

# The Treasury

## Mixed-use Buildings Under the Earthquake Commission Act 1993 Information Release

February 2021

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## **In Confidence**

Office of the Minister Responsible for the Earthquake Commission

Chair, Cabinet Economic Development Committee

# **MIXED-USE BUILDINGS UNDER THE EARTHQUAKE COMMISSION ACT**

## **Proposal**

1. This paper seeks agreement to proposed amendments to the Earthquake Commission Act 1993 (EQC Act) to be introduced in 2020. The amendment will focus on EQC cover of mixed-use buildings, and the EQC Act definition of 'residential building', which is a key determinant of the extent of EQC cover provided for a building. The amendments intend to ensure that the EQC Act equitably accounts for homeowners'<sup>1</sup> use of, and interest in, common areas in mixed-use buildings.

2. [33]

This paper

sets out the proposed amendments to be progressed through the Bill, with a focus on the coverage of mixed-use buildings under the EQC Act, and the Act's definition of 'residential building'.

3. I previously noted my intention to progress this work as part of reporting on the Treasury's analysis on property insurance markets (DEV-19-Min-0332 and CAB-19-MIN-0675 refer).

## **Relation to government priorities**

4. Issues around the residential building test and eligibility for EQC cover are becoming more salient due to wider changes in property insurance markets. More granular risk-based pricing by insurers and earthquake strengthening requirements are adding to financial pressures for homeowners of mixed-use buildings.
5. There is a risk that these pressures will undermine other initiatives to incentivise higher density urban development and living, such as the proposed National Policy Statement for Urban Development under the Resource Management Act 1991, and related work being progressed through the Urban Growth Agenda and Kāinga Ora. Initiatives such as these are a critical part of transforming our housing market to unlock productivity and growth and make houses more affordable.<sup>2</sup>

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<sup>1</sup> This paper uses the term 'homeowners' to refer to owners of residential dwellings in a mixed-use building.

<sup>2</sup> This is one of the key shifts set out in the government's Economic Plan.

## Executive Summary

6. The EQC scheme provides a capped level of insurance to owners of residential buildings and dwellings (such as apartments) in primarily commercial buildings.<sup>3</sup> The EQC scheme has two core elements:
  - 6.1. the scope of insurance cover provided by EQC to homeowners, and
  - 6.2. the manner by which EQC determines eligibility for that insurance cover.
7. I propose that both these elements of the EQC scheme should be amended through a targeted Bill to ensure that the EQC Act equitably accounts for homeowners' use of, and interest in, common areas in mixed-use buildings.
8. These changes are important in order to help ensure homeowners in mixed-use buildings are receiving an equitable amount of cover from EQC, and to help alleviate the financial pressures on homeowners in mixed-use buildings that are being exacerbated by changes in property insurance markets.
9. I propose that EQC cover for residential property in a primarily commercial mixed-use building be extended to take a "proportional" approach to covering common areas, which would currently not be covered by EQC. That is, in addition to the dwellings, appurtenant structures, and services already covered by EQC, EQC should also cover a proportion of the common areas in accordance with the residential share of the building.
10. Additionally, I propose that the residential building test set out in the EQC Act, which is used to determine whether a building is eligible for full EQC cover, be aligned with this increased scope of EQC cover. The proposed changes will improve the test by ensuring it accounts for appurtenant structures (which are already covered by EQC), as well as residential use of common areas in mixed-use buildings. Aligning the residential building test with EQC cover will also help to clarify the test and its relationship to EQC cover.

## Background

### *Broader changes in property insurance markets are putting pressure on homeowners*

11. Changes in property insurance markets are affecting mixed-use buildings. Residents are facing increasing premiums that appear to be caused by more granular risk-based pricing by insurers in the wake of earthquake events in Christchurch and Kaikōura. Earthquake strengthening requirements, while essential for our national resilience, are also adding to this mounting financial pressure for homeowners of such buildings.

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<sup>3</sup> This paper uses the term 'commercial' to refer to buildings and areas within mixed-use buildings that are non-residential under the EQC Act. Non-residential areas in mixed-use buildings may not necessarily be commercial in nature, for example these can also include not-for-profits or incorporated societies.

