

The Treasury

Budget 2017 Information Release

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[40]	Not in scope	

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Treasury Report: Earthquake Recovery - Budget Treatment of Major Investment Items

Date:	6 March 2017	Report No:	T2017/385
		File Number:	TY-2-3-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Steven Joyce)	<p>Agree to extend the Budget 2017 capital allowance to include the costs of reinstating State Highway 1 and rail after the Kaikōura earthquake sequence.</p> <p>Agree that the majority of costs of reinstating the Kaikōura three waters infrastructure after the Kaikōura earthquake sequence, to the extent that they are covered by the Permanent Legislative Authority, should not be counted against the Budget 2017 operating allowance.</p> <p>Agree that the funding associated with the expected call on the Crown guarantee to fund any EQC liquidity shortfall will not be counted against Budget 2017 allowances.</p>	Fiscal Issues meeting, 5.00pm Tuesday 7 March
Associate Minister of Finance (Hon Simon Bridges)	Note the contents of this report.	Fiscal Issues meeting, 5.00pm Tuesday 7 March
Associate Minister of Finance (Hon Amy Adams)	Note the contents of this report.	Fiscal Issues meeting, 5.00pm Tuesday 7 March

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Julia Pearce	Senior Analyst, Earthquake Recovery Strategy [39]		✓
Simon McLoughlin	Manager, Earthquake Recovery Strategy		

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury: 3672453v1

Treasury Report: Earthquake Recovery - Budget Treatment of Major Investment Items

Executive Summary

1. Overall, earthquake-related expenditure of ^[33] operating and ^[33] capital has been sought in Budget 2017 across the forecast period. In addition to this, the Southern Transport Corridor Reinstatement has a cost range of between \$1.4 and \$2 billion of capital expenditure.
2. The starting presumption with the current fiscal management approach is that all new expenditure should be managed within allowances. This is so the Government can manage fiscal indicators as much as possible to help meet their fiscal strategy.
3. It will be difficult to manage the Crown's costs for the Southern Transport Corridor from within the existing Budget 2017 allowances signalled in the Budget Policy Statement. This is because of the size of the commitment relative to the size of the remaining capital allowance (\$2.0 billion) and in light of other known pressures against Budget allowances (refer T2017/387).
4. We consider the best approach to managing the costs associated with the Southern Corridor Reinstatement project is to extend the capital allowance for Budget 2017 as:
 - a. It will send clear signals to agencies on the need to effectively manage the costs associated with the project, and provide a further mechanism to maintain oversight of the costs and support the early identification of cost overruns.
 - b. It is consistent with the treatment of other significant Crown-funded infrastructure projects, such as City Rail Link and the Accelerated Regional State Highways package.
 - c. It is aligned with the lessons learned from the treatment of costs associated with the Christchurch recovery and rebuild, in particular ensuring funding is subject to established decision-making processes for significant Crown investments.
5. The Budget 2017 capital allowance would need to be extended by \$1.4-\$2 billion on current estimates to include the Southern Transport Corridor Reinstatement. Whether it is included or not, these costs will be additional to what was assumed in the Half Year Economic and Fiscal Update (HYEFU) so will impact on net core Crown debt. HYEFU did have a net \$1 billion of fiscal costs for most other major earthquake-related items, including those related to local infrastructure and EQC, but excluded road and rail costs, which were assumed to come from existing transport funding or from insurance.
6. Upfront payments for the Crown's share (60%) of Kaikōura's "like for like" three waters restoration costs are likely to be covered under a Permanent Legislative Authority and do not count against Budget allowances. However, any "betterment" costs, lead contractor costs, ^[33] would have a minor impact on allowances.
7. The Crown guarantee for EQC is expected to be triggered by the Kaikōura earthquake sequence. This was forecast as a cost in HYEFU and, given previous treatment and low degree of discretion, we consider it should sit outside of Budget 2017 allowances.
8. You will receive further advice on the earthquake and resilience capital elements as part of the Investment Ministers meeting on 13 March and on the package as a whole at Budget Ministers on 20 March.

Recommended Action

We recommend that you:

- a **agree** to extend the Budget 2017 capital allowance to include the costs of reinstating State Highway 1 and rail after the Kaikōura earthquake sequence

Agree/disagree.

