

Treasury Report: Ministerial Committee Position on the Funding of Passenger Clearance Services

Date:	23 July 2004	Treasury Priority:	Urgent
Security Level:	IN-CONFIDENCE	Report No:	T2004/1334

Action Sought

	Action Sought	Deadline
Minister of Finance	Refer attached report to the Ministerial Group on the Funding of Border Services	As soon as possible
Associate Minister of Finance (Hon Trevor Mallard)	For your information	None
Associate Minister of Finance (Hon David Cunliffe)	For your information	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
			✓
David Galt	Manager, Environment & Natural Resources		

Enclosure: **Yes**

23 July 2004

SH-12-7-1

Treasury Report: Ministerial Committee Position on the Funding of Passenger Clearance Services

Purpose of Report

1. The Ministerial Committee on Border Funding is meeting at 9:15 am on Monday 26 July. The purpose is to establish the Committee's preferred option for funding passenger clearance services. This requires:
 - identifying a framework for allocating costs;
 - agreeing the quantum of Crown and third party funding; and
 - identifying the current and future costs for each services.
2. A summary of the main funding options has previously been circulated for this meeting [in Treasury report T2004/1314].
3. The current paper provides additional information on the main proposals, identifies officials' preferences and a recommended framework for identifying a preferred position. This paper also updates the Committee on other border funding related issues.

Recommended Action

We recommend that you **refer** the attached suite of reports to the Ministerial Committee on the Funding of Border Security (Ministers of Biosecurity, Tourism, Transport, Customs & Immigration) prior to the committee's meeting at 9:15 am on Monday 26 July.

Bruce Arnold

Senior Analyst, Environment & Natural Resources
for Secretary to the Treasury

Minister of Biosecurity
Minister of Tourism
Minister of Transport
Minister of Customs
Minister of Immigration
Minister of Transport Safety

Referred: Yes/No

Hon Dr Michael Cullen

Minister of Finance

Ministerial Committee on the Funding of Border Services

Minister of Finance
 Minister of Biosecurity
 Minister of Tourism
 Minister of Transport
 Minister of Customs
 Minister of Immigration

cc Minister of Transport Safety

Purpose

1. The Ministerial Committee on Border Funding of which you are a member is meeting at 9:15 am on Monday 26 July.
2. The purpose is to establish the Committee's preferred option for funding passenger clearance services. This requires:
 - Identifying a framework for allocating costs;
 - Agreeing the quantum of Crown and third party funding; and
 - Identifying the current and future costs for each services.
3. A summary of the main funding options has previously been circulated for this meeting [in Treasury report T2004/1314].
4. The current paper provides additional information on the main proposals, identifies officials' preferences and a recommended framework for identifying a preferred position. This paper also updates the Committee on other border funding related issues.

Executive Summary

5. Three consultation meetings have been held on the funding of passenger clearance services. Industry has positively engaged in this process and identified options and key issues.
6. Industry has now outlined its preferred funding package, and requested that the Government identify its position. Industry has also outlined a partnership proposal for the Government's consideration.
7. Officials recommended that the Ministerial Committee identify a preferred funding proposal for presentation to industry by the Minister of Finance. A framework to assist Ministers identify a preferred position is attached as annex 1.
8. Following discussion with industry a final funding proposal (reflecting any agreed changes) could proceed to Cabinet.
9. Two main options are proposed. These are:
 - i. Industry's preferred position (recommended by the Tourism and Transport):

- This position recognises that there are both public and private benefits from passenger clearance services and recommends a cost sharing approach that is both pragmatic and based on the principle that the primary beneficiaries of an activity should fund it,. Under this regime the Government would fully fund biosecurity and customs services, and industry would fully fund aviation security through a passenger charge on airline tickets.
- Advantages of this approach are its simplicity, its relatively uncontroversial nature and that it could be introduced almost immediately.
- Disadvantages are that it eliminates economic efficiency aspects of pricing (including location specific pricing) and exposes MAF and Customs to fiscal and performance risks from increased passenger growth.

The industry estimate this option would increase industry funding input by approximately \$32 million p.a. (including costs directly absorbed by industry) and Crown funding by approximately \$14 million p.a. (\$6 million p.a. from the removal of cost recovery for after hour's services).

ii. Shared funding whereby the Crown funds non-location specific costs (such as corporate overheads) and Customs secondary processing and recovers location specific costs (recommended by Customs, MAF, and Treasury, acceptable to Department of Labour, but immigration activities may not fit well)

- This approach also recognises that benefits for some services are shared but allocates costs so that airlines, airports and passengers receive direct price signals.
- Advantages are that decision making and allocation decisions are improved as the Government and industry face the cost of their decisions. This option also provides a basis for future funding decisions and minimises future fiscal risks as passenger growth is matched by revenue increases.
- Disadvantages are that implementation require legislations and may be drawn out, price signals may be also ineffective if airlines are either (as they assert) unable to alter their behaviour due to international allocation of arrival and departure slots, or if industry is simply able to pass on charges. The reduction in Crown contribution may also result in the outcome being seen as inequitable entirely fiscally motivated. An additional disadvantage is that immigration may not fit this approach well.
- This option would see Crown funding reduced by approximately \$12 million p.a. and direct industry costs increased by approximately \$41 million p.a. (excluding costs absorbed by industry).

10. In addition to the main cost sharing proposal industry has requested as part of this package:

- The removal of after-hours and regional airport charges (fiscal cost \$6 million p.a. in Vote Customs);
- Charging Aviation Security, Customs and Biosecurity services for the space they use at airports (fiscal cost \$2.05 million p.a.);

- Reimbursement of airline expenses in meeting new Government information requirements (fiscal cost \$2.75 million p.a.); and
- Service standards are set and funded to meet ICAO recommended processing times (cost not quantified).

11. Decisions on these proposals could be used as bargaining chips for final negotiations.
12. The treatment of new international airports remains an outstanding issue under either funding option. Officials recommend that further work be undertaken on an appropriate regime for the treatment of new international airports.