12. Government insurance cover provided by EQC can make a significant financial difference to homeowners in the wake of a natural disaster event. I am mindful of the importance of ensuring that incentives are strong for developing and building resiliently in the right places, and ensuring there is adequate signalling of risk via insurance premiums. However, in my view it is also important to ensure that homeowners of mixed-use buildings are getting EQC cover appropriate to the residential use of the building, particularly in the context of government's broader wellbeing and urban development objectives.
13. The proposed changes alone are unlikely to significantly address insurance affordability and availability concerns in high risk areas such as Wellington, due to the limited number of buildings that are expected to be affected. Related work is underway across government to consider insurance affordability and availability issues more broadly.

*The Earthquake Commission scheme provides cover to insured homeowners*

14. The EQC scheme provides a capped level of insurance to help insured homeowners to recover in the event of a qualifying natural disaster.
15. There are two different but related concepts at the core of the EQC scheme. These are:
  - 15.1. the scope of insurance cover provided by EQC to homeowners, and
  - 15.2. the manner by which EQC determines eligibility for that insurance cover.

*A residential building test determines which buildings qualify for full EQC cover*

16. Under the EQC Act, to qualify for EQC cover over a whole building (up to the capped amount), at least 50% of the building's floor area must be dedicated to dwellings.<sup>4</sup> This is referred to as the 'residential building test'. If the building is below that threshold (i.e., primarily commercial), EQC will only cover the parts of the building comprising:
  - 16.1. dwellings
  - 16.2. appurtenant structures (such as storage lockers and car parks associated with the dwellings), and
  - 16.3. associated services (such as sewerage pipes).
17. The residential building test becomes most relevant where a building is a mixed-use building. That is, a building that serves both residential and commercial purposes, such as a multi-unit, multi-storey building with offices or retail space on lower floors and apartments on upper floors.
18. This test is an important tool for ensuring EQC does not provide full building cover for buildings that are largely commercial. This would be inconsistent with the policy goals of the EQC scheme, which focus on residential property.
19. Most mixed-use buildings are either clearly residential (>50%) or clearly commercial (<50%). It is only in a few cases where buildings fall either side of, and are close to the 50% threshold, that the current residential building test can become problematic.

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<sup>4</sup> EQC cover is currently capped at \$150,000 (excluding GST) per dwelling disclosed to the private insurer.

*Being classified as a residential building under the EQC scheme has advantages*

20. Being a residential building under the EQC scheme has advantages, as EQC cover then applies to natural disaster damage to the entire building. EQC cover also applies to associated residential land.
21. In contrast, within a primarily commercial building, private insurers will cover commercial units and common areas with EQC only covering the dwellings, associated appurtenant structures or services within the building and associated residential land. The terms and conditions associated with private commercial insurance policies may be significantly different to those provided under the EQC scheme. For example, higher insurance excesses for damage.
22. Further, there is greater complexity in allocating the cost of the repair between EQC and the private insurer in cases where insurers and EQC cover different parts of a building. It can be difficult to identify which damage is covered by EQC, or by the private insurer.

**Problem definition**

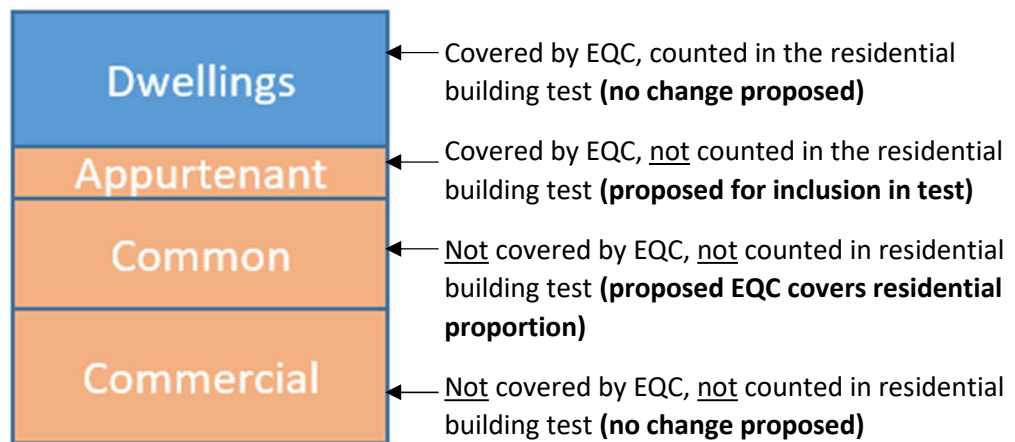
*The design of the current residential building test seems to result in inequitable outcomes*