- b **agree** that the majority of costs of reinstating the Kaikōura three waters infrastructure after the Kaikōura earthquake sequence, to the extent that they are covered by the Permanent Legislative Authority, should not be counted against the Budget 2017 operating allowance

Agree/disagree.

- c **agree** that the funding associated with the expected call on the Crown guarantee to fund any EQC liquidity shortfall will not be counted against Budget 2017 allowances

Agree/disagree.

Simon McLoughlin
Manager, Earthquake Recovery Strategy

Steven Joyce
Minister of Finance

Treasury Report: Earthquake Recovery - Budget Treatment of Major Investment Items

Purpose of Report

9. This report seeks your decision on the treatment of the costs of reinstatement of State Highway 1 and rail following the Kaikōura earthquake sequence. It also provides some information on our recommended treatment of the costs associated with the restoration of three waters in Kaikōura, and details of funding associated with a call on the Crown guarantee to fund any EQC liquidity shortfall. Each of these areas is discussed below.
10. A table of the initiatives received across earthquake recovery and Wellington resilience is attached to provide you with an initial sense of where these initiatives are at.

Background

11. The Half Year Economic and Fiscal Update (HYEFU) 2016 forecasts included \$2-3 billion as a gross estimate of the fiscal costs associated with the Kaikōura earthquakes. There were three key judgements that underpinned this estimate:
 - a. a significant portion of the costs (including the reinstatement of State Highway 1 and the rail network) were assumed to be funded from existing baselines, existing Budget allowances, and insurance proceeds.
 - b. any future policy decisions made by the Government would be managed through the existing Budget allowances.
 - c. a net \$1 billion was included in HYEFU based on the assumption that the funding of certain items, such as the EQC Crown guarantee and the Government's share of the three waters infrastructure, would be outside of Budget allowances.
12. To date there have already been a number of funding decisions – these were funded from whatever was agreed at the time by Cabinet or groups of Ministers as follow:

Funding treatment	Example
The Between-Budget contingency (BBC) set aside at Budget 2016	\$33 million for a range of response and recovery items, including Primary Sector Assistance, Temporary Housing Assistance and the initial tranche of Employment Support Subsidy.
Pre-commitment against the operating allowance for Budget 2017 [37], [38]	\$5 million for Extending Earthquake Support for the Kaikōura Region.
Existing tagged contingencies	\$1.8 million to support additional mental health services in affected regions from a tagged contingency for Risk Pool for Emerging Health Sector Risks.
Existing baselines	\$2 million of capital for a health relief package from within existing capital appropriations. A range of other reprioritisation of funds has been undertaken by agencies.

13. As much as possible, we are ensuring that funding requests to assist with recovery from the Kaikōura earthquake sequence are progressed through Budget 2017 processes. This means they can be given adequate consideration alongside other funding pressures the Government is facing.
14. A range of initiatives have been received covering:
 - Reinstatement of State Highway 1 and rail
 - Three waters restoration
 - Supporting enhanced council statutory tasks and activities
 - Kaikōura Harbour redevelopment
 - Mental health support in schools
15. A full table setting out the initiatives received and the funding sought, along with preliminary Treasury advice, is attached as Annex 1 of this report. Overall, earthquake-related expenditure of [33] operating and, excluding the capital costs of the Southern Transport Corridor Reinstatement, [33] capital has been sought in Budget 2017 across the forecast period.
16. We believe it will be difficult to manage the Crown's costs for the reinstatement of the road and rail network between Picton and Christchurch from within the existing Budget 2017 allowances signalled in the Budget Policy Statement. This is because of the size of the commitment (\$1.4-\$2 billion) relative to the size of the remaining capital allowance (\$2.0 billion) and in light of other known pressures against Budget allowances (refer T2017/387).
17. In addition to the initiatives outlined in Annex 1, there is likely to be a call on the Crown's guarantee to EQC for an expected cash deficiency.

Within or outside of Budget Allowances?

