

# The Treasury

## Treasury Advice Related to Modernising the EQC Act Information Release

December 2021

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- [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
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## Treasury Report: Coverage of Mixed-use Buildings under the Earthquake Commission Act: Further Advice

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<b>Date:</b>	28 January 2020	<b>Report No:</b>	T2020/100
		<b>File Number:</b>	TY-2-1-17-2

### Action sought

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	Action sought	Deadline
Hon Grant Robertson <b>Minister of Finance</b>	<b>Agree</b> to the proposed changes to the EQC Act to extend the scope of EQC cover for mixed-use buildings;	4 February 2020
<b>Minister Responsible for the Earthquake Commission</b>	<b>Agree</b> to the development of a Cabinet paper for your consideration, based on your preferred approach to amending the residential building test in the Earthquake Commission Act 1993.	

### Contact for telephone discussion (if required)

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Name	Position	Telephone	1st Contact
Danijela Tavich	Analyst, Earthquake Commission Policy Team	[39]	n/a (mob) ✓
Helen McDonald	Manager, Earthquake Commission Policy Team	[35]	

### Minister's Office actions (if required)

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Return the signed report to Treasury.

Note any feedback on the quality of the report

**Enclosure:** Yes (attached)

# Treasury Report: Coverage of Mixed-use Buildings under the Earthquake Commission Act: Further Advice

## Executive Summary

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We recently provided you with advice on amendments to the Earthquake Commission Act 1993 (the EQC Act) to be introduced in 2020, focusing on the Act's definition of 'residential building'. The definition is a key determinant of the extent of EQC cover provided for a building (T2019/4015 refers). The advice set out several options for amending the definition, and risks associated with each.

The current residential building definition sets out a "50% test" to determine if a building is residential. The test involves calculating the total floor area of a building's dwellings as a proportion of the total building. If that proportion amounts to at least 50%, the building is deemed residential. A building must be "residential" to qualify for Earthquake Commission (EQC) cover for the whole building, including areas used for commercial purposes. If the building is non-residential, EQC provides cover for the dwellings, appurtenant structures, and services.

You have asked for further advice on the option of **including all common areas** in the 50% test. In particular, you have asked for advice on criteria and options for mitigating the risks of this option.

### **We recommend taking a proportional approach to the treatment of common areas and extending the coverage of mixed-use buildings under the EQC Act**

We have worked through options to mitigate the risks outlined in our previous report. We note that policy work to date has been focused on amending the residential building definition without changing the scope of EQC cover. However, in discussions with EQC, we have developed an alternative proportional or 'pro-rata' option that we consider best addresses your concerns regarding the coverage of mixed-use buildings (MUBs) under the EQC Act by amending EQC cover along with an improved residential building test. This option is to take a proportional approach to the treatment of common areas in the 50% test. We suggest this should include in the 50% test:

- the area of the dwelling (status quo);
- the area of the appurtenant structures (includes carpark areas and storage areas); and
- a proportion of the total common area of the building based upon the total residential area component of the building versus the total commercial area component of the building.

Additionally, we suggest that, in the event that a MUB does not meet the 50% threshold to become a residential building, EQC should cover the 'residential share' of the common areas in addition to dwellings, appurtenant structures, and services as are currently covered.

The practical effect of this approach would be some increase in the floor area that is counted in the 50% test, which is likely to allow some currently non-residential buildings to become residential, therefore extending EQC cover to the entire building. It would also significantly increase the amount of EQC cover for dwelling owners in those buildings that remain non-residential, while reducing the confusion stakeholders highlighted around the mismatch between areas counted as 'residential' in the 50% test and areas covered by EQC (T2019/4015 refers).

The Treasury and EQC recommend this proportional approach because it is:

- *fairer* – MUB owners in primarily non-residential buildings receive EQC cover for an equitable proportion of the building; while EQC avoids providing cover for primarily commercial buildings;
- *simpler* – this removes the complexity of needing to understand the use of each common area element of a building, which also increases the likelihood that MUB owners can determine in advance of an event whether their building is residential; and
- *more intuitive* – this approach aligns the 50% test with the areas EQC will cover, which makes it easier to understand and communicate.

**While EQC guidance can support the inclusion of all common areas in the 50% test, risks remain around extending EQC cover to commercial spaces**

In terms of mitigating the risks associated with **including all common areas** in the 50% test, we consider that the risk of enabling some buildings to qualify as ‘residential’ that include substantial amounts of commercial space, for example, hotels with some permanent residents, cannot be mitigated through this policy process.

