THE TREASURY
Kaitohutohu Kaupapa Rawa

6 March 2012

Sir John Hansen
Convener
Canterbury Earthquake Recovery Act Review Panel
c/o Canterbury Earthquake Recovery Authority

Dear Sir John,

Changes to regulation due to managed repair process

The attached draft Order in Council proposes regulation to suspend the deadline for the Earthquake Commission (EQC) to settle claims and to allow EQC to invoice claimants for excesses. These changes are required by the Project Management Office (PMO) process which has been established to manage residential repairs to a high standard and control construction costs. As such, the changes would apply to reinstatement only.

The regulatory changes modify the Earthquake Commission Act 1993 (EQC Act), however the proposed authority for change is the Canterbury Earthquake Recovery Act 2011 (CER Act).

Background

Following the 4 September earthquake, the Government agreed that residential building claims above $10,000 and under the EQC cap of $100,000 would be managed through a PMO. The objectives of the PMO are to manage residential repairs to a high standard, maintain the quality of Canterbury housing stock, and control construction costs. This is consistent with the Government's overall objectives for a timely and coordinated rebuild.

EQC has the option in its current legislation to settle claims by replacement, reinstatement or cash payment. Historically, EQC's normal approach has been to settle claims by cash payment. This approach has allowed EQC to settle claims within a 1 year period, as required by the EQC Act. Where EQC has chosen to reinstate property in the past, this has been on a small enough scale that the 1 year deadline has not been an issue

EQC does cash settle a limited number of particular claims which would otherwise be managed within the PMO process. These exceptions are properties affected by "leaky building" syndrome, and properties where owners had already planned significant renovations prior to the Canterbury earthquakes or wish to completely rebuild a damaged property. Remaining claims are subject to managed repair.

The PMO approach has created difficulties for EQC in meeting two sections of the EQC Act. The Act requires EQC to:

1. settle claims as soon as reasonably practicable and in any event within 1 year of the damage being duly determined (s 29(4)); and
2. only pay the amount for which EQC is liable less the excess (cl 1, Third Schedule).

The draft Order in Council addresses each of these issues in turn.

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Deadline for settlement

Around 200-300 of the first claims which were assessed in the month immediately following the 4 September earthquake did not have repairs completed when the 1 year deadline for those claims begins to expire during September 2011. EQC is, therefore, in breach of the timeline contained in the current legislation. This carries a risk that claimants will force a cash settlement on the one-year anniversary of their claim, undermining the objectives of the managed rebuild.

EQC's is aiming to complete 80% of all managed repairs by 2014. However, this timeline is dependent on external factors including continued reduction in seismic activity, and the availability of labour and accommodation. In this context, it is not practicable to propose a new deadline for settlement.

The draft Order in Council proposes that Cabinet suspend the regulation requiring EQC to settle claims within one year.

Collecting excesses

EQC cover includes an excess as standard insurance policy and this excess is applicable to all claims. Excess amounts prevent a large volume of trivial claims. EQC is legally obliged to settle claims less excess amounts, so as to protect the Natural Disaster Fund.

Failing to collect excesses would not meet EQC's requirements to protect the Fund and, as such, would have a fiscal cost to the Crown. There may also be negative effects on reinsurance relationships. There are also issues of fairness given excesses are being deducted from all cash-settled claims, including a number of residential buildings claims such as over-cap properties, those under $10,000, leaky buildings and self-managed repair.

EQC has some ability to collect excesses for reinstated property claims under existing legislation. It can deduct excesses from related (cash-settled) claims. This is a partial solution only, as not all claims in the PMO process have related land and contents claims. Alternatively, it could elect to not complete non-structural work up to the value of the excess. This would be difficult to achieve in practice, and is inconsistent with the objective of building confidence in the managed repair process. It is not a preferred approach.

The draft Order in Council proposes that EQC be allowed to invoice for excess amounts in the case of claims settled by reinstatement.

Commencement date

The draft Order in Council takes effect from September 4, 2011. Retrospective changes to legislation are expressly allowed by the CER Act, and in this instance a retrospective change is required to ensure EQC is not in breach of its obligations.

Tom Hall
for Secretary to the Treasury

THE TREASURY
Kaitohutohu Kaupapa Rawa

12 March 2012

Convener
Canterbury Earthquake Recovery Act Review Panel
c/o Canterbury Earthquake Recovery Authority

Dear Sir John,

Canterbury Earthquake Recovery (Earthquake Commission) Order 2012

Thank you for your consideration of the above Order and accompanying letter dated 6 March 2012. I have received a set of questions from the Panel, and hereby address each in turn.

