

Regulatory Impact Statement: Review of the funding model for Fire and Emergency

New Zealand

Coversheet

| Purpose of Document | |
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| Decision sought: | <i>Cabinet policy approval</i> |
| Advising agencies: | <i>The Department of Internal Affairs is solely responsible for the analysis and advice set out in this Regulatory Impact Assessment (RIS). This analysis and advice has been produced for the purpose of informing policy decisions to be taken by Cabinet.</i> |
| Proposing Ministers: | <i>Minister of Internal Affairs</i> |
| Date finalised: | <i>13 October 2021</i> |
| Problem Definition | |
| <p>1. On 1 July 2024, Part 3 of the Fire and Emergency New Zealand Act 2017 will amend the insurance-based levy system that funds Fire and Emergency New Zealand. Some key stakeholders have concerns about the changes that the Part 3 levy will introduce. Insurance companies and insurance brokers believe that the Part 3 provisions will be complicated and expensive for them to implement. Some large non-residential property owners are worried about large increases in levy liability under the new system.</p> <p>2. There is an opportunity to ensure the funding model for Fire and Emergency New Zealand demonstrates good regulatory system design, and adheres, as much as possible given various constraints, to the principles in the Fire and Emergency Act 2017.</p> | |
| Executive Summary | |
| <p>The Fire and Emergency Act 2017 updates Fire and Emergency New Zealand's funding system</p> <p>3. The Fire and Emergency New Zealand Act 2017 (the FENZ Act) established a funding model which aimed to improve the insurance-based fire service levy which previously funded urban fire brigades. The FENZ Act specifies that the transitional levy that funds Fire and Emergency will be replaced by Part 3 of the FENZ Act on 1 July 2024. This is referred to as the Part 3 levy.</p> <p>4. Part 3 makes several important changes to the way the levy applies to property insurance. These are:</p> <ul style="list-style-type: none">the levy is calculated on insurance contracts against physical loss or damage to property, (referred to as material damage), rather than only on cover against damage by fire (fire damage); | |

- the levy is calculated on the 'amount insured' in the contract (the maximum that can be paid out under the terms of the contract). The transitional levy is calculated on "the amount for which the property is insured" (what this means varies depending on the type and terms of insurance contracts);
- all motor vehicle owners with insurance will be charged a flat fee on their insurance policy; and
- levy could be charged at different rates for different types of property – residential and non-residential.

Stakeholders had concerns about aspects of the new funding system

5. Insurance companies and brokers are legally required to calculate and collect the levy for Fire and Emergency New Zealand. They have raised concerns that the Part 3 provisions will be complicated and expensive for them to implement. Some large non-residential property owners also raised concerns, noting a potential increased levy liability under the new system.
6. In response to these concerns, Cabinet agreed to review Fire and Emergency's funding model in mid-2019 [CAB-19-MIN-076 refers]. The purpose of the review was to identify whether more suitable options exist for funding Fire and Emergency than an insurance-based levy.

Despite weaknesses, an insurance-based levy model is the best available funding option at present and needs to work for stakeholders

7. Work to this point showed that there is no clear solution that will resolve the issues for all stakeholders. In April 2021, Cabinet agreed that the scope of the funding review would be refined to focus on improving the insurance-based levy [CAB-21-MIN-0124].
8. The review focused on the levy mechanism, not the amount of funding. Commercial sensitivity of insurance data means that analysis of a new levy mechanism is a theoretical one and is difficult to assess in detail. This limitation means we cannot be certain of the financial impacts on policyholders.
9. Regardless of the funding mechanism, funding for Fire and Emergency will be secure. The levy rate can be adjusted to ensure that Fire and Emergency obtains the amount it needs to continue to provide its services.

There is the opportunity to ensure a secure and sustainable funding system for Fire and Emergency New Zealand that aligns with the principles of the FENZ Act and demonstrates good regulatory design

10. The insurance-based levy system funds a vital public service. Levy collection largely relies on insurers and brokers to accurately calculate, collect, and pass on levies from their customers to Fire and Emergency. Good regulatory system design means that it is as simple as possible for the collection agents to carry out their role, minimises compliance costs and is the least disruptive approach.¹
11. For any changes to the FENZ Act, the objectives are to ensure that the funding system:

¹ Government Expectations for Good Regulatory Practice, The Treasury, 2017, page 4.

- adheres to good regulatory design principles: ease of implementation, cost-effectiveness and least disruption; and
- aligns with the principles in the FENZ Act as closely as possible, which are that it is equitable, universal, stable, predictable and flexible.

The Department has worked with stakeholders to develop options

12. The Department and stakeholders identified two areas where Part 3 is likely to create additional complexity and cost when collecting the levy, if it is implemented as it stands:

- applying the levy to insurance contracts for material damage, and
- calculating the levy based on the amount insured.

13. Based on this, the Department has developed options for applying the levy to insurance contracts and calculating the levy. These options are outlined below.

Status quo: retain the Part 3 provisions

14. Part 3 applies the levy to “contracts of insurance...relating to any property...under which the property is insured against physical loss or damage (whatever the cause of the loss or damage), including— temporary or reparable loss or damage, and any consequential loss or damage”. We refer to this as ‘material damage’.

15. Applying the levy to contracts of material damage expands the levy application to a broader set of insurance policies than just fire damage. It can include any policies that insure against physical loss or damage, such as natural disaster, landslips and subsidence, and earthquake damage. This would also extend to policies such as terrorism policies, or stock damage and spoilage, as these policies provide insurance against physical loss or damage.

16. Part 3 states that the levy payable is calculated based on the “amount insured” in the insurance contract. The amount insured is defined as the *express maximum limit* contained in an insurance contract, or the declared value if no express maximum limit is contained in the contract. This means that if the insurance contract states a maximum figure that the insurance company must pay out (express maximum limit), then this is the amount insured. If there is no figure stated, then the amount insured is determined by either a signed statement from the policyholder as to the value of the property, or by a valuation certificate.

The alternative options - charging levy on fire damage insurance and applying the levy to sum insured

17. The alternative option for *charging* the levy applies it to insurance contracts against damage by fire (fire damage). A levy on fire damage is how it is collected under the transitional levy system. It is generally well understood and relatively simple for the insurance sector to apply.

18. The alternative option for *calculating* the levy is based on the “sum insured”. Sum insured is the value in the insurance policy. The term is used by almost all New Zealand-based insurers. It is the amount the policyholder is paid in the event of a total loss. This means that the insured party and the insurance company agree on the total sum that the property is insured for.

Options overview – the Part 3 provisions the alternative options

A better understanding of the levy collection system has led to a different conclusion to the 2016 Regulatory Impact Statement

| Variable | Transitional Levy | Part 3 | Alternative option |
|--|---|--|---|
| Type of insurance contracts that attract the levy | Applies to contracts of property insurance against damage by fire – rate per dollar | Applies to all contracts of property insurance against physical loss or damage, whatever the cause of loss or damage (i.e. not limited to damage by fire) – this is a rate per dollar, currently the transitional levy is a rate of 10.6 cents per \$100 of insurance. | Applies to contracts of property insurance against damage by fire - rate per dollar, for example 10.6 cents per \$100 dollars of insurance. |
| Amount the levy calculation is based on | Amount insured in the contract, or indemnity value | Amount insured: Levy is calculated on the maximum amount that can be paid out under the terms of the contract ² | Sum insured: Levy is calculated based on the figure agreed on in the insurance contract ³ |

19. When the FENZ Act was being developed, a Regulatory Impact Statement (RIS) [EGI-MIN-0064 refers] was undertaken – we refer to this as the 2016 RIS. The rationale for extending levy from contracts of fire insurance to contracts of material damage was that it:

- represents the simplest option for the insurance industry to collect the levy;
- makes it more difficult for levy payers to reduce their contributions by adopting split peril insurance policies⁴;
- reflects that fire services are responding to a growing number of non-fire related incidents (e.g. work to protect housing and businesses from flooding); and
- will expand the levy base.⁵

20. The Department now has on an improved understanding of the implementation challenges and costs to move to the Part 3 levy as written, and better information on inequity in the system. This information indicates that:

- material damage is likely to introduce significant complexity for the insurance industry in administering the levy which will make collecting the levy more challenging;
- Addressing issues around inequity and increased complexity through regulations is likely to be ineffective, or serve to increase complexity;
- approximately 1 per cent of policyholders take out split perils policies. Split perils may not be used as widely as a mechanism to reduce levy contribution as was thought, and it is not clear that retaining fire damage will result in more non-residential levy payers moving to split perils. We are still unable to determine the amount (or value) of

property covered by these policies due to commercial sensitivity but is likely to be relatively large; and

- the expansion of the levy base will be through redistribution of the levy to split perils policyholders, rather than the introduction of new levy payers.

21. Part 3 has affordability measures that allow caps for large levy payers who face large increases in levy and the power to exempt certain types of insurance from the levy.⁶

These are unlikely to be sufficient to address large levy increases because:

- small-medium businesses are likely to make up the shortfall created by the affordability measures, which would reduce the equity that moving to material damage seeks to achieve;
- the administration of the levy would be more complex for the insurance sector, as it requires insurers and brokers to identify contracts which are exempt and then process them differently; the cost to do this is likely to be passed onto policyholders; and
- excluding perils which relate to Fire and Emergency's remit, like earthquake or flood cover, contradict a key purpose of moving the levy to material damage, which is that the levy reflects Fire and Emergency's broader mandate.

The Department's preferred options are the alternative options – fire damage and sum insured

22. Fire damage:

- adheres more closely to principles of good regulatory design; it is simpler, and an already proven system, for insurers and brokers to collect the levy and for Fire and Emergency to administer and involves less disruption to the levy collection system;
- avoids costs to insurers and brokers for IT system upgrades, that are likely to be passed on to policyholders;
- means large non-residential policyholders with split perils policies are less likely to face substantial increase in fire levy costs⁷; and
- will not see improvements in equity for smaller non-residential insurance policyholders.

23. Sum insured:

- is supported by the insurance sector, who are responsible for calculating and collecting the levy;
- can be defined in the legislation in a way that the insurance sector is familiar with;
- would decrease compliance costs for insurers and brokers collecting the levy;
- means the statutory declaration process insurers and brokers must undertake would need to occur far less frequently, because the sum insured would be agreed upon in

² See the Glossary of Terms at the end of this document, for a fuller explanation of "amount insured".

³ See the Glossary of Terms at the end of this document, for a fuller explanation of "sum insured".

⁴ Split perils involve non-residential policyholders, generally those with large property portfolios, insuring for a lower sum against fire damage, than for other risks such as earthquakes or severe weather events.

⁵ Regulatory Impact Statement, Fire Services Review – cost of change and new funding arrangements, paragraph 76.

⁶ Clauses 42 to 44 of Schedule 1 of the FENZ Act contain provisions allowing the Minister of Internal Affairs to temporarily exempt a policyholder in whole or in part from the levy if they are subject to an "unreasonable burden because of any increase" in levy. Clause 141 (e)(ii) allows an exemption to be made for any contract of insurance or class of contract of insurance.

the contract of insurance. When this process does need to occur, it will be simpler for the policyholder and insurer; and

- insurers and brokers will be able to provide more certainty on the total value of property insured in New Zealand and the amount of levy they expect to collect, because sum insured is a term that they can more easily implement.

24. Whichever option is chosen for the type of insurance contract that attracts the levy, and how the levy is calculated, the levy rate can be set to ensure that Fire and Emergency will have sufficient funding.

25. We support the alternative options because, on balance, they are likely to be easier to implement, more cost-effective and require less change to the funding system. This is consistent with principles of good regulatory design and with the principles of stability and predictability in the FENZ Act.

Risks and mitigations

26. We may not have a complete understanding of the impact on Māori. During the consultation stage, we made significant efforts to engage with iwi/Māori stakeholders. We understand some of the potential impacts for iwi and hāpu, but there is a risk that we do not have a fully informed view of this. There will be further opportunities to engage with Māori during the drafting of an amendment bill and the levy setting process to assess any potential impacts and mitigations.

27. As the process to amend legislation progresses, some stakeholders may become concerned that proposed options cannot be implemented. It is difficult to model the full impacts of a theoretical model, and we cannot be entirely certain how it will operate in practice. This risk will be mitigated by ongoing work with stakeholders, in particular insurers and brokers and Fire and Emergency, to ensure that the policy decisions can be implemented. Work to date has shown that stakeholders have an interest in ensuring that the options can be implemented, as insurers and brokers and Fire and Emergency must administer the levy.

Stakeholders' views

28. Fire and Emergency has been highly engaged throughout the process and has provided information and support where needed. Fire and Emergency favours retaining the Part 3 model because it believes that:

- doing so would better align the levy funding mechanism with its purpose. Fire and Emergency's role is wider than firefighting and includes responding to a variety of emergencies;
- allocating the levy more widely better meets the principle that the levy system should be universal, so costs are shared among all that benefit from the potential to use Fire and Emergency's services;
- a wider levy base may result in a lower levy rate, if funding requirements do not change; and
- material damage will be more efficient for levy administration.

29. Despite preferring the Part 3 model, Fire and Emergency's primary concern is that they have stable and predictable funding.

30. There are differences between the views of the insurance sector and commercial property stakeholders. Commercial property stakeholders believe the non-residential sector should, as much as possible, pay only for the Fire and Emergency services that it uses, or potentially benefits from. These stakeholders prefer a complex risk-based model, where the levy can reflect measures that mitigate risk, such as sprinklers and new building technology. An increase in equity is supported, but only if this means there are not significant increases in levy.
31. The insurance sector, in contrast, support the alternative options of retaining fire damage and moving to calculating the levy on sum insured, because this provides a simplified levy system that will be more cost efficient to implement and collect the levy.

Limitations and Constraints on Analysis

The scope of the review has narrowed to insurance-based options only

32. The 19 April 2021 Cabinet decision [CAB-21-MIN-0124 refers] refined the scope of the funding review to improvements to the Part 3 insurance-based levy only. The scope of the analysis is limited to insurance-based funding options for Fire and Emergency.

Challenges of using an insurance-based model

33. The insurance-based model charges levy on property value, which is an inexact measure of the use of, or potential to use, Fire and Emergency's services. It does not represent risk related to the property or the size of response required. Given this, we are looking for the option that provides the best outcomes for policyholders, insurers and brokers, and Fire and Emergency under a set of less than optimal circumstances.

