Stage 2 Cost Recovery Impact Statement

Fire levy rates for 2017/18

Agency disclosure statement

This cost recovery impact statement (CRIS) has been prepared by the Department of Internal Affairs. It provides an analysis of the proposed rates of levy on contracts of fire insurance for the 2017/18 financial year.

From 1 July 2017, the New Zealand Fire Service Commission (including the New Zealand Fire Service (NZFS) and the National Rural Fire Authority (NRFA)) and 38 Rural Fire Authorities (RFAs) will amalgamate to become one organisation, Fire and Emergency New Zealand (FENZ). As a result of this reform, additional levy revenue is required in 2017/18 to meet new funding requirements arising from the absorption of rural fire costs, new ongoing operating and capital funding, and transition costs.

The analysis in this Cost Recovery Impact Statement (CRIS) is based on projected costs of FENZ for 2017/18 produced by the NZFS. Modelling of the impact of adjusted levy rates on levy revenue has also been undertaken by NZFS.

The key assumptions and uncertainties in this CRIS are:

- This CRIS has been prepared on the basis that the Fire and Emergency New Zealand Bill 2016 (the FENZ Bill), currently before Parliament, is enacted in its current form or without changes that have financial impacts for FENZ.
- The system that FENZ will use to cost activities is under development. Currently, information is available on fire-related costs, but information on non-fire related costs is limited.
- Rural fire costs are based on a 2016 review by MartinJenkins and therefore are subject to the assumptions made by MartinJenkins when collecting data from RFAs. There are no single, national, incident reporting data to provide actual costs of rural fire.
- In regard to FENZ's costs for 2017/18, it is assumed that:
  - FENZ is ready to operate from 1 July 2017.
  - There is no significant change to the FENZ workforce (specifically no significant change in number of volunteers).
  - FENZ's cost of prolonged rural fires is not significantly different to that forecast.
  - There are no natural disasters that require a significant FENZ response and recovery.
  - FENZ is not required to make any payments for rural fire assets to the current legal owners of those assets.
  - Operational service agreements for fire control and emergency services on Public Conservation and Department of Conservation managed land and Defence Areas do not impose additional costs on FENZ.

- In regard to FENZ's revenue for 2017/18, it is assumed that:
  - Insurance policies will be renewed as they expire and therefore will be subject to the new levies from 1 July 2017.
  - Insurers and brokers have systems in place to enable them to collect levy at the new rates from 1 July 2017.
  - There is very limited charging potential for FENZ to generate additional income.
  - The Government 'public good contribution' remains at $10 million.
  - There is no change to the Government's capital injection of up to $112 million over four years from 1 July 2016 to support transition costs and no delays in the timing of the annual drawdown on the capital injection.

Taking into account these limitations and assumptions, we consider that decision-makers can rely on the analysis in this CRIS.

Steve Waldegrave
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Contents

Executive summary 4

Status quo 6
- Background and problem definition 6
- Status quo 7
- Statutory authority 8

Cost Recovery Principles and Objectives 10

Policy rationale 11

The level of the proposed levy and its cost components 14
- Funding sources in the 2016/17 year 14
- Proposed charge level 14
- Cost components of activities of FENZ 15
- Assumptions 18
- Revenue 19

Impact analysis 21
- s9(2)(f)(iv)
- Impact of levy rate lower than proposed 22
- Impact of proposed rate on demand and reasonableness 23

Consultation 24
- Consultation Approach 24
- Scale of Change 24
- Submissions 24
- Response 25

Implementation plan 26

Monitoring, evaluation, and review 27
- Monitoring and reporting 27
- Review of levy rates 27

Recommendations 29

Executive summary

1. Cabinet agreed in November 2015, subject to decisions on funding, to reform the fire services by merging the New Zealand Fire Service (NZFS), the National Rural Fire Authority (NRFA), and 38 Rural Fire Authorities (RFAs) into a new organisation.[1]

2. Cabinet agreed in April 2016 that the new organisation, Fire and Emergency New Zealand (FENZ), should be funded by a levy on residential and non-residential property insurance, a levy on motor vehicle insurance, and a government 'public good contribution'.[2] Funding FENZ primarily by way of levy is a continuation of the current NZFS funding mechanism.

3. Increased levy revenue is required in 2017/18 to meet rural fire costs (previously funded from a range of non-levy sources), new operating costs, transition to the new organisation, repayment of the Government capital injection, and to cover the loss of ability to charge for services.

4. To fund these costs, the Board of the New Zealand Fire Service Commission (the Board) has proposed three changes to levy rates to take effect from 1 July 2017:
   - An increase from 7.60c to 10.60c per $100 of insured value for insured residential property, and retaining the current caps on insured value at $100,000 for buildings and $20,000 for contents.
   - An increase from 7.60c to 10.60c per $100 of insured value for insured non-residential property, with no cap applying to insured value (unchanged).
   - An increase from $6.08 to $8.45 per insured motor vehicle below 3.5 tonnes[3].

5. Two reviews, a PriceWaterhouseCoopers Operational and Performance Review of the NZFS and a MartinJenkins review of rural costs, have helped inform the proposed levy rates and the forecast baseline costs for FENZ.

6. The impact of the increase in levy is limited for residential and motor vehicle policyholders. Given the uncapped nature of the non-residential levy, the impact on non-residential policyholders may be more significant.

7. Between 27 October and 30 November 2016 the Board undertook a public consultation process on the proposed 2017/18 levy rate. Seventy-five submissions were received. The submissions were generally opposed (80%) to the proposed levy rate increase. The main reason for opposition was that submitters considered the levy rate increase was too great (38 submitters).

8. The Board considered the submissions and considers there is no opportunity to reduce or eliminate the proposed increase without jeopardising the effective operation of FENZ.

[1] CAB-15-MIN-0207 refers.

[2] EGi-16-MIN-0064 refers.

[3] Motor vehicles weighing 3.5 tonnes and above are treated as non-residential property.

9. The Board considers that a significant number of policyholders may renew their insurance contracts early to avoid the increase in levy rate, and that this will have a material impact on forecast levy revenue. Its preferred mitigation approach to this risk is to increase its borrowing facility, subject to the agreement of Ministers.

10. It is recommended that the Board's proposed new levy rates are adopted to ensure that FENZ is sufficiently funded to complete the amalgamation of NZFS, NRFA and RFAs, while ensuring the ongoing effective provision of fire and emergency services in New Zealand.