23. Under the current definition of 'residential building' in the EQC Act, common areas and appurtenant structures<sup>5</sup> in a mixed-use building are excluded from the calculation of residential floor area when determining whether a building is at least 50% residential.
24. Stakeholders, particularly affected homeowners, have raised concerns that this approach is not an equitable representation of the actual residential ownership or use of a mixed-use building. They are concerned that the test does not take into account homeowners' use of, and interest in, areas outside of a dwelling in a mixed-use building. For example, homeowners will often need access to areas such as carparks, storage lockers and lobbies in order to make apartment living practicable.
25. Further, fully excluding appurtenant structures and common areas from being 'residential' in the residential building test means that these areas are effectively counted in the commercial share of the building, because dwellings (like apartments) need to make up at least 50% of the floor area of the building. This means that these areas, despite being used by residents who may also have an ownership interest in them, can actually make it more difficult to pass the residential building test by adding to the non-dwelling/commercial floor area in the building (Figure 1 demonstrates this effect).

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<sup>5</sup> EQC practice takes 'appurtenant' to be that it belongs to the dwelling, in a way that is ancillary, i.e., ownership interest and used for household purposes; see section 1.3, page 6 of the EQC insurers' guide: [https://www.eqc.govt.nz/sites/public\\_files/documents/EQCover/EQCover-Insurers-Guide-Feb2019.pdf](https://www.eqc.govt.nz/sites/public_files/documents/EQCover/EQCover-Insurers-Guide-Feb2019.pdf)

**Figure 1: Example of a mixed-use building where appurtenant structures and common areas contribute to the commercial proportion of the building (residential area is blue, commercial area is orange). Note the residential proportion of the building must make up 50% of the entire building to qualify for full EQC cover.**



### The current residential building test is difficult to understand

26. By excluding common areas and appurtenant structures, the current residential building test creates a misalignment between what areas are considered 'residential' for the purposes of the residential building test, and what areas are considered residential for the purposes of EQC cover (which includes dwellings, appurtenant structures, and services).
27. This misalignment makes the test difficult to understand, and stakeholders have expressed confusion around how the residential building test applies and its implications for EQC cover. Through the consultation process, a lack of understanding was apparent among brokers, insurers and residential property owners regarding the test as it relates to mixed-use buildings.
28. Officials have advised me that while this lack of clarity is in part due to the confusing nature of the test itself, it is also exacerbated by a lack of clear guidance and public information about the residential building test, and particularly about how to navigate the test in more ambiguous situations where a building is not clearly over or under the 50% threshold.
29. Consequently, improved public information and guidance from EQC could go some way in addressing these issues, particularly by clarifying the workings of the residential building test and its distinction from EQC cover. However, legislation is required to change which areas are counted in the residential building test, as the relevant concepts relating to EQC cover and the residential building test are set out in the EQC Act.

### Extending EQC cover for primarily commercial buildings

30. The most significant change I propose is the extension of EQC cover in the event that a mixed-use building does not meet the 50% threshold in the residential building test.
31. Currently, EQC will only cover the following components of a primarily commercial building:
  - 31.1. the dwelling(s)
  - 31.2. appurtenant structures used for household purposes, and
  - 31.3. services (e.g. drainage, sewerage, etc.).
32. I propose that, in addition to these existing components of a mixed-use building that are covered by EQC, for primarily commercial buildings EQC cover should also extend to the residential proportional share of the common areas. This proportional approach recognises that residents have some interest in the common property in a mixed-use building, regardless of whether the building meets the 50% threshold.
33. Extending EQC cover in this way will likely increase the cover and compensation from EQC to homeowners in primarily commercial buildings in the wake of a natural disaster event. This could be the case for minor, moderate, or significant events for various reasons. For example, this could range from minor cosmetic damage to a large common area, or structural damage to a common building element that is currently not considered residential.

### Implementing a more equitable residential building test

34. My proposal to amend the residential building test is based on aligning the test with the extended scope of EQC cover. In taking a proportional approach to the residential building test, the test would make a direct comparison of the residential and commercial floor areas in the building, and then in effect allocate common area to the residential area on a pro-rata basis. This means:
  - 34.1. the area of the **dwelling** would be allocated to the residential area (status quo)
  - 34.2. the area of the **appurtenant structures** such as resident carparks and storage areas would also be allocated to the residential area (these areas are, in effect, allocated to the commercial area under the status quo), and
  - 34.3. a **proportion of the total common area** would in effect be allocated to the residential area (these are allocated to the commercial area under the status quo).
35. The practical effect of this approach would be a more equitable residential building test, as it will better account for the residential use of a building. Further, some increase in the floor area that is counted in the 50% test will likely cause some currently commercial buildings to become residential, therefore extending EQC cover to the entire building and associated land.