Free riding

34. Some businesses and individuals do not pay the Fire and Emergency levy but still receive the same benefits as those who do pay. Parties that are uninsured or self-insured (they use their balance sheet to cover any loss) do not pay levy but benefit from Fire and Emergency's services. As the insurance-based levy is being retained, some level of free-riding by uninsured property owners is expected.

Determining the amount of Crown Contribution

35. This is the level of funding that the Crown contributes, in recognition of the public good⁸ component of services provided by Fire and Emergency. Any change in the public good contribution would be made through the government's budget process, not through changes to the FENZ Act and the insurance-based levy. The level of public good contribution is not being assessed as part of this impact assessment.

Limitations on data and evidence in the proposal

The review relies on information from stakeholders' and evidence of their concerns

⁸ A public good has the property that excluding people from its benefits is either difficult or costly, and its use by one person does not detract from its use by another.

36. The analysis includes insurance sector projections that the cost to update their systems to charge the levy on material damage contracts will cost in excess of \$50 million. The cost of system changes has been provided by the Insurance Council of New Zealand (ICNZ), based on estimates by their members, who are the insurance companies that collect the Fire and Emergency levy. Insurers and brokers have told us that these estimates cannot be accurate without reference to new legislative provisions which would provide details of the changes required. Therefore, we cannot be certain that the cost of system changes will be in excess of \$50 million.

37. \$50 million is a one-off cost and equates to 8.7 per cent of the total levy that the system seeks to collect. The figure of \$50 million is in the same region as estimates of local government's cost to implement the Fire and Emergency levy.

38. The cost of the movement from indemnity value under the transitional levy, to sum insured or amount insured, will also require system changes. The cost of the change to amount insured is estimated by insurers at \$5.25 million. While insurers and brokers believe the cost to shift to sum insured will be lower than moving to amount insured, we are not able to confirm this in the available timeframes.

Detailed cost impacts of the options have not been modelled

39. Due to the data limitations noted above, we cannot model the overall financial impact of fire damage vs material damage on policyholders. The impact cannot be estimated because levy contributions would depend on:

- individual insurance contracts and how they are arranged; and
- how much the levy base would change with a levy on material damage.

40. Insurers and brokers have told us that to provide relevant data they need to know how the legislation is worded. This determines which insurance contracts the levy applies to, and how the term amount insured, or sum insured, will operate. These details will not be known until further on in the legislative process.

Assumptions underpinning the impact analysis

- cost projections by the insurers of \$50 million to update their systems are accurate;
- the estimated \$50 million in administrative costs for insurers to move to material damage is likely to be passed on to policyholders;
- agreement can be found between insurers and brokers and Fire and Emergency on a clear definition of "sum insured" which makes it a simpler option than amount insured;
- a cap on the amount of levy payable for residential levy payers and motor vehicle owners is retained; and
- the New Zealand insurance system will not undergo any fundamental changes that significantly decrease the level of funding on which the insurance-based levy is charged.

Overall impact of these limitations and constraints on confidence of Ministers to use analysis

41. This analysis relies on anecdotal information of relative impacts. There is no ability to scrutinise this because of commercial sensitivity and because accurate modelling would

require knowing the levy settings that were in place first and then calculating the size of the impacts and where they fall. The limitations and constraints on this analysis affect our confidence of the size of costs and benefits that will occur for the two options, but not the impact on types of policyholders.

42. Our analysis suggests that on balance, the alternative options, fire damage and sum insured, should improve the simplicity of Fire and Emergency’s funding system and provide more certainty for insurance policyholders. This comes at the cost of equity, with non-residential policyholders with split perils policy continuing to pay a smaller amount of levy, relative to their total property value, compared to non-residential policyholders that do not have split perils. On balance, we think avoiding the implementation costs for material damage and the efficiency gains provided by the alternative options outweigh these equity costs.
43. The changes in the alternative options will have positive impacts for the levy collection function that is performed by the insurance sector. As levy collectors, the insurance sector will avoid time-consuming and costly system changes and will be able to calculate levy amounts more accurately, which are then remitted to Fire and Emergency.

Responsible Manager(s) (completed by relevant manager)

Suzanne Doig
General Manager Policy Group
Department of Internal Affairs

15 October 2021

Quality Assurance (completed by QA panel)

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| Reviewing Agency: | The Department of Internal Affairs |
| Panel Assessment & Comment: | <p>The panel considers that the information and analysis summarised in the RIA partially meets the quality assurance criteria.</p> <p>The key question for regulatory impact statements is “whether Ministers have enough information, of sufficient quality, to make an informed decision.” The panel considers that the limitations of the data available about the costs of the preferred option to the insurance industry and, as a result, to its customers, mean that Ministers are being asked to make a decision without access to important information.</p> <p>The RIS articulates the constraints, limitations and assumptions that affect the analysis.</p> <p>Cabinet decided that this funding review should focus on refining and improving the insurance-based levy rather than look at other options. For a variety of reasons, including the commercial confidentiality of insurers and large non-residential policy holders, information was not available to the policy team that would have enabled them to undertake more substantial modelling of the likely cost impacts of the options under consideration.</p> |

Consultation focussed on major stakeholders, including the insurance industry, commercial property owners, and Fire and Emergency New Zealand. The views of other stakeholders, notably smaller, individual policy holders, do risk being under-represented. However, the panel considered that this was adequate, given the emphasis on the parties most affected by the proposals.

Much of the evidence base available for the RIS assessment comes from indicative estimates provided by the insurance industry about the potential additional costs that they may incur should the current provisions in Part 3 of the FENZ Act come into force in 2024. The industry contends that the Part 3 provisions will introduce significant additional complexity to the levy system than other options, and some large non-residential property holders (principally those holding split perils policies) are worried about large increases in levy liability. Based on the modelling that has been possible, the panel considers that the RIS sets out a reasonable argument in favour of the recommended option of charging a levy on fire damage insurance and applying the levy to the sum insured. The crux of this argument is that this option would be simpler and cheaper to administer than the Part 3 model, although how much cheaper cannot be quantified. The insurance industry, which is tasked with collecting the levy, is strongly in favour of the recommended option. Despite preferring the Part 3 model, Fire and Emergency New Zealand has indicated that it can accept the recommended option as it will still deliver stable and predictable funding.

The RIS is transparent about the fact that the preferred option may not be as equitable as the Part 3 model – i.e., some levy payers could arguably end up paying more, or less, than their “fair share”. The extent of the inequity across levy payers cannot be quantified. Part 3 of the FENZ Act does include exemption powers intended to address this. However, the panel was content to accept the authors’ case that using these powers risks adding to the complexity and cost of the system.

This statement was prepared with a draft RIS, received 12 October 2021. The panel was content to award the RIS a partially meets rating subject to the final draft incorporating changes to further enhance the Statement’s transparency concerning the limitations of the data available about the costs of the preferred option.

Section 1: Diagnosing the policy problem

1.1 The context behind the policy problem and how the status quo is expected to develop

Parties involved in the Fire and Emergency New Zealand funding system

44. **Policyholders** are the parties that fund Fire and Emergency through a levy on their insurance contracts (unless exemptions for levy apply). This group also includes direct payers of the levy. This group do not use a New Zealand insurer or insurance broker but contribute approximately \$12 million annually, directly to Fire and Emergency. Policyholders generally fall into three broad categories:
 - residential policyholders: the individuals that pay home and contents insurance,
 - non-residential policyholders: the private businesses and government organisations that have insurance on their property; and
 - motor vehicles policyholders: businesses, individuals and organisations that hold motor vehicle insurance.
45. **Insurers and brokers** are the insurance companies and insurance brokers who administer much of the levy collection infrastructure. Their role is to collect levy from insurance policyholders and pass the levy on to Fire and Emergency. The process to calculate the levy that must be paid by the insurance policyholder is also undertaken by insurers and brokers.
46. **Fire and Emergency** receives its funding from insurance policyholders. It also has a role in setting the amount of levy to be collected. Fire and Emergency administers the levy scheme, which includes determining levy liability or exemptions, auditing insurance contracts, and charging penalties for shortfalls or non-payment of levy.
47. **The Department of Internal Affairs** has responsibility for the FENZ Act, which contains the regulatory tools that determine how Fire and Emergency is funded. This includes the regulations relating to the levy itself – including setting rates for different types of property, maximum amounts of levy for different types of property (levy caps), and when a policyholder or property can be exempt from the levy.
48. **The Crown** makes a public good contribution to Fire and Emergency, currently \$10 million per annum, in recognition of the public good component of services provided – these are responses like medical callouts and natural disaster responses.

The establishment of Fire and Emergency New Zealand resulted in a single funding source for New Zealand's fire and emergency organisation

49. In 2017, the Fire and Emergency New Zealand Act 2017 (the FENZ Act) established Fire and Emergency. The FENZ Act brought together New Zealand's rural, urban, volunteer and paid firefighters, to create a single fire organisation.
50. Funding for Fire and Emergency needs to ensure that it can maintain the capacity for business-as-usual responses across New Zealand, while attending large-scale incidents like the Tasman wildfires (February – March 2019) and the New Zealand International Convention Centre fire (October 2019). These incidents require Fire and Emergency to bring firefighters, trucks and equipment from the length and breadth of the country. This ability of Fire and Emergency to surge its capacity to meet any situation or situations that may arise is essential to the safety of New Zealanders.

The FENZ Act and associated regulations determine the Fire and Emergency levy

51. Since the establishment of Fire and Emergency on 1 July 2017, a transitional levy system has been in place. Under this system, the levy provisions of the Fire Service Act 1975 remain in force, with a levy rate that was set at a level to support the amalgamation of the new Fire and Emergency organisation. The levy is charged on contracts of property insured against fire damage and is largely a continuation of the fire service levy which previously funded urban fire brigades. It is charged on three types of property: residential (residential building insurance and content insurance), non-residential property, and motor vehicles.
52. The transitional levy has a levy rate on property of 10.6 cents per \$100 of insurance. This is subject to upper limits and special calculations for several items such as:
 - residential buildings (maximum levy payable of \$106);
 - domestic contents (maximum levy payable of \$21.20); and
 - motor vehicles (flat rate of \$8.45 per motor vehicle not exceeding 3.5 tonnes).
53. Non-residential property is levied at 10.6 cents per \$100 of insurance. It is not subject to a levy limit, so for example the annual levy payable on a commercial building insured for \$10 million is approximately \$10,600.
54. The transitional levy provides approximately 95 per cent of Fire and Emergency's funding.⁹ The remaining five per cent comes from various sources, such as good corporate citizen contributions¹⁰, monitoring private fire alarms, gains on disposal of plant, property and equipment, rental revenue¹¹, donations, deployment recovery, the Government's public good contribution and other miscellaneous revenue.

The Part 3 levy will come into force on 1 July 2024, replacing the transitional levy

55. Section 2(6) of the FENZ Act specifies that the transitional levy will be replaced by Part 3 (sections 80 -140) of the FENZ Act, on 1 July 2024. This is referred to as the Part 3 levy. Any levy system can be used to fund Fire and Emergency's costs if the levy rate is set appropriately. The objective of the Part 3 levy is to ensure that levy is applied to a broader range of policyholders and applied more equitably across policyholders than under the transitional levy.
56. The impact of the levy changes on different property owners will vary depending on the final levy rates set under the new system, on the type of property insured and on individual insurance arrangements.

Part 3 will make important changes to the levy

57. Part 3 makes several important changes to the way the levy applies to property owners. These are:
 - the levy is calculated on the level of insurance cover against physical loss or damage to property, whatever the cause of loss or damage (referred to as material damage). This could be a flood or earthquake for example, rather than only on cover against fire damage, which is the case under the transitional levy. This expands the scope of insurance policies that the levy can attach to;

⁹ 2019/20 Fire and Emergency Annual Report: Levy Revenue: \$595,770,000 Total Revenue: \$625,991,000

¹⁰ Voluntary amounts paid by property owners who do not insure their property.

¹¹ Rental revenues received under operating leases for commercial and residential properties.

- the levy is charged based on the 'amount insured' in the contract (the maximum that can be paid out under the terms of the contract), rather than the indemnity value (depreciated value) of the property, which is typically the case under the transitional levy;
 - all motor vehicles owners with insurance will be charged a flat fee on their insurance policy, and this includes 3rd party only insurance contracts; and
 - levy could be charged at different rates for different types of property – residential and non-residential, as opposed to the same rate of levy that is charged to all property owners under the transitional levy.
58. Under Part 3 people with residential property and motor vehicle insurance are likely to pay a flat rate of levy. This is what occurs under the transitional levy system, where a cap on the residential property levy results in a flat rate for all residential property.¹² This works well and can be retained under Part 3.
59. With non-residential property, the value and nature of property varies. Proposed changes to the levy calculation are likely to impact some non-residential policyholders more than others.

Some stakeholders raised concerns about the Part 3 levy

60. The Part 3 levy provisions in the Fire and Emergency Act 2017 are due to come into force on 1 July 2024. After the 2017 Act was enacted, the insurance sector and large commercial property owners have continued to voice concerns about the Part 3 provisions.
61. Some large non-residential property owners raised concerns about their potential levy liability under the Part 3 levy system. The primary drivers for their concerns were:
- free-rider issues;¹³
 - the change to levying property insured against material damage rather than fire damage would result in a large levy increases for them.
62. The insurance sector also had a strong preference to move away from any form of insurance-based levy. As well as the free-rider issue identified above, the insurance sector believes that an insurance-based model:
- is complicated and expensive for insurers and brokers to implement;
 - pushes up the price of insurance; and
 - can distort the insurance market by compelling insurers to structure their insurance policies around the levy.

The Government initiated a review of the funding model for Fire and Emergency in 2019

63. In response to concerns raised by stakeholders, in mid-2019 the government agreed to review Fire and Emergency's funding model [CAB-19-MIN-076 refers]. The purpose of the review was to identify whether more suitable options exist for funding Fire and Emergency than an insurance-based levy. Any potential funding system was within scope, except for full Crown funding of Fire and Emergency. The principles of the review were taken from the Part 3 levy purpose in section 80 of the FENZ Act, and require the funding model to be: stable, universal,

¹² The value of residential property is capped at \$100,000 for transitional levy purposes. The level of the cap means in practice a flat rate of levy is paid on residential property, regardless of the value the house.