Total Passenger Clearance Service Costs to be Allocated

13. This process has been undertaken to identify appropriate and robust funding mechanisms to allocate the existing and future costs of passenger clearance services.
14. The cost of existing and proposed passenger clearance services is approximately \$84 million p.a.. The new services, primarily x-raying of hold stow baggage and increased levels of processing by Customs, are expected to be fully operational by October 2005. The cost per agency of the new and existing services is as follows:

Service (% currently Crown funded)	Existing cost \$m	Cost of new services \$m	Total cost
Aviation Security (0%)	11.42	21.4	32.82
Customs (73%)	19.67	6.8	26.47
MAF (100%)	18.62	0	18.62
Immigration (67%)	4.83	1.0	5.83
Total	54.54	29.2	83.74

15. Of the current total cost the Crown's contribution is \$36.19 million. Users currently pay \$18.35 million or about \$5.25 per passenger on average¹.
16. If all existing and new services were fully cost recovered the average per passenger cost would be approximately \$24.

Notes

- The above table identifies Government costs of passenger clearance only. A study for industry has put existing industry costs at \$9.2 million.
- Government agencies paying for the space they use at airports would add approximately \$2.05 million to the total cost to be allocated;
- Reimbursing airlines' costs for advanced passenger processing and insect spraying would add approximately \$2.25 million and \$0.5 million to the total cost to be allocated respectively;
- Onshore primary processing of passengers for immigration purposes is undertaken by the New Zealand Customs Service and funded through Vote Customs. Immigration services covers

¹ Based on 3.5 million passenger arrivals per annum. Not all of the costs are recovered directly from passengers.

advance passenger screening, interdiction, referrals from Customs' primary processing to the Immigration Service and other secondary processing.

Proposed Process for Finalising Funding Decisions

17. The proposed process is that the Minister of Finance presents Ministerial Committee decisions on funding to industry. Following any agreed final changes arising from consultation a paper be presented to Cabinet outlining the preferred funding methodology for passenger clearance services and consequential Crown funding.
18. Following Cabinet decisions on the quantum of Crown funding, consultation with industry will continue on a range of second order issues including:
 - Allocation of third party charges between locations and funding arrangements for new international airports (if not decided at the current time);
 - The most efficient collection mechanism for any charge – this is likely to involve building charges into ticket prices;
 - Any required legislative changes; and
 - Other implementation issues (e.g. the status of existing airport charges).

Future Decisions Required from the Ministerial Committee

19. The current guidance sought from the Ministerial Committee will identify the quantum of the Crown's funding for passenger clearance services. The current decisions will not, for most options, determine the mechanism by which third party costs are recovered or the extent of regional variation in airport costs. Separate papers will be developed for the Ministerial Committee on these issues pending decisions sought here.

Timeframe for Final Implementation of Passenger Clearance Decisions

20. The duration of consultation on second order issues is dependent on funding decisions but is expected to last no longer than two months. Following the conclusion of consultation the next steps and estimated timeframes are as follows:
 - consultation on implementation options - two to three months;
 - final policy sign off – two months,
 - Preparation of a Bill – three months
 - Passage of legislation – Unknown
 - Industry implementation – at least three months after the Bill is enacted (tickets are sold well in advance).
21. All up, while the key decisions will be taken, and could be announced in the next few months, it is expected that it will take approximately a year to fully implement final decisions. This timeframe presumes there are no legal challenges to either the decisions or the process and that a legislative slot is available. Note that if industry's preferred position is selected the required timeframe is considerably shortened. This would occur as existing funding mechanisms would be used and no legislative change would be required.

Industry's Preferred Position

22. Industry has engaged positively and constructively in the consultation process and has now identified its preferred funding position. This is:

- Funding decisions should be determined in line with Officials' proposed framework, [as outlined in Treasury report T2004/941] provided definitions of key words are agreed;
 - All costs incurred by the industry and the Government in meeting the Government's requirements should be taken into account in the cost sharing arrangements. For example, the Aviation Security Service, New Zealand Customs Service and Ministry of Agriculture and Forestry should pay for the utilisation of space provided free at airports (identified as approximately \$2.05 million), and for costs incurred by airlines in meeting new Advanced Passenger Processing and Advance Passenger Information requirements (approximately \$2.25 million);
 - The funding source for any future services should be examined on a case-by-case basis against the framework;
 - Gazetted hours and after hour charges should be abolished;
 - Funding should be shared for clearance services at all existing airports as follows:
 - MAF & Customs 100% Crown funded;
 - Aviation Security 100% Industry funded;
 - Immigration 100% Crown funded except for cost recovery (actual) from visa and passport applicants²;
 - Government funding should be set at a level that allows recommended international standards and practices for speed of passenger processing to be met; and
 - Once Crown and third party funding levels are agreed, the relative level of Crown funding should be maintained (i.e. demand increases due to passenger volume growth should be funded on the same basis as existing services).
23. Industry has also raised the possibility of a partnership with Government. We recommend you direct officials to discuss with Industry the adequacy of existing communications in preference to establishing a formal partnership.
24. Industry estimate this option would see their funding increasing by approximately \$32 million p.a. (including costs directly absorbed by industry) and Crown funding by approximately \$14 million p.a. (including paying for after hours and regional airport services).

Comment [AM1]: API is the Customs side of things.

Basis for industry's funding position

25. The officials' framework for the funding of passenger clearance services proposes that Crown funding be:

² Current cost recovery is only from immigration visa and permit applicants. Passports are issued by the Department of Internal Affairs, which is not part of this exercise.