This is due to the fact that the risk cannot be mitigated through guidance, as it directly relates to the scope of EQC cover in a manner that would be complex to address through a targeted legislative amendment. Further, we do not consider that regulation-making powers under the EQC Act can reasonably exclude certain types of buildings, which technically meet the residential building test under the Act.

As a result, we advise that, if you wish to proceed with the approach of **including all common areas** in the 50% test, the options at this time are to either:

- accept the risk of enabling some inappropriate buildings to become ‘residential’ in the short term, and this could be re-examined as part of broader work on the scope of EQC cover in the review of the EQC Act, along with other matters; or
- defer work on the ‘residential building’ definition to be considered in the review of the EQC Act alongside related matters raised by stakeholders such as the definition of self-contained, and whether the 50% bright-line test is set at the right level.

We will begin drafting a Cabinet paper in line with your preferred way forward, based on either:

- taking a proportional approach to the treatment of common areas, and extending the scope of EQC cover for non-residential MUBs; or
- including all common areas in the 50% test.

## Recommended Action

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We recommend that you:

a **agree** to

- i. progress changes to the residential building test to include appurtenant structures and take a proportional approach to the treatment of common areas **(recommended)**; and

*Agree/disagree.*

- ii. progress changes to EQC cover so that, in the event that a building is non-residential, EQC cover will apply to a residential proportion of the common areas **(recommended)**;

*Agree/disagree.*

b **or agree** to

- iii. progress changes to the residential building test to include all common areas that residents are legally entitled to use;

*Agree/disagree.*

c **agree** to the Treasury developing for your consideration a draft Cabinet paper recommending amendments to the EQC Act based on your preferred option of (a) or (b);

*Agree/disagree.*

d **agree** the Cabinet paper should be lodged for consideration by the Cabinet Economic and Development Committee on 4 March 2020;

*Agree/disagree.*

e **agree** to the Treasury beginning to work on drafting instructions for the Parliamentary Counsel Office based on your preferred option of (a) or (b).

*Agree/disagree.*

Helen McDonald  
**Manager, Earthquake Commission Policy Team**

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

# Treasury Report: Coverage of Mixed-use Buildings under the Earthquake Commission Act: Further Advice

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## Purpose of Report

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1. The purpose of this report is to:
  - provide further advice on how to mitigate the anticipated risks associated with including all common areas used for residential purposes in the 50% test set out in the EQC Act definition of a residential building;
  - provide advice on an alternative option for extending the cover of MUBs under the EQC Act; and
  - seek your agreement to draft a Cabinet paper reflecting your preferred approach, for your consideration.

## Background

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2. We provided you with a Treasury Report on 17 January 2020, regarding amendments to the EQC Act to be introduced in 2020. The proposed amendments are focused on the Act's definition of 'residential building', which sets out a test for determining whether a building is residential and thus eligible for EQC cover over the entire building (T2019/4015 refers). If the building does not meet the definition of residential building EQC cover applies only to the dwellings, appurtenant structures, and services.
3. The residential building test involves calculating the total floor area of a building's dwellings as a proportion of the total building. If that proportion amounts to at least 50%, the building is deemed residential. We call this the "**50% test**".
4. Treasury Report T2019/4015 set out options for amending the residential building definition to better align the EQC Act's treatment of public residential spaces, such as access corridors to apartments, with private residential dwelling spaces. The Report also set out the risks associated with each option. The options considered included:
  - **Aligning the areas included in the 50% test with the statutory definition of areas the EQC covers (previously recommended):** Including 'appurtenant structures' insured by EQC in the 50% test. This approach would include both the area of the dwellings and residential areas outside of the dwellings, like storage lockers and residential car parks. Those areas would then be compared with the floor area of the whole building, to determine whether it passed the 50% test. This approach would align with existing EQC practice, which would improve the coherence of the test.
  - **Including all common areas in the 50% test:** Including all common areas such as lobbies, access corridors and residents' car parking; we did not recommend this option as we consider it carried several risks.
  - **Removing common areas from the calculation:** Removing common areas from the 50% test completely, and comparing residential unit floor space directly with commercial unit floor space. This option was discounted due to its counterintuitive nature, as expressed by stakeholders during consultation.
5. You have asked for further advice on mitigating the risks associated with amending the residential building definition to **include all common areas** used for residential purposes in the 50% test. We also propose an alternative "proportional" option for the treatment of common areas and extending the cover of MUBs under the EQC Act.

## Mitigating the risks associated with including common areas in the 50% test

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6. We have identified three key risks associated with including common areas in the 50% test, through our analysis and stakeholder consultation process. These include:
  - the expectation this approach may create that any area used by the residents is covered by EQC;
  - the difficulty in identifying common areas in ambiguous situations; and
  - the risk of EQC providing whole building cover for buildings that are largely commercial but become 'residential' if all of a building's common areas such as lobbies are counted in the 50% test (some hotels, for instance).
7. Advice on each of these risks and mitigations is set out below.

### *The expectation that all common areas are covered by EQC*

8. Consultation has suggested that confusion around the 50% test is largely due to the fact that the areas counted in the test (dwellings) do not match the areas covered by EQC (dwellings, appurtenant structures, and services).
9. If the MUB remains below the 50% test and therefore is not a residential building, EQC cover would only apply to areas that are appurtenant. In practice, EQC takes appurtenant to mean having an ownership interest combined with use for household purposes. In the MUB context, whether areas such as internal access ways to an apartment are considered 'appurtenant' will depend on the use and legal structure of the building in question.
10. As a result, including all common areas in the 50% test would likely lead to some MUB owners thinking EQC covers **all** common areas when this may not necessarily be the case. This risk can be mitigated to an extent through clear guidance and education outreach by EQC, to clarify the 50% test and its relationship to EQC cover, for MUB owners, insurers, and brokers.

### *Defining ambiguous common areas*

11. Our analysis and stakeholder consultation has raised the potential for uncertainty around how more ambiguous common areas should be considered if all common areas are included in the 50% test – for example, how areas of a roof that residents can walk on should be treated. This can undermine certainty and clarity of the test.
12. Further work would be required to finalise a set of criteria for what common areas would be counted in the 50% test. Initial discussions with EQC has indicated that the simplest approach would likely be to count all internal common areas that are legally defined as common property in a MUB survey plan (ie. areas that residents have a legal entitlement to use).
13. Some areas, such as swimming pools, tennis courts, and other such areas that EQC would not cover for a standalone dwelling could be excluded from the test under Schedule 2 of the EQC Act.<sup>1</sup>
14. This issue can be addressed by setting out information on what common areas are and are not counted in the test in non-statutory guidance developed by EQC, or by developing regulations under the EQC Act. As outlined in T2019/4015, EQC has also noted that forthcoming operational improvements expected over the longer-term can also support public and insurer education on the 50% test, including increased educational outreach and better partnering with insurers to support the underwriting process.

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<sup>1</sup> Schedule 2 sets out property that is not insured under the EQC Act.  
T2020/100 Coverage of mixed-use buildings under the Earthquake Commission Act: Further advice

### *Providing cover for largely commercial buildings that become 'residential'*

15. The final and most significant risk is that **including all common areas** could enable some buildings to qualify as 'residential' that include substantial amounts of commercial space and therefore receive EQC cover for the entire building. For example, hotels with some permanent residents could become eligible for EQC cover, if large shared spaces such as lobbies are counted as residential space. This could incentivise developers to add dwellings to a primarily commercial building, to help it qualify for EQC cover once all common areas are counted.
16. This risk cannot be mitigated through guidance as it directly relates to the scope of EQC cover. We do not consider that regulation-making powers under the EQC Act can reasonably exclude certain types of buildings that technically meet the residential building test under the Act, either.
17. As most buildings are clearly residential or non-residential, we expect only those buildings on the margins to be affected by any amendment to the 50% test, and, in line with this, we estimate the scale of this risk to be small. However, due to a lack of detailed information and evidence about the numbers of MUBs and their makeup, we are unable to determine the exact impact.
18. We consider that, if you wish to proceed with the approach of including all common areas in the 50% test, the options at this time are to either:
  - accept the risk of enabling some inappropriate buildings to become 'residential' in the short term, and this could be re-examined as part of broader work on the scope of EQC cover as part of the review of the EQC Act, along with other matters; or
  - defer work on the 'residential building' definition to be considered as part of the review of the EQC Act, alongside related matters raised by stakeholders such as the definition of self-contained, and whether the 50% bright-line test is set at the right level.

### Taking a proportional approach to common areas and extending the coverage of MUBs under the EQC Act

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19. We have worked with EQC to develop an alternative option to mitigate the risks outlined above, and address your concerns around the coverage of MUBs under the EQC Act. This is to take a proportional or 'pro-rata' approach to including common areas in the 50% test, based on the residential versus commercial use of a building.
20. This approach is similar to the *removing common areas* approach we suggested in our previous advice (T2019/4015). However, we suggest that this approach can be improved by allocating the common areas in the MUB on a pro-rata basis in accordance with the residential to commercial proportions of the building. We note that this would lead to the same result in terms of a building's residential proportions, but would be more intuitive for owners, insurers and brokers.
21. This option would include in the 50% test:
  - the area of the **dwelling** (status quo);
  - the area of the **appurtenant structures** (includes areas such as resident carparks and storage areas); and
  - a **proportion of the total common area** of the building based upon the total residential area component of the building versus the total commercial area component of the building.

22. The practical effect of this approach would be some increase in the floor area that is counted as residential in the 50% test, which is likely to allow some currently non-residential buildings to become residential. We note that, in some cases, some common areas in a MUB will be appurtenant and thus counted in the test and covered by EQC in full.
23. Additionally, and importantly, we suggest flow on changes to EQC cover in the event that a MUB does not meet the 50% threshold to become a residential building. Currently, EQC will only cover the following components of a non-residential building:
  - the dwelling(s);
  - appurtenant structures used for household purposes; and
  - services (e.g. drainage, sewerage, etc.).
24. We propose that, in addition to these existing components of a MUB, for non-residential buildings EQC cover should also extend to the residential proportional share of the common areas.
25. This could amount to a significant increase in cover and compensation from EQC to MUB dwelling owners in non-residential buildings in the wake of a natural hazard 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 building element that is currently not considered residential.
26. The Treasury and EQC recommend this approach as it is:
  - *fairer* – MUB dwelling owners in primarily non-residential buildings will receive EQC cover for the proportion of the building that is residential; while minimising the extent to which EQC provides cover for primarily commercial buildings;
  - *simpler* – this removes the complexity of needing to understand the use of each common area element of a building, which also increases the likelihood that MUB owners can determine whether their building is residential proactively;
  - *more intuitive* – this approach aligns the 50% test with the areas EQC will cover, which makes it easier to understand and communicate (this was raised as a major source of confusion by stakeholders during consultation – T2019/4015 refers).
27. Further, the approach:
  - addresses equity concerns between how MUBs are treated in comparison with standalone dwellings;
  - aligns with the principles of the EQC Act, which is intended to allow insured home owners to recover in the event of a qualifying natural disaster; and
  - is less likely to be gamed by developers (who could in theory maximise the common areas of largely commercial buildings with some dwellings, in order to receive full EQC cover for the whole building).

#### *Alignment with the Unit Titles Act*

28. The approach is also better aligned with the approach to common areas implicit in the Unit Titles Act 2010 (UTA), which assigns residential 'ownership interest' for a MUB and implicitly pro-rates any unallocated common areas on the basis of the ownership shares. The need for better alignment between the UTA and EQC Act was a point raised by stakeholders during consultation.
29. We note that, as the UTA allocates ownership interest based on the *value* of residential to commercial units in a MUB, and pro-rates common areas in accordance with this, it

is likely that the UTA pro-rates greater proportions of common areas to residential ownership than the area-based approach we are proposing. Some MUB owners may feel that EQC is under-allocating common areas to the residential proportion, compared with the UTA results. We have discounted the option of using ownership interest for the 50% test as only applies to unit title buildings (T2019/4015 refers).<sup>2</sup>

*A proportional approach would likely lead to an increase in compensation paid by EQC*

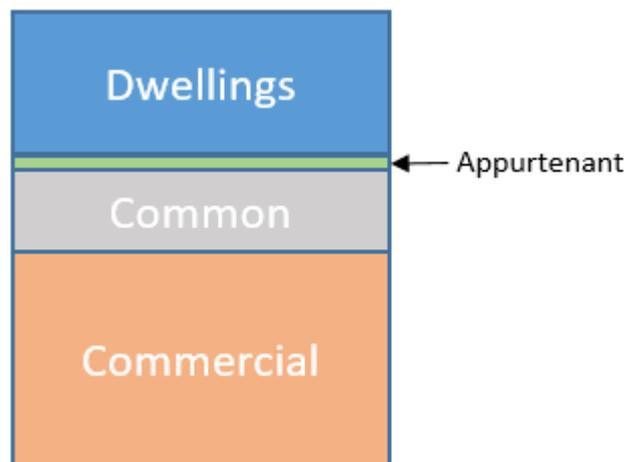
30. Taking a proportional approach to common areas would not affect the EQC cap,<sup>3</sup> but would mean EQC pays out more compensation (up to cap) to non-residential MUBs in the wake of a qualifying event, than the status quo.
31. Due to limited data available on MUBs, EQC is unable to model the financial impacts of this change, but expects it would be an increase in compensation paid than is currently the case under the status quo. EQC has indicated that it is comfortable with this increased liability as it is consistent with the intent of the EQC Act, which is to provide cover for insured home owners.
32. [34] However, our view is  
that this is an appropriate matter to be revisited as part of the wider review of the EQC Act.

## Options analysis and recommendation

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33. The practical effects of the alternative options is demonstrated as examples on the following page. Consider a MUB with the following make up, where the blue area is the area counted in the 50% test:<sup>4</sup>

- Dwellings: 1000sq/m
- Appurtenant: 100sq/m
- Common: 600sq/m
- Commercial: 1500sq/m
- **Total: 3200sq/m**



<sup>2</sup> This approach could also potentially be used for company share buildings, which allocates shares to owners in a similar manner.

<sup>3</sup> The EQC cap would continue to be calculated based on the number of residential dwellings within a building disclosed to the private insurers.

<sup>4</sup> Drawn to scale based on the figures given.

# Option comparison

## Status quo



### Is it residential?

Where only dwellings are counted, this MUB is **non-residential (31.25%)**.

### What is covered by EQC?

Dwellings, their appurtenant structures, and services.

## Previous recommendation (dwellings + appurtenant structures per T2019/4015)



### Is it residential?

Where dwellings and appurtenant structures are counted, this MUB is **non-residential (34.375%)**.

### What is covered by EQC?

Dwellings, appurtenant structures, and services.

## Proportional approach



### Is it residential?

Based on the proportional approach:

Residential space (Dwelling + Appurtenant):  $1100/2600 = 42\%$

Commercial space:  $1500/2600 = 58\%$

Common space: 600 split 42:58 = 252 residential and 348 commercial.

This MUB is **non-residential (42%)**.

### What is covered by EQC?

Dwellings, appurtenant structures, and services **plus** 42% of common areas.

## All common areas approach



### Is it residential?

Where all common areas are counted:

Residential space = Dwellings: 1000sq/m + Appurtenant structures: 100sq/m + Common: 600sq/m = 1700sq/m.

This MUB is **residential (53.125%)**

### What is covered by EQC?

This MUB would receive EQC cover for the whole building. This is in spite the majority of the actual used space being commercial (1500sq/m).

## Risks

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34. If you decide to take a proportional approach to allocating common areas in the 50% test, there is a risk that some building owners may not think this goes far enough to align the treatment of MUBs with standalone dwellings. This criticism would likely be on the basis of their view that equivalent common areas would be covered in a standalone dwelling and therefore should also be covered in a MUB. This was a view expressed by the Body Corporate Chairs Group.
35. EQC disagrees with the suggestion that there are equivalent common areas in standalone buildings which EQC provides compensation for. The Treasury considers that the reason 100% of similar areas is covered in a standalone residential building is 100% of the building is residential. In a MUB, this is not quite clear cut, and we suggest a proportional approach is a reasonable manner of addressing this.
36. This risk could be mitigated by noting that further consideration will be given to the residential building definition, including related issues that stakeholders are interested in such as whether 50% is the right threshold and the definition of 'self-contained', as part of the wider review of the EQC Act.
37. However, we consider this risk to be relatively low as even non-residential buildings would be significantly better off due to an increase in the scope of EQC cover. Further, we consider the option to be fair and to be perceived as fair, as EQC cover of common areas will reflect the residential proportion of a MUB in a way that is intuitive and equitable.

### *Expanding the scope of the amendment to include EQC cover risks pre-empting the wider review*

38. We note that, should you decide to progress the proportional approach to common areas, and to extend EQC cover for non-residential MUBs in line with this, this is a significant widening of scope of the EQC Amendment Bill. This does carry some increased risk of creating unintended consequences for other aspects of the EQC Act, and opens up more questions for lobbying and argument ahead of the wider review (and through the Bill's Select Committee process).

## Consultation

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39. EQC and the Parliamentary Counsel Office (PCO) have been consulted on this paper.
40. Our analysis and understanding of the issue and options have been informed by targeted stakeholder consultation over December 2019 to early January 2020 (T2019/4015 refers).

## Next Steps

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41. If you agree, we will begin drafting a Cabinet paper based on your preferred option.
42. We previously proposed the following Cabinet dates for the paper:
  - Cabinet Economic Development Committee (DEV) on 19 February 2020;
  - Cabinet on 24 February 2020.

43. However, due to the tight timeframes this would create for the development of a Cabinet paper and Regulatory Impact Statement, as well as cross-party consultation, we suggest that the Cabinet dates shift to the next available DEV meeting:
  - DEV on 4 March 2020;
  - Cabinet on 9 March 2020.
44. Cabinet Office circular CO(19)7 states that for a bill to be introduced (but not passed) before the election, instructions need to be provided to PCO preferably by the end of February, or no later than the end of March.
45. We note that moving the Cabinet dates out until March means we will miss PCO's preferred timeframes (end of February). We have consulted PCO on this who have confirmed that we are able to provide drafting instructions by 10 March (post-Cabinet).