¹³ Free riders are those who do not pay for a service but still receive the same benefits as those who do pay. Those who do not insure their property or self-insure using their cash reserves do not pay any levy but still receive the same service from Fire and Emergency.

equitable, predictable, and flexible. When the decision was made to establish Fire and Emergency, alternative funding models were not considered as part of the establishment process. Therefore, a broader review of how to fund Fire and Emergency was timely.

64. Commencement of Part 3 of the FENZ Act was delayed to 1 July 2024, to allow the Department to complete the funding review and provide time to implement any changes to the Fire and Emergency funding system.

The scope of the funding review was narrowed to improve the insurance-based levy

65. On 19 April 2021, Cabinet agreed to narrow the scope of the Fire and Emergency funding review [CAB-21-MIN-0124 refers]. The new scope of the funding review will focus on improving the insurance-based levy due to come into force on 1 July 2024. Cabinet also agreed that the principles for the funding review would remain the same. General taxation remained outside the scope of the review.
66. Work to this point showed that:
- there is no clear solution that will resolve the issues for all stakeholders;
 - there is a lack of readily available and integrated land and property data that could be used to calculate a property-based levy in a cost-effective way; and
 - a property-based funding and levy collection system could not be implemented in a way that is affordable to Government in the short-term.
67. Despite being the best funding mechanism available, the insurance-based levy system has inherent weaknesses. One weakness is that the value of property insured is not necessarily a fair reflection of either the benefit received, or potential benefit of Fire and Emergency's services.
68. Given that the insurance-based model is being retained, neither the Department nor stakeholders are calling for wholesale changes to the insurance-based funding model. However, there is an opportunity to adjust the fundamentals of Part 3 with only moderate legislative change.

1.2 The policy problem or opportunity

There is an opportunity to improve the Part 3 levy

69. As noted above, in April 2021 the scope of the funding review was narrowed. The new scope of the funding review will focus on improving the insurance-based levy, due to come into force on 1 July 2024.

Problem Definition

On 1 July 2024 Part 3 of the Fire and Emergency New Zealand Act 2017 will amend the insurance-based levy system that funds Fire and Emergency New Zealand. Some stakeholders have concerns about the changes that the Part 3 levy would introduce. Insurance companies and insurance brokers believe that the Part 3 provisions will be complicated and expensive for them to implement. Some large non-residential property owners are worried about large increase in levy liability under the new system.

There is an opportunity to ensure the funding model for Fire and Emergency New Zealand demonstrates good regulatory system design, and adheres, as much as possible given various constraints, to the principles in the Fire and Emergency Act 2017.

70. There is no risk to Fire and Emergency's funding. Regardless of the options chosen, the levy rate will be adjusted to ensure that Fire and Emergency obtain the amount required to continue to provide its services. Changing the type of contract that the levy applies to, and how the levy is calculated, should not significantly affect the revenue recouped by Fire and Emergency.
71. The impact of Part 3 on motor vehicles and residential policyholders is relatively minor and is not expected to create any significant issues, beyond the costs involved in implementation and administration of the levy collection process. These costs are likely to be passed on to policyholders in the form of higher premiums. As noted in paragraphs 45-48, the size of the cost increase is not known. This assumes a cap or maximum amount on the levy paid is retained, for example, insurance of motor vehicles, including third-party liability insurance, attracts a flat fee. Residential property will be charged an annual levy as a proportion of the amount insured. For example, the transitional levy rate is set at 10.6 cents per \$100 insured. A new levy rate and any caps will be set by regulations made under the FENZ Act. The impact on motor vehicles and residential policyholders has been assessed, however the biggest impact is expected to fall on non-residential policyholders and the insurance sector, so this is where the analysis focuses.

Part 3 creates complexity and adds cost to the levy collection system

72. The Department and stakeholders have identified two areas where the FENZ Act is likely to create additional complexity and cost to the levy collection system, if Part 3 is implemented as it stands – applying the levy to insurance contracts for material damage, and calculating the levy based on the amount insured. These two areas are outlined below.

Contracts that attract the levy: all contracts where property is insured against physical loss or damage (material damage)

73. Part 3 applies a levy to “contracts of insurance...relating to any property other than a motor vehicle under which the property is insured against physical loss or damage (whatever the cause of the loss or damage), including— temporary or reparable loss or damage; and any consequential loss or damage”.¹⁴ We refer to this as ‘material damage’.
74. Applying the levy to contracts of material damage expands the levy application to a broader set of insurance policies than just fire damage. It can include any policies that insure against physical loss or damage, such as natural disaster, landslips and subsidence, and earthquake damage. The intent behind this approach was to reflect the broader mandate of Fire and Emergency. Charging on material damage also sought to improve the equity of the system by basing the levy on a greater value of assets in split-perils policies.
75. The challenges of applying the levy to all contracts of material damage are outlined below.
76. Evidence of these issues is based on detailed discussions with a reference group of insurance sector stakeholders, commercial property stakeholders and Fire and Emergency. We do not have quantitative data on:
- the cost breakdown for the system changes the insurance sector would need to implement, to move to material damage, beyond the cost that insurers and brokers estimate to be in excess of \$50 million;
 - how much of the implementation cost is passed on to policyholders, in the form of increased insurance premiums;

¹⁴ Theft and fraud cover can be included as part of a material damage contract, depending on the specific policy details.

- how these implementation costs will be spread across the different insurance providers and policyholders;
- the number of large non-residential policyholders with split perils policies that would face an increase in levy under a move to material damage; and
- the amount of levy increase that large non-residential policyholders would face under a move to material damage, either on average or for individual policyholders.¹⁵

There is potential for increased complexity when applying the levy to contracts of material damage

77. Applying the levy to contracts of material damage is likely to create additional administrative requirements for the levy calculation performed by insurance sector, because of the complexity of the insurance contracts that would attract levy. Neither option aims to collect additional levy. However, including material damage policies will significantly increase the time and complexity of collecting the levy.
78. Levying on material damage will legally require the levy to be charged multiple times on multiple insurance policies that cover the same property. For example, an insurer may not be able to provide adequate cover for earthquake. This may result in a policyholder needing to buy a separate earthquake only policy. This property is now insured under two policies, with two lots of levy payable. Not only does this increase the workload for insurers calculating and collecting the levy, but it is also an inequitable result for these property owners. Other examples of these types of policies are listed in Appendix One.
79. Attempting to address issues of complexity or inequity through exempting some forms of insurance would not be effective or would add to the complexity of the levy system. Excluding perils which relate to Fire and Emergency's remit, like earthquake or flood cover, contradict a key purpose of moving the levy to material damage – i.e., the levy reflects Fire and Emergency's broader mandate. These exemptions could also have unintended consequences in terms of how insurance cover is offered in New Zealand. Any exemption also adds to the complexity of the levy system as it requires insurers and brokers to identify contracts which are exempt and then process them differently.
80. Additional complexity for the levy calculation process using material damage includes:
- additional testing of levying and charging systems for new insurance products that are levied under material damage. Levy calculation would be more complex and there is greater risk of mistakes, resulting in greater risk of penalties;
 - insurers' systems were not designed for levy to be collected on material damage. This may result in levy calculation issues that did not need to be previously considered to be worked through.
 - manual checking of levy calculations made by intermediaries. As calculations are more complex, errors will be more likely;
 - older 'legacy' systems will need to be maintained and run in parallel to any new levy calculating system. This ensures that policy adjustments applied before Part 3 came into

¹⁵ ICNZ informs the Department that split perils policies account for less than 1% of all its clients' insurance contracts. Insurance information is commercially sensitive, so we do not know how many property owners hold split perils policies, or the value of those policies.

force can be calculated and charged or refunded. Legacy systems may need to run for up to two years; and

- as levy calculation errors under Part 3 are more likely, insurers will receive financial penalties. Fines will add to insurer operational costs.
81. There is disagreement between the insurance sector and Fire and Emergency over the auditing requirements resulting from material damage. Insurers believe Fire and Emergency audit resources would need to be improved so that it understands more about insurance policy contracts and structures. More auditors may be required, as this auditing will be new and will take longer as it will have to be a manual process. Insurers claim that auditing material damage policies would be too complex for automated auditing.
82. Fire and Emergency believe that auditing a levy based on material damage will be less demanding as it will no longer have to account for split perils policies.
83. The Department believes that, on balance, insurers assessment of the additional auditing requirements for Fire and Emergency appears justifiable, but without implementing material damage, we cannot be certain of these assertions.

Additional complexity means the levy could drive the design of insurance products rather than the insurance market

84. Insurance policyholders are unlikely to accept being charged multiple times for the same property, as it is inequitable. This may breach insurer's obligations under the sector's Fair Insurance Code, which requires insurers to act in the interests of their customers by treating them honestly and fairly.¹⁶ Previous analysis on the levy in the 2016 RIS does not take this into account.
85. As Part 3 contains provisions to prevent and penalise levy avoidance, insurers and brokers would have to alter their insurance products, and their systems, to ensure that the levy is only charged once, and the correct amount is charged. Each insurance product and their unique scope of cover, structure, sums insured and cover sub-limits would need to be individually addressed, to prevent multiple levy charges on the same property. This involves a range of changing costs and complexities and the risk that reducing any overlapping coverage introduces risks for policyholders by introducing gaps in cover.
86. Insurers are responsible for ensuring that the products they sell meet policyholders' risk management needs. This means that insurance policies overlap to reflect different situations (e.g., home renovations) and avoid any gaps in coverage. Insurers tell us that the extra levy that would need to be charged on multiple policy extensions (such as additional earthquake cover, breakdown cover, or stock spoilage) may result in insurers having to either provide these cover extensions as standard even if they are not required by policyholders or not provide them at all.
87. Insurers may need to redesign many of their products around the levy, rather than what is best for policyholders. If this were to occur, it is highly likely that the insurance sector would provide sub-optimal products, with the additional administrative requirements. There is a risk that the fire levy would distort the insurance market resulting in insurance products that are not to policyholders' needs or potentially stifling innovation in the provision of insurance.

¹⁶ Insurance Council of New Zealand, Fair Insurance Code, page 5

Disproportionate increases in costs to non-residential policyholders with split perils policies

88. Levying property insured against material damage rather than fire damage is likely to increase costs to some large non-residential property owners with split perils policies. The types of organisations that use split perils policies include private businesses and government agencies such as District Health Boards, universities and other educational institutions. Split perils policies are a rational and legitimate way to structure insurance. A fire is likely to do less damage across a property portfolio than an earthquake or a severe weather event, so a lower level of insurance coverage is purchased for fire damage.
89. As noted in the 2016 RIS, split perils policies also provide a mechanism to reduce levy costs for policyholders, because of their split insurance policies.¹⁷
90. Split perils policyholders pay the levy on the lower amount of insurance cover, against fire damage. However, under Part 3 of the FENZ Act they will pay a levy on the higher level of cover for material damage. Non-residential property owners with split perils policies expect to face significant levy increases because of the change to material damage. These property owners generally have large property portfolios. This means that the increases in levy under Part 3 for these property owners could be quite large, while the resulting decrease in levy for other non-residential property owners would be relatively low as it is distributed across many more property owners.

Material damage will increase costs for the large policyholders and may force trade-offs

91. Large non-residential property owners in both the public and private sector have told us that the levy increase could be significant enough to alter how they structure their insurance. The increase in levy for some non-residential property owners may lead to unintended consequences, such as under-insurance, or uninsured property to minimise the levy.
92. The Ministries of Education and Health have raised concerns about possible significant cost increases. The size of the levy increase is uncertain and will be specific to the policyholder. However, because we know the proportion of split perils policyholders, we do know that the average levy increase will be large, whereas the average levy decreases for non-residential policyholders who do not have split perils policies will be relatively small. We cannot determine the impact of levy increases on individual split perils policyholders, as it would depend on the decisions of individual policyholder on whether they reduce their insurance cover or make trade-offs.

Implementation costs are likely to increase the cost of insurance

93. Moving to charging levy on contracts of material damage will require insurers and brokers who collect the levy to update their systems to collect levy correctly. ICNZ estimates, based on surveying its members, that the cost of reprogramming insurance systems to meet the proposed Part 3 requirements is likely to cost in excess of \$50 million. Due to the COVID-19 disruptions, many insurers have had to bring certain back-office and IT system maintenance and development functions back to New Zealand and Australia that were previously contracted to organisations in India and Southeast Asia. The local cost inflation for IT expertise, and a significantly constrained talent pool due to COVID-19, would likely see costs exceed \$50 million.

¹⁷ Regulatory Impact Statement, Fire Services Review – cost of change and new funding arrangements, paragraph 76.

94. Insurance sector representatives have stated that these costs will be passed on to policyholders, in the form of higher insurance premiums. Insurers were unable to say if premiums would increase for all policyholders or certain types of insurance policyholders would face more of an increase than others.

Applying the levy to the “amount insured”

95. Evidence of this problem is based on detailed discussions with a reference group of insurance sector stakeholders and Fire and Emergency about how amount insured could operate if the legislation came into force.
96. We do not have quantitative data on the number of insurance contracts:
- for which an express maximum limit can or cannot be easily calculated;
 - that include extensions or reinstatement provisions in addition to the sum insured which could affect the level of cover; or
 - that include ‘demand surge’ provisions¹⁸.
97. Amount insured is a new term introduced in Part 3. Part 3 states that the levy payable is calculated based on the “amount insured” in the insurance contract. The amount insured is defined as the express maximum limit contained in an insurance contract, or the declared value if no express maximum limit is contained in the contract. This means that if the insurance contract states a maximum figure that the insurance company must pay out (Express Maximum Limit), then this is the amount insured. If there is no figure stated, then this figure is determined by either a statement from the policyholder as to the value of the property, or by a valuation certificate. The intent behind this approach is to reduce any opportunities for levy minimisation.
98. Following the passing of the FENZ Act, and feedback from stakeholders, the Department now believes using the term amount insured will be more complex to interpret than expected. “Amount insured” and “express maximum limit” are not used by insurers and brokers. Each insurer or broker may interpret these terms in a different way and there is a risk that the terms may not be applied consistently across insurance policyholders. The insurance sector informs us that legal and technical costs will be incurred in trying to determine the “Expressed Maximum Limit” in insurance contracts and to adjust levy calculations accordingly.
99. Insurance sector stakeholders are uncertain whether express maximum limit is intended to include all policy extensions. Policy extensions mean that under certain circumstances a value higher than the amount insured may be paid out, such as “demand surge” provisions. Calculating levy based on amount insured in a case like this would mean that the policyholder pays levy on the amount that includes a demand surge, regardless of whether there is in fact a surge in demand or not. This would be an inequitable way of charging or calculating levy. The levy would affect many different insurance products with many variations in levy charging rules required.
100. Compliance issues are likely to occur when insurers and brokers calculate levy on the relatively small number of complex contracts. Compliance issues could also occur for the very large volumes of straightforward property insurance contracts where there is low or no risk of

¹⁸ Demand surge provisions apply where an increase in the cost of repair or replacement of damaged property occurs following a large-scale disaster where many individuals and organizations vie for a limited supply of labour and materials needed for repair.

avoidance. This is because simple contracts often include extensions that result in the maximum that can be paid out in a claim being higher than the sum insured.

