that industry incurs the full costs of providing aviation security. This includes Avsec's full operational costs, including the costs of capital equipment depreciation, capital charge and finance costs.
- 3.2 The proposed charges set out below have been calculated on a two-year average basis and seek to recover the full costs of providing international and domestic aviation security by Avsec over the financial period 2011/12 – 2012/13 and fully utilise any accumulated surplus.
- 3.3 The proposed charges are a temporary measure set to reduce the accumulated surpluses. The charges will again be reviewed in two years (30 June 2013) to recover the full costs of Avsec's services and consider funding the replacement of hold baggage screening equipment.

Accumulated Surplus from Passenger Security Charges - Current Status

- 3.4 In December 2009 Avsec forecast an accumulated surplus at 30 June 2013 of \$42m (exclusive of the \$7.5m contingency reserves) if the charges were not adjusted. Accordingly, the charges were reduced from \$15 to \$10 GST incl (\$13.33 to \$8.89 GST

¹ The 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. Access to these funds requires Board Approval.

excl) for the international and \$4.66 to \$4.35 (\$4.14 to \$3.87 GST exc) for the domestic passenger security charge in order to fully utilise this surplus within the charge period.

- 3.5 In December 2010 Avsec forecast an accumulated surplus at 30 June 2013 of \$27.4m at the current charge (exclusive of the \$7.5m contingency reserve).
- 3.6 The financial projections underpinning the setting of the charges in 2010 were based on the best available information of projected airline and airport activity at that time. However, since undertaking these projections in late 2009, on the back of an economic recession, the recovery in international and domestic passenger volumes has exceeded expectations, staffing levels have been thoroughly reviewed and reduced, a drive for efficiency improvements introduced, and projects deferred and reprioritised, which resulted in the reduced utilisation of the reserves.
- 3.7 The table below summarises the projected surplus over the remaining charge period, exclusive of the \$7.5m (\$4.5m international and \$3.0m domestic) contingency reserves.

Memorandum Account Balance (S) Exclusive of the \$7.5m contingency reserves (\$ Millions)	International Passenger Security Charge	Domestic Passenger Security Charge	3rd Party Contracted Services ²	Total
Balance forecast at 30 June 2011	31.519	7.194	(0.780)	37.933
Balance forecast at 30 June 2012	25.357	7.290	(0.340)	32.307
Balance forecast at 30 June 2013	18.906	8.116	0.361	27.383

- 3.8 Under the proposed new charges the memorandum balances currently forecast for the international passenger security charge of \$18.906m and domestic passenger security charge of \$8.116m (exclusive of the established reserves) will be nil at 30 June 2013.

4 Avsec Financial Projections Moving Forward

- 4.1 The Board and Avsec are committed to ensuring that Avsec forecasting is as close as possible to where the actual costs end up for the charge period. However, the impact of the Christchurch and Japanese earthquakes is simply not known at this time.
- 4.2 Avsec financial projections underpinning the lowering of the charges are set out below:

		Projected Expenditure		
	2009/10 Actual	2010/11	2011/12	2012/13
Personnel & Employment Costs	54,625	56,482	59,325	60,047
<i>% inc</i>	6.3%	3.4%	5.0%	1.2%
Operating	8,553	10,108	10,772	10,936
<i>% inc</i>	-3.0%	18.2%	6.6%	1.5%
Ownership Costs	6,813	7,164	7,779	7,724
<i>% inc</i>	0.6%	5.2%	8.6%	-0.7%
Total Expenditure	69,991	73,754	77,876	78,707
<i>% inc</i>		5.4%	5.6%	1.1%
Interest income & other income o	(2,676)	(2,937)	(2,052)	(1,511)
Total Net Expenditure	67,315	70,817	75,824	77,196
<i>% inc</i>		5.2%	7.1%	1.8%

² The deficit under other fees and charges relates to services requested by airlines and other third parties provided under contract, for which the establishment costs are recovered over the duration of the contract. Also included in this category is the cost of providing and administering the airport identity card system, vetting, and card issue.