18. The starting presumption with the current fiscal management approach is that all new expenditure should be managed within allowances. This is so the Government can manage fiscal indicators as much as possible to help meet their fiscal strategy.
19. There are some notable exceptions, including some items to help avoid pro-cyclical fiscal policy (e.g. changes in the cost of debt servicing, the Jobseeker Support benefit); impairments, revaluations and other changes due to valuations of large assets and liabilities, which are highly volatile and are often non-cash; and previously forecast growth in expenditure.
20. Given the uncertainty around the volatility of some expenses, the fiscal management approach provides some flexibility to apply a degree of judgement. A good example of this was the response to the Canterbury earthquakes. The costs were initially managed outside of allowances in the Canterbury Earthquake Recovery Fund.
21. We consider the following questions to help guide us on whether items should be treated outside of Budget allowances.
 - a. how is the expenditure funded under current rules or recent precedent?
 - b. what degree of parliamentary scrutiny has it already received?
 - c. does the approach create inconsistencies with the treatment of other items?

- d. what is the degree of government decision-making rights with this expenditure?
 - e. is the Government obligated by an existing mechanism (contracts or indemnities)?
 - f. is there a risk to the credibility of the fiscal strategy?
22. There are relatively unique aspects to a large event like the Kaikōura earthquakes in terms of the treatment of recovery funding, including:
- a. there is limited discretion around some of the costs due to past policy decisions, as a result some expenditure will be funded through a Permanent Legislative Authority (i.e. the appropriation authority is permanent and does not need to be approved each year by Parliament).
 - b. the size of the costs are large and will predominately be one-off. The largest funding item associated with the earthquakes – the reinstatement of the transport corridor between Picton and Christchurch – has already been agreed by Cabinet for the roading component and in-principle for the uninsured rail component and could crowd out investments within the current capital allowance.
 - c. there may be separate resilience expenditure not directly related to the Kaikōura earthquakes but occurring as a result of the heightened risk of a future event.
23. In HYEPU we assumed material costs which were a direct result of past policy decisions would be managed outside of Budget allowances (e.g. the Crown's guarantee to EQC and local authorities around three waters restoration). We believe this treatment is still appropriate for fiscal management purposes, consistent with previous treatments and the low degree of discretion. More detail on the three waters restoration is included below given the relatively unique circumstances for Kaikōura District Council (KDC). It is worth noting any revisions to our initial estimate of these costs to the Crown will have an impact on net core Crown debt.
24. With the Budget initiatives received to date, we believe there is a choice on how to treat the reinstatement of State Highway 1 and the rail network. The reason we require a decision at this point is to confirm:
- a. Budget parameters prior to the development of the 2017 Budget package; and
 - b. the treatment for the preliminary fiscal forecasts, which will need to reflect Cabinet decisions up to the forecast finalisation date.
25. As noted above, it will be difficult to manage the reinstatement of State Highway 1 and the rail network within the remaining Budget 2017 capital allowance. Our preferred option would be to extend the capital allowance for Budget 2017, which will have an impact on net core Crown debt of between \$1.4 - \$2 billion.
26. We are aware that the costs associated with the initiatives are still moving to some extent. For example, there remains a reasonable level of uncertainty around the level and phasing of costs for the Southern Corridor. Ministers will receive further information on 9 March via a draft Cabinet paper which is discussed below.

Reinstatement of State Highway 1 and Rail

27. State Highway 1 (SH1) and KiwiRail's Main North Line (MNL) north and south of Kaikōura were severely damaged by the earthquakes. Critical links for the communities and for the freight and tourism industries of both the South Island and New Zealand were severed as a result.
28. In response to the earthquakes, the Government has taken several decisions to advance the repair of the road and rail links as quickly as possible. These decisions included:
- a. On 5 December 2016, Cabinet [CAB-16-MIN-0675 refers]:
 - i agreed to rebuild and improve SH1 and the MNL along their current coastal route, with improvements to the safety and resilience of the route, at an estimated cost in the range of \$1.4 billion to \$2.0 billion ("the reinstatement project")
 - ii agreed to fund, in principle, the uninsured cost of reinstating the rail line
 - iii agreed to fund the roading component of the costs of the reinstatement works along the coastal alignment

[37], [38]

29. The current estimated cost range is \$1.4-2.0 billion, [37], [38]

30. [37], [38]

31.