- a. limited to services for which the Crown or the public are a direct beneficiary³; and (for those services only)
 - b. set at the level required to fund a reasonable minimum level of services.
26. The reasonable minimum level of service would be determined on a case-by-case basis. Responsibility for funding services above the minimum level would then be determined by considering who demanded the service as well as the ability and equity of charging those responsible for driving costs.
27. The assumptions underlying industry's position are that:
- New Zealand is the direct beneficiary of biosecurity, customs and immigration services and so should fund the full cost of these services;
 - New Zealand and travellers are both direct beneficiaries of aviation security services however the airlines and travellers are the main beneficiaries and so should pay; and
 - The reasonable minimum level of service that the Crown funds should be that required to fully meet the ICAO recommended passenger processing standards at the seven existing international airports.
28. Alternative assumptions, such as recovering costs from those directly at risk from the absence of Aviation Security (passengers and airlines), or recognising passengers as a beneficiary of speed of processing through border clearance services significantly changes these results. Industry does not accept that its decisions (e.g. time and place of arrival of craft, flights running off schedule, the opening of new airports) also drive the costs of passenger processing. Rather it sees the costs as driven by government requirements. Alternate assumptions are considered in the scenarios in the attached paper.

Advantages and Disadvantages of the Industry Preferred Funding Option

29. A deal along the lines proposed by industry would have several advantages:
- It would be a relatively clean and simple system to implement;
 - Transaction costs would be minimised as a single fee would be collected through an established collection mechanism;
 - There would be no precedent effects for domestic aviation security screening that may come from partial Crown funding of international aviation security;
 - It would remove Removes inequitable charging of some regional airports and out-of-hours passengers at the main airports; and
 - The initial fiscal cost of such a deal would also not be significantly different from the outcome under some of the funding options achieved from following the framework (the full fiscal cost would depend on whether airports were allowed to charge for space provided to government agencies).

³ Direct beneficiary would mean only those immediately or directly harmed if the service was not provided. In the case of airline security this would be airlines or passengers. Second round effects such as loss of tourist confidence would not be considered as second order effects are too easy to assert and cannot be readily quantified or proven.

30. Such a deal would also have disadvantages including:

- It would remove incentives on airlines or airports to minimise the costs on biosecurity or customs services (where they have some control over the cost drivers of these services);
- There would be substantial costs to MAF, Customs and Immigration if (as industry has proposed) ICAO recommended practices for processing times for passenger clearance were to be met. Under the deal proposed by industry the Crown would be responsible for meeting those costs;
- Passenger arrivals are forecast to grow at rates exceeding 5% p.a. The Crown would either have to meet all the additional costs of processing these arrivals or relax facilitation or risk management standards, however, growing tourism export earnings and the resultant GST returns to the government (\$487 million in 2003) offset fiscal risks;
- Removing the concept of out-of-hours charges and cost recovery for passenger processing at regional airports would remove current disciplines on airports and airlines to control the costs faced by Customs;
- It could be seen to be benefiting the current international airports and acting to discourage any new entrants to the industry; and
- It would provide a pragmatic, but not a robust basis for existing funding decisions.

Areas of Agreement with Industry

31. Officials agree with the following aspects of the industries proposal:

- Funding decisions should follow the framework outlined in Treasury report T2004/941;
- The funding source for any future services be examined on a case-by-case basis against the framework;

32. And agree in principle with the proposal that, contingent on agreement with industry as to how risks associated with this can be best managed:

- After hours and regional airport charges should be abolished. The removal of these is supported as they tend to conflict with the need of airports to operate at hours that suit the needs of travellers and may unfairly favour incumbents with existing slots and therefore discourage competition.

33. While officials agree with the removal of gazetted hours, this does not necessarily mean that the costs of achieving this should be Crown funded.

Areas of Disagreement with Industry

34. Officials do not agree with industries' proposal that:

- The Government should pay for costs incurred by airlines in meeting new Advanced Passenger Processing requirements and Advance Passenger Information (approximately \$1.3 million).

- While airlines act as the Government's agent in collecting this information officials do not agree with direct compensation being paid for this role as:
 - It is standard international practice for airlines to be responsible for ensuring that they do not bring ineligible passengers to a country. Providing this information is therefore a reasonable measure to expect airlines to perform;
 - The Crown does not typically compensate businesses for performing regulatory roles (for example taxes collection or complying with holidays or OSH regulations);
 - The Crown would have limited control over the costs claimed by airlines;
- The proposed funding share for clearance services be:
 - MAF & Customs 100% Crown funded;
 - Aviation Security 100% industry funded;
 - Immigration 100% cost recovery from visa and passport applicants;

35. Officials differing on whether the industry option is preferable to other options.

- Government funding should be set at a level that allows ICAO recommended practices for passenger processing to be met;
 - Officials' objections to this are based on:
 - 1 ICAO recommended practices are non-binding are non-binding; and
 - 2 While the MAF and Customs services provide direct public benefits, the benefit from a quick processing time is mainly private.

36. Officials recommend that Ministers defer a decision on this matter as it is currently being addressed as part of a separate process.

- Once the Crown - third party funding mix is agreed, the relative level of Crown funding should be maintained.
 - Officials' acknowledge that maintaining an open border will require some increase in Crown funding over time in the face of increasing passenger numbers. However, officials do not agree that funding should necessarily bear a linear relationship to passenger numbers due to the lumpy nature of passenger clearance costs and hence the existence of significant economies (and diseconomies) of scale in the provisions of passenger clearance services.
 - Instead officials' recommend that any bids for increases in Crown funding be submitted as a Budget bid and be considered alongside other priorities for Government expenditure as part of the normal Budget process.

Alternatives to the Industry Preferred Position

37. The main alternative recommended by the Treasury, Customs and MAF is 'Option 3'. A summary of other options considered is provided in Annex 2.
38. The Option 3 approach allocates funding on the basis of non-location costs being borne by the Crown and location specific costs being cost recovered. In addition, the Crown would fund Customs' entire Secondary passenger processing (\$11.8m p.a.).
39. For MAF biosecurity screening and Customs' primary processing of passengers: the Crown funds those costs which are more long-term (e.g. some capital items and depreciation) and non-location specific and recovers all the costs which are variable in the short-to-medium term and location specific. For the Aviation Security Service the Crown meets nationally focused costs such as governance.
40. The fiscal and location specific costs of this approach would be as below:

Service (% Crown funded)	Crown funding \$m	Third party funding \$m
Aviation Security	1.91	30.81
Customs	2.85 (+\$11.8 m for secondary processing)	11.82
MAF	3.5	15.12
Immigration	4.63	1.2
Total	24.69	59.03
Change from existing funding	-11.5	+40.68

Location Specific Impacts

41. If applied on a location specific basis the impact and cost per passenger would be:

Airport	Option 3	
	3rd Party (\$m)	Departure charge per return trip
Auckland	36.29	\$14.28
Wellington	4.77	\$21.06
Christchurch	9.76	\$18.37
Palmerston North	1.87	\$48.82
Hamilton	2.09	\$36.44
Dunedin	1.66	\$42.05
Queenstown	1.39	\$169.92

Note: Excludes immigration costs as these may not be recovered on tickets

42. Future funding implications

- Forecast growth in passenger numbers would need to be funded by periodic increases in Budget funding for Aviation Security, Customs, Immigration and MAF (as non-location specific and Customs' secondary processing costs increased).

