

The Treasury

Budget 2017 Information Release

Release Document July 2017

www.treasury.govt.nz/publications/informationreleases/budget/2017

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1]	to prevent prejudice to the security or defence of New Zealand or the international relations of the government	6(a)
[4]	to prevent prejudice to the maintenance of the law, including the prevention, investigation, and detection of offences, and the right to a fair trial	6(c)
[11]	to damage seriously the economy of New Zealand by disclosing prematurely decisions to change or continue government economic or financial policies relating to the entering into of overseas trade agreements.	6(e)(vi)
[23]	to protect the privacy of natural persons, including deceased people	9(2)(a)
[25]	to protect the commercial position of the person who supplied the information or who is the subject of the information	9(2)(b)(ii)
[26]	to prevent prejudice to the supply of similar information, or information from the same source, and it is in the public interest that such information should continue to be supplied	9(2)(ba)(i)
[27]	to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information - would be likely otherwise to damage the public interest	9(2)(ba)(ii)
[29]	to avoid prejudice to the substantial economic interests of New Zealand	9(2)(d)
[31]	to maintain the current constitutional conventions protecting collective and individual ministerial responsibility	9(2)(f)(ii)
[33]	to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials	9(2)(f)(iv)
[34]	to maintain the effective conduct of public affairs through the free and frank expression of opinions	9(2)(g)(i)
[36]	to maintain legal professional privilege	9(2)(h)
[37]	to enable the Crown to carry out commercial activities without disadvantages or prejudice	9(2)(i)
[38]	to enable the Crown to negotiate without disadvantage or prejudice	9(2)(j)
[39]	to prevent the disclosure of official information for improper gain or improper advantage	9(2)(k)
[40]	Not in scope	

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) and section 18 of the Official Information Act.

Chair
Economic Growth and Infrastructure Committee

Technical Initiative – Capital requirement for Southern Response Earthquake Services Limited

Proposal

1. We are seeking Cabinet approval for a technical bid in Budget 17 to fund Southern Response Earthquake Services Limited's (Southern Response) capital requirements being \$250 million greater than current Crown support arrangements.
2. Shareholding Ministers will subscribe for \$250 million of uncalled capital in Southern Response. This will increase the current uncalled capital facility from \$750 million to \$1,000 million. The uncalled capital will be callable by Southern Response based on shortfall forecasts and payable by the Crown to the company to enable Southern Response to discharge policyholder claims.

Key points

3. Southern Response reported an increase of \$189 million in its ultimate claims cost as at 31 December 2016, with the net amount of claims still to be settled and paid standing at \$776 million. This increased the company's negative equity position to a level \$126 million greater than the remaining uncalled capital available to it under current Crown support arrangements. The next valuation of the outstanding claims liability (as at 31 March 2017) is currently being prepared by the independent actuaries and will be reported to the board in April. [25], [37]
4. The recent increases in liabilities valuation have been driven by two factors:
 - a. increases in the number of claims currently with EQC but now anticipated to go overcap and become Southern Response's responsibility in the future; and
 - b. the increasing incidence of unsettled claims having complex and more expensive issues which need to be dealt with.

5. The below table shows changes to Southern Response's total overcap claims, settlements and the value of the company's claim liability since 2012.

Year (ending 30 June)	2011	2012	2013	2014	2015	2016	Dec16
Overcap claims (total)	5,383	6,527	6,760	7,028	7,564	7,909	7,972
New overcaps (in FY)*	-	1,144	233	268	536	345	63
Settled claims (total)	-	10	139	3,459	4,610	5,996	6,648
Newly settled claims (in FY)	-	-	129	3,320	1,151	1,386	652
Remaining claims (total)	-	6,517	6,621	3,569	2,954	1,913	1,324
(\$ million)							
Central estimate liability (total)	1,819	2,157	2,254	2,364	2,716	2,903	3,172
Increase in central estimate	-	338	97	110	352	187	269
Remaining claims liability	740	1,122	1,230	1,249	1,115	788	776
Staff resources (FTEs)	N/A	173	162	173	149	145	142**

* These are primarily the claims that have transferred to Southern Response from EQC in the FY. These numbers do not include the claims with EQC that have been assumed will go overcap in the future (as discussed below).