Status quo

Background and problem definition

11. The statutory role of the NZFS includes fire safety, fire prevention, and fire extinction. NZFS falls under the control of the NZFS Commission (Commission), a Crown entity. The responsible minister for the Commission is the Minister of Internal Affairs. The work of NZFS has expanded over time to include response to a variety of non-fire emergencies such as motor vehicle accidents, spills of hazardous materials, and natural disasters.

12. Cabinet agreed in November 2015, subject to a decision on funding, to reform the fire services by merging the NZFS, the NRFA, and 38 RFAs into a new organisation.[4] Cabinet also agreed that the new organisation (FENZ) should provide national fire and emergency service functions to protect and preserve life, prevent or limit injury, and prevent or limit damage to property, land, and the environment.

13. The aim of the reform is to address four major problems relating to the governance and support of the fire services:
    - changing expectations of fire services, in particular that fire services are expected to, and do, respond to many non-fire emergencies (for example earthquake rescue, medical emergencies and traffic accidents) outside the current framework;
    - lack of coordination and variable leadership, in particular a lack of coordinated support for volunteers, sometimes poor operational coordination between NZFS and rural brigades, and the lack of national oversight of rural fire governance;
    - inconsistent investment for community needs, which has led to underinvestment in the rural sector and volunteer firefighter support (both urban and rural); and
    - differences in culture between rural and urban firefighters, and paid and volunteer firefighters, leading to operational issues.

14. Legislation to give effect to Cabinet's decisions on fire services reform, the Fire and Emergency New Zealand Bill 2016 (the FENZ Bill), was introduced to Parliament in July 2016. The Government Administration Committee considered the draft legislation and reported back to Parliament with an amended FENZ Bill in December 2016. This Cost Recovery Impact Statement (CRIS) has been prepared on the basis that the FENZ Bill is enacted in its current form (or materially its current form), as reported back to Parliament.

15. Cabinet agreed in April 2016 that the new organisation, FENZ, should be funded by a levy on residential and non-residential property insurance, a levy on motor vehicle insurance, and a government 'public good contribution'.[5] Funding FENZ primarily by way of levy is a continuation of the current NZFS funding mechanism.

[4] CAB-15-MIN-0207 refers.

[5] EGI-16MIN-0064 refers.

16. A repayable Government capital injection of up to $112 million has been made available over a period of four years to support transition costs.[6]

Status quo

17. The current rates of fire levy, set in 2008[7], are shown in Table 1 below.

Table 1: 2016/17 fire levy rates

Category	Current levy
Residential property	7.60 cents per $100 insured (insured amounts capped at $100,000 for residential buildings and $20,000 for contents)
Non-residential property	7.60 cents per $100 insured (uncapped)
Motor vehicles (less than 3.5 tonnes)	$6.08 (flat rate)

18. Operating FENZ for the year commencing 1 July 2017 is estimated to cost $534.8 million. This cost includes the amalgamated urban and rural fire services, the cost of transition and the first repayment of the capital injection, as set out in Table 2 below.

Table 2: Forecast FENZ expenditure in 2017/18

Costs	Total
Baseline costs of NZFS and NRFA	$411.1m
Rural fire costs	$29.3m[8]
New ongoing support expenditure (rural and volunteer)	$47.4m[9]
Transition costs	$38.0m
Repayment of capital injection	$9.0m
Total	$534.8m

19. If levy rates remain unchanged, it is estimated that levy revenue for FENZ in 2017/18 would be approximately $368 million. In this case, the costs of activities necessary to deliver the fire service reform objectives will not be met. Some operational commitments may have to be met from other budget sources and service levels may be affected.

[6] EGI-16-MIN-0064 refers.

[7] Fire Service Levy Amendment Order 2008

[8] This number varies from the $22.0 million included in the Consultation Document. This is explained in Appendix A.

[9] This number varies from the $39.4 million included in the Consultation Document. This is explained in Appendix A.

20. The impact of levy rates being set below the proposed rate is discussed further in the Impact Analysis section below.

Statutory authority

21. Urban fire services in New Zealand have largely been funded through a levy on fire insurance for many decades.[10] The current legislation requires the responsible minister, the Minister of Internal Affairs, to review the rate of the levy annually.[11] The current review of the fire service levy is prompted by the Cabinet decisions and draft legislation described above. As of 1 July 2017, levy revenue will need to meet the additional costs associated with rural firefighting, new ongoing operating costs (including improved support for volunteer firefighters, local advisory committees, and capital upgrades), and transition to a new modernised organisation.

22. The statutory authority for setting the new levy for the 2017/18 financial year will come from Subpart 3 of Schedule 1 of the FENZ Bill, which will come into force when the FENZ Bill receives Royal assent, subject to the passage of legislation.[12] The provisions of that subpart enable the making of regulations to prescribe the rate of levy for the 2017/18 financial year (clause 26). Before recommending a new rate of levy for 2017/18, the Minister must be satisfied that FENZ (or by extension its predecessor organisation, the Commission) has undertaken public consultation on the proposed new rates, and the activities of FENZ in 2017/18.

23. It is anticipated that, subject to the passage of legislation, the regulations setting the rate of levy will be made at Executive Council following the date the FENZ Bill receives Royal assent, and the provisions described above come into force.

24. Clause 30 of Schedule 1 of the FENZ Bill provides that the review and consultation requirements in relation to setting the 2017/18 levy rate are satisfied if the review and consultation take place prior to the commencement of the subpart, in order to facilitate the making of the regulations.

25. A small number of submissions received as part of the consultation on the levy rate suggested that the consultation process was illegitimate because the provisions of subpart 3 of the FENZ Bill have not yet come into force, and may not come into force depending on the passage of legislation.

26. We are satisfied that the consultation is legitimate because:

- Clause 30 clearly anticipates that pre-commencement consultation may be required, given the short period of time between the commencement of subpart 3 and 1 July 2017.

[10] The current levy regime set out in section 48 of the Fire Service Act 1975 has been in place since 1993. Prior to 1975 the levy was payable pursuant to the terms of the Earthquake and War Damage Act 1944. Under the Fire Service Act 1975 as first enacted, the levy was calculated on the amount for which the relevant property was insured against earthquakes under the Earthquake and War Damage Act. This arrangement remained in place until the Fire Services Amendment Act 1993.

[11] Section 48(3) of the Fire Service Act 1975.

[12] It is anticipated that the date of Royal assent will be in March or April 2017.

- As a Crown entity, the Commission can chose to consult on matters from time to time, and no statutory authority is required for any consultation.
- Regulations setting levy rates will not be made unless and until the FENZ Bill comes into force in its current form. Should the FENZ legislation not pass, or should it pass in a materially different form, the current consultation will not be relied on to inform the setting of the levy rates.