32. We are currently preparing a draft Cabinet paper outlining our preferred approach to funding the reinstatement work. This is to fund the roading component via a grant to the New Zealand Transport Agency (NZTA) for the estimated 2016/17 costs and the estimated cost to December 2017, with the balance being set aside as a tagged contingency. The appropriation can be adjusted by Ministers following completion of detailed design and cost estimates in mid-June 2017.

1 [37], [38]

33. In less severe or smaller events the NZTA would self-insure for the cost of reinstatement either through its disaster management facility, or by reprioritising other projects. Given the size of this event, the NZTA advised it would not be able to fund the reinstatement without significant reprioritisation within the National Land Transport Programme and, based on this assessment, Cabinet agreed to fund the roading component of the reinstatement project
34. While Cabinet agreed to fund the roading component of the reinstatement project in full, the Ministry of Transport have requested further information from the NZTA about the ability of the National Land Transport Fund (NLTF) to pay for some of the rebuild and the impact of this on other priority projects. There may be some headroom in the NLTF to fund a portion of the reinstatement work (noting that to date the NZTA has spent \$37 million on the initial response, funded from headroom and emergency works funding in the NLTF).
35. [37], [38]
- 36.
37. In light of the other significant pressures on the Budget 2017 capital allowance, we consider the best approach to managing the costs associated with the Southern Corridor Reinstatement project is to extend the capital allowance for Budget 2017. This is our preferred option because:
- a. It will send clear signals to NZTA and KiwiRail of the need to effectively manage the costs associated with the project, and provide Ministers with a further mechanism to maintain oversight of the costs and support the early identification of cost overruns.
 - b. It is consistent with the treatment of other significant Crown-funded infrastructure projects, such as City Rail Link and the Accelerated Regional State Highways package.
 - c. It is aligned with the lessons learned from the treatment of costs associated with the Christchurch recovery and rebuild. In particular, managing within the capital allowance means that earthquake-related spending is subject to established decision-making processes for significant Crown investments.
38. The key risk associated with extending the capital allowance for Budget 2017 to include the costs for the Southern Reinstatement project (rather than managing this outside of allowances) is the risk of cost overruns that may further constrain investment decisions both at Budget 2017 and in future Budgets. The draft Cabinet paper on the Southern Transport Alignment project will outline the risks associated with the current cost uncertainty and the mitigations. This Cabinet paper will reflect your decision on the treatment of this cost for Budget 2017.

Three Waters Restoration

39. Under current policy as set out in the Guide to the National Civil Defence Emergency Management Plan 2015, the Government is required to reimburse local authorities 60% of eligible costs for repair of essential infrastructure such as water, storm water and sewerage facilities (the “three waters”).
40. As a result, the Government’s share of these costs will be recognised in the 2016/17 financial year as the obligation is deemed to have existed as soon as the earthquakes occurred. As such, no Budget allowance exists.
41. The general rule is that the affected council arranges for the repairs and then invoices the Crown for reimbursement later on (generally after the repair work has been completed), though there is provision for advance payment, subject to Cabinet approval, if the likely eligible reimbursement will be greater than \$0.250 million.
42. Section 115A of the Civil Defence Emergency Management Amendment Act 2016 provides Permanent Legislative Authority (PLA) for, among other things, reimbursements of eligible costs where these “meet the criteria for being reimbursed or paid in a Government policy that was in force before the emergency occurred”. Previously such costs required annual appropriation.
43. The Kaikōura District Council (KDC) is the second smallest in New Zealand in terms of rating base. [37]

^D A small amount may also be added to the overall costs to cover a lead contractor to manage project from within KDC, given the scale of the project and KDC’s limited resources.