** 124 as at March 2017

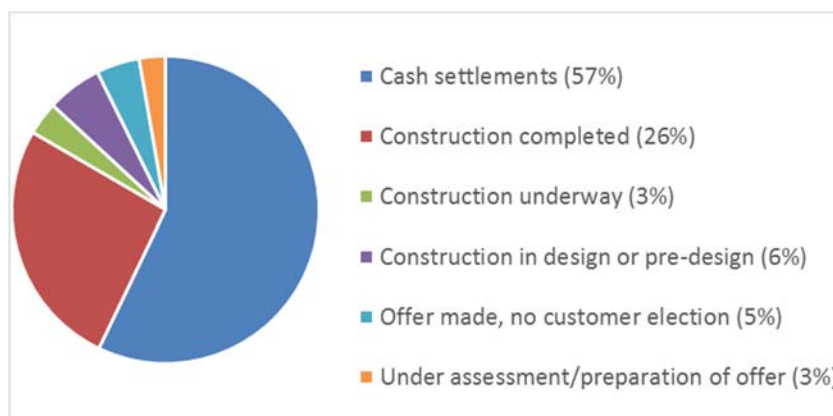
6. The board is expected to consider the latest valuation and Southern Response's capital requirements at its April board meeting. We expect a request for an increase in Crown capital support to ensure Southern Response is solvent and able to fulfil its obligations to claimants will be made the week following that board meeting.
7. Based on current forecasts the company has access to sufficient capital to meet its cash flow requirements until March 2018.
8. In continuing to operate ahead of decisions on additional Crown support, the directors are relying on previous public statements by the former Prime Minister and Minister of Finance that the government will continue to support the company to achieve its purpose of settling all the claims of AMI residential policyholders arising from the Canterbury earthquakes.
9. The most practical way of dealing with this issue is through an increase in the existing uncalled capital facility from \$750 million to \$1,000 million which requires corresponding appropriations of \$250 million. These appropriations are to provide for the injection of equity into the company and to immediately write down the investment to nil as recovery is deemed unlikely.
10. We are therefore seeking Cabinet's approval to new appropriations so that shareholding Ministers can subscribe for sufficient uncalled capital to accommodate further increases in Southern Response's claims liability.
11. Any increase in Southern Response's forecast requirements represents a change in forecast for an existing policy initiative – being to settle all outstanding claims of AMI residential policyholders arising from the Canterbury earthquakes. Consistent with previous years, increasing the necessary appropriations to provide for the equity injection and immediate write-down will not impact on Budget allowances.

Background

12. Southern Response is a fully Crown-owned company listed on Schedule 4A of the Public Finance Act 1989. The company's purpose is to settle the claims of the former AMI Insurance Limited (AMI) policyholders' residential policy claims from the Canterbury earthquake events up to 5 April 2012. Once all claims have been settled the company will be wound up.
13. A Crown Support Deed was entered into by the Crown and AMI in April 2011 which outlined the terms of the Crown's support for the company. This deed was amended on 5 April 2012 to reflect the Crown's ownership of AMI's Canterbury claims.
14. In accordance with the terms of the April 2012 amended deed, the Crown has paid for \$500 million of convertible preference shares which have been converted into ordinary shares in the company. All the shares have been paid for and issued, and the funds have been fully used to settle claims.
15. Under the terms of a second deed of amendment and restatement to the Crown support deed dated 30 January 2013, the Crown subscribed for 500 million ordinary shares through an uncalled capital facility with a value of \$500 million.
16. Under the terms of a third deed of amendment and restatement to the Crown support deed dated 20 October 2016, the Crown subscribed to a further 250 million shares through the uncalled capital facility with a value of \$250 million.
17. Of the existing \$750 million uncalled capital facility, \$358 million remains uncalled following drawdowns of \$43 million in June 2016, \$100 million in September 2016, \$122 million in December 2016, and \$93 million in March 2017.