- Location specific (variable) costs would increase automatically in line with passenger growth. Periodic reviews of charge levels would be essential to ensure no over- or under-recovery of costs.

42. **Advantages of approach**

- Spreads cost recovery over all passengers/airports/airlines.
- Strong economic signals as provides location specific cost recovery.
- Provides a good basis for determining the level of cost recovery for new international airports.
- Efficient as industry and passengers meet most of the cost of growth in passenger arrivals.
- Provides strong economic price signals.
- Removes arguably inequitable charging of some regional airports and out-of-hours charging at the main airports.
- Government contributes in recognition of public benefits.

43. **Disadvantages of approach**

- Encourages gaming by industry and agencies in determining if costs are location specific or not;
- May be seen as fiscally driven.
- Immigration activities may not fit this model. There is a permanent immigration presence only at Auckland, with other airports served remotely or on demand. Immigration airport activities arise largely from referral of cases with immigration complications, e.g. refugee status claimants. Pre-embarkation checks of passenger documentation requirements and alerts are conducted through the Advance Passenger Screening (APP) system (which is to expand to mandatory use for all inward passengers during 2004/05). APP checks produce a result offshore and are therefore not specific to a New Zealand location. The largest component by cost (\$3.63m of \$4.83m) of current immigration border activities is for services that are delivered, or produce a result, offshore. This differs from the other agencies, whose activities are undertaken onshore and are location specific. While the immigration activities could conform to an outcome based on option iii, they do not fit as well as other agencies' activities. Alternative approaches could include:
 - recovering the costs of transactions through APP in place of the location specific costs to be recovered for other agencies. APP transactions could be seen as analogous in the immigration system to the location-specific primary processing functions carried out by other agencies, because all passengers will be subject to APP checks;
 - excluding immigration activities from this exercise and retaining the current funding process for the time being. The current process includes some cost recovery, through a component of visa and permit application fees.

43. Industry views would be sought on how to handle immigration activities if it does not fit well with the option iii model as it develops.

Recommendations

Officials recommended that the Ministerial Committee:

a **agree** that:

- Funding decisions should follow the framework outlined in Treasury report T2004/941 that Crown funding be:
 - limited to services for which the Crown or the public are a direct beneficiary⁴; and
 - where a service produces benefits to the community and to third parties such as travellers, Crown funding would be set at the level needed to deliver on a reasonable minimum service.

Responsibility for funding services above the minimum level would be determined by considering who demanded the service and the ability and equity of recovering costs from those responsible for driving the costs of the service.

- The funding source for any future services be examined on a case-by-case basis against this framework.

b **agree** that funding between the Crown and third parties be allocated on the basis of:

Either

- i. Industries preferred funding split (100% Crown funding of MAF and Customs, status quo funding for Immigration and 100% cost recovery for Aviation Security) - (recommended by Tourism and Transport);

Or

- ii. Shared funding whereby the Crown funds non-location specific costs (such as corporate overheads, IT and Customs secondary processing) and recovers location specific costs - (recommended by Customs, MAF, Immigration and Treasury acceptable to Department of Labour, but see below).

c **note** that immigration activities may not fit this model, and if a model based on option iii is agreed alternative approaches for immigration would be considered;

d **agree** in principle to the following, contingent on satisfactory arrangements being made with industry to manage potential fiscal risks;

- The removal of after-hours and regional airport charges (fiscal cost \$6 million p.a. in Vote Customs); and

⁴ Direct beneficiary would mean only those immediately or directly harmed if the service was not provided. In the case of airline security this would be airlines or passengers. Second round effects such as loss of tourist confidence would not be considered as second order effects are too easy to assert and cannot be readily quantified or proven.

- Charging Aviation Security, Customs and Biosecurity services for the space they use at airports (fiscal cost \$2.05 million p.a.) – (Not recommended by Customs).
- e **decline** the proposal for reimbursement of airline expenses in meeting new Government information requirements (fiscal cost \$2.75 million p.a.) on the basis that complying with this requirement is a legitimate business cost and would set undesirable precedents for other Government required actions;
- f **decline** the request that passenger processing services be set to meet ICAO recommended processing times (cost not quantified), as a separate work stream is occurring on this issue;
- g **invite** the Minister of Finance to present the Committee's preference to industry at the next consultation meeting;

This will demonstrate the Government's commitment to an open consultation process and allow industry to voice any final arguments;

- h **direct** officials to continue consultation with industry on second order issues including:
- Industries' proposed public private partnership proposal
 - Allocation of third party costs between locations and arrangements for new international airports;
 - Efficient collection mechanisms for any charge, including building charges into ticket prices;
 - Any necessary legislative changes; and
 - Other implementation issues.
- i **direct** officials to conduct further work review on the appropriate treatment of new international airports including whether Government approval should be required prior to their establishment; and
- j **direct** officials to discuss with Industry the adequacy of existing communications in preference to establishing a formal partnership.

Annex 1**Framework for Developing a Ministerial Position**

Ministers may wish to refer to the following framework in developing a position on the funding of passenger clearance costs at airports.

