The Treasury

Material Provided to the Public Inquiry into EQC Information Release

August 2021

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[31] 9(2)(f)(ii) - to maintain the current constitutional conventions protecting collective and individual ministerial responsibility

[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment;

[36] 9(2)(h) - to maintain legal professional privilege

[37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

[38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

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CROWN OWNERSHIP MONITORING UNIT

Treasury Report: Increasing the EQC Levy

Date:	1 June 2011	Report No:	T2011/1202

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Agree** to recommendations	Friday 10 June 2011

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Andrew Blazey	Manager, Commercial Transactions Group	[39]	[23]	✓
Juston Anderson	Senior Analyst, Commercial Transactions Group	[39]	[23]	

Minister of Finance's Office Actions (if required)

None.

Enclosure: **No**

Treasury Report: Increasing the EQC Levy

1. You have asked for some advice on what level the EQC levy could be set at, should you decide to increase it.

Principles

2. We suggest that in considering an increase to the EQC levy, the following principles should be kept in mind:

   - the levy should recover the expected long-term cost to the Crown of providing natural disaster insurance via the EQC, and should only change if that cost has changed;
   - the levy should be set on a long-run basis. We do not think that frequent changes in the levy are either required or desirable; and
   - the levy should exceed EQC's annual operating costs, so that part of the levy is being set aside to cover the cost of future claims.

Increases in Reinsurance Costs

3. The table below shows EQC's financials for 2009/10, the last full year before the Canterbury earthquakes.

	$m
Reinsurance purchase	39
Operating costs	13
Crown underwriting fee	10
Total (excluding claims costs)	62
Claims costs	46
Total expenses	**108**

EQC levy	86
Investment income	377
Total revenue	**463**

Net surplus (increase in NDF)	**355**

4. As the table shows, EQC's levy revenue exceeded expenses (excluding claims costs) by around $24 million in 2009/10. However, EQC's investment income was responsible for EQC's surplus of $355 million.

5. Based on current pricing information from overseas reinsurers, EQC estimates that it will need to spend around $60 million on purchasing the same level of reinsurance cover in 2011/12. If current prices are sustained, and EQC purchases the same reinsurance cover in the future, the cost of doing so will increase to approximately $80 million in 2012/13 and $100 million 2013/14.

6. As a result, assuming EQC's expenses other than reinsurance do not change significantly[1], EQC's total expenses (excluding claims) will increase by around 33% in 2011/12, 66% by 2012/13 and 100% by 2013/14.

7. In 2011/12 the current EQC levy would approximately match EQC's expenses (excluding claims costs). In 2012/13 the levy would only be slightly higher than EQC's reinsurance purchase costs, and by 2013/14 it would not be sufficient to fund the reinsurance purchase, let alone help cover EQC's operating costs. Therefore, increases in the Natural Disaster Fund (NDF) would come only from investment income on the Fund's assets (which will be halved relative to the pre-quake position, given the NDF will reduce from around $6 billion to around $3 billion once all claims from the Canterbury earthquakes are settled).

8. Given this, an increase in the levy could be justified when taking a medium term view. However this needs to be considered against:

   - the fact that future reinsurance prices are unknown and could change;
   - EQC may choose to purchase less reinsurance in future, or purchase reinsurance with a larger excess, if recent price increases are sustained; and
   - a review of the EQC scheme appears inevitable (and desirable) in light of the Canterbury earthquakes.

Changes in Reinsurance Prices

9. Because of the way that EQC has structured its past reinsurance purchases, price changes are smoothed for the next three years rather than impacting EQC immediately. Beyond that, EQC's price smoothing arrangements will no longer be in place and so reinsurance price changes will impact EQC immediately.

10. However, we do not think that annual increases in the EQC levy for the next three years would be desirable. The EQC levy should reflect the long-term cost to the Crown of natural disaster insurance, and therefore should change relatively rarely, rather than be subject to annual adjustments.

11. Historical experience suggests that reinsurance premiums increase significantly following major natural disasters, but then over time decline due to competition between reinsurers. Therefore, if there are no further major natural disasters, the reinsurance prices that EQC is facing for next year may not be sustained in future years. And, as noted above, if they are sustained the EQC might choose to purchase less reinsurance.

12. These factors suggest not locking in an increase in the EQC levy now based on what EQC's reinsurance costs might be in three years' time.

Possible Review of the EQC

13. It is likely that the natural disaster cover provided by the EQC will be changed as a result of lessons learned from the Canterbury earthquakes. Any changes to EQC's coverage should be reflected in changes to the EQC levy.

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[1] Both claims payments and administration costs relating to the Canterbury earthquakes should be met by EQC's reinsurance, providing the gross cost to EQC of either earthquake does not exceed $4 billion.