- 4.3 These projections set revenues \$3.608m higher and costs \$21.079m lower than forecast in the 2010/13 SOI projections based on the current charge.
- 4.4 All of Avsec's underlying projection assumptions have been strongly challenged, costs have been severely scrutinised, and cuts made whilst maintaining existing levels of service. The projections assume no change to the level of service provided (which is recognised as being of an appropriate high standard), the security threat assessment or to any existing equipment specifications in order to deliver the current level of service. They also assume no significant increase in the number of new airline carriers, no major new international requirements nor the establishment of Avsec services at new or additional domestic airports.
- 4.5 Avsec's existing performance indicators have, to date, been largely focused on operational effectiveness and quality. These indicators include the average passenger waiting time at screening points, the number of unauthorised or prohibited items that have passed undetected through screening points, and customer complaints.
- 4.6 The Board and Avsec have recently developed additional, new performance indicators to better monitor Avsec's costs, operational efficiency, and memorandum account balances. From April 2011 the new performance indicators will be reported by Avsec every six months to the Board of Airline Representatives New Zealand, quarterly to the Ministers of Transport, and monthly to Avsec's management and the Board, and to the Ministry.
- 4.7 In addition, since its last Review of charges, Avsec has conducted a significant internal operational Efficiency Review (covering areas such as staff numbers, rostering, business tools and evaluation measures). During this time the Minister of Transport also conducted an independent review of Avsec. This independent review had as its brief to seek independent advice to thoroughly and robustly review Avsec's planned cost structure going forward and seek independent advice to identify robust monitoring measures and performance indicators to achieve better transparency, and to assure reasonableness and efficiency around Avsec's projected costs. Both of these reviews have resulted in a more efficient and well-equipped organisation into the future.
- 4.8 The financial impacts of the key changes compared with Avsec 2010/13 SOI projections are summarised below

	2011	2012	2013	Total
	\$000	\$000	\$000	\$000
Changes due to:				
Increase/(Decrease) in Revenue				
International passenger volume increase (net change)	1,700	1,309	1,557	4,566
Domestic passenger volume increase (net change)	14	(174)	(391)	(551)
Interest income	(168)	(24)	319	127
Other fees and charges	(200)	(138)	(196)	(534)
Total revenue changes	1,346	973	1,289	3,608
Increase/(Decrease) in Costs				
Employment costs reduction				
Reduction in staff	(2,324)	(4,649)	(6,873)	(13,846)
Lower projected remuneration /CPI increases	(1,228)	(1,327)	(1,356)	(3,911)
Reduced training costs	(203)	97	10	(96)
Total Employment cost changes	(3,755)	(5,879)	(8,219)	(17,853)
Cost / efficiency savings in operating costs	(1,335)	(470)	(540)	(2,345)
Reduced depreciation	(426)	(13)	68	(371)
Reduced Capital Charge	(212)	(148)	(150)	(510)
Total cost changes	(5,728)	(6,510)	(8,841)	(21,079)
Total Financial Impact	(7,074)	(7,483)	(10,130)	(24,687)

Increased Passenger Revenue

- 4.9 Passenger growth is slightly exceeding the April 2010 forecast. International growth is forecast at an average 2.67% and domestic 1.95% over 2010/13, contributing an additional \$4.566m (535k pax) international revenue and \$0.551m (107k pax³) domestic revenue reduction against expectation. New international carriers, coupled with an increase in the carrying capacity of both domestic fleet operators and the withdrawal of Pacific Blue, are contributing to this change. Overall, passenger volumes are difficult to predict due to the commercial sensitivity of information, and growth being driven through marketing and pricing initiatives.

Staffing Levels

- 4.10 A comprehensive review of staffing levels has been undertaken (October 2010). The review sought to move some positions from full time to part time in an effort to improve staff rosters and obtain a more flexible work force. The review concluded a reduction of 53 FTE (6.3%) will be made by 2011/12 against the 2010/11 SOI projection: 34 FTE were vacancies carried over from 2009/10 (Avsec cautionary response to the economic recession which initiated the staffing review) and a further 19 FTE will be lost through attrition to 2012 (7 FTE in Christchurch, 2 FTE to reflect changes to full time/part time equivalents weightings and 10 FTE resulting from across the board roster efficiencies delivered by the new national rostering system). This results in savings of \$13.846m.
- 4.11 It should be noted that these reduced FTEs still ensure adequate staffing of last port of departure (LPD) flights to the US, provision for a third domestic lane and the return of a sixth international lane at Auckland Airport, and staff requirements for the Rugby World Cup (RWC).