Question 1 – What Services Should Receive (at least) Partial Crown Funding

1. Should the following services be (at least) Partial Crown Funding to recognise direct public benefits?
 - i. Aviation security
 - ii. Biosecurity screening
 - iii. Customs primary processing (including immigration primary processing)
 - iv. Customs secondary processing (questioning and/or searches of people of interest)
 - v. Immigration advance passenger screening, interdiction and secondary processing

Consequence:

- Any service which does not provide direct benefits to the Crown or public would be fully cost recovered.
- For other services it is proposed that the Crown fund a reasonable minimum level of service to recognise the benefit from New Zealand being open to international travel.

Question 2 – Is the Crown Prepared to Recognise Industry Costs?

2. Should the Crown's contribution cover:
 - i. All Government agencies' space at airports?
 - ii. Airline costs incurred in collecting information for advance passenger processing/screening?

This will determine the total costs to be allocated.

Question 3 – Should Charges for After Hours Services be Abolished?

3. In recognition that aviation is a 24 hour industry should charges for services provided to airlines outside gazetted hours be abolished?

Question 4 – What is the Preferred Funding Model?

4. For services where it was agreed response to question 1 that some Crown contribution is appropriate, what is the preferred funding option:
 - i. Extension of the status quo?
 - ii. Industry preferred cost sharing?
 - iii. Crown bears non-location specific costs, industry bears location specific costs?
 - iv. Crown funds average per passenger cost (at the rate of the cheapest airport)?

Question 5 – Are Adjustments to the Suggested Results of the Preferred Funding Model Justified for Efficiency, Growth or Equity Reasons?

5. Are there reasons to adjust the proposed level of cost recovery or Crown contribution for reasons of:
 - i. Economic efficiency –
 - Would the behaviour of those who drive the costs of the risk or cause the risk necessitating the service be improved by increasing the level of charge on them?
 - ii. Economic growth considerations
 - Will the level of charge significantly reduce the net number and value of travellers to New Zealand?
 - If so, will the net wealth of New Zealand be reduced?
 - Is additional funding desirable to offset the negative impacts of any increase in cost recovery?
 - iii. Regional development – Are there regional development benefits (or disadvantages from reducing the cost of passenger clearance services at airports outside the major metropolitan centres?
 - iv. Equity considerations
 - Should travellers pay for services that benefit others?
 - Should those who do not travel pay to prevent risks (and enjoy the benefits) bought by those who do travel?
 - It is possible that travellers pay more in tax than they receive in benefits - Should action be taken to address a possible wealth transfer from tourists to New Zealanders?

Question 5 – Should Decisions Apply to New International Airports

6. Should the same regime apply to new international airports?
 - i. Should new airports receive the same Crown contributions as existing regional international airports?
 - ii. Should new international airports have to fully cover the cost of all Crown provided services?

Annex 2

Additional Information and Officials' Position on Key Questions

To determine a preferred Crown funding split, officials have applied the guidelines provided by the Ministerial Committee Ministerial Committee decisions, the Treasury *Guidelines for Setting Charges in the Public Sector* and the Officials' funding framework.

The primary objectives behind officials' positions are that:

- Funding arrangements should support the maintenance of New Zealand's links to the world;
- Services should be funded for by those who benefit from a service;
- Economic efficiency can be improved if those who drive the costs of a service help meet these costs.

Following from the above objectives, proposed guidelines for determining the funding of passenger clearance services are:

- A party should contribute to the cost of a service where they are a direct beneficiary of a service;
- Those who receive only secondary benefits or positive externalities should not be required to contribute to the funding of a service;
 - This is proposed as due to the existence widespread externalities from air travel (like many services) it is possible to identify multiple beneficiaries for any services. The total identifiable benefits to all possible beneficiaries are also likely to greatly exceed the cost of a service. It is therefore recommended that for funding decisions, consideration only be given to direct beneficiaries of a service.
- The level of a party's contribution to the funding of passengers clearance services should reflect the relative public and private benefits of these services. This will be determined on a case by case basis and will include consideration of:
 - The direct public and private benefits of a service;
 - Economic or regional development reasons for subsidising a service;
 - Economic efficiency (signalling) effects; and
 - Equity considerations.
- A party may also be expected to contribute to the cost of a service where their direct actions (innocuous or deliberate actions) determine either:
 - The level of service provided; or
 - The way that the service is provided; or
 - Whether the service is provided.
- Charges will be location specific, but may not necessarily reflect the full cost of services delivered at a particular location

Selection of Preferred Funding Option

In selecting a preferred funding option, there appear to be six relevant questions. These are

1. Which passenger clearance services should receive some Crown funding (in recognition of direct public benefits)?
2. What costs should any Crown contribution cover?
3. Should charges for services provided to airlines outside gazetted hours and at regional airports be abolished?
4. By what methodology should funding be determined (for passenger clearance services for which at least partial Crown funding is deemed appropriate)?
5. Are there economic efficiency, economic growth, regional development or equity reasons to adjust the proposed level of cost recovery or Crown contribution identified by the methodology chosen in question 4?
6. How should new international airports be treated?

Officials' position on each of the above questions is identified below.

Question 1 – What Services Should Receive (at least) Partial Crown Funding

Officials agree that of the following services should receive at least partial Crown funding as these services are primarily provided for the benefit of New Zealanders rather than travellers, airlines or airports.

- i. Biosecurity screening
- ii. Customs' primary processing (including immigration primary processing)
- iii. Customs' secondary processing (questioning and searches of people of interest)
- iv. Immigration advance passenger screening, interdiction, and secondary processing

The Treasury considers that the cost of Aviation Security services should be fully cost recovered as the direct beneficiaries of these services are airlines and passengers whose planes are protected from incidents.

The Treasury also notes that the Crown already makes a significant contribution to aviation security through the funding of Police at airports, as well as intelligence services.

The Ministry of Transport notes that, if secondary beneficiaries are taken into account, there is a case for ongoing Crown funding of a portion of Aviation Securities activities on the basis that any terrorist attack would in effect be an attack on New Zealand.

Question 2 – Is the Crown Prepared to Recognise Industry Costs?