14. We haven't yet given much thought to the preferred timing for any review of the EQC, as we think it is still too early to begin a review. However, we think mid 2014 would be a reasonable guess for when changes to the EQC scheme might come into effect:

- a review might start in, say, mid 2012. At this point most policy decisions relating to the rebuild of Christchurch should have been taken;
- by 2012 the government should also be in a better position to assess the strengths and weaknesses of EQC policy settings as a result of the Canterbury earthquakes, and to properly evaluate EQC's operational response;
- a review might take 6 to 12 months to complete, depending on the potential for public input. That would put completion of the review some time in 2013; and
- a further, say, 12 months might be required for Cabinet decisions and legislative change – putting the start date for policy changes in roughly mid 2014.

15. It is hard to see a wide-ranging review of EQC policy settings being completed significantly earlier than this, and easy to imagine that it could take longer, particularly if fundamental changes are proposed.

16. We would argue against making changes to EQC policy settings ahead of a wide-ranging review; we think a fundamental review, looking at all aspects of EQC's policy and operations (and potentially private insurance for natural disasters) is required in light of the Canterbury earthquakes.

Conclusion

17. Given the above points we suggest that if you want to increase the EQC levy:

- the increase is justified based on the expected increase in EQC's total operating costs (excluding claims) over the next three years, which is driven by an expected increase in reinsurance prices;
- the increase is also justified by the approximately 50% reduction in the size of the NDF, once all claims from the Canterbury earthquakes are paid, and therefore the approximately 50% reduction in the EQC's investment income from the NDF; and
- an increased levy rate is set now to apply for the next three years (i.e. to mid 2014) with a commitment that it will not change during that period, and with any changes beyond that point subject to a review of EQC policy settings (with the timing and content of that review to be decided).

18. Therefore, we suggest you consider increasing the EQC levy by 50% to 7.5 cents per $100 of coverage. This would mean an annual EQC levy of $103.50 including GST, up from the current $69 including GST.

19. This new EQC levy should result in EQC having a surplus of levy revenue over operating costs (excluding claims payments) of around $25 million in 2011/12 (assuming the increased levy applies from 1 September, as discussed below) falling to a surplus of around $5 million by 2013/14 – i.e. part of the EQC levy is being set aside to cover the cost of future claims.

Impact on the NDF

20. Under current settings, we estimate that the NDF will grow to around $6 billion of assets by around 2027, the same level as it was prior to the Canterbury earthquakes. This is based on a number of important assumptions, including the amount spent by the EQC on reinsurance, the amount of claims against the EQC in future years from natural disasters, and the long-term return on the investments in the NDF. And of course there is no reason to think that $6 billion is the optimal size for the NDF.

21. Using the same assumptions, but increasing the revenue from the EQC levy by 50%, the NDF would grow to around $6 billion by around 2024 – around three years earlier than with the current levy.

Process and Timing for any Increase

22. An increase in the EQC levy would require a Cabinet decision, and then new regulations under the EQC Act to replace or amend the current Earthquake Commission Regulations 1993. An increase can be done at any time.

23. We are not aware of any operational or practical constraints for changing the levy. We have asked EQC if it is aware of any constraints, but have not heard back yet. Given that the levy has not been increased for a very long time (if ever) EQC may not be aware of any constraints (if there are any).

24. We think it would be desirable to give private insurers sufficient advance notice of the increase, so that they could arrange to change their systems to pass the increase on to their customers. We don't know how long this would take, and so it may be appropriate to give a reasonably long notice period.

25. Therefore, should you wish to increase the EQC levy, we suggest that the increase take effect from 1 September 2011. This would allow for the Cabinet process to happen over June, and so for insurers and the public to have around 8 weeks' notice.

Recommended Action

We recommend that you:

EITHER:

a **discuss** the contents of this report with Treasury;

OR:

b **agree** to increase the EQC levy from 5 cents plus GST per $100 of cover to:

i. 7.5 cents plus GST per $100 of cover; or

Agree/disagree.

ii. some other amount (please indicate):

Agree/disagree.

c **agree** that the new EQC levy should apply from 1 September 2011;

Agree/disagree.

d **agree** that the new EQC levy should apply until 30 June 2014, with any changes beyond that point subject to a review of EQC policy settings in light of the Canterbury earthquakes (with the timing and content of that review to be decided);

Agree/disagree.

e **direct** Treasury to draft a Cabinet paper for your signature, seeking Cabinet's agreement to increase the EQC levy.

Agree/disagree.

Andrew Blazey
Manager, Commercial Transactions Group
for Secretary to the Treasury

Hon Bill English
Minister of Finance