### Ensuring EQC does not take on undue commercial liability

36. I have considered whether, instead of the proposed 'proportional approach', all common areas used by the residents could be counted as residential for the residential building test. This would mean that common areas would contribute to the residential proportion of the building, rather than the commercial as is the status quo.

37. I have decided against this approach primarily because of the risk that including all common areas could enable some buildings to qualify as 'residential' that include substantial amounts of commercial space. For example, hotels with some permanent residents could become eligible for EQC cover over the whole hotel, if large shared spaces such as lobbies and extensive common areas are considered residential.
38. In my view, including all common areas would create an inequitable effect for mixed-use buildings as it would over-represent the residential proportion of the building. As the purpose of the EQC scheme is to provide cover for residential property, it is important to note that the purpose of the residential building test is not only to ensure homeowners get adequate cover from EQC, but also to ensure EQC does not take on undue commercial liability.

### **Expected beneficiaries**

39. As most mixed-use buildings are either clearly residential (>50%) or clearly commercial (<50%), it is likely that only a small number of buildings will be affected by these proposed changes.
40. The primary beneficiaries of the policy change are expected to be:
  - 40.1. homeowners whose buildings are commercial under the current residential building test and become residential under a new test, and
  - 40.2. homeowners in primarily commercial buildings under the proposed definition who receive increased cover from EQC due to the new inclusion of the residential share of common areas.
41. The primary effects for homeowners whose buildings change from commercial to residential would likely be:
  - 41.1. EQC accepting claims for damage in common and commercial areas of the building (transfer of liability)
  - 41.2. a lower private insurance claims excess on damage outside areas currently covered by EQC, and
  - 41.3. EQC covering more of the associated land, as residential buildings receive additional land cover from EQC.
42. By enabling more buildings to meet the residential building test, EQC would cover a greater proportion of the natural disaster risk for mixed-use buildings.
43. The primary effects for homeowners whose buildings remain classified as 'commercial' is that EQC would now cover a proportion of damage in common areas of the building that EQC would not previously have covered.
44. These changes are important in helping ensure homeowners in mixed-use buildings are receiving an equitable amount of cover from EQC, and to help alleviate the financial pressure on homeowners in mixed-use buildings that are being exacerbated by changes in property insurance markets.

### **Related work underway to support insurance affordability and availability**

45. Issues around the residential building test and eligibility for EQC cover are becoming more salient due to wider changes in property insurance markets. More granular risk-based pricing by insurers and earthquake strengthening requirements are adding to financial pressure for homeowners of mixed-use buildings.



46. These market and regulatory changes mean there is more at stake in cases where a building does not meet the 50% threshold in the residential building test, and consequently does not receive full cover by EQC. With insurance costs rising, the potential reduction in excesses that can come from being fully covered by EQC can make a significant financial difference to homeowners in the wake of a natural disaster event.
47. Other work is already underway across the public and private sectors to help alleviate financial pressures on multi-unit buildings, including mixed-use buildings. This includes:
  - 47.1. policy advice by the Treasury on options for changes to the Earthquake Commission (EQC) cap <sup>[33]</sup>
  - 47.2. Cabinet Business Committee approval of the Residential Earthquake Prone Building Financial Assistance Scheme. This Scheme will provide low cost loans to owner occupiers of units in earthquake prone buildings who meet the hardship criteria described in the Scheme settings
  - 47.3. development of guidance by the Ministry of Housing and Urban Development (MHUD) on how body corporates can comply with the requirement under the Unit Titles Act 2010 to insure buildings to full insurable value, and
  - 47.4. engagement between the Insurance Brokers Association New Zealand and the Insurance Council New Zealand on regulatory expectations around product design and communication with customers. This is likely to include discussion on ensuring body corporates are well-informed about premium increases and have sufficient notice periods before policy renewals.