In addition to costs directly incurred by Crown agencies, industry has recommended that two costs incurred directly by industry should be recognised as part of the cost to be allocated. These are:

The cost of Government agencies space at airports

Following the proposed framework there is a case for the Aviation Security Service, New Zealand Customs Service and Ministry of Agriculture and Forestry to be charged by airport companies for the space they occupy at airports (current value approximately \$2.05 million).

Note that the cost of this space may form part of the overall recoverable costs of border services.

The advantage of allowing airports to charge for the space they provide to Government agencies are that:

- This will place incentives upon Government agencies to act in an efficient manner and on airports to make more space available in line with increasing demand; and
- It is consistent with requiring expenses incurred by Government agencies to be appropriated in line with Public Finance Act requirements;

Against these views are the considerations that:

- The implications for Aviation Security's domestic screening activities at airports and Customs at seaports and other places that require space to be devoted to Customs (e.g. CCA's) without charge need to be considered;
- It could be considered a legitimate cost of being an international airport (in the same way that space provided for Police is provided free of charge);
- As a monopoly supplier of space airports may be able to unfairly use their position to extract excessive prices from government agencies; and
- Airports are able to recover these costs from airlines or, more likely, through the passenger departure charge.

Officials' positions

Overall the Treasury and Transport recommend that Ministers agree that airports be allowed to charge Government agencies for the space that these agencies use at airports. The primary advantage of such charging will be to place incentives on airports and Government agencies to act efficiently and be responsive to demands for increased space by making these decisions standard commercial decisions.

The New Zealand Customs Services recommends that Ministers do not agree that airports be allowed to charge Government agencies for the space that these agencies use at airports. This is based on the issues identified above and, in particular, because of the implications for other Customs' places. Customs' also considers that airports are not commercially disadvantaged and are in fact recovering these costs through departure charges.

This decision would require amendment of the Customs and Biosecurity Acts so that the New Zealand Customs Service and the Ministry of Agriculture and Forestry can be charged by airport companies for the cost of the space they occupy at airports. The current value of this space has been estimated by the airports as being approximately \$2.05 million.

Ministers may however wish to hold back a decision on this matter in reserve for use as a bargaining chip with industry in final negotiations.

Airline costs incurred in collecting information for advance passenger processing /information?

Industry has requested that they be compensated for the costs of meeting legislative requirements that have little or no benefit to the airlines. The estimated cost to the airlines of collecting this information is approximately \$2.25 million.

All officials recommend that Ministers decline this request. While airlines are acting as the Government's agent in collecting this information:

- It is standard international practice for airlines to be responsible for ensuring that they do not bring ineligible passengers to a country. Providing this information is therefore a reasonable measure to expect airlines to perform;
- The Crown does not typically decompensate businesses for performing regulatory roles (for example taxes collection or complying with holidays or OSH regulations);
- The Crown would have limited control over the costs claimed by airlines.

Question 3 – Should Charges for After Hours and Regional Airport Services be Abolished?

All officials agree in principle that there is a case for after hours and regional airport charges to be abolished. These tend to conflict with the need of airports to operate at hours that suit the needs of travellers and may unfairly favour airline incumbents with existing time slots and therefore discourage competition. However, removing the concept of out-of-hours charges and cost recovery for passenger processing at regional airports would remove current disciplines on airports and airlines to control the costs faced by Customs.

Officials therefore recommend Ministers support the removal of after hours and regional airport charges contingent on adequate arrangements being made with industry to control future demand for services including fiscal risks.

The immediate fiscal impact of removing cost recovery for after-hours and regional airport services would be a reduction in Customs' third party revenue of up to \$6 million p.a.. This may be partly offset depending on the funding mechanism chosen.

Question 4 – What is the Preferred Funding Model?

Officials considered five funding methodologies. These are:

- i. Extension of the status quo where new services are recovered in the same proportion as existing cost recovery);
- ii. Industry preferred cost sharing;
- iii. Crown bears non-location specific costs, industry bears location specific costs;
- iv. Crown funds average per passenger cost (at the rate of the cheapest airport);
- v. Minimum service level (where the Crown defines and funds a minimum service level)

The fiscal and third party costs, future funding implications and the pros and cons of each of these options are considered on the following pages.

Future Fiscal Risk

Note that any funding regime, excluding full cost recovery, the Government's contribution will be linked to growth in passenger volumes.

As current forecasts are for future growth in passenger arrivals of around 5% p.a., further increases in Crown funding will be required over time. Any such increases will be considered through normal budget processes. Note, however, that any cost increases will be effectively offset by extra revenue (particularly GST) from visitors.

Funding Options Assumptions

The following options are based on the following assumptions:

- i. All figures are based on the 2002/03 financial year and include the full year cost of proposed new services;
- ii. Fiscal drivers are not a factor in the current border funding service. No scenario has therefore been developed with the specific intention of minimising fiscal cost;
- iii. The Government will fund passenger clearance services where there is a direct public benefit to ensure that New Zealand remains an open economy;

Option i: Extension of the status quo where new services are recovered in the same proportion as existing cost recovery)

New services would be funded in the same proportion as existing services (e.g. 100% cost recovery for aviation security, 73% for Customs);

Service (% Crown funded)	Crown funding \$m	Third party funding \$m
Aviation Security (0%)	0	32.82
Customs (73%)	19.31	7.17
MAF (100%)	18.62	0
Immigration (67%)	3.91	1.92
Total	41.84	41.91
<i>Change from current funding</i>	+5.65	+23.56

Location Specific Impact

If applied on a location specific basis the impact and cost per passenger would be:

Airport	Option 1	
	3rd Party (\$m)	Departure charge per return trip
Auckland	22.45	\$8.83
Wellington	3.84	\$16.95
Christchurch	7.36	\$13.84
Palmerston North	1.76	\$45.99
Hamilton	1.85	\$32.28
Dunedin	1.40	\$35.61
Queenstown	1.33	\$162.28

Note: Excludes immigration costs as these may not be recovered on tickets

Future funding implications

- Forecast growth in passenger numbers would need to be funded by periodic increases in Budget funding for Customs, MAF and Immigration.
- Aviation security funding would increase automatically in line with increasing passenger numbers. The rate of passenger charges would need to be periodically reviewed to ensure that overcharging was not occurring.