27. The 2017/18 financial year is a transitional year for the levy regime with the reforms of the fire services. Increased levy revenue is required to meet rural fire costs (previously funded from a range of non-levy sources), new operating costs, and repayment of the capital injection. However, in 2017/18 the levy will continue to apply to the same base of assets insured against fire damage. This is the reason for the large increase in the rate: the additional transition, rural, and ongoing costs must be met from the existing levy base.

28. From 1 July 2018, the levy base will expand, subject to passage of the FENZ Bill, as:
    - the levy will apply to third party motor vehicle insurance;
    - the levy will apply to assets insured against all physical loss or damage, rather than just fire damage;
    - the levy will be calculated on the amount for which property is insured, rather than the indemnity value of property; and
    - current exemptions from the levy are removed from the legislation, and are to be replaced with regulations for levy exemptions.[13]

29. Levy rates for 2018/19 will be set subject to the levy setting procedure set out in Part 3 of the FENZ Bill.

[13] Schedule 3 of the Fire Service Act 1975 sets out 21 categories of property which are exempt from the fire levy. Subject to policy decisions from Cabinet, it is likely that many of these exemptions will not continue under the FENZ legislation, reflecting the broader functions and mandate of FENZ.

Cost Recovery Principles and Objectives

30. The principles underlying the levy regime are set out in the FENZ Bill. Clause 69 states that the purpose of Part 3 of the Bill is to provide for a levy that is:

- A *stable* source of funding to support FENZ in the performance of functions and duties and exercise of powers under the FENZ legislation.
- *Universal*, so that FENZ's costs are generally shared among all who benefit from the potential to use FENZ's services.
- *Equitable*, so that policyholders should generally pay a levy at a level commensurate with their use of, or benefit from the potential to use, FENZ'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).
- *Predictable*, so that policyholders and levy payers are able to predict the amounts that they will need to pay and FENZ is able to predict how much levy income it will receive.
- *Flexible*, so that the levy can adapt to changes in the use, benefit, or risk associated with those who benefit from the potential to use FENZ's services; variations in FENZ's costs; and changes to the expectations of the Crown and the strategic needs of FENZ.

31. The objectives of the fire levy regime, described in previous Cabinet papers[14], are to ensure that:

- Funding to FENZ is at an appropriate level to support its main and additional functions (fire and non-fire), and the costs of transition from the Commission to FENZ.
- FENZ delivers a fit-for-purpose and consistent fire and emergency response service across the country.
- Policyholders contribute at a level commensurate with their use or benefit from the potential to use, FENZ's services.
- The regime is sufficiently simple and legally certain to ensure that policyholders and levy payers do not face unreasonable costs in determining the correct level of levy to be paid.
- Opportunities to avoid levy are minimised.
- New Zealanders are incentivised to take reasonable precautions to protect and insure their property from the risk of fire and other perils.
- Information about the costs of FENZ's activities, its performance, levy setting, and other elements of the levy regime is made accessible to stakeholders to allow them to assess and comment.
- Decisions about FENZ's costs, activities, and the attribution of levy across different classes of policyholder are reviewed regularly following informed public consulation.

[14] EGI-16-MIN-0064 refers.

Policy rationale

32. Cabinet agreed in April 2016 that FENZ's costs, including the costs of its rural activities, should be funded by a levy on residential and non-residential property insurance for material damage perils. Cabinet noted that the broadening of the levy base from fire damage to material damage perils reflects the new organisation's legal mandate and the benefits received by all levy payers of fire services that respond to floods and storms, hazardous substances emergencies, earthquakes, and fire.[15] FENZ will also be funded through a levy on motor vehicle insurance (including third party insurance), and a government 'public good contribution'.

33. Partial cost recovery is proposed. Levy revenue will account for the majority of FENZ income. Cabinet has agreed to make a government 'public good' contribution of $10 million per annum for three years. This will contribute to the costs of those of FENZ's services which cannot easily be apportioned to property or motor vehicle insurance.[16]

34. The levy will be paid by policyholders who insure property and motor vehicles. It is anticipated that in 2017/18:

- $284.1 million (58.8 per cent) of levy will be collected on non-residential property insurance.
- $177 million (36.6 per cent) of levy will be collected on residential property insurance.
- $22 million (4.6 per cent) of levy will be collected on motor vehicle (under 3.5 tonnes) insurance.

35. New Zealand has a high rate of residential insurance cover in international terms.[17] As a result, 'free riding' of FENZ's services is not as significant an issue when compared with other countries.

36. Legislation to give effect to Cabinet's decisions on fire services reform, the FENZ Bill, was introduced to Parliament in July 2016. The Government Administration Committee considered the draft legislation and reported back to Parliament with an amended FENZ Bill in December 2016.

37. The charge proposed is a levy. This is consistent with Cabinet decisions referred to above. A levy is an appropriate means of funding a service with some private good and club good elements.

[15] EGI-16-MIN-0064 refers. The Cabinet paper and minute have been proactively released and are available here: https://www.dia.govt.nz/vwluResources/FSR-Cab-Paper-Funding-April-2016/$file/FSR-Cab-Paper-Funding-April-2016.pdf (paper) and https://www.dia.govt.nz/vwluResources/FSR-EGI-16-MIN-0064-Minute-funding-April-2016/$file/FSR-EGI-16-MIN-0064-Minute-funding-April-2016.pdf (minute).

[16] The government 'public good' contribution is intended to cover medical emergencies, services to the public and police, rescue and other emergencies, domestic and commercial water services and wider emergency management that are currently paid by residential levy payers.

[17] According to the Earthquake Commission (EQC), New Zealand has one of the highest rates of residential insurance cover for natural disasters in the world (EQC 2015/16 Annual Report). EQC uses an insurance penetration rate of over 90% in its modelling. This figure is estimated using the premiums it receives from insurers and the number of houses in New Zealand. According to unpublished EQC findings, 96% of earthquake damaged homes in Canterbury were insured.

38. Alternative funding methods were not pursued:

- Funding from general taxation would be inconsistent with Cabinet decisions and would add significant additional expenditure to annual budget.
- Funding through a property-based levy collected through local authority rates would be inconsistent with Cabinet decisions and would have the effect of narrowing the levy base by excluding the many classes of property which are exempt from rates.
- User charges would not be appropriate given the public and club good elements.[18] A user charge could risk disincentivising people from using FENZ services. It would also be impractical to model revenue and set fee charges to fund the entire organisation in this way, given the variation in the cost of individual emergency responses and the unpredictablity of fire and emergency events.