#### **Relationship to the Fire and Emergency New Zealand levy**

48. The current Fire and Emergency New Zealand Act 2017 uses the definition of 'residential building' in the EQC Act to calculate the Fire and Emergency New Zealand (FENZ) levy.<sup>6</sup> The levy regime is therefore linked to the EQC Act definition for the duration of the transitional period for the FENZ Act (currently, until 1 July 2024).<sup>7</sup> The Minister of Internal Affairs has asked that a savings provision be included in the Bill so that the current EQC Act residential building definition continues to apply for the FENZ levy.

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<sup>6</sup> cl 24, Schedule 1, Fire and Emergency New Zealand Act 2017

<sup>7</sup> The Fire and Emergency New Zealand (Levy) Amendment Act 2019 passed into legislation on 7 May 2019 and changed the commencement date for new levy provisions in the Fire and Emergency Act 2017 (sections 80 to 140) to 1 July 2024.

## **Implementation**

49. Should Cabinet agree to the proposed amendments to the EQC Act as set out in this paper, I propose the following timing for the legislation:
  - 49.1 Drafting instructions to PCO: March 2020
  - 49.2 LEG and Cabinet for approval and introduction: May 2020
  - 49.3 Introduction of the Bill: May 2020
  - 49.4 Select Committee report back: Early 2021
  - 49.5 Date of enactment: Early 2021
  - 49.6 Date of commencement: 1 June 2021.
50. The proposed amendments will commence from 1 June 2021, to align with renewal of EQC reinsurance contracts, which will need to be renegotiated in line with the new rules. The new rules will apply to individual buildings as individual insurance policies are renewed or new contracts are entered into, so that private insurers have the opportunity to price premiums based on the changes.

## **Review of the EQC Act**

51. A broader review of the EQC Act has already started and is planned to continue during 2020 and 2021. It will be informed by the Public Inquiry into EQC, which is due to report on 27 March 2020. The review is intended to consider design features of the EQC, and the impact of this proposed amendment would be considered as part of that wider work.
52. Amending the EQC Act to better provide for mixed-use buildings should take place ahead of the review to ensure homeowners have access to adequate cover from EQC should a natural disaster event occur prior to the implementation of broader changes to the Act.

## **Financial Implications**

53. The Treasury and EQC have informed me that implementing this proportional approach to common areas would not affect the EQC cap,<sup>8</sup> nor the EQC levy. The proposals would only have financial consequences for EQC following a significant natural disaster event, as the amount EQC would pay in a claim for primarily commercial buildings would increase where there was damage to common areas not previously covered by EQC.
54. Due to data limitations, EQC is unable to model the financial impacts of this change, but expects it would be an increase in compensation paid compared to the status quo. The increased EQC entitlements (and hence costs) will be significant for some affected building owners. However, as the change is expected to affect a very small fraction of buildings insured by EQC, the increase in costs is expected to be very small as a proportion of total EQC claims.

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<sup>8</sup> The EQC cap would continue to be calculated based on the number of residential dwellings within a building disclosed to

55. I am comfortable with the increased liability for EQC as it is consistent with the intent of the EQC Act, which is to provide cover for insured homeowners, including owners of dwellings in mixed-use buildings that are primarily commercial.

### **Legislative Implications**

56. Legislation is required to give effect to the proposed changes, as the relevant concepts are described in the EQC Act.
57. [33]
58. The current Act was amended in February 2019. This proposal is required if the proposed changes are to be in place if a significant claims event occurs while the more extensive EQC legislative review processes are still under way (that longer process is likely to take several years).
59. The Bill's provisions are expected to be binding on the Crown. (The current EQC Act is binding on the Crown).

### **Impact Analysis**

#### *Regulatory Impact Statement*

60. The impact statement requirements apply to proposals in this paper. An impact statement has been prepared and is attached as Annex 1.
61. A quality assurance panel with representatives from the Treasury has reviewed the 'Coverage of mixed-use buildings under the Earthquake Commission Act' Regulatory Impact Statement (RIS) prepared by the Treasury and dated 5 March 2020.
62. The panel considers the RIS meets the quality assurance criteria.

#### *Climate Implications of Policy Assessment*

63. The Ministry for the Environment has been consulted and confirm that the Climate Implications of Policy Assessment (CIPA) requirements do not apply to this proposal as the threshold for significance is not met.