Advantages of approach

- Easy to implement;
- Low fiscal impact;

Disadvantages of approach

- Maintains current ad hoc practice whereby some costs are met by regional airports and out-of-hours passengers at the main airports. This is seen as inequitable. If there is to be cost recovery it should be spread equitably across all passengers;
- Difficult to defend as reasoned outcome of consultation process;
- Provides no basis for evaluating the funding source for new initiatives;
- Customs and Immigration cost recovery would need to be expanded in ad hoc manner to maintain existing levels of cost recovery;
- Maintains and exacerbates current poor economic price signals in system.

Evaluation

Not recommended

Option ii: Industry preferred cost sharing

As defined by industry

Service (% Crown funded)	Crown funding \$m	Third party funding \$m
Aviation Security (0%)	0	32.82
Customs (100%)	26.47	0
MAF (100%)	18.62	0
Immigration*	0	5.83
Total	45.09	38.65
Change from existing funding	+8.09	+20.3

*All Immigration funding would be recovered from passports & visas (not from airports or airlines)⁵

Location Specific Impact

Industry's proposal is silent on whether costs should be location specific but individual members have made strong representations for and against this issue. If Aviation Security costs were recovered on a location specific basis the impact and cost per passenger would be:

Airport	Option 2	
	3rd Party (\$m)	Departure charge per return trip
Auckland	18.55	\$7.30
Wellington	3.17	\$13.99
Christchurch	5.78	\$10.88
Palmerston North	1.41	\$36.85
Hamilton	1.55	\$27.05
Dunedin	1.15	\$29.27
Queenstown	1.21	\$147.66

Note: Excludes immigration costs as these may not be recovered on tickets

Future funding implications

- Forecast growth in passenger numbers would need to be funded by periodic increases in Budget funding for Customs and MAF.
- Aviation security funding would increase automatically in line with increasing passenger numbers.
- Maintaining relativity with agreed contribution levels through Budget processes would be difficult and funding growth would be unrelated to actual costs.

Advantages of approach

- Industry would support.

⁵ As noted above, passport fees are collected by Internal Affairs, which is not part of this exercise.

- Removes inequitable charging of some regional airports and out-of-hours passengers at the main airports.
- Growing tourism export earnings and the resultant GST returns to the government (\$487 million in 2003) may partially offset increased costs caused by increasing traveller numbers.

Disadvantages of approach

- High fiscal impact.
- Service levels (and costs) would be set by external parties. Crown would be obliged to fund to meet service levels.
- Provides no basis for evaluating the funding source for new initiatives.
- Maintains and exacerbates current poor economic price signals in system.
- Increases the immigration costs recovered from an already small group of passengers, i.e. the 10-15% who require a visa to travel to New Zealand.

Evaluation

Supported by Tourism and Transport

Option iii: Crown bears non-location specific costs, industry bears location specific costs

This option is outlined in the main report

Evaluation

Recommended by Treasury, Customs and MAF; acceptable to Department of Labour, but immigration activities may not fit well.

Option iv: Fully Allocated Average Cost – Crown funds average per passenger cost (at the rate of the cheapest airport)

The Crown funds services at all airports. The level of Crown funding is set at the average clearance cost per passenger at the cheapest airport (i.e. All airports would receive a subsidy for the Crown's contribution based on the average cost of passengers at Auckland).

Service (% Crown funded)	Crown funding \$m	Third party funding \$m
Aviation Security	24.94	7.88
Customs*	24.3	2.16
MAF	18.4	0.22
Immigration	5.83	0
Total	73.47	10.26
Change from existing funding	+37.28	-8.09

*Including Customs secondary processing

Location Specific Impact

If applied on a location specific basis the impact and cost per passenger would be:

Airport	Option 4	
	3rd Party (\$m)	Departure charge per return trip
Auckland	-	\$0.00
Wellington	2.01	\$8.87
Christchurch	3.27	\$6.15
Palmerston North	1.38	\$36.04
Hamilton	1.34	\$23.33
Dunedin	1.23	\$31.12
Queenstown	1.32	\$160.74

Note: Excludes immigration costs as these may not be recovered on tickets

Future funding implications

- Forecast growth in passenger numbers would need to be funded by periodic increases in Budget funding for Aviation Security, Customs and MAF. Level of funding would be driven by average cost and may fluctuate significantly
- Location specific (variable) costs would increase automatically in line with passenger growth. Periodically reviews of charge levels would be essential to ensure no over-recovery of costs.

Advantages of approach

- Provides price signals to more expensive airports.
- Spreads cost recovery over all passengers/airports/airlines except at Auckland. Note that many foreign international airlines only serve Auckland].

- Strong economic signals as provides location specific cost recovery.
- Provides a good basis for determining the level of cost recovery for new international airports.
- Efficient as users make a contribution to meeting growth in passenger arrivals.
- Provides strong maintains and exacerbates current poor economic price signals in system.
- Removes inequitable charging of some regional airports and out-of-hours passengers at the main airports.
- May be seen as favouring Auckland's commercial position at the expense of other airports.

Disadvantages of approach

- High maintenance system. Figures would be constantly subject to revision
- Doesn't deal with issue of cost increases due to passenger growth, especially if this happens at the three main airports.
- Not based on drivers of the costs of the service at any given location
- Crown is exposed to funding of passengers through any new airports

Evaluation

Not Recommended

Option v: Minimum service level - where the Crown defines and funds a minimum service level and recovers costs for services delivered above this level

Description

This option would require the Crown to determine a basic level of service and fund services to this level. This option has not been costed. To cost this option would require a number of assumptions on acceptable staffing levels, times in queues and hours of service at each airport. A second set of assumptions would then be necessary as to passengers desired levels of services with passengers then being responsible for paying for the difference between the Government minimum level and the assumed passengers desired level.

Advantages of approach

- Theoretically useful method of determining appropriate level of Crown contribution.
- Efficient as those who request extra services pay for them.
- Removes inequitable charging of some regional airports and out-of-hours passengers at the main airports.