Claims settlement progress

18. By 31 March 2017, 86.2% of Southern Response's reported overcap claims had been fully settled (a total of 6,908 claims). In the 9 months to 31 March 2017 the company settled 912 claims (48% of those outstanding at 1 July 2016).
19. More comprehensive data as at 31 March is still to be released but as at 31 December 2016, 741 of the 1,324 claims then remaining were either under construction or in the design and documentation phase. The breakdown of claims at 31 December 2016, by status, is shown in the figure below:



20. Southern Response's projections in December were for all but a few claims to be settled by October 2018. However, there continues to be a flow of AMI claims previously on EQC's books moving overcap and transferring to Southern Response. This makes it less likely that Southern Response will completely settle all of its claims before the end of calendar year 2018.
21. To maintain momentum and to properly discharge the Crown's responsibilities, EQC has been working with Southern Response (as it has with private sector insurers) to gain greater visibility of the remaining claims on EQC's books which may go overcap.
22. Southern Response and EQC have progressed these joint arrangements further than others, and the two entities have been considering the benefits of increased Southern Response involvement to accelerate the pace of claims settlement.
23. The two have been working on a Memorandum of Understanding (MOU) to enable Southern Response to have an even more active involvement at an earlier stage with respect to AMI claims on EQC's books. This MOU is based on the Kaikoura MOU and a version with final edits was sent to EQC last Friday for their comments. Subject to any issues EQC may come back with, Southern Response management advise it hopes to get the MOU to Southern Response's board meeting in April.
[25], [37], [38]

Liabilities valuation and key drivers

24. Southern Response's outstanding claims liabilities were valued at \$776 million as at 31 December 2016. Including claims already settled, the central estimate for all overcap claims was \$3,172 million, \$1,015 million higher than the estimate in June 2012. The main drivers of this increased liability include an increase in notified overcap claims from 6,527 in June 2012 to 7,972 in December 2016 (an increase of 22%), initial under-recognition of hidden damage – especially in terms of land conditions and underfloor damage – the benefits of experience on technical complexities and building design gained over time, and a court decision requiring the subsequent inclusion of professional fees and contingencies in cash settlements. Public disclosures by the private sector insurers show trend increases in their expected ultimate claims liability have been at least as great as Southern Response has experienced.
25. There has been a substantial flow of newly reported overcap claims from EQC. For example, Southern Response records show 944 newly reported overcap claims between 30 June 2014 (when there were 7,028 notified overcap claims) and 31 December 2016. The level of notified overcap claims at 30 June 2014 compares with 6,908 claims Southern Response had settled as at 31 March 2017.
26. Southern Response's 31 December 2016 liability valuation includes the 1,324 remaining claims known to be overcap (many of which are in progress) and a
[25], [37] that the independent actuary expected to come from EQC in the future. This figure is likely to increase once further work has been undertaken.
27. [25], [37], [38]

high risk list. Southern Response expects

to largely complete its preliminary assessment of claims on EQC's books prior to 30 June 2017.

28. Southern Response's remaining claims are increasingly complex and expensive to settle. This is due to technical and other challenges that are sometimes specific to only a few properties (and therefore not easily anticipated) but spanning a wide range of issues including difficult land conditions (potentially requiring substantial foundation work), construction-related issues (including difficult sites) or customer fatigue and disputes. These are all leading to higher average costs for settling the remaining claims.
29. These issues, of flow from EQC and complexity, have driven upward revisions to the outstanding claims liability. For example, the latest quarterly valuation to 31 December 2016 saw the valuation rise \$189 million, mainly due to
 - An increase in the estimate for newly reported overcap claims in the future (\$98 million)
 - Escalation in design and land remediation costs and the emergence of higher variations during the construction process due to complexities with the rebuild or repair (\$57 million)
 - An increase in estimates for cash settlements which reflect the increasing proportion of claims with complex issues (\$18 million).
30. The outstanding claims liability valuation as at 31 March 2017 is now being prepared and will be considered by the Southern Response board this month. The Treasury has advised that following discussions it has had with management, the trends of rising expected flow from EQC and increasing complexity will have a further impact this quarter. [25], [37]

these factors, we consider it prudent to provide an additional \$250 million in capital.

31. In the event that fewer claims go overcap or the remaining per claim costs fall short of the amount appropriated, then the uncalled capital facility would not be drawn down and appropriated funds will remain with the Crown.

Consultation

32. The Treasury and Southern Response have worked together to ensure that we and Cabinet are well informed in making this decision. The Treasury has informed the company that this paper was being prepared for submission to Cabinet.