### **Population Implications**

64. There are no specific population implications of the proposals in this paper.

### **Human Rights**

65. There are no human rights implications of the proposals in this paper.

## **Consultation**

66. The Treasury undertook targeted stakeholder consultation on this issue and the available options over December 2019 to early January 2020.
67. Those consulted included EQC, Ministry of Housing and Urban Development (MHUD), Department of Internal Affairs (DIA), Insurance Council of New Zealand, IAG NZ, AON NZ, the Body Corporate Chairs Group, Survey and Spatial New Zealand (formerly New Zealand Institute of Surveyors), New Zealand Institute of Valuers, Wellington City Council, Crombie Lockwood, and the Marion Square Body Corporate.<sup>9</sup>
68. Stakeholders presented a range of differing views on the topic and various options, but were broadly supportive of the policy intent. The views expressed by stakeholders have informed the Treasury's analysis and my decisions.
69. EQC, MHUD, DIA, MBIE and the Parliamentary Counsel Office have been consulted on this paper.

## **Communications**

70. I intend to announce my intention to introduce an Earthquake Commission Amendment Bill, subject to Cabinet agreement to the proposals set out in this paper.

## **Proactive Release**

71. A version of this paper, along with key advice papers received from the Treasury on the coverage of mixed-use buildings under the EQC Act, will be published on the Treasury's website following Cabinet agreement to the proposals set out in this paper. These papers will be published subject to withholdings that are consistent with the Official Information Act 1982.

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9 The Marion Square Body Corporate made a submission on the issue of non-residential mixed-use to the Select Committee that considered the Bill that became the Earthquake Commission Amendment Act 2019.

## Recommendations

I recommend that the Committee:

### Policy

1. **note** the EQC scheme provides a capped level of insurance cover (EQC cover) to allow insured homeowners to recover in the event of a qualifying natural disaster;
2. **note** that to qualify for EQC cover over a whole building, at least 50% of the building's floor area must be dedicated to dwellings (residential building test). If a building is below that threshold, cover will only be for the parts comprising the:
  - 2.1. dwellings
  - 2.2. appurtenant structures (such as storage lockers and car parks associated with the dwellings), and
  - 2.3. associated services (such as sewerage pipes).
3. **note** that the current residential building test and EQC cover settings do not fairly reflect the homeowners' use of, and interest in, a mixed-use building, because:
  - 3.1. the residential building test only takes into account the floor area of the dwellings themselves, and not the appurtenant structures or common areas the homeowners have use of and an interest in, and
  - 3.2. if the residential building test is not met, no cover is provided for common areas that the homeowners have use of and an interest in.
4. **agree** to amend the residential building test to account for the floor area of the dwellings, appurtenant structures, and the homeowners' proportionate interest in common areas;
5. **agree** that where a building is below the 50% threshold in the residential building test, EQC cover will extend to common areas on a proportionate basis, determined using the residential floor area in the building;
6. **note** that, as most mixed-use buildings are either clearly above or below the threshold in the residential building test, it is likely that only a small number of buildings will be affected by the proposed change to that test;
7. **note** that a savings provision will be included in the Bill so that the current residential building definition in the EQC Act continues to apply for the Fire and Emergency New Zealand levy;

### Fiscal

8. **note** that the proposals have no impact on EQC levy revenues. In a significant natural disaster event, they will increase the expected value of claims settlements;
9. **note** that the proposals have no fiscal effects for operating balance, total Crown cash flows or core Crown net debt (assuming no significant natural disaster events);

## Legal

10. [33]
11. **invite** the Minister Responsible for the Earthquake Commission to issue drafting instructions to the Parliamentary Counsel Office to give effect to the above proposals by amendments to the EQC Act and any other legislation requiring consequential amendment as a result of the changes proposed in this Cabinet paper;
12. **authorise** the Minister Responsible for the Earthquake Commission to make decisions on transitional provisions and other policy matters that arise as the Bill is drafted;
13. **invite** the Minister Responsible for the Earthquake Commission to bring a draft Earthquake Commission Amendment Bill to Cabinet Legislation Committee;
14. **note** the Minister Responsible for the Earthquake Commission's intention to introduce an Earthquake Commission Amendment Bill in May 2020;

## Communications

15. **note** the Minister Responsible for the Earthquake Commission will announce his intention to introduce an Earthquake Commission Amendment Bill, subject to Cabinet agreement to the proposals set out in this paper.

Authorised for lodgement

Hon Grant Robertson  
Minister of Finance  
Minister Responsible for the Earthquake Commission