44. [37] and a “betterment” portion (\$2.4 million), in recognition of the fact that the required nature and extent of repairs will not be fully known until the work is being undertaken. Also, while the Council has insurance for its 40% share of costs, [37]
45. We are still investigating whether advance payment of the Government’s 60% share of repair costs meets the criteria for being covered by the PLA, or else requires annual appropriation. Treatment under the current fiscal management approach is subtly different for PLAs and annual appropriations:
 - If covered by the PLA, then the expense would be treated as a forecast change. Forecast changes do not directly count against the Budget 2017 operating allowance. Instead, the Treasury sums up all of the forecast changes, positive and negative, that occur during the year. If the net impact is a cost, then this net cost is charged against the next year’s Budget allowance.
 - If not covered by the PLA and so requiring annual appropriation, the expense would count against the Budget operating allowance.
46. As there is no limit for advance payments stipulated in the Guide (they simply need to be approved by Cabinet if greater than \$0.5 million or by the Minister of Civil Defence under delegation if less than this amount), our thinking is that the [37] advance payment for ‘like for like’ repairs would be covered by the PLA.

2 [33]

47. As regards the \$2.4 million for “betterment”, it depends on the nature of the work carried out: if consistent with the criteria as set out in the Guide, then relevant expenses would be covered by the PLA; otherwise they would require annual appropriation. In either case the treatment under the fiscal management approach would be as set out in paragraph 45.
48. [37], [33]
49. Our advice is therefore that:
- The costs associated with the upfront payment of the Crown’s 60% share of three waters restoration costs should not be counted against the Budget 2017 allowance, except to the extent that the payment for ‘betterment’ and for a lead contractor may not be covered by the PLA.
 - [33]

EQC

50. As a result of the Canterbury earthquakes, actuarial estimates of EQC’s claims liabilities exceeded its assets after accounting for reinsurance. Therefore for several years EQC has reported a negative equity position. A negative equity position does not trigger the Crown guarantee obligations under section 16 (s.16) of the EQC Act. The guarantee is only triggered if EQC does not have the liquidity to meet its liabilities. The Crown has previously confirmed in writing to EQC its intention to meet its obligations under the Crown guarantee if required and provide the funds necessary to enable EQC to meet its liabilities.
51. Pre-Kaikōura, while the actuarial estimates indicated that EQC was in a negative equity position, from a cash flow perspective EQC was still paying all its expenses and claims as they became due. As EQC’s forecast income flows exceeded its forecast expense track, it did not expect to require s.16 funding from the Crown unless there was another significant natural disaster.
52. The 14 November Kaikōura earthquake was that disaster. EQC is now expected to require support under s.16 of the EQC Act. EQC will be providing the Treasury with updated cash deficiency estimates later in March 2017, and we will then provide an update on the expected cash deficiency and the Crown Guarantee financing requirement. Ongoing negotiations between EQC and LINZ for insured residential red zone land claims are expected to conclude in March/April 2017, with payment in May 2017, which will affect EQC’s overall position.
53. Although at HYEPU the anticipated EQC liquidity shortfall was treated as a loan (consistent with previous forecasts), the Treasury has since recommended to Ministers that the s.16 Crown guarantee funding facility be implemented as an operating grant, with payments made to EQC on a cash flow evidence basis (including a claw-back provision). The change of treatment from a loan to an operating grant will not initially increase net core Crown debt, and has no overall impact on OBEGAL, because HYEPU did not forecast a repayment of the loan within the forecast period.

54. Payments to EQC are made under the PLA established under s.16 of the EQC Act. As noted earlier in this report, HYEPU assumed the material costs of past policy decisions including the Crown's guarantee to EQC would be counted outside of allowances. We see no reason for this to change and therefore ask you to agree that the costs of EQC's Crown guarantee will not impact on the Budget 2017 allowances.

Next Steps – Investment and Budget Ministers' Meetings

55. The Investment Panel considered earthquake and Wellington resilience proposals with capital elements on 3 March. Ministers will receive their advice at Investment Ministers on 13 March (Investment Ministers should be receiving their packs with the Panel report on the afternoon of 8 March).
56. Budget packages will continue to be developed, using the guidance from Ministers about the treatment of these major expenses. To recognise the fiscal impacts of the initiatives related to earthquake recovery and Wellington resilience, they will show up in three parts of the Budget. We have allocated the initiatives to the existing Budget package they are most closely linked to. You will therefore see earthquake recovery and Wellington resilience initiatives as part of:
- The Capital package where there are capital implications, for example road and rail reinstatement and three waters restoration.
 - The Business Growth Agenda Infrastructure package, where the operating expenditure associated with the capital elements will be recognised as well as a couple of initiatives which are operating only.
 - The Social Sector package, where two initiatives related to expenditure in Health and Education are being recognised.
57. Advice on each of the initiatives and the initiatives to improve Wellington's earthquake resilience will be presented to Budget Ministers on 20 March as part of the packages indicated above.