39. Table 3 below compares the proposed new levy rates and the current rates (status quo) against the objectives of the fire levy regime described above.

Table 3: Assessment of proposed user charge against objectives

Objective	Proposed levy rates	Status quo
FENZ's main and additional functions (fire and non-fire) are supported	Meets objective	Does not meet objective – major problems currently faced by fire services (set out at paragraph 13 above) not addressed
FENZ delivers a fit-for-purpose and consistent fire and emergency response service across the country	Meets objective	Does not meet objective – major problems currently faced by fire services (set out at paragraph 13 above) not addressed
Policyholders contribute at a level commensurate with their use or potential to use FENZ’s services	Meets objective	Meets objective
Regime is simple and legally certain	Partially meets objective	Partially meets objective
Opportunities to avoid levy are minimised	Partially meets objective	Partially meets objective
New Zealanders are incentivised to take reasonable precautions to insure their property	Meets objective – but weaker than status quo as increased levy rates may incentivise non-residential policyholders to reduce insurance cover	Meets objective

[18] Most non-fire response services (for example flood or hazardous substance responses) are public goods. Fire services can be private goods, but given the risk of the spread of fire, they can be seen as local public goods, or even club goods, to the extent that urban property owners enjoy much faster response time (a higher level of service) than rural property owners.

Objective	Proposed levy rates	Status quo
Information about FENZ's activities and levy setting is accessible	Meets objective – proposed rate change will not impact transparency	Meets objective
Decisions about FENZ's costs and levy rates are reviewed regularly	Meets objective – proposed rate change will not impact on levy review cycle	Meets objective

The level of the proposed levy and its cost components

Funding sources in the 2016/17 year

40. The majority of funding for the Commission currently comes from:

- Levy on contracts of fire insurance and motor vehicle insurance;
- Charges for false alarm callouts;
- Cost recovery from responses to hazardous substances incidents, and to vegetation fires outside of urban fire districts;
- Penalty interest and penalty surcharges (from late or non-payment of levy);
- Investment interest; and
- Commercial building advisory services.

41. Funding for rural fire services, provided by RFAs, currently comes from:

- Local government through rates;
- Rural Fire Grant Assistance Scheme (from fire levy);
- Department of Conservation contribution;
- Forest owners and landholders through levies; and
- Cost recovery from people responsible for rural fires.

Proposed charge level

42. The 2017/18 year is a transitional year for FENZ. Due to the limited information avaliable regarding rural costs and the short timeframe to collect information from insurers and brokers, proposed changes during 2017/18 have been restricted to adjusting the rate of levy for non-residential and residental property, and motor vehicles. Further changes to the levy regime, including the broadening of the levy base and the introduction of an anti-avoidance regime, will be introduced from 1 July 2018.

Table 4: Proposed rates of levy for 2017/18[19]

Category	Current 2016/17 levy	Proposed 2017/18 levy	Difference
Residential	7.60 cents per $100 insured (insured amounts capped at $100,000 for residential buildings and $20,000 for contents) Maximum levy payable per house is $76 and $15.20 for personal property	10.60 cents per $100 insured (insured amounts capped at $100,000 for residential buildings and $20,000 for contents) Maximum levy payable per house is $106 and $21.20 for personal property	An increase of 3.0 cents per $100 insured (a maximum increase of $30.00 per annum for residential buildings and $6.00 per annum for contents), or 39 per cent

[19] All levy figures exclusive of Goods and Services Tax (GST).

Category	Current 2016/17 levy	Proposed 2017/18 levy	Difference
Non-residential	7.60 cents per $100 insured (uncapped)	10.60 cents per $100 insured (uncapped)	An increase of 3.0 cents per $100 insured (e.g. an additional $3,000 per annum for those with insurance of $10 million), or 39 per cent
Motor vehicles (less than 3.5 tonnes)	$6.08 (flat rate)	$8.45 (flat rate)	An increase of $2.37 per vehicle per annum, or 39 per cent

Cost components of activities of FENZ

43. Given the limited information available, for the 2017/18 year the activities of FENZ have been categorised as:
    - existing Commission activities;
    - transferred rural fire and emergency services; and
    - new ongoing support activities for FENZ (for example increased training and support for volunteers).

44. The costs of these activities, plus the costs of transition to FENZ are set out in Table 5 below.

Table 5: Forecast FENZ capital and operating expenditure in 2017/18[20]

	2017/18 financial year		
	Operating expenditure	Capital expenditure	Total
Baseline NZFS and NRFA activities (see Table 6 below)	$357.5m	$53.6m	$411.1m
Rural fire activities (see Table 7 below)	$29.3m		$29.3m
New ongoing support (see Table 8 below)	$38.6m	$8.8m	$47.4m
Transition costs (up to)	$26.6m	$11.4m	$38.0m
Repayment of capital injection	$9.0m		$9.0m
Total	**$461.0m**	**$73.8m**	**$534.8m**

[20] Figures exclusive of GST.

45. Due to the short timeframe before 1 July 2017 and the significant changes required to establish FENZ by that date, the Board considers it is not feasible to change the current range of activities or the levels of service associated with those activities in the 2017/18 year without adversely affecting the transition. The Department of Internal Affairs (DIA) supports the Board's assessment.

46. It is intended that levy setting for 2018/19 and beyond will be informed by cost estimates for activity categories such as fire response, motor vehicle response, and medical emergencies. An activity-based costing model is currently being developed by the Board.

Existing Commission activities

47. Existing Commission activities include fire response, fire safety public education, fire risk reduction, fire authority coordination services, and other emergency responses.

48. Cabinet agreed that the Minister of Internal Affairs would initiate an operations and performance review of the Commission to inform the setting of its 2017/18 costs[21]. The review was undertaken by PriceWaterhouseCoopers and found that:
    - the Commission is performing well with respect to operational expectations;
    - the 2015/16 baseline was sufficient for the Commission's business-as-usual operations; and
    - there are opportunities to improve efficiency and effectiveness that the Commission may wish to consider in the future.