Does the deadline extension just cover building reinstatement or does it extend to the reinstatement of land?

The extension will be applied to both building and land claims. The Fletcher PMO is managing under-cap land and building repairs as part of the overall repair programme on each property. With multiple earthquakes having occurred and ongoing events resulting in more widespread and complex damage, the one-year timeframes for both sets of repairs will not be achieved in many cases.

Why was the draft Order not promulgated earlier?

The Earthquake Commission approached the Treasury in August 2011 with an account of the problem to be addressed. Cabinet agreed to the policy change in September 2011. The process thereafter to enact the changes has not been smooth. A decision as to which Act should be used – the Earthquake Commission Act or CER Act – involved a number of legal arguments, and the drafting process also took some negotiation. Cabinet and the Cross-Party Forum processes were delayed over the election and Christmas periods. More recently, the Crown Law Office and Treasury took some time to resolve further drafting and legal concerns.

The Earthquake Commission is anxious to resolve the situation, particularly with regard to the collection of excesses. Repair completions are running at approximately 80 per day, and EQC would like to be able to communicate the existence of an excess so claimants can budget accordingly.

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What are the impacts of the proposal in terms of retrospective application?

EQC estimates that currently the number of claims not settled within one year of due determination is relatively small (an exact number is unavailable). The number, however, is expected to rise rapidly over the coming months. To date, no claimants have pursued litigation to seek cash settlement within the deadline. The propensity for claimants to pursue legal action is unknown, but should some do so and prove successful, this will likely encourage further legal action and undermine the managed repair programme. Retrospective application of the Order will reduce the risk of these outcomes.

Why is the deadline for repairs to be extended to April 2016 instead of a shorter extension with the possibility of review?

There have been multiple seismic events in Canterbury and these events are expected to be ongoing, compounding damage and adding significant complexity to the managed repairs process. The initial estimate of the reconstruction timeframe following the 4 September 2011 event was 80 per cent completion within three years. With ongoing seismic events and 90,000 repairs still to be completed, EQC is clear that repairs are unlikely to be completed in a shorter timeframe than that proposed by the Order.

EQC has a responsibility to customers, insurers, reinsurers and ultimately taxpayers to ensure reinstatement occurs promptly. This responsibility, the proposed requirement under the Order to carry out repairs "as soon as reasonably practical", and the sun-setting mechanism common to all Orders under the Act, together provide strong incentives for EQC to manage repairs as quickly as feasible, without the false expectations created by setting and reviewing an interim deadline.

What will be the impact of not proceeding with the draft Order (an approximation of the number of claims and the total cost of the claims)?

EQC is unable to provide an estimate of the number of claims affected by the one year deadline. It has informed the Treasury that the number is currently small but is expected to rise rapidly in the coming weeks.

All 90,000 repairs still to be completed will be affected by the excess clause.

It is the Treasury's understanding that EQC does not intend to cash settle claims as they reach the one year deadline. In this way, the impact of not proceeding with the Order would be that EQC would be operating outside its legislation, in favour of proceeding with the managed repair programme, established after the September earthquake. The managed repair programme is designed to (1) ensure ongoing confidence in the Canterbury housing stock (quality of repairs), (2) ensure equitable access across the community to quality, affordable repairs (cost-containment) and (3) limit the inflationary impact on New Zealand. Cabinet has asked EQC to report back on the managed repair process to ensure it is as efficient as possible and is meeting its objectives.

Are there alternatives for the homeowner to bypass the PMO process and take a cash settlement, or alternatively manage the repairs themselves and seek reimbursement from EQC?

EQC does cash settle a limited number of particular claims which would otherwise be managed within the PMO process. These exceptions are properties affected by "leaky building" syndrome or asbestos and properties where owners had already planned significant renovations prior to the Canterbury earthquakes or wish to completely rebuild a damaged property. Cash settlements in these cases ensure that the progress of the repairs is not slowed (and EQC's liability not exceeded) by the additional repair or construction work required.

Apart from these limited exceptions, homeowners have the option of "opting-out" of the PMO process. These homeowners do not receive a cash settlement. Instead they are responsible for managing their own repairs and building act compliance in order to receive payment on production of an invoice. This approach offers greater control to homeowners, while ensuring EQC's payments are applied to repairs and not to other expenses.

I trust these answers are useful to you in your deliberations.

Please do not hesitate to contact me if I can be of further assistance.