Annex 1 - Earthquake Response and Wellington Resilience initiatives - Budget 2017

Vote	Package	Title	Initiative Description	Operating						Capital						VA Assessment
				16/17	17/18	18/19	19/20	20/21	Total Opex	16/17	17/18	18/19	19/20	20/21	Total Capex	
Prime Minister and Cabinet	BGA and Capital	Kaikōura District Council - [33] support restoration of three waters network post November 2016 earthquake	3 waters - restore water, sewerage and stormwater services to original capacity with some additional resilience and capacity where appropriate. [33] As the asset evaluation has not been completed there will be an additional process of assessing the necessity of adding in additional resilience as part of reconstruction. [33]	[33]												Consider for investment - [33] include contingency fund. Allows essential work to progress. Contingency to cover costs [33] or for small amounts of betterment where this makes sense.
Prime Minister and Cabinet	BGA	Earthquake recovery - supporting councils' enhanced statutory tasks and activities	Councils face increased statutory activity. Small territorial authorities particularly have substantial pressures: increased consent processing (RMA, building), financial planning, rating assessments, new infrastructure projects, community interaction/communication, and investigations for change of land use decisions (rural and some urban). Opportunities for shared resources are expected.	0.500	1.250	0.750	0.000	0.000	2.500	0.000	0.000	0.000	0.000	0.000	0.000	Consider for investment - similar precedent for Chathams. Covers costs where volume of work will significantly rise. Other options to borrow staff from neighbouring councils not possible.

[33]

Prime Minister and Cabinet	BGA and Capital	Kaikōura Harbour: contribution [33]	[33]															Do not support - largely eco development focussed, would have been a project for Council anyway, not clear it meets to needs of key stakeholders [34]
Transport	Capital	Southern Transport Corridor Reinstatement	The Crown has committed to fund the reinstatement of State Highway 1 and the rail line post the earthquakes.	0.000	0.000	0.000	0.000	0.000	0.000	210.000	890.000	0.000	0.000	0.000	1100.000	Roading component. Precommitment, assumes lower-bound estimate		
				[37], [38]														
[33]																		

Internal Affairs	BGA	Improving Wellington's Emergency Water Resilience	<p>Following the 14 November earthquake, central and local government have been investigating options for increasing Wellington's resilience to a major earthquake event. Wellington is currently at higher than usual risk of a major (M7+) earthquake.</p> <p>This bid focusses on a series of actions to improve residents' and critical services' access to potable/fresh water and sanitation following a major earthquake.</p>															Consider for investment via concessional loan, options to scale being pursued.
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[33]

[33]

Health	Social Sector and Capital	Wellington earthquake resilience	<p>This funding will be used to enhance the health sector's ability to respond to mass casualties in the event of a severe Wellington earthquake by providing specialist resources</p> <p>[33]</p> <p>Wellington region is particularly vulnerable because of the risk of transport and lifeline utility disruption into and across the region.</p>	[33]													Partially support at scaled figures shown. In patient surgical facility supported in full [33]
																	support out patient surge capacity [33] but remaining questions around associated opex which is linked with ownership so opex may increase (around \$0.5m opex).
Education	Social Sector	Earthquake recovery and response	The initiative supports the Recovery Programme for all schools impacted by the November 2016 earthquake and floods, by providing Boards of Trustees, principals, teachers and support staff with information and appropriate support on employment options during the implementation of a recovery programme.	0.645	0.570	0.240	0.000	0.000	1.455	0.000	0.000	0.000	0.000	0.000	0.000		Support - provides mental health support to teachers, students and principals. Main concern is overlap with Health funding already provided and additional Whānau Ora resource. NB - numbers still moving, figures to be added for 16/17

Total to be considered for investment [33]
Total sought