Table 6: Baseline NZFS and NRFA costs in 2017/18

	Operating	Capital
Employee and volunteer benefits expenditure	$268.2m	
Fleet	$15.2m	$15.9m
Information and communications technology (ICT)	$16.2m	$3.8m
Property	$17.2m	$23.0m[22]
Operational clothing, equipment and consumables	$2.4m	
Travel (mainly for volunteer and career operational training)	$10.0m	
Publicity and advertising (primarily Fire Safety)	$4.8m	
Other (includes grants, insurance, professional fees, office equipment, consumables)	$23.5m	
Plant and equipment		$2.0m
Regional expenditure such as minor property works and plant		$1.6m
Strategic projects such as ICT platforms		$7.3m
Total	**$357.5m**	**$53.6m**

[21] EGI-16-MIN-0064 refers.

[22] This includes seismic strengthening and the Christchurch rebuild.

Rural fire activities

49. NZFS engaged MartinJenkins to review the costs of rural fire servicing in the financial year to 30 June 2016. Its report forms the basis of the estimated costs of FENZ's rural fire and emergency activities for 2017/18 in this CRIS. MartinJenkins determined that the cost of rural fire servicing for the year ended 30 June 2016 was $35 million.

50. A comparison of the different estimates of rural costs provided in the NZFS consultation document for 2017/18 levy rates, the MartinJenkins report, and this CRIS is attached at Appendix A. It shows that the estimate of rural fire costs provided in the consultation document is $900,000 less than the MartinJenkins estimate. The Board intends to fund this through the 2017/18 budgeted new ongoing expenditure.

51. It has been assumed that rural fire assets will be transferred to FENZ at no cost. This assumption is currently being tested as the Commission works through agreements with RFAs for use and transfer of these assets from 1 July 2017. Assets are therefore being treated as neutral for the purposes of the 2017/18 levy.

Table 7: Rural fire transfer costs in 2017/18

	Operating
Staff	$12.2m
Uniforms, equipment, and appliances	$7.6m
Land and buildings	$0.8m
Training	$1.0m
Fire Suppression	$7.7m
Total	**$29.3m**

New ongoing support for FENZ

52. New ongoing support expenditure will be incurred in the 2017/18 financial year to provide additional support for:
    - closing rural fire service gaps in areas such as fleet, equipment and property maintenance, protective equipment and clothing, and a national rural fire reduction programme;
    - volunteers, in areas such as recognition programmes for both volunteers and employers, and wellbeing initiatives for volunteers; and
    - supporting local advisory committees and enhancing the corporate functions required in a larger organisation.

Table 8: New ongoing support costs in 2017/18

	Operating	Capital
Volunteers and incentives	$11.4m	
Risk and performance management	$4.1m	
Larger corporate functions	$5.9m	$0.2m

	Operating	Capital
Local advisory committees	$1.3m	
Rural staff	$4.8m	
Uniforms, equipment and appliances	$5.9m	$6.9m
Land and buildings	$1.9m	$1.7m
Training	$3.9m	
Total	**$38.6m**	**$8.8m**

Assumptions

53. In regard to FENZ's costs for 2017/18, it is assumed that:

- *FENZ is ready to operate from 1 July 2017.* Transition is well underway and we consider the risk that FENZ will not be able to deliver essential mandated services is low.
- *There is no significant change to the workforce (specifically no significant change in number of volunteers).* Transition is well underway and we consider the risk that FENZ will not be able to deliver essential mandated services is low.
- *The cost of campaign fires (a prolonged rural fire) are not significantly different to those forecast.* This is inherently uncertain and a new cost, as rural fire fighting costs are currently met by rural fire authorities (who can recover costs in some circumstances) not NZFS. After 1 July 2017, rural firefighting costs will be met by FENZ out of levy revenue. FENZ's 2017/18 budget includes $10 million for response to campaign fires. An initial estimate of the cost of fighting the recent major Port Hills fire is up to $14 million.
- *There are no natural disasters that require a significant FENZ response.* It is also inherently difficult to assess this risk, though we note that natural disasters occur less frequently than campaign fires.
- *FENZ is not required to make any payments for rural fire assets to the current legal owners of those assets.* The risk that FENZ is required to pay for rural assets is low to medium. However, some assets may carry debt, so if they are transferred to FENZ this will impact FENZ's balance sheet. Work continues to understand the scale of this risk but the focus for day one is the use agreements which are low risk.
- *Operational service agreements for fire control and emergency services on Public Conservation and Department of Conservation managed land and Defence Areas do not impose additional costs on FENZ.* This is a medium risk, but the impact of any costs imposed in relation to Department of Conservation or New Zealand Defence Force land will be manageable.
- *The rural costs estimated by MartinJenkins are accurate and the assumptions on which the calculations are based are correct.* This a low risk, we consider the analysis is reliable, and any inaccuracy will be relatively minor.
- *The FENZ Bill, currently before Parliament, is enacted in its current form or without changes that have financial impacts for FENZ.* This is a low risk: the Bill enjoyed strong support at its second reading.

54. In regard to FENZ's revenue for 2017/18, it is assumed that:

- *Insurance policies will be renewed as they expire and therefore will be subject to the new levies from 1 July 2017.* This is a medium to high risk with a potentially significant impact. s9(2)(g)(i)
- *Insurers and brokers have systems in place to enable them to collect levy from 1 July 2017 at the new rate.* This is a medium risk as some insurers may be unable to adjust their systems to meet the 1 July 2017 deadline. NZFS and DIA are mitigating this risk by ensuring the insurance sector will have sight of the approved rates at the earliest possible opportunity. The impact of this risk may not be significant, as only some insurers will miss the deadline, and they will adjust their systems within a few months.
- *There is limited charging potential for FENZ to generate additional income.* Subject to the passage of legislation, it is fairly certain that FENZ's ability to charge for services will be limited.
- *The Government 'public good contribution' remains at $10 million.* This is very low risk, approved in Budget 2016.
- *There is no change to the Government's capital injection of up to $112 million over four years for transition costs and no delays in the timing of the annual injection drawdown application.* This is low risk, approved in Budget 2016.
- *The FENZ Bill, currently before Parliament, is enacted in its current form or without changes that have financial impacts for FENZ.* This is a low risk: the Bill enjoyed strong support at its second reading.

Revenue

55. As 2017/18 is a transitional year, and a further levy setting process will occur for 2018/19, revenue has only been forecast for one year. Funding for 2017/18 is set out in Table 9 below.

56. It is anticipated that FENZ's operating costs will remain fairly stable between 2017/18 and 2020/21, during the period of transition and as the new organisation establishes itself. Cabinet has previously agreed that that after four years, subject to the 2021/22 funding arrangements and any detailed business cases, the Board must make sure that the new organisation funds the new support costs from efficiencies found from bringing the separate fire services together. This would be reflected by a drop in baseline costs from 2021 onwards.[23]

57. Cabinet also noted that it is anticipated that these efficiencies would be gained from the regional committees' focus on community risks and needs, with FENZ designing a flexible service model that is not 'one size fits all' approach, and that if these efficiencies are not able to be fully realised by 2021, it is not intended to make workforce cuts to fund the shortfall.