Realistic salary adjustments

- 4.12 Avsec's Collective Employment Agreement is due for renegotiation effective 1 July 2011. In line with Government expectations, Avsec will negotiate realistic salary increase over the period 2011/13. In addition, Avsec has factored in \$0.400m pa savings from shared services (Avsec and CAA) from July 2011 resulting in \$3.911m of savings.

Reduced Training costs

- 4.13 Training costs decrease initially due to lower staff numbers than originally anticipated, then increase marginally in out years with the introduction of E-Learning modules, which further enhances productivity through reduced classroom training, coupled with a more efficient use of down time resulting in \$0.096m of savings.

Cost/efficiency savings

- 4.14 In the April 2010 passenger security charges review, the Minister expressed concern that Avsec costs were projected to increase faster than inflation. A concerted effort has been undertaken to review and restructure Avsec's costs to curb this growth which has been reflected in these projections. A net \$2.345m in operational cost savings will be made by 2013 against the 2010/11 SOI projection for the same period (primarily in IT, communications, travel, and insurance \$2.163m, HBS maintenance and equipment \$1.633m. Offsetting these savings will be \$0.594m in premises rentals and operating costs and \$0.857m of project related consulting costs).

Reduced depreciation/Capital Charge

- 4.15 The savings realised in depreciation result from a combination of delays in securing new national office and Auckland operational base premises, airport developments (Christchurch and Auckland), a replacement roster system, and in replacement screening equipment - and the global economic recession. The result is a \$1.946m reduction in required crown finding for 2010/11 reflecting in both the capital charge and depreciation

³ Growth is expected to decline to 2.3% (budget 3.01%) in 2010/11 with Pacific Blue withdrawal (loss of competition). Out year growth of 3.3% in 2011/12 is due to RWC settling back to an average 1.83% and 1.02% for the following two years respectively

charges going forward. Avsec may be in a position to make further capital charge savings in the future. Should this be the case these will be factored into the 2013 review.

4.16 The capital expenditure projections see Avsec enter a maintenance phase of its capital expenditure programme, having completed all major expenditure investment until its HBS equipment replacement in December 2013.

4.17 The projected capital expenditure programme is summarised below:

Capital Expenditure Summary	2010/11	2011/12	2012/13
Assets			
Furniture & Fittings	590,789	-	-
Computer Hardware	216,849	49,600	80,000
Leased Assets [Cargo Equipment]		-	688,188
Leasehold Improvements	3,063,482	150,000	-
Motor Vehicles	704,585	658,000	1,056,000
Office Equipment	135,000	29,000	-
Plant & Equipment	1,737,920	2,173,680	856,500
Computer Software	1,635,580	248,000	30,000
	8,084,205	3,308,280	2,710,688
Expenditure type			
New Assets	1,809,600	160,500	-
Projects	4,327,770	248,000	125,000
Replacements	1,946,835	2,899,780	2,585,688
	8,084,205	3,308,280	2,710,688

5 International and Domestic Passenger Projections

5.1 Avsec receives the domestic passenger security charge from all commercial domestic carriers operating aircraft in excess of 90 seats, on a per passenger/sector charge basis. The international passenger charge is received from airlines based on passenger departures on international flights. Exemptions apply to infants under two years of age, crew, repositioning crew or transiting international passengers, all of which are however still subject to screening measures.

5.2 Based on an analysis of the current passenger numbers and trends, and having taken into account the views of industry, and relevant travel statistics, Avsec has applied the following international and domestic passenger numbers in its financial projections and modelling.