Key Assumptions underpinning the analysis

101. This analysis assumes that the insurance-based levy will remain a stable source of funding. It does not consider risks associated with Fire and Emergency being exposed to risks to its revenue, without a corresponding reduction in the demand for its services or its expected capability. This could be through:
- a reduction in insurance cover (and hence levy payments) resulting from increased use of self-insurance or “split perils” insurance policies (including by Government agencies);
 - an economic downturn resulting in less insurance activity in general; or
 - insurance companies declining to offer certain types of insurance contracts, for example, in areas where the risk of damage due to climate change is judged to be too high.

1.3 Objectives

102. For any changes to the FENZ Act, the objectives are to ensure that the funding system:
- adheres to good regulatory design principles: ease of implementation, cost-effectiveness and least disruption; and
 - any changes must also ensure that the insurance-based funding model aligns with the principles in the FENZ Act as closely as possible, given the constraints in the system.
103. Section 80 of the FENZ Act establishes the following principles of the levy system:
- **Equitable:** Insurance policyholders should generally pay a levy at a level commensurate with their use of, or benefit from the potential to use, Fire and Emergency’s services and with the risks associated with the activities that policyholders carry out (but without strict apportionment according to use, benefit, or risk having to be observed).
 - **Universal:** Costs are shared by those who benefit from the potential to use Fire and Emergency’s services and opportunities to avoid the levy are minimised.
 - **Stable:** There is a stable source of funding to support Fire and Emergency in the performance of functions and duties and exercise of powers under the FENZ Act.
 - **Predictable:** Policyholders and insurers and brokers can predict the amounts that they will need to pay, and Fire and Emergency is able to predict how much levy income it will receive.
 - **Flexible:** so that the levy can adapt to— (i) changes in the use, benefit, or risk associated with those who benefit from the potential to use Fire and Emergency’s services; and (ii) variations in Fire and Emergency’s costs; and (iii) changes to the expectations of the Crown and the strategic needs of Fire and Emergency.

Changes to the funding system should be consistent with good regulatory system design

104. The Government Expectations for Good Regulatory Practice set out the regulatory principles that the Department is expected to consider and give appropriate effect to.¹⁹ Any new regulatory system component should not be introduced unless we are satisfied it will deliver net

¹⁹ Government Expectations for Good Regulatory Practice, The Treasury, 2017.

benefits for New Zealanders. Outcomes of real value to New Zealanders are more likely when a regulatory system:

- seeks to achieve those objectives with minimal cost, and with the least adverse impact on market competition, property rights, and individual autonomy and responsibility;
- is proportionate, fair and equitable in the way it treats regulated parties; and
- sets out legal obligations and regulator expectations and practices in ways that are easy to find, easy to navigate, and clear and easy to understand.

105. The insurance-based levy system funds a vital public service. Fire and Emergency's funding relies on insurers and brokers to accurately calculate, collect, and pass on levies to Fire and Emergency. Good system design involves making it as easy as possible for insurers and brokers to carry out their role and minimises associated costs. A clear, simple, cost-effective system is more likely to deliver funding stability for Fire and Emergency and its public services because it can operate more effectively.

Section 2: Deciding upon an option to address the policy problem

2.1: Criteria used to compare the alternative option to Part 3

106. The criteria to compare the alternative options to the Part 3 provisions are linked closely to the objectives, listed in section 1.3 above.

Criterion 1: Compliance with the Principles in the FENZ Act

107. This criterion assesses how closely the option adheres to the principles described in paragraph 109, above.

Criterion 2: Compliance with the Principles of good regulatory design

Criterion 2A: Implementation costs

108. This criterion assesses the costs to insurers and brokers of making changes to their systems to collect the levy, because of changes to the insurance-based funding model. A simpler system is likely to have fewer system changes and lower implementation costs.

109. Implementation costs that are incurred as part of levy collection are likely to be passed on by the insurance sector to policyholders, in the form of increased insurance premiums.

Criterion 2B: Simple to administer

110. This is the administrative costs of operating under the levy system once it is put in place. This criterion assesses the simplicity for insurers and brokers, Fire and Emergency and policyholders when operating under the new levy system. Levy collection costs are also likely to be passed on by the insurance sector to policyholders, in the form of increased insurance premiums.

111. These principles of good regulatory design also relate to some of the principles in the FENZ Act – primarily stability and predictability.

Trade-offs between criteria

112. There is likely to be a trade-off between principles within the FENZ Act. A system with lower implementation costs that is simple to administer has more stability and predictability but may mean less equity and universality across policyholders. The Department will favour the options that adhere to the principles in the FENZ Act *and* to good regulatory system design. This will ensure that any changes to the levy system represent good value for money – the increases in equity must be balanced against implementation costs and ongoing administration costs.

2.2 What scope will options be considered within?

Ministerial Commissioning

113. Cabinet agreed that the funding review will focus only on improving the insurance-based levy that is due to come into force on 1 July 2024 [CAB-21-MIN-0124 refers]. Only options that relate to the insurance-based funding model are in scope for consideration. Cabinet also agreed that the principles for the funding review would remain the same. These are the principles listed in section 1.3 above.

114. Changes to the funding system that are outside the insurance-based model were not considered, such as:

- funding from general taxation;
- the Crown contribution;²⁰
- funding through a property data-based levy;
- user charges;
- collecting levy based on vehicle licensing;
- examples from overseas jurisdictions, because there are not relevant insurance-based funding models; and
- caps and exemptions, as these will be addressed during the levy setting phase; and
- uninsured and self-insured parties.

115. Not all beneficiaries of Fire and Emergency's services contribute under an insurance-based levy model. Some property owners do not insure their property or choose to self-insure. These situations are described more fully in Appendix Two.

Alternative Risk Financing work is not expected to reduce government levy contributions

116. The Risk Financing and Insurance team at the Ministry of Business, Innovation and Employment (MBIE) is working on a project, "Alternative Risk Financing" (ARF). ARF is an all-of-government approach to reform how entities insure public assets and liabilities. This approach aims to introduce a more collaborative and cost-effective model than previously used, and MBIE anticipates that it will provide significant reductions in costs to government entities.

117. The use of ARF may result in government agencies no longer using an "insurer" as defined by the FENZ Act. MBIE has had discussions with Fire and Emergency about the implications on Fire and Emergency's funding. MBIE's expectation is that agencies' levy payments to Fire and Emergency will not be reduced under an ARF approach.

²⁰ This is the funding that the Crown contributes, in recognition of the public good component of services provided by Fire and Emergency, these are responses like medical callouts and natural disaster responses

Regulatory solutions are required

118. Non-regulatory options on their own are insufficient to address the problem. The transitional levy that is in place will be replaced by Part 3 of the FENZ Act on 1 July 2024. The amendment in Part 3 of the FENZ Act will change how the levy is applied to insurance contracts and the figure within the contracts that the levy is applied to. This will have the impacts identified in the following section. To avoid these impacts, the type of contracts that the levy applies to and the figure that the levy is based on must be changed.
119. Operational-level solutions may be possible to accompany regulatory changes. Further work will determine the level and type of guidance required by Fire and Emergency about how the levy will be administered and audited. This could include guidance on the levy calculation process and explicit prescription for how Fire and Emergency would audit how the levy has been calculated.

Insurance-based options that were not pursued

A levy based on insurance premiums

120. The insurance premium is the amount that a policyholder pays for their insurance cover. Often this is a monthly payment for residential insurance, or annually for commercial insurance. The primary purported benefit of attaching the levy to insurance premiums would be that the levy paid would better reflect the risk of fire. However, following consultation it was determined that there are several problems with attaching a levy to premiums:
- premium values are highly volatile, and Fire and Emergency's revenue would decrease if insurance premiums being paid decreased;
 - premiums are affected by other factors besides risk, like global financial markets, the cost of reinsurance and domestic competition; and
 - premiums are also vulnerable to levy minimisation as they are affected by the excess level selected by the policyholder.
121. Given the above factors, and the strong insurance sector support for the simplest possible option, the Department did not assess attaching the levy to the value of the insurance premium.

Measures to reduce levy for buildings that meet safety standards

122. Under this option, regulations would be made to reduce levy for buildings that meet certain safety standards, such as sprinkler standards or building code standards. This would provide incentives for building owners to improve the safety of their buildings.
123. It would take several years to determine what building standards have a meaningful impact on the likely call on Fire and Emergency's services. The threshold for becoming eligible for a levy reduction would likely need to be very high to prevent the system from capturing all commercial properties. The Department has not assessed measures to reduce the levy for buildings that meet safety standards.

Retaining indemnity value to calculate the amount of levy to be paid.

124. Indemnity value is used to calculate the transitional levy.²¹ The FENZ Act moves away from indemnity value because of the complexity of using this term and the additional administrative

²¹ See the Glossary of Terms at the end of this document, for a fuller explanation of "indemnity value".

costs it places on both insurers and brokers and Fire and Emergency. Fire and Emergency agree that indemnity value is a term unique to the Fire and Emergency funding system and is not used for any other purpose other than the levy calculation. The Department has not assessed retaining indemnity value when calculating the amount of levy to be paid.

Step-change in the implementation of levies

125. A step-change in implementing the levy across several years would involve non-residential property owners facing lower levy increases in the early stages, then the rate could increase over time, rather than a steep, one-off increase. A step-change in implementation has not been considered in this analysis but will be considered as part of the levy-setting process.

2.3 Options considered

126. We have worked closely with stakeholders to identify the options considered.

Insurance and property stakeholders have been highly engaged

127. Options have been developed with targeted stakeholders from the insurance sector, commercial property sector and with Fire and Emergency. Residential property owners and motor vehicle owners were not included in targeted consultation because Part 3 or any changes that are made will have minimal impact on these groups. These groups will be consulted during the levy setting stage of the process.

128. The insurers and brokers reference group represents organisations that are responsible for collecting the Fire and Emergency levy. It was important to get perspectives from members of this group because they are responsible for levy collection. For changes in the system to work successfully, understanding the impacts on the insurance sector is essential. Key stakeholders that were engaged with were insurance sector representatives, include the Insurance Council of New Zealand, IAG, the Insurance Brokers Association of New Zealand, Crombie Lockwood, Marsh and FMG.

129. The commercial property owners reference group included organisations that own large property portfolios and could therefore be liable for large amounts of fire levy. It is important to get perspectives from this group as any change to the fire levy could have significant impacts on commercial property owners' levy costs. The property sector reference group included the Property Council of New Zealand, Foodstuffs, NZ Airports and the Forest and Rural Fire Association.

130. Business New Zealand put forward the views of small New Zealand businesses who make up a large proportion of the smaller non-residential policyholders.

131. The key difference between these stakeholders is the emphasis on a user-pays model versus simplicity. Commercial property stakeholders believe the non-residential sector should, as much as possible, pay only for the Fire and Emergency services that it uses, or has the potential to use, even if it comes at the expense of some simplicity in administration. For example, these stakeholders would prefer a complex risk-based model, where the levy can reflect measures that mitigate risk, such as sprinklers and new building technology. The insurance sector favours a simplified levy system that will be more cost efficient to implement and simpler to administer levy collection.

Overview of Options

132. The table below summarises the two options. The transitional levy is in place until 1 July 2024, when the Part 3 provisions will come into effect if no action is taken.

| Variable | Transitional Levy | Part 3 | Alternative options |
|--|---|--|--|
| Type of insurance contracts that attract the levy | Applies to contracts of property insurance against damage by fire – rate per dollar | Applies to all contracts of property insurance against physical loss or damage, whatever the cause of loss or damage (i.e., not limited to damage by fire) - rate per dollar | Applies to contracts of property insurance against damage by fire – rate per dollar |
| Amount the levy is based on | Amount insured in the contract, or indemnity value | Levy is calculated on the amount insured for the property (Express Maximum Limit) | Levy is calculated based on sum insured (to be defined in a way that stakeholders are familiar with) |

Three solutions are available, in addition to retaining the Part 3 provisions

133. As alternatives to Part 3 provisions coming into effect, there are three different combinations of options that could be put in place:

- both the alternative options of fire damage and sum insured could both be adopted.
- the levy could be charged on fire damage and the Part 3 provisions of calculating the levy on the amount insured are retained.
- the Part 3 material damage provisions could be retained, and the sum insured option for calculating the levy is introduced.

Fundamental differences between the Part 3 material damage provisions and the alternative, fire damage

134. The Part 3 provisions:

- are expected to create a larger levy base;
- should collect a greater amount of levy from large non-residential property owners that use split perils insurance to reduce their insurance costs;
- are supported by Fire and Emergency New Zealand who see Part 3 as easier to administer, and will reflect their wider mandate beyond fighting fires;
- improves equity across non-residential policyholders, as larger non-residential policyholders pay a larger proportion, and smaller non-residential levy payer pay a smaller proportion of the non-residential levy;
- will add implementation costs, for insurers and brokers to update their systems; and
- adds costs to the levy collection process, that are likely to be passed on to policyholders through higher premiums.

135. The alternative option, fire damage:

- is simpler for insurers and brokers to collect the levy;
- avoids costs to insurers and brokers for system upgrades, that are likely to be passed on to policyholders; and
- will not see improvements in equity for smaller non-residential insurance policyholders.