[23] EGI-16-MIN-0064.

Table 9: Estimated FENZ costs and funding in 2017/18

	Costs/funding
Cost of operating FENZ in 2017/18 (see Table 5)	**$534.8m**
Funding from:	
Capital injection drawdown (up to)	$38.0m
Crown contribution (subject to annual budget process)	$10.0m
Other income (for example investment interest)	$3.7m
Remaining funding required from levy in 2017/18	**$483.1m**

58. The breakdown of forecast levy revenue by insurance policy category is set out below under Impact Analysis.

Impact analysis

59. Individuals and organisations who insure their property against fire damage or who take out motor vehicle insurance will be affected by the changes in levy rates.

Table 10: Forecast impact of proposed rates of levy on different categories of insurance policy

	Forecast 2016/17 levy		Proposed 2017/18 levy		Difference	
	Amount of total levy take	Percentage of total levy take	Amount of total levy take	Percentage of total levy take	In amount	Percentage
Residential	$133.8m	36.4%	$177.0m	36.6%	$43.2m	0.2%
Non-residential	$217.7m	59.2%	$284.1m	58.8%	$66.4m	-0.4%
Motor vehicles (less than 3.5 tonne)	$16.4m	4.5%	$22.0m	4.6%	$5.6m	0.1%
Total	**$367.9m**	**100%**	**$483.1m**	**100%**	**$115.2m**	

60. Table 10 above shows the percentages of total levy take by each group does not alter significantly between the forecast 2016/17 levy and the proposed 2017/18 levy.

61. The impact on owners with insurance for residential property is shown in Table 4. The maximum annual levy payable for each residential policy will rise from $76 to $106, a maximum increase of $30 per annum. Similarly the maximum annual levy payable for residential contents policies will rise from $15.20 to $21.20, a maximum increase of $6 per annum. The value used as the basis for this calculation is capped at $100,000 for buildings and $20,000 for property which ensures that the impact is limited.

62. The impact on those with motor vehicle insurance will be an annual increase from $6.08 to $8.45, an increase of $2.37 per vehicle per annum.

63. The impact of the proposed levy increase will be most significant for non-residential insurance policyholders. The policyholders for the 150 largest portfolios will experience an increase, on average, of $153,000 each. This will account for approximately $23 million of the forecast $66.4 million increase in non-residential levy take.

64. An increase of nearly 40 per cent in levy costs will put pressure on the budgets of some policyholders, in particular large organisations who will face the most significant increases in absolute terms. Non-profit organisations and other entities with limited ability to raise revenue will also face pressure. Insofar as public entities with large property holdings (such as district health boards and tertiary education institutions) may seek additional funding to meet increased levy costs, there may be budget implications for the Crown.

s9(2)(g)(i)

Impact of levy rate lower than proposed

70. If levy rates remain at their current levels, FENZ's funding in 2017/18 would remain at the 2016/17 level of $368 million. Taking into account the loss of non-levy rural funding sources (discontinued after 1 July 2017), and assuming other non-levy funding for 2017/18 (shown in Table 9 above) remain in place, this would mean a shortfall in funding for FENZ of $115.1 million for 2017/18. Approval of levy rates higher than existing rates, but lower that those proposed, would see a commensurate funding shortfall for FENZ.

71. In such a scenario, in order to maintain delivery of essential services, aspects of the transition would need to be delayed. This may carry some risk in terms of the confidence of personnel and the public in the reform. s9(2)(g)(i)

s9(2)(f)(iv)

Impact of proposed rate on demand and reasonableness

72. There is no relationship between levy levels and the demand for fire and emergency services. Therefore, the proposed change in levy is not expected to impact on service demands.

73. It is difficult to assess the reasonableness of the levy rates by comparison to private and international providers. In 2012 the DIA examined international best practice and found that "New Zealand's current funding model differs from those applied in Australia and internationally (e.g. in that it is almost solely relying on a capped levy on insurance premiums to fund fire and rescue services)".[25] It is therefore not possible to compare our levy rates to similar international services. There are no comparable private businesses in New Zealand that provide the same range of services.

74. The Board's proposed levy rates have been informed by two reviews, the New Zealand Fire Service Operational and Performance Review (PriceWaterhouseCoopers, 2016) and the Assessment of the Costs of Rural Fire (MartinJenkins, 2016). The first considered the costs of the Commission and the second assessed current costs to deliver rural fire services. These reviews have informed the FENZ cost estimates and proposed funding arrangements for 2017/18.

[25] Department of Internal Affairs, *Fire and Emergency Services - International Best Practice* (2012).

Consultation

Consultation Approach

75. Between 27 October and 30 November 2016 the Board undertook a public consultation seeking public views on the activities proposed for FENZ and proposed rates of fire levy for the 2017/18 financial year.

76. In undertaking this consultation the Board hosted a dedicated website that provided background information to the consultation, a process map and a consultation document.

77. To increase public awareness of the consultation, the Board took out advertising in the five major daily newspapers, published banner advertising on several websites, issued press releases, and directly emailed or wrote to approximately 230 key stakeholders to alert them to the consultation.

Scale of Change

78. Given the scale of change required to create FENZ, the Board considered that changes to the types and level of service should not be considered in 2017/18. The Board also considered that there was insufficient information available to enable differential levy rates or levy caps to be proposed for the residential and non-residential sectors.

79. The Board proposed three changes to levy rates:

- An increase from 7.60c to 10.60c per $100 of insured value for insured residential property with a cap on insured value at $100,000 for buildings and $20,000 for contents.
- An increase from 7.60c to 10.60c per $100 of insured value for insured non-residential property with no cap applying to insured value.
- An increase from $6.08 to $8.45 per insured motor vehicle.

Submissions

80. Seventy-five submissions were received. Nineteen submissions were from individuals and 56 from organisations. Individual submitters included brokers, past and present members of the fire services, and individuals owning businesses. Fourteen submissions came from business organisations, including from the manufacturing and retail sectors. Seven not-for-profit organisations made submissions, including museums, churches, and clubs. Five local authorities made submissions. Nine submissions (12 per cent) came from insurers or broker organisations. The majority (80 per cent) of submissions opposed the proposed levy rate increase. The main reason for opposition was that submitters considered the levy rate increase was too great (38 submitters). Four submitters supported the levy rate increase (5 per cent), one submitter gave partial support, and four submitters were neutral.