By Airport	2009/10 Actual		2010/11		2011/12		2012/13		2010-2014		
		% Inc		% Inc		% Inc		% Inc	Overall	AVG	CAGR
									%	4 YRS	4 YRS
International											
Auckland	3,237,484	2.67%	3,390,508	4.73%	3,482,461	2.71%	3,587,359	3.01%	14.22%	3.55%	3.38%
Hamilton	25,075	5.44%	30,101	20.04%	30,951	2.82%	31,849	2.90%	30.93%	7.73%	6.97%
Rotorua	6,628	0.00%	9,549	44.07%	9,712	1.71%	10,104	4.04%	57.08%	14.27%	11.95%
Palmerston North	-	0.00%	-	0.00%	-	0.00%	-	0.00%			
Wellington	311,420	-0.48%	324,501	4.20%	333,597	2.80%	343,342	2.92%	13.65%	3.41%	3.25%
Christchurch	795,754	4.98%	811,235	1.95%	833,482	2.74%	858,335	2.98%	11.19%	2.80%	2.69%
Dunedin	24,503	-4.68%	29,897	22.01%	30,670	2.59%	31,633	3.14%	33.08%	8.27%	7.41%
Queenstown	50,814	31.40%	61,311	20.66%	62,849	2.51%	64,870	3.22%	31.63%	7.91%	7.11%
	4,451,678	3.23%	4,657,102	4.61%	4,783,722	2.72%	4,927,492	3.01%	14.10%	3.52%	3.35%
Domestic											
Auckland	2,255,180	6.97%	2,308,463	2.36%	2,387,003	3.40%	2,430,792	1.83%	9.08%	2.27%	2.20%
Hamilton											
Rotorua	331		-		-		-				
Wellington	1,487,084	-4.13%	1,509,850	1.53%	1,561,251	3.40%	1,589,864	1.83%	8.19%	2.05%	1.99%
Christchurch	1,498,756	0.80%	1,528,862	2.01%	1,580,161	3.36%	1,609,104	1.83%	8.65%	2.16%	2.10%
Dunedin	191,178	-6.39%	192,231	0.55%	198,693	3.36%	202,333	1.83%	7.10%	1.78%	1.73%
Queenstown	271,204	11.01%	299,971	10.61%	310,057	3.36%	315,764	1.84%	17.83%	4.46%	4.19%
	5,703,733	1.48%	5,839,377	2.38%	6,037,165	3.39%	6,147,857	1.83%	9.38%	2.34%	2.27%

% inc = Year on Year percentage increase

- 5.3 Avsec believes these passenger projections are appropriate for the current economic climate and for the purpose of calculating the charges. The projected passenger movements are based on outbound passenger numbers for which Avsec collects a passenger security charge. This is different from the total passenger movement at a particular airport.
- 5.4 These passenger projections were undertaken prior to the Christchurch and Japanese earthquakes. It is unclear what effect the earthquakes will have on passenger volumes in the short to medium term, and will continue to keep a watching brief and any changes will be corrected in the fuller 2013 review.
- 5.5 During the last passenger security charges review in April 2010, passenger projections were agreed with industry. However, those growth projections have been exceeded which further contributed to an over-recovery. This is one of the reasons why this current review is being undertaken.
- 5.6 The passenger numbers applied in the April 2010 security charge review/Avsec 2010 SOI projections compared with the current forecast for the 2011 charges review is set out below:

	2009/10		2010/11		2011/12		2012/13		2010-2013		
		% Inc		% Inc		% Inc		% Inc	Overall	AVG	CAGR
									%	3YRS	3 YRS
International											
2010 SOI / Charges Review	4,393,947	1.89%	4,455,083	1.39%	4,631,059	3.95%	4,746,835	2.50%	8.03%	2.01%	2.61%
	Actual										
2011 Charges Review	4,451,678	3.23%	4,657,102	4.61%	4,783,722	2.72%	4,927,491	3.01%	10.69%	2.67%	3.44%
Forecast Inc / (Dec) in passengers	57,731		202,019		152,663		180,656				
Domestic											
2010 SOI / Charges Review	5,631,116	0.19%	5,800,818	3.01%	6,082,159	4.85%	6,248,812	2.74%	10.97%	2.74%	3.53%
	Actual										
2011 Charges Review	5,703,733	1.48%	5,839,377	2.38%	6,037,165	3.39%	6,147,857	1.83%	7.79%	1.95%	2.53%
Forecast Inc / (Dec) in passengers	72,617		38,559		(44,994)		(100,955)				