Fundamental differences between the Part 3 amount insured provisions and the alternative, sum insured

136. The Part 3 amount insured provisions:

- are likely to create a simpler system for levy collection, compared to the transitional levy arrangement;
- may not be interpreted consistently across the insurance sector, despite the definition being set in legislation; and
- under certain circumstances, may lead to a value higher than the specified amount insured being paid out by an insurer, which can lead to confusion over what figure the levy should attach to;

137. The alternative option, sum insured:

- is more likely to be defined in the legislation in a way that the insurance sector is familiar with;
- is likely to decrease compliance costs for insurers and brokers collecting the levy;
- the statutory declaration process insurers and brokers must undertake would need to occur far less frequently, because the sum insured would be agreed upon in the contract of insurance. When this process does need to occur, it will be simpler for the policyholder and insurer; and
- insurers and brokers should be able to provide more certainty on the total value of property insured in New Zealand and the amount of levy they expect to collect, because sum insured is a figure that they can use.

2.3.1 The type of insurance contracts that attract the levy

138. There are two options being considered for the contracts to which levy would apply; the Part 3 provisions and an alternative option – contracts of insurance against fire damage. The 2016 RIS proposed to extend the levy from contracts of fire insurance to contracts of material damage because it:

- represents the simplest option for the insurance industry to administer;
- makes it more difficult for levy payers to reduce their contributions by adopting split insurance policies;
- reflects that fire services are responding to a growing number of non-fire related incidents (e.g., work to protect housing and businesses from flooding); and
- will expand the levy base.

139. In undertaking this RIS, the Department now has an improved understanding of the implementation challenges and costs to move to the Part 3 levy as written, and better information on inequity in the system. However, this analysis relies on anecdotal information of relative impacts. There is no ability to scrutinise this information because of the commercial sensitivity of information about insurance contracts.

Option One – Part 3 provisions

140. This option will occur if the Part 3 levy comes into force on 1 July 2024 unchanged.
141. **Contracts that attract the levy:** Part 3 will apply the levy to a contract of insurance under which the property is insured against physical loss or damage, whatever the cause of the loss or damage, including temporary or reparable loss or damage and a consequential loss or damage (material damage).

Material Damage may distort insurance contracts and make insurance harder to understand

142. As outlined in paragraphs 88-91, insurers and brokers are very likely to need to re-design many of their policies so that the levy is only applied once to property that has multiple policies. Movement to material damage risks distorting the insurance market so that policies are driven by the Fire and Emergency levy and compliance with the levy, rather than policies providing insurance products that policyholders need.
143. Some insurance providers within the insurance sector struggle to provide a clear explanation to policyholders of the products they are provided. The Financial Markets Authority's July 2021 update on insurance conduct and culture noted that:

The basic requirement that premiums are accurate, transparent, administered correctly and with value communicated to the customer has clearly not been met in a number of situations. This is particularly important for fire and general insurance products, where it is very hard for the customer to understand how their premiums have been calculated.²²

144. Designing insurance products around the levy may make it more difficult for the insurance sector to explain to policyholders the value of its products and how premiums are calculated. This is the context where insurance products are already challenging for policyholders to understand and many in the insurance sector struggle to communicate this effectively.²³

Material damage creates a bigger pool of assets to levy by redistributing the levy

145. As noted in the 2016 RIS, large non-residential insurance policyholders with split perils policies would pay levy on the higher level of insurance coverage for material damage, rather than lower amount covered for fire damage.²⁴ This is expected to broaden the pool of assets the levy is charged on because it will include property insured under split peril contracts. The value of split perils policies is unknown, but we expect it to be relatively large. We expect that the policyholders who are paying the levy would remain largely unchanged (if exemptions remain the same). Those policyholders with split perils would be paying a larger proportion of the non-residential levy compared to if the levy remains on fire damage.
146. The overall financial impact of collecting levy from material damage compared to fire damage cannot be estimated at this point because levy contributions would depend on individual insurance contracts and how they are arranged. The financial impact of moving to material damage would also be determined by how much the levy base changes (and in turn how much the levy rate falls or rises) because of collecting the levy on material damage. Because these are not known, detailed financial impact on individual policyholders cannot be determined.

²² Insurance conduct and culture: Fire and general insurers update, Financial Management Authority, July 2021, page 4.

²³ Insurance conduct and culture: Fire and general insurers update, Financial Management Authority, July 2021, page 9.

²⁴ Regulatory Impact Statement, Fire Services Review – cost of change and new funding arrangements, paragraph 77.

Material damage will increase levy contribution from split perils policyholders

147. The 2016 RIS noted that material damage makes it more difficult for levy payers to reduce their contributions by adopting split insurance policies.²⁵ The impact of levy payers reducing their contributions by adopting split insurance policies was a concern set out in the 2016 RIS.²⁶ Applying the levy to insurance for material damage means those large non-residential policyholders with split perils insurance would pay a greater levy contribution and some smaller property owners will pay less, depending on their individual insurance arrangements. More large property owners will be paying levy on a larger proportion of their property, which is in line with smaller non-residential policyholders who generally have an insurance policy that covers the total value of their assets.
148. In 2016, the Department did not have information on the prevalence of split perils policies and there was the potential that many larger policyholders were using split perils policies to reduce their levy contributions.²⁷ We now know that split perils policies that are used by large public and private entities make up less than 1 per cent of all policies.²⁸ We were not able to find out the dollar value of these policies, due to the commercial sensitivity of the insurance information. The value of this property is likely to be significant because split perils policies are generally used by entities with large property portfolios. This information provides us with a better basis for assessing the size and impact of split perils policies.
149. We know the ratio of split perils policyholders and this means that we can be confident of the direction of these cost impacts and the relative size of cost impacts.²⁹ The redistribution of levy will see significant increases in levy for split perils policyholders and result in comparatively small decreases in levy for other non-residential policyholders.
150. Fire and Emergency has noted there is a risk that non-residential policyholders could move to split perils policies when the Part 3 provisions come into effect and the levy is no longer calculated on the indemnity value of a property. Policyholders could move to a split perils policy under existing provisions, but it has not occurred at any large scale. This is possibly because the benefit of reduced levy does not outweigh the risk that the organisation is under-insured. This suggests that the likelihood of many policies moving to split perils would be low. However, the likelihood and impact of these changes is difficult to predict, as this would be a decision for the individual policyholder and would require the Department to have accessed commercially sensitive insurance information. There is a stronger case for change to material damage if the use of split perils policies was widespread and many entities were using this to reduce their levy contributions.

Impact of material damage on Māori

151. A move to material damage will impact insurance for marae and for Māori commercial property holders. We expect that the impact on Māori commercial property owners to be the same as other non-residential policyholders – with some larger policyholders facing an increase in levy, where they have split perils insurance.

²⁵ Regulatory Impact Statement, Fire Services Review – cost of change and new funding arrangements, paragraph 76.

²⁶ Regulatory Impact Statement, Fire Services Review – cost of change and new funding arrangements, paragraph 76.

²⁷ Regulatory Impact Statement, Fire Services Review – cost of change and new funding arrangements, paragraph 33.

²⁸ Insurance Council of New Zealand estimate based on membership survey.

²⁹ Because the total levy collected remains the same, any levy increase for a small number of non-residential property owners will be offset by a much smaller levy reduction for the remainder of non-residential property owners.

152. Some iwi have collective marae insurance, which enables multiple marae to be insured under one policy, meaning that more competitive pricing and lower premiums can be negotiated due to risk pooling, and the combined purchasing power of marae.³⁰
153. The impact on marae, including collective marae insurance, would depend on their insurance contract. We know that for marae with split perils insurance, charging the levy on contracts of material damage will mean an increase in levy costs, because the marae would have previously been paying levy on a lower amount which is insured against fire damage. Where a marae or collective does not have split perils insurance, the move to material damage is likely to result in a slight decrease in the insurance levy, as larger non-residential policyholders with split perils would pay a greater proportion of the levy.
154. We do not know the number of marae that are insured or the type of insurance coverage – fire damage or material damage. This is commercially sensitive information that cannot be provided to us by insurance companies. Anecdotally, we have heard that for some iwi, approximately 35 per cent of their marae are uninsured. Fire and Emergency cannot identify levy paid for marae as it is often part of wider insurance contracts for an iwi trust or rūnanga. While the Department does not have this detailed information on size of the cost impact (how large or small the increase or decrease in levy is), we can be certain about the nature of the cost impact that will occur (an increase or decrease), depending on the type of insurance arrangements.
155. Marae that are not insured will not be directly affected. They are not paying the levy so a move to material damage will not increase costs. As noted above, we do not know the number of marae that are uninsured, nor do we know the level of insurance for commercial property portfolios.
156. We do not have a complete understanding of the impact on Māori. We believe this is due to a combination of several factors:
- the commercial sensitivity of the insurance information held by insurance and brokers, that cannot be shared;
 - minimal engagement from iwi at this stage of the process – the review may not be as relevant to iwi until the levy rates and caps/exemptions are being set;
 - the amount of work government is doing with iwi means that resources are stretched, and they are not able to engage; and
 - iwi have other priorities – reforms such as Three Waters or the Resource Management Act reforms are likely to be higher priorities.

Increase in costs for large non-residential policyholders can be mitigated with affordability measures, but these affordability measures increase the complexity of the system

157. Clauses 42 to 44 of Schedule 1 of the FENZ Act contain provisions allowing the Minister of Internal Affairs to temporarily exempt a policyholder in whole or in part from the levy if they are subject to an “unreasonable burden because of any increase” in levy. This exemption is available between the 2018/19 and 2024/25 financial years and is intended to allow entities time to adjust to increased costs. These provisions in Schedule 1 could be extended, to help ensure that affordability issues associated with the calculation of the levy on physical loss or damage are reduced, as affected entities adjust to the new levy system.

³⁰ Māori Financial Services Institutions and Arrangements, Discussion Paper, Reserve Bank of New Zealand, 15 April 2021

158. While Schedule 1 would make the levy more affordable, we know that any exemptions or exclusions within the levy system add complexity and cost to the system's administration. This means affordability measures would also have the following potential consequences, which were identified in 2016.³¹

- small-medium businesses are likely to make up the shortfall created by the affordability measures, which would reduce the equity that moving to material damage seeks to achieve;
- the administration of the levy would be more complex for the insurance sector, the cost of which the sector is likely to pass onto entities through their insurance premiums;
- the administration of the levy and public consultation would be more complex Fire and Emergency; and
- adding any complexity into the levy setting increases the ability of entities to avoid paying the levy, which only further erodes the levy.

Material damage adds costs to the levy collection system

159. As noted in section 1.2, above, the use of material damage will require significant system changes to the levy collection function performed by insurers and brokers. These changes are estimated to add costs to the levy collection system of approximately \$50 million.

160. These costs are likely to be passed on from the insurance sector to policyholders in the form of higher premiums.

161. \$50 million is 8.7 per cent of the total levy that the system collected in 2019/20³². This additional cost that amounts to 8.7 per cent of levy collected is one of the factors to be balanced in assessing material damage.

Option Two – The Alternative Option

162. **Contracts that attract the levy:** The alternative option would apply the levy to contracts of property insurance against fire damage.

Costs and changes to the insurance sector's systems would be avoided

163. A levy on fire damage is what happens under the transitional levy. It is already used by insurers and brokers, and Fire and Emergency; and it is generally well understood and reasonably easy to apply in comparison to levying contracts of material damage. A levy on fire damage would also avoid the complexities involved in applying the material damage levy, as insurers and brokers will not need to set up their systems to apply the levy to policies for material damage.

164. The need for insurers and brokers to reconfigure their systems to avoid charging a levy multiple times on one property is reduced, as only contracts for fire damage are levied. Levy on fire damage should mean that the instances when an insurer or broker needs to apply the levy to the same property multiple times is less frequent. Some properties do have multiple policies covering fire damage, so this issue would still exist, but would occur less frequently.

165. Levying against fire damage would avoid the costs of moving to material damage, which insurers and brokers estimate is in excess of \$50 million.

³¹ Regulatory Impact Statement, Fire Services Review – cost of change and new funding arrangements, paragraph 79.

³² Fire and Emergency Annual Report 2019/20.

The risk of distortion of insurance contracts is avoided

166. Under fire damage, insurers and brokers would not need to re-design as many of their policies so that the levy is only applied once to property that has multiple policies. As outlined in paragraphs 88-91, this risks distorting the insurance market so that policies are driven by the Fire and Emergency levy and compliance with the levy, rather than policies providing insurance products that customers need.

Some large non-residential policyholders should avoid significant potential levy increases

167. If the levy remains on fire damage, this avoids the potential for significant increases in levy that some large non-residential property owners would see under a levy on material damage. It is likely to avoid any trade-offs that large non-residential policyholders might need to make to avoid a reduction in insurance coverage that might result from the increase in levy. We know that, on average, the increases faced by split perils policyholders will be larger than the relatively small average levy decrease for non-residential policyholders without split perils policies.

Some inequity across non-residential policyholders remains

168. Applying the levy to insurance against fire damage has disadvantages. It would be less equitable than using contracts of material damage. As mentioned in section 1.2, large public and private entities who use split perils policy insure for material damage at a higher amount than the insurance for fire damage. As the levy would be charged on peril of fire only, these property owners would continue to be charged on the lower sum, and contribute proportionally less to the levy, with smaller non-residential policyholders contributing proportionally more. This may be less equitable if you consider these larger non-residential policyholders have a greater potential to benefit from Fire and Emergency’s services because they have more valuable property. Yet larger non-residential policyholders pay a lower percentage of their property’s value relative to smaller property owners that are often insured to fully cover the value of their property. As mentioned earlier, however, there is not necessarily a strong link between the value of property and its potential to benefit from a Fire and Emergency response.