Response

81. The Board closely considered the costs of FENZ when determining the proposed rate of levy for 2017/18. The proposed increases reflected the costs of the transition to FENZ, the costs of rural fire activities the new ongoing support expenditure, and the repayment of the capital injection.

82. The proposed rates take into account the impact of payment dates on levy cash flow. Levy is paid two months after insurance contracts commence. The first two months of 2017/18 will therefore see the receipt of payments for insurance contracts commenced in the last two months of 2016/17, calculated at the prior levy rate (7.6 cents per $100 of insured value).

83. The MartinJenkins review of rural costs provided a total figure higher than the estimate originally developed in the early stages of the fire services reforms. The difference in rural fire activities cost estimates is discussed in Appendix A. The Board will accommodate this in its 2017/18 budget.

84. While the majority of submissions opposed levy rate increases, the Board considered that there is no opportunity to reduce the proposed increase in rates without jeopardising the transition and key operational initiatives. The proposed activities are consistent with Cabinet's decision that FENZ deliver mandated fire and emergency service functions, responding not only to fire but also floods, storms, hazardous substances emergencies, and earthquakes. Cabinet also agreed that FENZ should be funded from a levy on insurance and that rural fire funding sources and the ability to charge for rural fire be removed.

85. A number of submissions criticised the lack of detailed information on costs and activities in the discussion document. The Board had noted the limited nature of the available financial data prior to the release of the consultation document and had planned to address this as part of the 2018/19 consultation on levy rates and FENZ activities.

86. A significant number of submissions were received on matters outside the scope of the consultation. Forty-two submissions expressed a desire for an alternative funding method to levying insurance policies. Suggestions included a levy on local government property rates, general taxation, or to include the levy in vehicle registration charges. As described above, in April 2016 Cabinet decided to fund FENZ through a levy on insurance.

87. Some submissions also proposed differential levy rates (for example in recognition of fire risk mitigation measures), a cap on levy payments, and exemptions for particular sectors. The FENZ Bill provides for the creation of exemptions by regulation. Any exemptions applying from 1 July 2018 will be taken into account during the levy setting process for 2018/19. Exemptions were outside the scope of the 2017/18 levy rate consultation. The Board will consider differential levy rates and levy caps alongside the 2018/19 levy rates.

Implementation plan

88. If approved by Cabinet, changed levy rates will be given effect by regulations under the FENZ legislation.

89. It is intended that the current mechanisms for levy payment and reporting will continue after the establishment of FENZ. The Commission, the Insurance Council of New Zealand (ICNZ), and the Insurance Brokers Association of New Zealand (IBANZ) are working together to improve the way levy information will be provided to FENZ.

90. Timeframes associated with the determination and confirmation of 2017/18 levy rates are limited. In early discussions, both ICNZ and IBANZ identified the time requirements for system changes as a risk to the implementation of new rates in their systems. The Commission has been managing this risk through early communication to ICNZ and IBANZ about the proposed changes and their phasing, to provide insurers and brokers with sufficient time to make changes.

91. FENZ will take a risk-based approach to identifying potential levy avoidance. It will work with levy payers and policyholders when levy payment issues are identified.

Monitoring, evaluation, and review

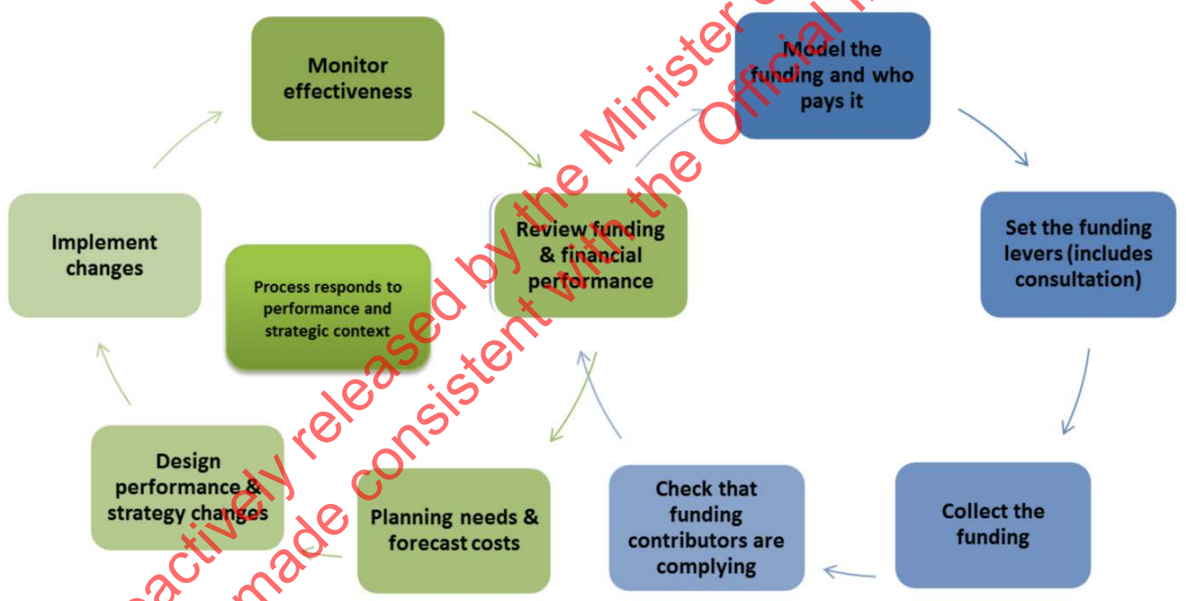
Monitoring and reporting

92. As a Crown agent, FENZ will be subject to the financial and non-financial reporting requirements of the Crown Entities Act 2004. Since the levy and activities will represent 'business as usual' for FENZ, levy setting and the associated processes will be part of the regular Ministerial reporting and accountability cycle.

93. The levy review cycle will be aligned with the performance review cycle to enable the most accurate information to be used in public consultation, levy setting and reporting of results. This relationship is set out in Figure 1.

94. Subject to resourcing, a formal post-implementation review of the new organisation should also be conducted within two years of the changes, including (for example) the effectiveness of fire service levy integrity provisions.