Disadvantages of approach

- Unwieldy and probably unworkable in practice.
- Requires significant assumptions for which no qualitative basis exists.
- High maintenance as the assumptions made in determining service levels would then need to be frequently revised.
- Difficult to attribute additional demands to users (as new requirements often come through circuitous route).
- Provides no basis for evaluating the funding source for new initiatives.

Evaluation

Not recommended

Question 5 – Are Adjustments to the Suggested Results of the Preferred Funding Model Justified for Efficiency, Growth or Equity Reasons?

For each service consideration could be given to whether the level of proposed funding should be changed for any of the following reasons.

i. Economic efficiency

- Would the behaviour of those who drive costs or cause the risk for which the service is required be improved by increasing the charge on them?

ii. Economic growth

- Will the level of charge significantly reduce the net number of travellers to New Zealand?
- If so, will the net wealth of New Zealand be reduced?
- Is additional funding desirable to offset the negative impacts of any increase in cost recovery?

The Treasury considers that there is no compelling economic case for Crown funding of passenger clearance services as a means of improving economic outcomes for New Zealand. This conclusion is based on:

- Border charges of the magnitude being considered are not a significant influence in decisions to travel to New Zealand.
- The net economic loss from discouraging travellers is unclear as border charges discourage outgoing as well as incoming travellers.
- Charging creates incentives for those paying to demand efficient processes and minimum costs, thereby improving overall service delivery.

The Treasury considers that while there may be a business case for additional funding of targeted tourism marketing, any such bid should proceed through normal Budget processes for consideration against other spending priorities.

iii. Regional development; or

- Are there regional development benefits (or disadvantages from reducing the cost of passenger clearance services at airports outside the major metropolitan centres)?

The Treasury considers that there are no regional development benefits from subsidising regional airports. It is unclear that the existence of regional international airports significantly contributes to regional economic growth. Furthermore as the costs of cross subsidising regional airports would be a deadweight drag on more successful airports it is possible that overall New Zealand welfare may be reduced.

iv. Equity Arguments for Funding Border Security

There is no compelling economic argument for funding passenger clearance services. There are, however, strong equity arguments for, and against, travellers paying for the cost of border services. In brief these are:

- taxpayers who do not travel should not fund services required for those who do travel. There are however precedents for this with many services (such as public broadcasting or universities) being fully or partly funded by those who do not use them.
- travellers give rise to the need for biosecurity, customs, immigration and aviation security services, and it is reasonable that they should share in meeting the costs of these services;
- travellers make a significant contribution to the economy and pay half a billion dollars in GST. This represents a direct wealth transfer from foreign travellers to New Zealanders, as foreigners are excluded from free education and social welfare services. Reducing border charges would be one way of reducing the inequitable return for the taxes that travellers pay.
 - Should travellers pay for services that benefit others?
 - Should those who do not travel pay to prevent risks (and enjoy the benefits) bought by those who do travel?
 - It is possible that travellers pay more in tax than they receive in benefits - Should action be taken to address a possible wealth transfer from tourists to New Zealanders?

Officials have no basis or mandate to assess equity considerations.

Question 6 – Should Decisions Apply to New International Airports

1. Should the same regime apply to new international airports?
 - Should new airports receive the same Crown contributions as existing regional international airports?
 - Should new international airports have to fully cover the cost of all Crown provided services?

This question may be answered depending on the funding option chosen.

Note: The proposed funding scenarios may mean that new international airports could face more, or all, of the costs of passenger clearance services. This would be likely to discourage, but would not prohibit, the establishment of new international airports.

If a specific approval process for new international airports was desired, then policy work on this would need to be separately commissioned by Ministers. Officials recommend that Ministers direct officials to undertake further work on an appropriate regime for the treatment of new international airports

Other Relevant Information for Ministers

Funding of Novel Infectious Diseases and Other One-Off Emergency Services

The proposed funding mechanism would only cover existing and new “permanent” clearance services. This would exclude responses to novel infectious diseases such as the SARs virus.

Funding for such incidents would need to be dealt with on a case-by-case basis under the same framework as other new services. The current framework does, however, provide a framework for considering the appropriate funding arrangements for one-off incidents.

Annex 1**Other Border Related Issues**

The passenger clearance work has overlaps with a number of other issues. Where appropriate these issues are being directly coordinated. The status of these issues is:

- Auckland International Airport congestion,

A report is due shortly on short-term measures to be introduced to relieve congestion in passenger clearance services at Auckland International Airport at peak times.

- Rebalancing of the Aviation Security Services' international and domestic charge rates,

A final decision on whether the Crown is to fund part of Aviation Security's ongoing costs can be made simultaneously for both international and domestic activities. The level of both the domestic and international charges would be affected by any decision to require Aviation Security to pay for the space at airport terminals devoted to its screening activities. If it is decided to agree with the industry position, the establishment costs for hold stow baggage screening that Aviation Security urgently requires Crown funding for could subsequently be recovered by a higher international charge on the airlines.

- the proposed monitoring levy for Asian Gypsy Moth Surveillance; and

A draft Cabinet paper has been prepared and agreed by departments with the exception of one issue. MAF considers that the levy should fully recover costs (ie head office overheads and variable operational costs). MFAT has raised concerns that this would not be GATT compliant and that the levy should be restricted to variable operational costs. Once this issue is resolved MAF will be presenting the draft Cabinet paper to the Ministerial Committee on funding of border security seeking approval to submit it to Cabinet.

- Custom's Goods cost recovery:

A discussion document on a proposal to implement fees to recover Customs' increased goods clearance costs was released for submissions on July 19. It is expected that a paper on the results of this consultation and making any necessary recommendations for regulations to implement fees will be presented to Cabinet towards the end of August.

- Biosecurity cost recovery

A draft Cabinet paper has been prepared and MAF is developing a discussion document for industry on matters where an increased industry funding contribution is proposed, such as for development of import health standards, and pest surveillance and response. Once the discussion document is completed MAF will be presenting it to the Ministerial Committee on funding of border security seeking approval to submit the Cabinet paper and the discussion document to Cabinet.