How the alternative option, fire damage compares to the Part 3 provisions, material damage

| | Counterfactual: Part 3 (Material damage) | Alternative Option (Fire damage) |
|--|--|--|
| Consistent with principles in the FENZ Act | Levy is charged on all contracts of insurance which cover physical damage or loss 0 | <p style="text-align: center;">+</p> <p>Less universal: Levy does not reflect Fire and Emergency’s expanded mandate.</p> <p>Less equitable: small non-residential entities pay a greater proportion of the levy relative to their assets. However, some improvement in equity as properties are not charged levy multiple times.</p> <p>More stability: levy collection is simpler and more cost effective, so compliance is easier</p> <p>More predictable: Policyholders and insurers and brokers are better able to predict the</p> |

| | Counterfactual: Part 3 (Material damage) | Alternative Option (Fire damage) |
|------------------------------|--|---|
| | | amounts that they will need to pay and FENZ is able to predict how much levy income it will receive. The levy system does not drive the design of insurance products, avoiding potential distortion of the insurance market. Flexibility is neutral: both options will provide stable funding and allow for flexibility through changing the levy rate. |
| Cost to implement | Insurers and brokers must update IT systems and redesign insurance products to calculate and collect levy on material damage. 0 | ++ Fewer IT and underwriting system changes for levy collection by the insurance sector. Estimated \$50 million in levy collection costs for insurers and brokers that would pass to insurance policyholders, are avoided. |
| Simpler to administer | Calculating and collecting levy on material damage will involve manual calculations and uncertainty. 0 | ++ Retains current settings. Better understood, easier for insurance sector to apply. |
| Overall assessment | Charging levy on material damage seeks to improve equity in the system, but does so at increased cost and complexity and to the detriment of other principles in the FENZ Act 0 | + Less equitable but costs that insurers estimate at \$50 million to implement system changes are avoided. Simpler for insurers and brokers to collect levy. |

++ much better than status quo, + somewhat better than status quo, - no different to status quo, x somewhat worse than status quo, xx much worse than status quo.

2.3.2 The amount of money in the insurance contract that the levy is calculated on

169. These are the two options considered for the specific amount of money within the insurance contract which the levy would be calculated on.

Option one – Part 3 provisions

170. **Amount that the levy calculation is based on:** Amount insured. Amount insured is defined in Part 3 of the FENZ Act as the express maximum limit contained in an insurance contract, or the declared value if no express maximum limit is contained in the contract.

Using amount insured should reduce compliance costs

171. Moving to an amount insured levy calculation method is likely to create a simpler system that reduces the insurance sector's day-to-day compliance costs. Policyholders may not need to be contacted for indemnity declarations and indemnity valuations, and these documents would not need to be reviewed, stored and levy calculations then made based upon them.

The term amount insured is not supported by insurers and brokers

172. Using the amount insured has disadvantages, as noted in part 1.2 above. The term "amount insured" and the phrase "express maximum limit" are not used by insurers and brokers. Insurance sector stakeholders are uncertain if "amount insured" is intended to include all policy extensions such as demolition amounts, professional fees, and many contingency policy benefits. These are outlined in more detail in Appendix one. The levy would affect many different insurance products and require variations in levy charging rules. Although we are reliant on information from insurers and brokers on this problem, we consider that their concerns are justified. A lack of clarity on the way the law should be applied may affect equity in the levy system, if different insurers and brokers apply the law in different ways due to the uncertainty of the how the term amount insured is to be applied to insurance contracts.

Amount insured can be inequitable for some non-residential policyholders

173. Levying the amount insured in the contract may result in an inequitable increase in costs for some non-residential property owners who have changes in their level of cover throughout the year. For example, a retail business with stock levels that peak at Christmas will be charged levy on the highest amount in the contract, despite having less stock and less risk of loss the remainder of the year. These policyholders pay their premium once a year, so they would be charged on the highest figure specified in the contract, under a levy on the amount insured.

Option Two – The Alternative Option

174. **The amount the levy calculation is based on:** Sum insured. The maximum amount that the insurance policy can pay to the policyholder for any one incident of loss of damage.

Sum insured can be used by the insurance sector

175. Sum insured is already a term used by the insurance sector. Insurers and brokers tell us that it can be defined in the legislation in a way that the insurance sector is familiar with. Assuming an agreed definition can be found, insurers consider that compliance costs will be low compared to the status quo. This would effectively reduce the compliance costs associated with building business systems and processes to apply the levy, creating a simpler system for both the insurance sector and Fire and Emergency.
176. There is also the potential that with clear terminology, the statutory declaration process insurers and brokers must undertake would occur far less frequently, because the sum insured would be agreed upon in the contract of insurance. When this process does occur, it will be simpler. Insurer and brokers have also told us that there should be little impact on the vast majority of

straightforward insurance contracts, which will already have a sum insured value that can be used.

Administrative processes for Fire and Emergency should be simplified

177. Insurers and brokers should be more certain about the total value of sum insured in New Zealand because sum insured is a figure that is easier to use. More accurate estimates of the total sum insured should make setting the levy rate a more accurate process for Fire and Emergency. This may provide greater certainty for Fire and Emergency in understanding funding adequacy and may also reduce the resource that Fire and Emergency must dedicate to auditing, accountability and investigating levy issues.

Cost savings for insurers and brokers are more likely

178. There will be administrative costs for insurers and brokers to move to sum insured. Insurers and brokers are more supportive of the system changes needed to use sum insured, they see it is likely to make a simpler levy system that provides efficiency gains and reduce future administrative costs. If costs are passed on, insurers and brokers believe it will be lower costs than if amount insured is used.

179. Insurers and brokers believe that the term sum insured would be much easier to define and agree upon, across the insurance sector. We consider it would remove some of the complexity when collecting the levy and reduce the possibility of insurers and brokers interpreting the term in different ways. This in turn would increase the likelihood that the levy was applied consistently across insurance policyholders.

How the alternative option, sum insured compares to Part 3, amount insured

| | Counterfactual: Part 3 (Amount insured) | Alternative Option (Sum insured) |
|---|---|---|
| Consistent with principles in the FENZ Act | 0 | <p style="text-align: center;">++</p> <p>More predictable: consistency will help Fire and Emergency prevent levy avoidance.</p> <p>Predictable for policyholders as it is based on an agreed "sum insured".</p> <p>Equity: Clarity ensures levy is charge consistently. Greater likelihood that term can be understood and applied by both insurers and brokers and Fire and Emergency.</p> <p>More stability: levy collection is simpler and more cost effective, so compliance is easier.</p> <p>Flexibility is neutral: both options allow for flexibility through changing the levy rate.</p> |
| Cost to implement | 0 | <p style="text-align: center;">+</p> <p>Some costs to insurers and brokers, but simpler system changes.</p> |
| Simpler to administer | 0 | <p style="text-align: center;">++</p> <p>Easier term for insurance sector and Fire and Emergency work with, more likely to reduce the need for statutory</p> |

| | | |
|---------------------------|---|--|
| | | declarations process and will simplify the process when it does occur. |
| Overall assessment | 0 | ++ Greater predictability, lower cost to implement, simpler to calculate and collect. |

++ much better than status quo, + somewhat better than status quo, - no different to status quo, x somewhat worse than status quo, xx much worse than status quo

2.5 The option likely to best address the problem, meet the policy objectives, and deliver the highest net benefits

180. One policy objective is to ensure the funding model for Fire and Emergency is certain and simple to administer, to ensure that policyholders and insurers and brokers collecting the levy do not face unreasonable increases in costs. A second objective is to ensure that the insurance-based funding model aligns with the principles in the FENZ Act as closely as possible, while meeting the requirements of good regulatory design.
181. The Part 3 provisions and alternative options will have the same level of flexibility. This assumes that the New Zealand insurance system will not undergo any fundamental changes that significantly decrease the level of funding on which the insurance-based levy is charged. Regardless of the options chosen, the levy rate can be adjusted to ensure that Fire and Emergency obtain the funding they need to continue to provide their services.
182. As noted in paragraph 109 this analysis is looking to ensure that the funding system adheres as closely to the principles in the FENZ Act as possible. Additionally, any changes to the levy collection system must represent good value for money, and allow for an efficient levy collection system, as this is consistent with good levy design principles.
183. The Department's preferred options are to apply the levy to insurance contracts against fire damage and to calculate the levy based on the sum insured.

Applying the levy to contracts of fire damage is preferred

184. Applying the levy to fire damage will result in improved stability and predictability within the levy system. It would also largely avoid the administrative complexity and cost required to implement and administer a levy based on material damage, which is consistent with good regulatory design.
185. Applying levy to material damage will lead to an increase in equity; a small number of large non-residential policyholders with split perils policies face a large increase in levy, while many small non-residential policyholders would receive a small decrease in the levy (all other things being equal). This is because large non-residential policyholders now pay a greater share of the levy, but there are a much smaller number of them. This increase in equity comes with an ongoing cost of increased administrative complexity and one-off costs to the levy collection function of implementing system changes.
186. Our analysis suggests that the gains in equity by moving to material damage are likely to be outweighed by the cost and increased complexity added to the levy collection system.
187. We cannot be certain of this impact on individual policyholders, but at a higher level, based the type of policyholder (small non-residential vs large non-residential with split perils policies) we have more confidence in the impacts. This confidence is due to discussions with stakeholders,

data on the types of insurance contracts held by small non-residential policyholders and the proportion of non-residential policyholders with split perils policies.

188. No option under an insurance-based model will fully support all the principles set out in the FENZ Act. Given this, we are looking for the option that provides the best outcomes for policyholders, insurers and brokers, and Fire and Emergency under a set of less than optimal circumstances. Acknowledging the limitations on data and information in this analysis, we think that on balance, fire damage adds more benefit and has lower costs.

Calculating levy on the sum insured is favoured over amount insured

189. We are uncertain how a levy on the sum insured, or amount insured will affect levy liability for individual policyholders, and what flow-on effect this will have for Fire and Emergency's overall levy revenue and overall equity of the system.
190. The term sum insured is more likely to be consistent with the principles in the FENZ Act, it is more likely to provide predictability, and increase equity. Despite having an interest in reducing costs, the insurance sector is responsible for collecting the levy and has the best understanding of how the definitions are likely to work in practice.
191. Applying the levy to the sum insured rather than the amount insured, is more likely to create a simpler system that reduces administration and compliance costs in the levy collection process.
192. Sum insured is a term that is already used, and it is more likely an agreed definition can be reached by stakeholders. Insurers and brokers are confident sum insured can be defined in a way that the insurance sector is familiar with. If the term amount insured is retained, it will require insurers and brokers who collect the levy to use a term that may carry increased complexity. Because of this increased complexity, there is a risk that levy collection will not be consistent across the insurance sector. This increases the cost of administration of the levy.
193. There is a low risk that agreement cannot be found on how sum insured is defined, this is much less likely than if amount insured is used. The legislative process to change the Part 3 provisions allows for a clear and agreed definition of sum insured to be worked through and tested with stakeholders.
194. Both the insurance sector and commercial property owners prefer using sum insured as the basis for calculating the levy. Fire and Emergency would prefer that the levy is calculated on the amount insured. It has acknowledged that calculating the levy on the sum insured, would be workable if there is a clear and agreed definition across the insurance industry and a mechanism for managing disputes. Part 3 provisions do provide for a disputes resolution process.
195. Both options would have little impact on residential home and contents policyholders, assuming a cap on the amount of levy payable is retained. There would be a low impact on motor vehicle policy holders, for both options. Motorists with third party insurance will start paying levy. Motorists with comprehensive insurance should see a slight reduction in levy.
196. Our assessment of using sum insured as the basis of the levy calculation is that it will remain consistent with some of the Part 3 levy principles. It appears that it will more effectively achieve the objectives of ensuring the system is sufficiently simple, and certain to ensure that policyholders and levy payers do not face unreasonable costs in determining the correct level of levy to be paid.

This analysis has a different conclusion to the 2016 Regulatory Impact Statement

197. Moving from the transitional levy to the alternative levy involves less regulatory change than the shift to the Part 3 levy. This is important because unless there are compelling reasons, we should aim for the least disruptive approach. This is particularly essential when the ultimate outcome of the review will be the same - Fire and Emergency will be able to obtain sufficient funding.
198. The reasons why a more disruptive approach could be worth taking were laid out in the 2016 RIS. The 2016 RIS proposed to extend the levy from contracts of fire insurance to contracts of material damage because it:
- represents the simplest option for the insurance industry to administer;
 - makes it more difficult for levy payers to reduce their contributions by adopting split insurance policies;
 - reflects that fire services are responding to a growing number of non-fire related incidents (e.g., work to protect housing and businesses from flooding); and
 - will expand the levy base.
199. In undertaking this RIS, the Department now has an improved understanding of the implementation challenges and costs to move to the Part 3 levy as written, and better information on inequity in the system. This information indicates that:
- material damage is not likely to be the simplest option for the insurance industry to administer;
 - a relatively low proportion of policyholders take out split perils policies – although these policies may be for substantial amounts of property. This suggests split perils policies are not being widely used as a mechanism to reduce levy contribution, and it is not clear that retaining fire damage will result in more non-residential levy payers moving to split perils.
 - material damage appears to reflect Fire and Emergency's response to a growing number of non-fire related incidents, which improves equity across non-residential levy payers. However, property value is a rough proxy for use of, or potential to use, Fire and Emergency's services as it does not represent risk related to the property or the size of response required; and
 - while it is correct to say that levy base will expand, this will be through redistribution of the levy to split perils policyholders, rather than the introduction of new levy payers.
200. The Department's position is that on balance, the purported benefits of material damage do not outweigh the additional complexity and cost. If levy collection becomes more difficult and costlier, this creates a risk in terms of stability of funding for FENZ, as it is harder for insurers and brokers to comply and they have less incentive to do so. Both fire damage and sum insured minimise implementation costs and ongoing compliance requirements. Insurers and brokers will be able to accurately calculate, collect, and pass on levies more effectively. This in turn is more likely to deliver funding stability for Fire and Emergency and its public services.