⁴ AVG = Average percentage growth over the period
CAGR = Compound Annual Growth Rate (annualised percentage growth rate year on year over the period)

6 Proposed new passenger security charges

Summary

- 6.1 Treasury guidelines recommend that any accumulated surplus or deficit (memorandum account balance of available reserves) should be taken into consideration when setting subsequent charges, and that the charges should be set to reflect the (whole of life) cost of providing the service.
- 6.2 In applying this methodology, Avsec has given consideration to the relative size of the surpluses and the resulting impact these would have on the respective passenger security charges over both the short and medium term - the emphasis being on ensuring that the charges reflect the true cost of providing the service and maintaining stability in the charges over the medium term.
- 6.3 As a consequence, and having considered previous attempts to reduce the memorandum account surpluses, Avsec is proposing to fully offset both the international and domestic passenger security charges net available accumulated surpluses over the next two-year charge period.

Proposed New International Charge

- 6.4 Avsec proposes an international passenger security charge of \$8.07 GST inc (\$7.02 GST exc), a reduction of \$2.15 GST inc over the current charge of \$10.22 GST inc, and a reduction of \$6.93 over the charge of \$15.00 GST inc which applied prior to 1 April 2010.

Proposed New Domestic Charge

- 6.5 Avsec proposes a domestic passenger security charge of \$3.71 GST inc (\$3.23 GST exc), a reduction of \$0.74 GST inc over the current charge of \$4.45 GST inc, and a reduction of \$0.95 over the charge of \$4.66 GST inc which applied prior to 1 April 2010.

Baseline International and Domestic Passenger Security Charges

- 6.6 The baseline international passenger security cost underlying this two year period has been determined at \$11.80 GST inc per passenger. This baseline is \$0.64 GST inc higher than the 2010/11 international passenger security baseline cost.
- 6.7 The baseline domestic passenger security cost underlying this two year period has been determined at \$4.40 GST inc per passenger. This baseline is \$0.03 GST inc higher than the 2010/11 domestic passenger security cost.
- 6.8 Both of the above costs are the minimum that should be charged in order for Avsec to fully recover its projected operating costs over the 2011/13 financial years and are provided as a reference point from which the proposed charges should be measured.

7 Pre-Paid Airline tickets

- 7.1 The airline industry has argued in the past that it is unable to impose and therefore recoup or refund the cost of any passenger security charge increase or decrease for tickets sold prior to the Gazetting of the new passenger security charges for travel undertaken after the implementation date of the new charges.
- 7.2 Accordingly a dispensation is considered and may be given to allow for the passenger security charges to be paid at the rate on the prepaid tickets at the time of sale for a specified period post the charges Gazetting.
- 7.3 Avsec is of the view that given we are moving to reduce the accumulated surpluses over a short period and return to a full cost recovery basis, to apply this pre-paid ticket dispensation in this instance will further reduce the proposed charge or slow the run down of accumulated reserves. Consequently Avsec is proposing that for the purpose of this charges review, (as was the case with the 2010 charges reduction) that no prepaid

ticket dispensation should apply, and that the charge becomes effective from the date the new charges are gazetted.

- 7.4 This treatment is administratively easier for all parties but would afford a saving to International and domestic airlines carriers of approximately \$0.935m (500,000 passengers) and \$0.256m (400,000 passengers) respectively in over collected passenger security charges based on historic prepaid passenger claims and Avsec's preferred options outlined above.

8 Consultation Process

- 8.1 Written responses from industry to this consultation document are sought by 5pm Wednesday 20 April 2011. In addition to the formal consultation meetings as outlined in the covering letter to this document, senior Avsec staff are also available to discuss or clarify this consultation document during the consultation period.

- 8.2 Written responses from industry to this consultation document are to be sent to:

Jeffery Bull
Chief Finance & Information Officer
Aviation Security Service
PO Box 2165
Wellington
New Zealand

DDI: + 64 4 460 4718
Fax: + 64 4 495 2432
Email: Jeffery.Bull@avsec.govt.nz

- 8.3 Following the consultation period, a proposal will be put before the Cabinet on any proposed changes to the charges, regulations will be set, and any new charges are expected to be in place in on 01 July 2011.