Figure 1: Funding review cycle connected to the performance review cycle



Review of levy rates

95. Statutory requirements for the review of levy rates from 1 July 2018 are set out in the FENZ Bill. Clause 105 requires the responsible Minister to review the levy rate at least every third financial year. The Minister must estimate the direct and indirect costs to FENZ of performing functions and duties and exercising its statutory powers, and any income that FENZ will receive in the period from any source other than the levy. The Minister must then determine the portion of FENZ's net costs for the period that are to be met by levies, and recommend levy rates on that basis.

96. Before making any recommendations in respect of FENZ's net costs and levy rates (and any other levy regulations), the Minister must be reasonably satisfied that FENZ has:

- consulted with levy payers, policyholders, and any other persons that FENZ considers to be substantially affected, about the proposed levy rates (and any other levy regulations), and FENZ's proposed activities;
- published a notice describing and inviting comment on FENZ's proposed activies, an estimate of FENZ's net costs and the proposed levy rates, the methods and assumptions behind the net costs and levy rates; and
- considered comments on the public notice.

97. Any recommendation by the Minister in respect of levy rates would then be subject to approval by Cabinet and the Executive Council.

98. An activity-based costing model currently being developed by the Commission will support transparency in how costs of activities are attributed to different classes of levy payers, and the Crown contribution for 2018/19 and beyond.

Recommendations

99. It is recommended that three changes to levy rates apply from 1 July 2017:

- An increase from 7.60 cents to 10.60 cents per $100 of insured value for insured residential property with a cap on insured value at $100,000 for buildings and $20,000 for contents.
- An increase from 7.60 cents to 10.60 cents per $100 of insured value for insured non-residential property with no cap applying to insured value.
- An increase from $6.08 to $8.45 per insured motor vehicle.

Appendix A: Comparison of rural costs estimates

1. The estimate of the cost of servicing rural fires of $22.0 million per annum provided in the public consultation document was based on the best data available at the time. Because of the uncertainty around rural costs, MartinJenkins was engaged to provide an assessment of the costs of servicing the rural fire sector. It estimated rural fire costs for the year ending 30 June 2016 at $35.0 million.

2. This appendix sets out:
   - the estimated cost of the rural fire responsibilities provided in the Board's public consultation document on the 2017/18 levy rates (consultation document);
   - the estimated costs of servicing rural fire for the year ended 30 June 2016 provided by MartinJenkins; and
   - the final estimated cost of the rural fire responsibilities used in this CRIS.

3. While the consultation document had one line for rural costs, some related costs were also included in Baseline NZFS and NRFA costs, as well as the rural cost line. In the consultation document, the rural cost line was $22.0 million and an additional $6.4 million of rural costs were included in the Baseline NZFS and NRFA cost estimates. The total combined cost of servicing rural fire in the consultation document was therefore $28.4 million as set out in Table 1.

Table 1: Rural costs included in the consultation document

2017/18	
Rural cost line estimate	$22.0m
Proxy for campaign fires and rural grant assistance (included in Baseline NZFS and NRFA costs)	$6.4m
Total	**$28.4m**

4. MartinJenkins estimated the rural costs for the 2015/16 year to be $35 million. Table 2 below set out the components of MartinJenkins' estimate.

Table 2: MartinJenkins estimate of rural costs for 2015/16

2015/16	
Personnel	$11.1m
Training	$1.3m
Equipment and vehicle	$5.5m
Administration and overhead costs	$2.3m
Building	$1.4m
Fire suppression	$5.1m
Depreciation	$2.7m
Insurance	$0.6m
Other	$5.0m
Total	**$35.0m**

5. The Commission reviewed the MartinJenkins estimate and made a number of adjustments to reflect the fact that only some of these costs will transfer to FENZ. Table 3 and paragraphs 6 through to 11 outline these adjustments.

Table 3: Reconciliation of MartinJenkins estimate to show which costs will transfer to FENZ

2015/16	MartinJenkins	Adjustment	CRIS
Personnel	\$11.1m		\$11.1m
Training	\$1.3m		\$1.3m
Equipment and vehicle	\$5.5m		\$5.5m
Administration and overhead costs	\$2.3m	(\$1.4m)	\$0.9m
Building	\$1.4m		\$1.4m
Fire suppression	\$5.1m		\$5.1m
Depreciation	\$2.7m	(\$2.7m)	
Insurance	\$0.6m	(\$0.5m)	\$0.1m
Other	\$5.0m		\$5.0m
Less: Forestry (not transferring to FENZ or already budgeted for)		(\$6.6m)	(\$6.6m)
Plus: Fire Suppression		\$4.7m	\$4.7m
Plus: CPI adjustment[26]		\$0.8m	\$0.8m
Total	**\$35.0m**	**(\$5.7m)**	**\$29.3m**

6. Administration and overhead costs have been reduced as they are mostly allowed for in the new ongoing costs of FENZ. A third of the administration and overhead costs calculated by MartinJenkins has been retained as there is an expectation that some of these will continue with the new organisation.

7. Depreciation has been removed from the MartinJenkins figure as it has already been included in the rural capital spending estimates for 2017/18.

8. Most insurance costs have been removed as they are already allowed for in the new ongoing costs (listed in Table 8 in the CRIS above).

9. Table 3 above breaks down the costs by cost category. In its report MartinJenkins also showed cost by organisation type (Rural Fire Authorities, Enlarged Rural Fire Districts, and forestry). MartinJenkins calculated forestry costs as \$10.6 million of the total \$35 million cost of rural fire servicing. As the MartinJenkins calculation included a number of forestry-related costs that FENZ will not be responsible for or that have been budgeted for in other cost lines, the MartinJenkins rural fire servicing costs have been reduced by \$6.6 million (from \$10.6 million to \$4.0 million).

[26] Personnel costs have been increased 5.6 per cent, building costs have been increased by 8 per cent and other costs have been increased by 3 per cent.

10. MartinJenkins normalised the 2016 fire suppression costs which reduced the costs from $9.8 million to $5.1 million. The Board considers the actual 2016 cost, not the normalised figure, should be used given the uncertainty of this cost and FENZ's limited ability to fund fire suppression costs from other sources.

11. The MartinJenkins estimate is for the year ended 30 June 2016. The costs have been adjusted to account for increases in the Consumer Price Index given the CRIS relates to the year ended 30 June 2018. Personnel costs have been increased 5.6 per cent, building costs have been increased by 8 per cent, and other costs have been increased by 3 per cent.

12. The difference between the adjusted MartinJenkins rural cost figure ($29.3 million) and the rural costs included in the consultation document ($28.4 million) is $900,000. To accommodate this additional amount in the cost of rural fire activities, the Board will fund this from the 2017/18 budgeted new ongoing expenditure.