2.6 The marginal costs and benefits of the alternative options

Marginal Costs and Benefits of Fire Damage

| Affected groups | Comment <i>nature of cost or benefit (e.g., ongoing, one-off), evidence and assumption (e.g., compliance rates), risks.</i> | Impact <i>\$m present value where appropriate, for monetised impacts; high, medium, or low for non-monetised impacts.</i> | Evidence Certainty <i>High, medium, or low, and explain reasoning in comment column.</i> |
|--|---|--|--|
| Additional costs of the preferred option compared to taking no action | | | |
| Insurers and brokers | Retains levy on fire damage. Minimal change in collecting levy. | Low – no change, or very little change needed. | High – already using fire damage, very little change needed. |
| Fire and Emergency | No cost impact in administration of levy. Smaller pool of funding from which Fire and Emergency can obtain funding – non-residential policyholders may move to split perils policies. | No direct financial impact – same amount of funding will be collected by adjusting the levy rate. | High – levy setting process ensures rate of levy can be adjusted to obtain the funding level required. |
| Residential policyholders | No significant change in costs would occur for this group (assuming cap on levy amount remains). | Low – no significant change. | High – impacts will affect larger non-residential policyholders, minimal change for residential, assuming cap on the amount of levy is retained. |
| Motor vehicle policyholders | Motorists with third party insurance will start paying levy (assuming cap on levy amount remains). | Low - levy on third party motor vehicle insurance is likely to be minimal. | High – minimal change for motor vehicle policies. |
| Non-residential policyholders | Smaller non-residential policyholders will continue to pay a larger proportion of the non-residential levy, relative to split perils policyholders. | Medium – levy cost does not decrease, as we estimate it would under the Part 3 provisions. | Medium – smaller policyholders continue to pay a larger proportion of the levy; quantum is not known. |
| | Split perils policyholders will continue to pay proportionally less of the non-residential levy. | Low – retains current levy settings. | Medium – split perils policyholders continue to pay a smaller proportion of the levy; quantum is not known. |

| Affected groups | Comment <i>nature of cost or benefit (e.g., ongoing, one-off), evidence and assumption (e.g., compliance rates), risks.</i> | Impact <i>\$m present value where appropriate, for monetised impacts; high, medium, or low for non-monetised impacts.</i> | Evidence Certainty <i>High, medium, or low, and explain reasoning in comment column.</i> |
|--|--|---|--|
| Additional costs of the preferred option compared to taking no action | | | |
| Iwi / Māori | Smaller marae/commercial property owners will continue to pay a greater proportion of the levy, compared to those with split perils. | Medium – levy cost does not decrease, as we estimate it would under the Part 3 provisions. | Medium – smaller policyholders continue to pay a larger proportion of the levy; quantum is not known. |
| | Marae/commercial property owners with split perils will continue to pay a smaller proportion of the non-residential levy. | Low – retains current levy settings. | Medium – smaller proportion of levy is paid by marae/owners with split perils, quantum is not known. |
| Insured Government Agencies | Smaller agencies without split perils policies will continue to pay a larger proportion of the non-residential levy. | Medium – levy cost does not decrease, as we estimate it would under the Part 3 provisions. | Medium – smaller agencies continue to pay a larger proportion of the levy; quantum is not known. |
| | Split perils policyholders will continue to pay a smaller proportion of the non-residential levy. | Low – retains current levy settings. | Medium – split perils policyholders continue to pay smaller proportion of levy relative to their assets, quantum is not known. |
| The State / Government | No financial implications. | Nil/low – no impact on Crown contribution. | High – Crown contribution unchanged. |
| Total monetised costs | Not Applicable. | Not Applicable. | Not Applicable. |
| Non-monetised costs | Smaller pool of funding from which Fire and Emergency can obtain funding. Smaller policyholders continue to pay a larger proportion, relative to split perils policyholders. | Medium – decrease in levy for smaller non-residential policyholders does not occur. | Medium – impact on types of policyholders is known, but size of financial impact is unknown. |

| Affected groups | Comment <i>nature of cost or benefit (e.g., ongoing, one-off), evidence and assumption (e.g., compliance rates), risks.</i> | Impact <i>\$m present value where appropriate, for monetised impacts; high, medium, or low for non-monetised impacts.</i> | Evidence Certainty <i>High, medium, or low, and explain reasoning in comment column.</i> |
|---|--|---|--|
| Additional benefits of the preferred option compared to taking no action | | | |
| Insurers and brokers | <p>Minimal changes required to IT and underwriting systems for insurance sector.</p> <p>Collecting levy is simpler, more certain and easier to comply with.</p> | <p>Minimal financial impact – costs would be passed on to policyholders.</p> <p>Medium/high – current system is working and significant changes to administering levy collection are avoided.</p> | <p>High – insurers have repeatedly said that costs will be passed on to policyholders.</p> <p>Medium – improvements expected, exact impact of improvements unclear</p> |
| Fire and Emergency | <p>No financial benefits. Funding information for Fire and Emergency has greater certainty and simplicity. Fewer issues with auditing, accountability and levy avoidance.</p> | <p>No financial impact – funding that is required will be collected by adjusting the levy rate.</p> <p>Medium – levy administration improved.</p> | <p>Medium – improvements expected, exact impact of improvements unclear.</p> |
| Residential policyholders | <p>No significant change is proposed for this group.</p> <p>Avoids increased insurance premiums that would result from implementation and administrative costs of material damage.</p> | <p>Low – no significant change.</p> <p>Low/Medium – impact of avoiding increase would depend on who insurance sector passes on \$50 million implementation costs on to.</p> | <p>High – minimal change for residential, assuming cap on the amount of levy is retained.</p> <p>Medium – costs from material damage are avoided, exact amount is unknown.</p> |
| Motor vehicle policyholders | <p>Motorists with comprehensive insurance should see a slight reduction in levy.</p> <p>Avoids increased insurance premiums that would result from implementation and administrative costs of material damage.</p> | <p>Low – change to levy will likely be small.</p> <p>Low/Medium – impact of avoiding increase would depend on who insurance sector passes \$50 million implementation costs on to.</p> | <p>High – inclusion of third-party insurance will reduce levy, but change will be small.</p> <p>Medium – Clear that costs from material damage are avoided, exact amount is unknown.</p> |
| Non-residential policyholders | <p>All non-residential policyholders avoid increased insurance premiums that would result from implementation and administrative costs of material damage.</p> | <p>Low/Medium – impact of avoiding increase would depend on who insurance sector passes \$50 million implementation costs on to.</p> | <p>Medium – Clear that costs from material damage are avoided, exact amount is unknown.</p> |

| | | | |
|---------------------------------|---|--|--|
| | Smaller non-residential policyholders continue to be charged on fire damage. | Low – unlikely to see change in levy cost. | High - minimal change for smaller non-residential. |
| | Non-residential policyholders with split perils policies will not face substantial increases in levy costs. | Medium/High – dependant on difference in the value of property insured under fire damage and material damage coverage. | Medium – discussions with stakeholders and available data suggests impact will be medium/high. |
| Iwi / Māori | All iwi/Māori policyholders avoid increased insurance premiums that would result from implementation and administrative costs of material damage. | Low/medium – impact of avoiding increase would depend on who insurance sector passes on costs on to. | Medium – costs from material damage are avoided, exact amount is unknown. |
| | Smaller iwi/Māori policyholders continue to be charged on fire damage. | Low – unlikely to see change in levy cost. | High - minimal change for smaller iwi/Māori policyholders. |
| | Iwi with collective marae insurance and large commercial property owners with split perils policies will not face substantial increase in levy costs. | Medium/high – dependant on gap between fire damage and material damage coverage. | Medium – discussions with stakeholders and available data suggests impact will be medium/high. |
| Insured Government Agencies | All non-residential policyholders avoid increased insurance premiums that would result from implementation and administrative costs of material damage. | Low/medium – impact of avoiding increase will depend on policyholder. | Medium – costs from material damage are avoided, exact amount is unknown. |
| | Agencies with split perils policies do not face substantial increase in levy costs. | Medium/high – exact amount unknown individually, but across class of policyholders, this is likely to have medium/high impact. | Medium – discussions with agencies and available data suggests impact will be medium/high. |
| The State/ Government | No financial implications. | Low – no impact on Crown contribution. | High – Crown contribution unchanged. |
| Total monetised benefits | Cost to implement material damage expected to be passed on to policyholders is avoided. | Medium - estimated \$50 million cost to levy collection avoided. | Medium – exact amount of cost avoided is estimate. |
| Non-monetised benefits | Collecting levy is simpler, more certain and easier to comply with. | Medium – efficiencies across sector for Fire and Emergency and policyholders. | Medium – simplicity and certainty likely to improve. |

Marginal Costs and Benefits of Sum Insured

| Affected groups | Comment <i>nature of cost or benefit (e.g., ongoing, one-off), evidence and assumption (e.g., compliance rates), risks.</i> | Impact <i>\$m present value where appropriate, for monetised impacts; high, medium, or low for non-monetised impacts.</i> | Evidence Certainty <i>High, medium, or low, and explain reasoning in comment column.</i> |
|--|---|---|--|
| Additional costs of the preferred option compared to taking no action | | | |
| Insurers and brokers | One off cost to reconfigure systems to levy on sum insured. | Medium - cost expected to be lower than using amount insured – this cost will be passed on to policyholders. | Medium – Evidence of fewer changes needed to reconfigure systems. |
| Fire and Emergency | One off cost to reconfigure systems to levy on sum insured. | Medium - cost expected to be lower than using amount insured, amount is unknown. | Low – cost to reconfigure systems is unknown. |
| Residential policyholders | Costs from movement to sum insured passed on by insurance sector. | Low - cost expected to be lower than using amount insured. | Medium – costs likely to be passed on, unclear where they will fall, or how much they will be. |
| Motor vehicle policyholders | Costs from movement to sum insured passed on by insurance sector. | Low – estimate less cost impact than amount insured. | Low – unclear if costs will be passed on, where they will fall, or how much they will be. |
| Non-residential policyholders | Costs from movement to sum insured passed on by insurance sector. | Low – estimate less cost impact than amount insured. | Low – unclear if costs will be passed on, where they will fall, or how much they will be. |
| Iwi / Māori | Costs from movement to sum insured passed on by insurance sector. | Low – estimate less cost impact than amount insured. | Low – unclear if costs will be passed on, where they will fall, or how much they will be. |
| Insured Government Agencies | Costs from movement to sum insured passed on by insurance sector. | Low – estimate less cost impact than amount insured. | Low – unclear if costs will be passed on, where they will fall, or how much they will be. |
| The State / Government | No financial implications. | Low – No impact on Crown contribution. | High – Crown contribution unchanged. |
| Total monetised costs | Not applicable. | Not applicable. | Not applicable. |
| Non-monetised costs | Agreement on definition by insurance sector and Fire and Emergency is not certain. | Low – could slow down implementation of the Act. | High – clear that agreement on the definition of ‘sum insured’ still needs to be reached. |

Additional benefits of the preferred option compared to taking no action

| | | | |
|---------------------------------|--|--|--|
| Insurers and brokers | Simpler to calculate and collect levy. | Medium – increased efficiency across insurance sector. | Low – based on insurance sector estimate. Exact nature of system change is not known so cost has not been estimated. |
| Fire and Emergency | Less potential for fluctuations in levy due to a definition that is easier to use. Simplicity reduces issues with auditing and accountability. | Medium – levy administration should improve. | Low – sum insured has not been used, cannot be certain how it will operate, but appears simpler to administer than amount insured. |
| Residential policyholders | Cost savings from efficient administration of levy passed to policyholders or increase in premiums is avoided. | Low - amount unknown. | Low – dollar amount uncertain, unclear if benefits would be passed on. |
| Motor vehicle policyholders | Cost savings from efficient administration of levy passed to policyholders or increase in premiums is avoided. | Low - amount unknown. | Low – dollar amount uncertain, unclear if benefits would be passed on. |
| Non-residential policyholders | Cost savings from efficient administration of levy passed to policyholders or increase in premiums is avoided. | Low - amount unknown. | Low – dollar amount uncertain, unclear if benefits would be passed on. |
| Iwi / Māori | Cost savings from efficient administration of levy passed to policyholders or increase in premiums is avoided. | Low - amount unknown. | Low – dollar amount uncertain, unclear if benefits would be passed on. |
| Insured Government Agencies | Cost savings from efficient administration of levy passed to policyholders or increase in premiums is avoided. | Low - amount unknown. | Low – dollar amount uncertain, unclear if benefits would be passed on. |
| The State/ Government | No financial implications. | Low – No impact on Crown contribution. | High – Crown contribution unchanged. |
| Total monetised benefits | Not applicable. | Not applicable. | Not applicable. |
| Non-monetised benefits | Administering levy is simpler and more certain and easier to comply with. | Medium – efficiencies across insurance sector, and for Fire and Emergency. | Medium/high - Simplicity, certainty, compliance likely to improve. |

201. The key assumptions underlying this cost-benefit analysis:
- cost projections by the insurance sector of \$50 million to update their systems for material damage and \$5.25 million to move to sum insured, are accurate;
 - the \$50 million in administrative costs for insurers and brokers to move to material damage is likely to be borne by policyholders; and
 - agreement can be found between insurers and brokers and Fire and Emergency on a clear definition of “sum insured” which makes it a simpler option than amount insured.
202. The insurance sector’s estimate of \$50 million dollars in transition and implementation costs is an estimate based on an ICNZ survey of its members. It is uncertain how reliable this estimate is, as the required work has not gone out for tender. However, the increase to the sector’s previous estimate can be attributed to increased costs for IT services. The \$50 million figure is in the same region as the estimated cost of local government to implement the Fire and Emergency levy. This would involve using the land rating system for levy collection but would require upgrades to local government collection systems.

Possible unintended impacts of the fire damage option

203. A key concern for Fire and Emergency is the possibility of increased split perils policies being taken out if the levy on insurance for fire damage is retained. We understand the concern, as this would lead to reduced levy from entities taking these policies out but no change to their demand for Fire and Emergency’s services. Large policyholders could make these changes to split perils under existing provisions. This option is available to policyholder under the transitional levy system but has not occurred at any large scale. This is possibly because the benefit of reduced levy does not outweigh the risk that the organisation is under-insured. The likelihood and impact of these changes is difficult to predict. However, the Department believes that the likelihood of a large number of policies moving to split perils would be low.
204. Fire and Emergency are also concerned that some policyholders use low indemnity values to reduce their levy burden and that these policyholders will seek another avenue to reduce their levy if we move to ‘sum insured’. It is not clear that this would be the case, as using a low indemnity value does not affect the amount the policyholders will be paid in the event of a loss due to fire. Limiting the sum insured for fire damage will reduce the amount a policyholder receives if there is a fire, so there seems to be significant risk in taking such an approach to reduce the levy payment.
205. It is worth noting that if the number of split perils policies did increase, and the levy collection mechanism appeared to be at risk of not collecting sufficient levy, Part 3 requires the levy rate to be updated at least every three years. This would help to mitigate the risk of Fire and Emergency not obtaining enough funding.

Risks or uncertainties

Impact on Māori

206. We do not have a complete understanding of the impact on Māori. We believe this is due to a combination of several factors
- minimal engagement from iwi at this stage of the process – the review will not be relevant to iwi until the levy rates and caps/exemptions are being set;

- the amount of work government is doing with iwi means that resources are stretched and are not able to engage; and
 - iwi have bigger priorities – reforms such as Three Waters or the Resource Management Act reforms, are likely to be higher priorities.
207. During the legislative process, the Department will have targeted engagement with iwi on the exposure draft of the Bill. Given that this will involve a clearer expression of the changes to the levy system, that can be better understood, the Department is hopeful that this will allow us to gain a clearer understanding of the impact on Māori.
208. Impacts on Māori will be more evident at the levy setting stage when there is opportunity for the impacts to be assessed and addressed when the levy rate is set along with caps and exemptions.

Assessing the financial impact has been challenging

209. There may be areas where we do not have a full understanding of financial impacts because consultation has been too targeted – such as the likelihood of non-residential policyholders moving to split perils insurance because of the levy remaining on insurance against fire damage. We think this risk can be mitigated by the ability to set the levy rate based on the pool of funding available.
210. Some stakeholders may remain unhappy about levy increases from the approach proposed here. It is difficult to consult on a theoretical model, and we cannot be entirely certain how the model will operate in practice. We think this risk will be mitigated by ongoing work with stakeholders, in particular, insurers and brokers, and Fire and Emergency, to ensure that the policy decisions can be implemented. Work to date has shown that stakeholders have an interest in ensuring that the options can be implemented, as insurers and brokers and Fire and Emergency must administer the levy.

Timing

211. As noted in section 3.1 below, some insurers and brokers may find it challenging to make changes to their systems to meet the 1 July 2024 deadline, when the Part 3 levy commences. This can be mitigated by extending the deadline or offering a penalty-free amnesty period beginning on 1 July 2024, for a fixed period.

Section 3: Delivering an option

3.1 How the new arrangements will be implemented

The legislative process will involve stakeholders

212. If Cabinet agrees, the process we expect to follow is that the Fire and Emergency Act 2017 will be amended to make the improvements to the Fire and Emergency levy. The Department expects drafting instructions to be sent to the Parliamentary Counsel Office in November 2021. We will seek approval to release an exposure draft of the amendment Bill in early 2022. The Department will work with government agencies, the insurance sector and Fire and Emergency on the exposure draft. This would allow input from insurance companies and brokers who collect the levy, and Fire and Emergency as the regulator and Te Puni Kōkiri for a greater understanding of impacts on Māori. We expect this will result in practical law and smoother implementation which will ensure that the ongoing operation of the levy system is successful.
213. The Department is looking to seek approval to bring legislation in the House in the first quarter of 2022, with the Bill going to Select Committee in the second quarter of 2022 and Select Committee reporting back in the first quarter of 2023. The Department aims to have the Bill passed early in the second quarter of 2023 and for the amendments to come into effect on 1 July 2023. The process to make regulations to set the levy rate would also begin early in 2022, and conclude in June 2023, prior to amendments coming into force. This would provide Fire and Emergency and insurers and brokers one year to update their systems, before the new system comes into force on 1 July 2024, but this date could be extended if insurers and brokers required more time.

Māori involvement in the legislative process

214. As noted in paragraph 197, during the legislative process, the Department will have targeted engagement with iwi on the exposure draft of the Bill. We will also consult with Te Puni Kōkiri during work on the exposure draft and as legislation progresses through the House.
215. Consultation with Māori will occur again at the levy setting stage of the process. This will provide the opportunity for Māori to ensure that the impacts of levy rates can be assessed and addressed when the rate is set, along with any application of caps and exemptions.

The levy system will continue to be administered by Fire and Emergency

216. Fire and Emergency regulates and has a compliance and enforcement role within the levy system. By drawing on existing internal expertise, implementation can be undertaken efficiently. The Department will continue to work closely with Fire and Emergency and insurers and brokers to ensure that changes to the levy system can be implemented.

The levy setting process involves public consultation

217. We expect the levy setting process will begin in early 2022. Section 143 of the FENZ Act requires Fire and Emergency to consult policyholders about the regulations that set the rate of levy to be paid by different types of property owners (residential, non-residential, motor vehicles). The public will be informed of changes to the levy rate following the levy setting process.

Implementation risks

The commencement date of 1 July 2024 may be challenging, but can be extended

218. One implementation risk is the uncertainty around time taken to make the changes and whether the changes can be made by 1 July 2024.
219. As noted in section 1.2 above, changes from the transitional levy to either the Part 3 levy or an amended Part 3 levy will require insurers and brokers and Fire and Emergency to update their systems to collect and administer the levy effectively. It will also require a new levy rate to be calculated. The levy rate is calculated based on a projection of Fire and Emergency's costs to deliver its services and will require public consultation. This means lead-time will be required to implement the Part 3 levy. Insurers and brokers have told us that they cannot begin building new systems until the details of the legislation, including the levy regulations, are finalised, complete with fully defined requirements including the provision of clear guidelines free from ambiguity. Some insurers and brokers may take as long as two years to make changes and undertake testing. This work needs to be completed well in advance of final implementation, as the impact on customers and potential penalties insurers face for any system errors would be significant. Any new levy charging system would also need to run parallel with the old system for several years to deal with legacy issues such as coverage changes like additions/deletions that require premium and levy adjustments from past periods.
220. The insurance industry inform us that it will be making these changes when it has a significant load of new regulatory issues to work through and implement over the 2022-2025 period. This includes:
- the review of the Conduct of Financial Institutions, by MBIE;
 - the review of the Insurance (Prudential Supervision) Act 2010 and Solvency Standards, by the Reserve Bank;
 - compliance with the International Financial Reporting Standard 17;
 - the insurance contract law review, by MBIE; and
 - changes resulting from the review of the Earthquake Commission Act 1993.
221. Accordingly, insurers and brokers believe that making the necessary changes to its systems to meet a 1 July 2024 commencement date will be challenging, regardless of the lead time.
222. The risk that the 1 July 2024 commencement date could be mitigated by a penalty-free amnesty period beginning on 1 July 2024, for a fixed period. This would allow insurers and brokers extra time to adjust their systems. Alternatively, the commencement date could be extended beyond 1 July 2024, to give insurers and brokers the time needed to make the changes.

Stakeholders' interpretations of the legislation may differ

223. There is the potential that insurers and brokers may have different interpretations of the new legislation and how it is to be applied to insurance contracts. This risk will be mitigated by consulting with Fire and Emergency and insurers and brokers in the development of the draft Bill amending the FENZ Act and subsequent regulations prescribing the levy. Following legislative changes, Fire and Emergency will continue to provide guidance on how the levy will be calculated, collected and audited. This can include guidance on the levy calculation process and how Fire and Emergency will audit how the levy has been calculated. This would ensure

both insurers and brokers and Fire and Emergency can agree on the insurance contracts that attract the levy and the amount insurers and brokers should charge policyholders.

3.2 How will the new arrangements be monitored, evaluated, and reviewed?

The Department's role as steward

224. The Department administers the FENZ Act and has a role as a steward of the Fire and Emergency funding system. The Public Service Act 2020 requires the Department to oversee the legislative framework and proactively promote stewardship of the FENZ Act. The FENZ Act and its related regulations will be reviewed regularly as part of the Department's regulatory stewardship strategy.
225. Though there are significant unknowns in making these changes, the Department has a role as regulatory steward and will continue to engage with stakeholders.
226. Section 142 of the FENZ Act requires the Minister of Internal Affairs to review the levy rate at least every three years, including public consultation on its levy proposed rate. Cabinet sets the rate on the recommendation of the Minister of Internal Affairs. Any inequitable outcome of the proposed approach may be able to be mitigated through this process. For instance, this might include setting different levy rates for different classes of property.
227. Fire and Emergency will play an essential role in monitoring new funding arrangements. It will have the information on the amount of funding it is receiving and whether the model is working. The FENZ Act and regulations require levy payers to provide information returns together with their levy payments. Fire and Emergency uses this information to identify potential avoidance, and to model future levy revenue and to inform levy rate setting

Glossary of Terms

228. **Sum Insured:** Where the insured party and the insurance company agree on the total sum that the property is insured for. If the asset is destroyed, the insurance company pays to replace/rebuild the property, up to that specified dollar figure. It is the maximum amount the policyholder is paid, in the event of a total loss.
229. **Amount insured:** Where a contract of insurance provides that the insurer must pay to the policyholder an amount equal to the cost of replacing or reinstating the property up to a maximum of \$800,000. This is the express maximum limit, so the amount insured is \$800,000.
230. If there is no amount insured stated in the policy, the amount insured is the amount the policyholder declares the property is worth, or the amount set out in a valuation certificate.
231. **Indemnity Value:** The amount that the property was worth just before it was damaged. This is usually equivalent to the depreciated replacement cost of the property, this factors in the property's age and condition. Some older buildings have a low indemnity value, because the building has deteriorated and is not worth as much as it was when it was first constructed.

Appendix One: Detailed impacts of Part 3 on insurance policies

List of insurance policies impacted by material damage

232. The following insurance policies could be subject to levy charges and would require the policyholder to be charged levy, resulting in levy being charged multiple times on the same property:
- Mortgage Redemption policies covering a bank's interest in an otherwise insured property;
 - Commercial Use policies provided by employers for employees using their privately insured vehicles for business use;
 - Stock Spoilage and Deterioration policies providing additional cover for refrigerated stock otherwise insured under a material damage policy that excludes spoilage and deterioration;
 - Breakdown Cover providing additional cover for certain technical equipment such as computers or machinery otherwise insured under a Material Damage policy that exclude breakdown;
 - Money, Fidelity and Crime policies otherwise covered under a Material Damage policy;
 - Standalone Earthquake policies; and
 - Standalone Terrorism Damage policies.

The impact of "amount insured" on insurance policies

233. The following policies, or policy extensions, which are additional insurance coverage, create uncertainty for insurers for which sum will be used when calculating the amount insured:
- Automatic seasonal stock increases - this may never be used by the insured.
 - Margins Clauses: these are an automatic policy where the sum insured increases, for example by 10 per cent, when certain events occur. Often margin clauses sit outside of the normal sum insured since the policyholder will normally never require this cover.
 - Capital Additions Clauses: this is an automatic coverage, usually of 10 per cent, for any additional property that may be acquired during the policy period. This usually sits outside the sum insured as the policyholder will normally never require this cover.
 - Transit extensions on material damage policies: this automatically provides coverage for incidental transits up to a small sub-limit. This usually sits outside the sum insured as the policyholder will normally never require this cover.
 - Demolition Coverage Limit: sometimes the demolition amount is sub-limited. Normally the fire levy is not charged on standalone demolition coverage. It is unclear whether the term "expressed maximum amount insured" would include levy on demolition if demolition coverage sits outside the sum insured.

Appendix Two: Self-insured and uninsured property owners (free riders)

234. Some property owners do not insure their property or choose to self-insure. Self-insurance is where a property owner will mitigate their risk of loss or damage to their property either by having access to funds on their balance sheet, or through their capacity to borrow. These property owners see this as the most economical way for them to manage their risk and will forego insurance cover. As the levy is applied to insurance contracts, residential and non-residential property owners that do not insure their property do not contribute any levy to Fire and Emergency. These property owners still receive benefit from Fire and Emergency's services.
235. As the insurance-based levy is being retained, some level of free-riding by self-insured and uninsured property owners is expected. About 95 per cent of residential property and 90 per cent of motor vehicles in New Zealand are insured³³. The level of self-insured and uninsured non-residential property in the New Zealand market is difficult to determine. There is no central database of self-insured or uninsured organisations. Property owners that are self-insured or uninsured are not known to the insurance sector.
236. The Department is not aware of any self-insured entities in the motor vehicle or residential sectors, but Fire and Emergency has informed the Department that it is aware of a small number of commercial entities that self-insure – specifically property owners with large asset bases and multiple revenue streams. These organisations contribute to Fire and Emergency on the condition that they remain anonymous, so Fire and Emergency were not able to share specific examples with the Department.

Self-insured and uninsured public assets are not addressed

237. Like private businesses, after assessing risks, public entities can choose to self-insure, such as relying on either their capacity to borrow funds or their cash reserves. Several State-owned enterprises (SOEs), local authorities and related entities, and electricity lines businesses have chosen to self-insure some or all their assets. In 2013, the Auditor-General's report, *Insuring Public Assets*, suggested that less than half of public assets (based on their current value) have insurance cover³⁴. More recent data is difficult to find, so it is difficult to tell if the percentage of assets insured has increased. Public sector organisations that do not insure do not contribute to Fire and Emergency, or they contribute proportionally less than insured entities if some of their assets are not insured.
238. Some stakeholders in the commercial property sector believed that they are cross-subsidising the public sector agencies, who are not contributing their fair share of funding to Fire and Emergency. As self-insured and uninsured assets are outside the insurance-based funding model, they are not in within scope of this analysis.

Fire and Emergency does receive some funding from self-insured or uninsured entities

239. Some entities make good corporate citizen payments to Fire and Emergency in lieu of levy. In the year ended 30 June 2021, Fire and Emergency received \$2.292 million in such payments, from a mixture of government and private organisations. Payments were made on the condition that the organisations remain anonymous, so specific examples cannot be given. This funding

³³ Insurance Council of New Zealand estimate based on membership survey.

³⁴ *Insuring Public Assets*, Auditor-General's Report, July 2013.

is reasonably stable but cannot be relied upon by Fire and Emergency as a secure income source.

Organisations with their own insurance company do still pay the levy

240. Property owners that are uninsured or self-insure are distinct from organisations that choose to create their own insurance company, known in the insurance sector as a 'captive'. These organisations pay money to an insurance company that the organisation itself owns and is sometimes located outside New Zealand. Currently, property owners that use a captive are covered by section 49B of the Fire Service Act and these property owners are required to pay levy to Fire and Emergency. Anecdotally, an insurance broker responsible for a large amount of the self-insurance in New Zealand has advised the Department that its clients that self-insure do contribute to the levy.

Proactively released by the Department of Internal Affairs