Yours Sincerely,

Tom Hall

Tom Hall
Manager, Earthquake Co-ordination Team

THE TREASURY
Kaitohutohu Kaupapa Rawa

16 March 2012

Canterbury Earthquake Act Review Panel
c/o Canterbury Earthquake Recovery Authority

Dear Sir John,

Canterbury Earthquake (Earthquake Commission) Order 2012

I understand that you are seeking more detailed information on the above Order in Council. Please accept my apologies if I have not been sufficiently forthcoming or clear in previous exchanges. If this letter in turn does not fully answer your questions, I am more than willing to provide any information you need to properly consider the proposed Order.

The starting point for this issue is the 2010 decision to use a managed-repair process, rather than settling claims by cash payments (except in tightly-defined circumstances). In smaller-scale natural disasters, work led by individual claimants ensures speedy and cost-effective repairs and rebuilds. In the case of the response to the Christchurch earthquakes, however, the large scale project-management from a managed repair programme is the best way to achieve co-ordination, contain costs and ensure Canterbury's housing stock is safe and of good quality.

The trade-off with these benefits is a loss of control for individual claimants. Detailed analysis of the costs and benefits of the decision to use a managed-repair process is not yet possible, but as time passes the benefits of the approach are becoming clearer. As one example, the Fletcher PMO is able to coordinate repairs relating to multiple claims at a single property. This would be more challenging if everyone were managing repairs individually.

The Treasury has asked EQC what it would do if the Order did not become law. It answered that it would cash-settle as quickly as possible to mitigate the extent of the breach. It predicts that the consequences of such a large increase of cash in the market for repairs could be price gouging, long waiting lists, labour shortages, and competition for repairs, which would favour wealthier over less wealthy people. It also predicts multiple individual law suits and possibly class-action law suits. The overall managed-repair process would break down, and the benefits of an efficient and effective rebuild would be lost.

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Since my previous letter, Treasury has also received more information from EQC on the number of properties affected by the one-year settlement timeframe. EQC estimates that by the end of 2012, it will still have about 75,000 repairs to complete under the managed-repair programme. Assuming no further events, it forecasts that it would be in breach of the one-year deadline for most of these 75,000 properties. EQC estimates that there are likely to be about 20,000 repairs still to be completed at the end of 2014, but that it will be able to complete repair for all properties by April 2016, when the Order expires. The Order has not been drafted with an earlier expiry date, because we do not believe that earlier completion of the repair programme is feasible. I apologise for not being able to provide this information previously, and hope it clarifies the scope of this issue.

The Review Panel may ask whether the proposal strengthens or weakens the incentives on EQC to complete repairs as expeditiously as possible. In a general sense, the Order is a corollary of the managed-repair programme, and as such contributes to a speedy repair effort. As I noted in my letter to you of 12 March, the ministerial and public expectations on EQC, the requirement under the OiC to carry out repairs "as soon as reasonably practicable", and the sun-setting mechanisms to all Orders under the CER Act, provide strong incentives to manage repairs as quickly as feasible.

I understand that the Review Panel has expressed concern at the retrospective nature of this proposal. I share this concern. However, I see the current Order as a good candidate for section 75(3) or the CER Act, which specifically provides for Orders in Council to be applied retrospectively. EQC approached Ministers in August 2011 once the scale of the repair programme became clearer, and has been proactive in attempting to minimise breaches before the Order comes into effect (if approved). Were the Order approved for future claims or breaches only, a subset of claimants would be in a position to pursue cash settlements while those eventually waiting even longer for repairs would not. Retrospective application of the Order would prevent this inequitable outcome.

I acknowledge that the proposal has come to the Review Panel later than is desirable. This has arisen for three main reasons:

- The ongoing disaster sequence and the extent, type and complexity of resulting damage delayed EQC's ability to identify the likely impact on the managed repair programme and the legislation, delaying the approach to Treasury.
- The election and Christmas break slowed decision-making.
- The process of developing regulations is deliberately lengthy, with extensive requirements to consult key stakeholders.

In the case of the current proposal, the delay was exacerbated by legal debate about which Act (EQC Act or CER Act) to use as a vehicle for the proposal, and concern about whether it was in fact *ultra vires* of the CER Act. I can provide a detailed timeline of the process of developing the Order, if the Review Panel wishes.

As noted above, this letter aims to address your concerns about the Order, as I understand them. If it does not do so, please do feel free to contact me by e-mail (Tom.Hall@treasury.govt.nz) or phone (04) 471-5150. If you wish to discuss the Order directly with EQC or myself, we are more than happy to meet with you in person.

Yours sincerely

Tom Hall

Tom Hall
Manager, Earthquake Coordination Team