Financial Implications

33. Two appropriations are needed. The first for the subscription of shares in the company, and the second for the impairment expense that is recognised after making the investment.
34. At the time when the company is likely to make a call on the Uncalled Capital Facility, a capital expense will be recognised and an appropriation that provides for this need to be in place. The remaining amount is disclosed as a contingency.

35. The additional investment in Southern Response is written down immediately as recovery is deemed unlikely.
36. The effects on the Crown's financial accounts of appropriations to provide for an increase in the uncalled capital facility by up to \$250 million are outlined below:
 - a. There is no impact on the operating balance or the balance sheet directly. Instead this is captured when Southern Response forecasts its operating results
 - b. The impact on core Crown net debt occurs progressively as Southern Response makes calls on the facility, and
 - c. Consistent with the treatment in previous years, there is no impact on the between-Budget contingencies or Budget allocation, as this represents a valuation change relating to an existing liability rather than a new policy decision.

Human Rights

37. The proposal is not inconsistent in any way with the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993.

Legislative Implications

38. This proposal has no legislative implications.

Regulatory Impact Analysis

39. The RIA requirements do not apply.

Gender Implications

40. There are no gender implications.

Disability Perspective

41. There is no disability perspective on this proposal.

Publicity

42. The increase in capital for Southern Response will be made public in the Budget. If Cabinet approves the recommendations in this paper, this will increase the total amount the Crown has set aside to enable Southern Response to settle the Canterbury earthquakes-related claims of AMI residential policyholders to \$1.5 billion. This is expected to generate public interest. The publicity will be managed as part of the proactive release of Budget documents.

Recommendations

43. We recommend that the Committee:

- 1 **agree** to provide for additional support to Southern Response Earthquake Services (Southern Response) to settle the outstanding claims of AMI policy holders arising from the Canterbury earthquakes;
- 2 **note** that when the investment in Southern Response is made, it will be immediately impaired as recovery of that investment is considered unlikely;
- 3 **authorise** the Minister of Finance and Minister supporting Greater Christchurch Regeneration to enter into a further amendment and restatement of the Crown Support Deed to extend the existing uncalled capital facility by \$250 million;
- 4 **note** the impact on core Crown net debt occurs progressively as Southern Response makes calls on the facility;
- 5 **authorise** the Minister of Finance and Minister supporting Greater Christchurch Regeneration to delegate to the Treasury the authority to authorise and pay calls on the facility, when those calls are accompanied by satisfactory documentation as required under the existing uncalled capital facility;
- 6 **approve** this Budget initiative in Vote Finance for inclusion in the 2017 Budget package;
- 7 **agree** to increase expenditure to provide for costs associated with the policy decision in recommendations 1 and 3 above with the following impacts on the operating balance and net core Crown debt:

	\$m – increase/(decrease)				
	2016/17	2017/18	2018/19	2019/20	2020/21 & Outyears
Operating balance Impact	-	-	-	-	-
Debt Impact	250.000	-	-	-	-
No Impact	250.000	-	-	-	-
Total	500.000	-	-	-	-

- 8 **agree** to the following changes to appropriations to give effect to the policy decision in recommendations 1 and 3 above to increase the Crown's support for Southern Response:

	\$m – increase/(decrease)				
	2016/17	2017/18	2018/19	2019/20	2020/21 & Outyears
Vote Finance					
Minister Supporting Greater Christchurch Regeneration					
Non-Departmental Capital Expenditure:					
Southern Response Earthquake Services Ltd: Equity Investment	250.000	-	-	-	-
Non-Departmental Other Expense:					
Impairment of Investment in Southern Response Earthquake Services Ltd	250.000	-	-	-	-
Total Operating	250.000	-	-	-	-
Total Capital	250.000	-	-	-	-

- 9 **agree** that the proposed changes to appropriations for 2016/17 above be included in the 2016/17 Supplementary Estimates and that, in the interim, the increases be met from Imprest Supply;
- 10 **agree** to the in-principle expense and capital transfers of any 2016/17 underspend into 2017/18;
- 11 **note** that there is no impact on the between-Budget contingencies or Budget allocation, as consistent with previous years as this is a valuation change relating to an existing liability; and
- 12 **note** that the operating balance impact of the above transaction has been captured separately through the forecasts for Southern Response.

Hon Steven Joyce
Minister of Finance

Hon Gerry Brownlee
Minister supporting Greater Christchurch Regeneration

Date:

Date: