The Treasury

Treasury Advice Related to Modernising the EQC Act Information Release

December 2021

Information Withheld

Some parts of this information release would not be appropriate to release and, if requested, would be withheld under the Official Information Act 1982 (the Act).

Where this is the case, the relevant sections of the Act that would apply have been identified.

Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Key to sections of the Act under which information has been withheld:

[25] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information or who is the subject of the information

[26] 9(2)(ba)(i) - 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 to prejudice 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

[27] 9(2)(ba)(ii) - 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

[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

[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

Where information has been withheld, a numbered reference to the applicable section of the Act has been made, as listed above. For example, a [25] appearing where information has been withheld in a release document refers to section 9(2)(b)(ii).

TE TAI ŌHANGA
THE TREASURY

Treasury Report: Modernising the Earthquake Commission Act: Monetary caps on retaining walls, bridges and culverts

Date:	10 March 2021	**Report No:**	T2021/332
		File Number:	TY-2-1-17-2

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Note** this report.	None.
Hon Dr David Clark **Minister Responsible for the Earthquake Commission**	**Agree** that the indemnity value limit on retaining walls be replaced by a fixed value limit of $50,000 (plus GST), and the indemnity value limit on bridges and culverts be replaced by a fixed value limit of $25,000 (plus GST). **Agree** that the fixed value limits: • apply per EQC-insured dwelling, and • be reviewed at least every five years.	17 March 2021.

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Steve Cantwell	Principal Advisor, Earthquake Commission Policy Team	[39]	[35]	✓
Helen McDonald	Manager, Earthquake Commission Policy Team			

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: Yes (attached)

Treasury Report: Modernising the Earthquake Commission Act: Monetary caps on retaining walls, bridges and culverts

Executive Summary

As recently directed by you (T2020/2771 refers), this report seeks your decisions on proposals to revise the basis for determining monetary caps on EQC cover of retaining walls, bridges and culverts (collectively dubbed "land structures") in the Earthquake Commission Act 1993 (the EQC Act).

Earthquake Commission (EQC) settlements for damaged land structures and associated damaged land currently pay:

- the estimated (or actual) cost of repairing the damaged item, up to the indemnity (depreciated) value of the damaged land structure, plus
- the value of any associated damaged land.

The indemnity value limit often results in settlement amounts for land structures that are insufficient to replace them. This is inconsistent with the policy intention that EQC land cover "contribute resources to reinstate or replace land damaged by natural disaster where that land contributes to providing support and protection for a residential building, and/ or the main accessway to the building" (T2020/2771 refers). This outcome is most likely when the land structure is older, and so largely depreciated, and when the associated damaged land is of relatively low value, and so makes a relatively modest contribution towards costs of repairing the damaged land structure. Further subsidiary concerns are:

- Reinstatement or replacement of land structures, especially large or complex retaining walls, can be very expensive (settlements can be for several hundred thousand dollars). This raises equity issues (noting EQC land cover is not separately priced through levies) and raises policy issues regarding appropriate risk sharing between EQC, homeowners, and private insurers.
- Indemnity values are not known in advance of a claim, so are not clear, certain, and transparent. This means homeowners can only estimate their level of EQC cover for land structures, making it difficult to make informed choices regarding the purchase of further top-up cover for these structures from private insurers.

Officials recommend addressing these concerns by:

- replacing the indemnity value cap with an undepreciated value cap. Undepreciated value is the estimated cost of replacing the damaged structure with exactly the same structure, i.e. a like-for-like replacement. Indemnity value is calculated by depreciating that value. Therefore, the undepreciated value will always be larger than the indemnity value, and
- introducing a fixed monetary cap, akin in concept to the monetary cap on building cover.

Regarding the actual monetary values for these caps, our suggested key policy aims are to:

(a) provide cover for a large proportion of damage to land structures within the EQC monetary cap, and

(b) provide a clear point from which homeowners with more extensive land structures can buy private insurance top-up cover.

Based on EQC's claims data and analysis, summarised below, we propose a monetary cap on EQC retaining wall cover of $50,000 per dwelling, and a monetary cap on cover for bridges and culverts of $25,000 per dwelling (both amounts excluding GST).

The available (limited) EQC claims data suggests that the great majority of EQC claims settlements involving these land structures would be increased or unchanged by these proposals. The proposals would result in lower claims settlements for expensive structures, in particular retaining walls with repairs and indemnity values of more than $50,000. EQC data suggests that such claims are rare, but can be large, e.g. several hundred thousand dollars.

EQC land claims since 2014 have cost EQC an average of $19.4 million per annum. EQC claims data does not separate the claims costs of land structures from the total costs of all land claims. Therefore, to estimate the cost of these proposals, EQC has sampled claims from 2014-2020, and on this basis EQC estimates that the proposals would cost about $8.7 million per annum. Treasury and EQC officials consider this is likely to be a material over-estimate. However, data limitations prevent a better estimate being developed.

In line with the approach taken to the modernisation of the EQC Act as a whole, any changes to these monetary caps will be forward-looking: current EQC claims would not be affected by any change.

Recommended Action

We recommend that you:

a **note** that, in settlements for damaged retaining walls, bridges and culverts, EQC currently pays:

i. the estimated (or actual) cost of repairing the damaged item, up to the indemnity (depreciated) value of the damaged land structure, plus
ii. the value of any associated damaged land

b **note** that the indemnity value limit can result in settlement amounts for these items being insufficient to replace them, with this gap increasing as the item ages, and when the associated damaged land is of relatively low value

c **note** that you recently directed officials to provide further advice on replacing the indemnity value limit with either undepreciated value, or a fixed monetary cap (T2020/2770 refers)

d **agree** that EQC settlements for damaged retaining walls, bridges and culverts continue to be based on the estimated (or actual) cost of repairing the damaged item, subject to any new or existing limits arising from the below recommendations

Agree/disagree.

e **agree** that the indemnity value limit on retaining walls be replaced by the undepreciated value of the damaged structures(s), up to a monetary cap of $50,000 (plus GST)

Agree/disagree.

f **agree** that the indemnity value limit on bridges and culverts be replaced by the undepreciated value of the damaged structures(s), up to a monetary cap of $25,000 (plus GST)

Agree/*disagree*.

g **agree** that these fixed value limits apply per EQC-insured dwelling that the damaged retaining walls, bridges and culverts are associated with

Agree/disagree.

h **note** that recently you agreed "…that EQC's key financial settings, including the insurance premium and EQC insurance cap, should have a maximum review period of five years" (recommendation (d) of T2020/3648 refers)

i **agree** that the fixed value limits for land structures be included in the key financial settings that the modernised EQC Act will require to be reviewed at least every five years (T2020/2886 refers)

Agree/disagree.

j **note** that the changes recommended above would replace only the current indemnity valuation of damaged land structures, with the valuation of associated land damage being unaffected by the proposals

k **note** that data limitations make it difficult to estimate the costs of these proposed changes. EQC estimate the upper bound of the increase in EQC's expected annual settlement costs in a typical (i.e. non-catastrophe) year is approximately $8.7 million.

Helen McDonald
Manager, Earthquake Commission Policy team

Hon Dr David Clark
Minister Responsible for the Earthquake Commission

Treasury Report: Modernising the Earthquake Commission Act: Monetary caps on retaining walls, bridges and culverts

Purpose of report

1. The purpose of this report is to seek decisions from you regarding the basis for determining monetary caps on EQC cover of retaining walls, bridges and culverts in the modernised Earthquake Commission Act 1993 (the EQC Act).

Background

2. You recently decided to change the current basis for determining monetary caps on EQC cover of retaining walls, bridges and culverts (referred to in this paper collectively as "land structures"), and requested more reporting on reform options (T2020/2771 refers). This two-stage approach was adopted as, while the desired direction of reform was clear, EQC data to help inform decisions on the value of monetary caps was not available at the time of the initial report, and was anticipated to be available in February 2021.

3. In line with the approach taken to the modernisation of the EQC Act as a whole, any changes to these monetary caps will be forward-looking: current EQC claims would not be affected by any change.

Valuing damage to retaining walls, bridges and culverts

Background

4. In settlements for damaged retaining walls, bridges and culverts, EQC currently pays:

    - the estimated (or actual) cost of repairing the damaged item, up to the indemnity (depreciated) value of the damaged land structure, plus
    - the value of any associated damaged land.

5. The land and land structure settlement forms one pool, so settlement monies from land damage that are not directed to land reinstatement may be devoted to reinstating land structures, and vice-versa.

6. The indemnity (depreciated) value limit often can result in settlement amounts for land structures that are insufficient to replace them. This is most likely when the land structure is older, and so largely depreciated, and when the associated damaged land is of relatively low value, and so makes a relatively modest contribution towards costs of repairing the damaged land structure. In areas with high land values, such as Auckland, the value of the damaged land can often enable an EQC settlement that is sufficient to repair the damaged structure, despite EQC cover to the structure being limited to indemnity cover.

7. As outlined in T2020/2771, the use of a cap based on the indemnity valuation of the particular damaged land structure raises three issues of policy concern:

- The indemnity value cap can result in payments that are insufficient to reinstate or replace the damaged structure. That is inconsistent with the policy intention for EQC land cover (T2020/2771 refers).

- Reinstatement or replacement of land structures, especially large or complex retaining walls, can be very expensive (settlements can be for several hundred thousand dollars). This raises equity issues (noting EQC land cover is implicitly covered through community-rated levies on building policies, rather than being separately priced) and raises policy issues regarding appropriate risk sharing between EQC, homeowners, and private insurers.

- Indemnity values are not known in advance of a claim, so are not clear, certain, and transparent. This means homeowners can only estimate their level of EQC cover for these structures, making it difficult for homeowners to make informed choices regarding the purchase of further top-up cover for these structures from private insurers.

8. In response, you recently agreed to change the indemnity-based monetary cap on the valuation of damaged land structures to either undepreciated value, or a fixed monetary cap (T2020/2771 refers).

Replacing indemnity value with an undepreciated value monetary cap

9. Officials recommend replacing the indemnity value cap with an undepreciated value cap. Undepreciated value is the estimated cost of replacing the damaged structure with exactly the same structure, i.e. a like-for-like replacement. Indemnity value is that value after deducting depreciation. Therefore, the undepreciated value will always be larger than the indemnity value. This change would advantage EQC claimants where the indemnity value (rather than repair cost) is currently the limiting factor of the settlement, while commensurately increasing the costs of affected EQC settlements.

10. Undepreciated value is *not* the estimated cost of fully reinstating a damaged structure using solutions acceptable today (known as “replacement value”). This is because usually, in the case of land structures, a new replacement structure will be more substantial, and hence expensive, than the structure that failed. This is in part due to regulatory and engineers’ professional standards increasing over time, and in part because land structures that generate EQC claims are not randomly selected – poorly built or under-engineered structures are more likely to fail and generate a claim than more sturdy structures are.

11. We recommend against replacing the indemnity value cap with a cap based on the replacement value, that is, the actual cost of replacing the failed structure with a structure built to modern regulatory and engineering requirements. This approach would lead to perverse and inequitable outcomes as EQC would fully fund replacement of poorly built (and relatively low-cost) structures with properly built and engineered ones.

12. If only the change to undepreciated value were made, EQC cover would meet a large fraction of the reinstatement or replacement costs of very expensive and substantial structures. As EQC premiums (set for building cover and not for land cover) are flat-rate, and do not reflect property-specific risks regarding sometimes-expensive land structures, this would raise equity concerns within the scheme, and reduces incentives on owners of those structures to consider and manage the ownership obligations and financial risks they pose.

13. Therefore, we recommend that the shift from indemnity value to undepreciated value caps is accompanied by the introduction of a fixed monetary cap, akin in concept to the monetary cap on building cover.

Choosing a monetary value for the cap

14. Regarding the actual monetary values for these caps, our suggested key policy aims are to:

    (a) provide cover for a large proportion of damage to land structures within the EQC monetary cap, and

    (b) provide a clear point from which homeowners with more extensive land structures can buy private insurance top-up cover.

15. Therefore, we recommend a fixed monetary cap which fully captures a large fraction of EQC's expected land structure claims. Fixed monetary caps would align the design of this cover more closely with EQC building cover, and private insurer cover for land structures.

16. Based on EQC's claims data and analysis, summarised below, we propose a monetary cap on EQC retaining wall cover of $50,000 per dwelling, and a monetary cap on cover for bridges and culverts of $25,000 per dwelling (both amounts excluding GST).

17. These amounts are substantially more than the 95th percentile of estimated indemnity values for both retaining walls and culverts, and the 85th percentile for bridges, circled in Table 1 below. Therefore, the proposed monetary caps would be a significant improvement in cover, compared to the status quo, for the great majority of EQC claimants where the current indemnity value is the limiting factor on their claim.

Impact of a fixed cap on claims involving high-value structures

18. The fixed monetary cap would limit EQC settlements on high-value land structures to specified dollar value - $50,000 or $25,000. To be worse off than under the current scheme, claims would need to combine two features:

    1. The indemnity value of the damaged land structure would need to be higher than the fixed monetary cap, and

    2. The repair of the damaged structure would need to cost more than the fixed monetary cap, plus the value of damaged associated land.

19. Many high-value claims are likely to have the first feature, but not the second. This is because the economics and incentives on landowners dictates that high value structures are almost always built on high value land. On lower-value land the better option is to develop an alternative site requiring fewer land improvements.

20. Therefore, EQC claims involving high value land structures are usually accompanied by substantial claims for damaged associated high-value land. The land component of the claim helps fund repair of the land structure. The proposals retain this feature of EQC cover.

21. High-value retaining wall claims are relatively rare. None of the sample of 59 EQC land claims discussed in the "Financial Implications" section below are worse off under these proposals.

Brief summary of status quo versus the change proposal

22. Status quo: EQC pays to repair damage to land structures, up to a cap determined by the indemnity value of the structure.

23. Proposal: EQC pays to repair damage to land structures, up to a cap determined by the lesser of the undepreciated value of the structure, or the specified monetary cap (of $50,000 or $25,000 plus GST per associated dwelling).

24. The undepreciated value will always be more than the indemnity value of the structure. Therefore, compared to the status quo, this proposal will benefit all claimants with indemnity values less than the fixed dollar caps.

25. These proposals retain the existing rules regarding valuation of damaged land associated with land structures.

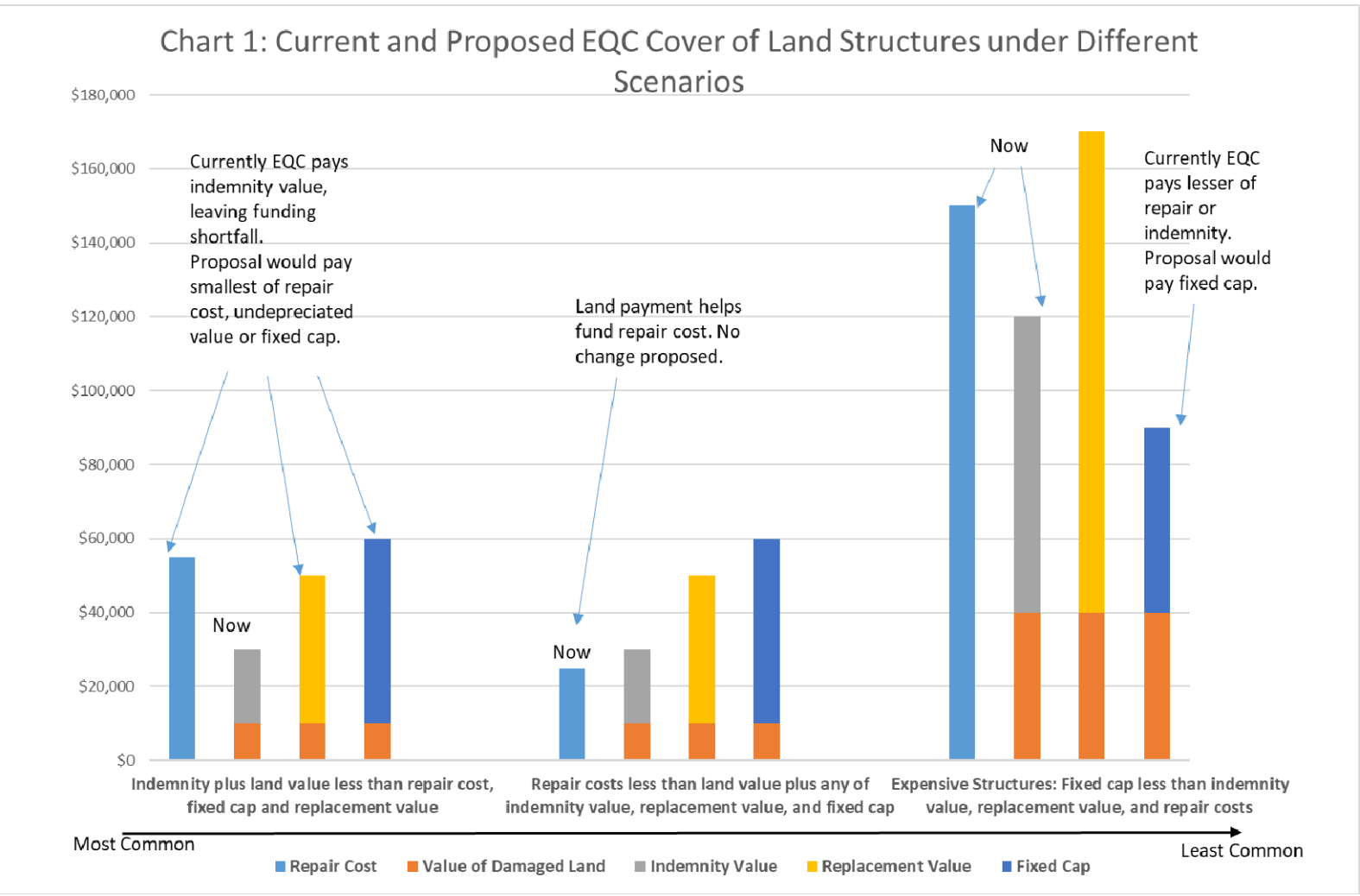
Estimated indemnity and repair values of retaining walls, bridges and culverts

26. The below tables summarise EQC's estimates of the 50th through to 95th percentile indemnity values and repair costs of retaining walls, bridges and culverts. Repair costs are estimates of the cost to repair the damaged structure. As EQC does not record undepreciated values, repair costs also serve as an imperfect proxy for undepreciated value. All estimates are rounded to the nearest $1,000. The data and estimates are subject to a range of caveats outlined in the *EQC Claims Data* section of this report (from paragraph 29).

Table 1: Estimated values of specified percentiles of (GST-exclusive) retaining wall, bridge and culvert indemnity values and repair costs

Percentile	Retaining Walls		Bridges		Culverts	
	Indemnity value (status quo)	Repair cost	Indemnity value (status quo)	Repair cost	Indemnity value (status quo)	Repair cost
50th percentile	$8,000	$33,000	$10,000	$13,000	$2,000	$6,000
60th percentile	$10,000	$41,000	$13,000	$16,000	$3,000	$7,000
70th percentile	$12,000	$52,000	$17,000	$20,000	$4,000	$9,000
80th percentile	$15,000	$68,000	$23,000	$27,000	$6,000	$12,000
90th percentile	$22,000	$100,000	$36,000	$41,000	$9,000	$18,000
95th percentile	$29,000	$136,000	$52,000	$58,000	$12,000	$25,000

27. Many claims are currently settled for estimated repair costs, not indemnity value, and would be unaffected by the proposed change. Chart 1 shows stylised scenarios of current and proposed EQC cover for retaining walls under four different scenarios.



28. Lastly, you recently agreed "…that EQC's key financial settings, including the insurance premium and EQC insurance cap, should have a maximum review period of five years" (recommendation (d) of T2020/3648 refers). We propose that these monetary caps for land structures be subject to the requirement to be reviewed at least every five years.

Relevant recommendations

agree that the indemnity value limit on retaining walls be replaced by a monetary cap of $50,000 (plus GST).

agree that the indemnity value limit on bridges and culverts be replaced by a monetary cap of $25,000 (plus GST).

agree that the fixed value limits for land structures be included in the key financial settings that the modernised EQC Act will require to be reviewed at least every five years.

Claims data availability and key caveats

29. EQC has examined claims data since 2014 regarding land structures. This was a labour-intensive manual process, as the elements of claims cost that help inform a decision regarding a monetary cap are not recorded in a readily accessible form, and needed to be located using text mining of claim notes stored in the claims administration system. This is unlikely to provide 100% coverage of all relevant claims, as details may only be recorded in PDF assessment scopes.

30. The sample sizes are small. EQC reviewed all claims from 2014, as these are more likely to have included the required items in the claim notes due to process improvements at that point. EQC identified 31 claims involving at least one bridge and 28 claims involving at least one culvert. EQC looked at 59 claims involving at least one retaining wall. This includes the bridge and culvert claims that involved a retaining wall, as well as other claims between 2014 and 2020 that were randomly selected from a list of claims with at least one retaining wall.

31. The proposal is to introduce caps based on the undepreciated value of the existing structure, that is, the estimated cost of rebuilding the damaged structure, as it was when it was new. However, EQC does not currently record estimated undepreciated values, and does not have the data necessary to retrospectively estimate those values. Therefore, estimated repair cost has been used as a proxy for undepreciated value.

32. The repair cost shown is the estimated cost of repairs to remediate the damaged land or land structures using the repair solution recommended by EQC's expert advisors (typically geotechnical engineering experts) as part of assessing the claim. In practice, as discussed earlier, the cost of the recommended repair solution is likely to be greater than the undepreciated value of the existing (damaged) structure.

33. There are various reasons for this. The proposed remedial solution is typically more substantial in size, design and construction than the existing structure which has been built under lesser (but considered appropriate at the time) construction standards. Also, the proposed remedial solution includes costs which are not included in the undepreciated value of the existing structure e.g. enabling works and certain professional fees.

34. Therefore, as the above Table 1 shows estimated repair costs, not undepreciated values, the estimated repair costs for retaining walls are conservative; that is, the repair costs likely overstate estimated undepreciated values.

35. For bridges and culverts, repair costs likely understate undepreciated values. This is because, in addition to the abovementioned dynamics that create pressures for repair costs to be larger than undepreciated values, there are other opposing dynamics that tend to result in repair costs being much lower than undepreciated values.

36. In particular, damage to bridges and culverts is often able to be repaired for a small fraction of the value of the structure. EQC assessors often see damage that scours the land surrounding the bridge, undermining it to some degree. The remedial solution is relatively cheap, e.g. adding gabion baskets (i.e. cages full of rocks) or other erosion protection to the waterway surrounding the bridge. This shows in the data; for retaining walls, indemnity costs average about 25 percent of repair costs. For bridges and culverts the respective indemnity costs average around 90 percent and 50 percent of the repair cost.

Should the cap apply per land structure, per dwelling, or per residential building?

37. We propose the cap apply per dwelling. That would mean that the cap for multi-unit residential buildings (MUBs), such as apartment buildings, would be the relevant multiple of the land structure cap(s) for a single dwelling.

38. We also considered applying the cap per residential building, so an entire MUB would have the same cap, irrespective of how many dwellings it contained. This would align with private insurance policies, which for these land structures typically apply a global fixed cap per insurance policy. Private insurance policies are typically issued one per residential building (but policies in MUBs that are not unit titled or company shares (e.g. small townhouse developments) may also have one private insurance policy per-dwelling).

39. We also considered applying the cap on a per land structure basis, so, a residential property with, say, three retaining walls would be entitled to three retaining wall caps. We rejected this on equity and complexity – a property with three modest retaining walls would receive a higher cap than a property with one more substantial retaining wall, and determining whether one land structure is one retaining wall, or multiple retaining walls, can sometimes be open to differing opinion and dispute.

40. Therefore, we recommend the EQC monetary cap on land structures applying per dwelling, as that is the basis for calculating EQC levies, so spreading one monetary cap over multiple dwellings in a MUB would provide a lower level of cover per dwelling. In addition, MUBs can be very large buildings, say with 100 or more apartments, with correspondingly large (and expensive) land structures.

Relevant recommendation

agree that the monetary caps apply per EQC-insured dwelling.

Financial implications for EQC

41. EQC land claims since 2014 have cost EQC an average of $19.4 million per annum. EQC claims data does not separate the claims costs of land structures from the total costs of all land claims. Therefore, to estimate the cost of these proposals, EQC has sampled 59 land claims from 2014-2020 that included a retaining wall claim, and estimated what the new settlement cost would be if those claims had been settled on the basis of the new proposals.

42. The resulting estimate from the sample used is that the proposals would increase settlements for claims involving retaining walls by about 40 percent, and increase the cost of land claims from 2014-2020 by about $8.7 million per annum. However, we consider that this figure is likely to be an over-estimate of the total cost. The average annual cost for all land claims was $19.4 million over the same period and claims involving retaining walls would only be a subset of this total. This would indicate a cost of less than $7.8 million (i.e. 40% of $19.4 million).

43. We are confident that the $8.7 million provides an upper bound for the expected cost, but existing data limitations mean that EQC are unable to make an estimate with any greater certainty.

44. If these proposals are implemented, the higher expected costs will be reflected in future advice regarding the appropriate levels of EQC premium.

Consultation

Insurance Council of New Zealand and private insurers

45. Treasury has consulted stakeholders, most notably the Insurance Council of New Zealand (ICNZ), and private insurers, over several years on a range of EQC land cover design questions.

46. ICNZ feedback from November 2020 on revising the cover for land structures included:

> *"We agree to separate monetary caps being introduced for retaining walls, bridges and culverts in principle, in the interest of certainty, fairness and the sustainability of the regime.*
>
> *Our preference would not be to structure retaining wall cover on a per dwelling or residential basis for simplicity and as there is no clear connection between the number of dwellings/residential buildings and number of retaining walls a customer may have."*

Government departments and agencies

47. EQC, the Ministry of Business, Innovation and Employment, Reserve Bank of New Zealand, Ministry for the Environment, Land Information New Zealand and Department of Internal Affairs were consulted during the preparation of this report and their feedback is reflected in it. The Department of Prime Minister and Cabinet (Policy Advisory Group) was informed.

Next Steps

48. Your decisions on this paper will be included in the upcoming second Cabinet paper on EQC Act modernisation, currently expected to be with you in early April 2021.