

8. SOI et al

**From:** Peter Rose <Peter.Rose@southernresponse.co.nz>  
**To:** Mike Shatford <Mike.Shatford@parliament.govt.nz>  
**Sent Date:** Jun 30, 2015 10:11:13  
**Subject:** SOI et al  
**Attachment:** [image001.jpg](#)  
[image002.jpg](#)  
[Ministerial documentation.pdf](#)

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Mike,

Your query. First, see the attached, already supplied to the Ministers. I have highlighted a number of points of interest. The SOI is quite a benign document, Probably more topical though are the following:

- Ultimate claim numbers remain uncertain with continued flow from EQC (actuaries from both entities are talking). With it the capital position of the company is somewhat tenuous as is the project timeline.
- Possible class action from Grant Cameron Lawyers – yet to materialise
- Possible builder failure. We are managing one closely.
- Management of the business as it moves into its run-down phase – maintaining it fit for purpose with skill levels and resource numbers remaining optimum

**Peter Rose**

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**Treasury Report:** Southern Response Earthquake Services Limited: Report on 2015/16 Draft Statement of Intent, Statement of Performance Expectations and Business Plan

<b>Date:</b>	14 May 2015	<b>Report No:</b>	T2015/999
		<b>File Number:</b>	KI-3-2-3

**Action Sought**

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Agree to the recommendations	21 May 2015
Minister for Canterbury Earthquake Recovery (Hon Gerry Brownlee)	Agree to the recommendations Sign the letter	21 May 2015

**Contact for Telephone Discussion (if required)**

Name	Position	Telephone	1st Contact
David Stanley	Principal Advisor, Governance and Performance, Commercial Operations	s9(2)(a) (wk) (mob)	✓
Fiona Chan	Manager, Governance and Performance, Commercial Operations	s9(2)(a) (wk) (mob)	

**Actions for the Minister's Office Staff (if required)**

Once **signed**, send attached letter to the Chair  
Return **signed** report to Treasury

**Enclosure:** Southern Response - SOI 2015-2019 final draft @ 20150430 (Treasury:3182856v1)

Southern Response Statement of Performance Expectations 2016 final draft @ 20150430 (Treasury:3182861v1)

Southern Response - business plan 2015-19 final draft @ 20150430 (Treasury:3182879v1)

**Treasury Report:** Southern Response Earthquake Services Limited:  
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Plan

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**Executive Summary**

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Southern Response Earthquake Services Limited (SRES) has submitted its draft Statement of Intent (SOI), Statement of Performance Expectations (SPE) and Business Plan to shareholding Ministers for comment.

s9(2)(g)(i)

SRES is a Schedule 4A company. Its purpose as a run-off insurer will have been achieved once customers' claims arising from the Canterbury earthquake events have been settled and the company has performed all its obligations including rebuilds. The timeframe for this to occur has lengthened to the end of 2018 (for all but a minority of very complex claims) due primarily to the flow of newly reported overcap claims from EQC.

Recognising the challenging technical and customer environment (including many distrustful recent transfers), SRES's business plan outlines initiatives to more effectively engage with customers through joint technical and claims meetings with them onsite, appropriate flexibility to finalise claims and continued use of the effective builder panel system.

s9(2)(g)(i)

SRES will begin to draw on support provided under the Crown Support Deed once it has fully utilised its own investments, cash reserves and reinsurance recoveries. Treasury will prepare advice to shareholding Ministers about the likely timing and flow of draw downs on the \$400 million remaining unpaid on the called Convertible Preference Shares (the "Crown Receivable") and calls on the \$500 million of uncalled capital. The first drawdown is currently expected to be needed for cash flow shortfalls beginning in January 2016. Crown forecasts based on SRES's central estimate (i.e not including the risk margin) are for total support of \$705 million from the \$900 million available.

*... the Board is assessing the liabilities valuation's robustness under certain scenarios*

The greatest risks relate to SRES's earthquake liabilities, particularly the ultimate number of claims transferred as overcap by EQC. SRES is engaging with EQC, as are each company's actuaries directly to gain some clarity on this matter. Other risks are categorised and actions are being taken where possible. In our opinion, SRES's board and management are well aware of the risks in the business and we consider the company is taking (or intending to take) appropriate actions where possible to mitigate their potential impact.

The SRES board is reviewing the company's current position and financial implications of any further adverse movements in the company's insurance liabilities. This is being achieved in part through sensitivity analysis and stress testing of models provided by the independent actuaries. SRES will furnish Treasury with this model shortly and initial findings for officials to assess. The company is also examining other risk mitigation options such as the purchase of adverse development cover. The board expects to be able to advise shareholding Ministers of its findings and likely future capital requirements by the end of May.

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**Treasury Report: Southern Response Earthquake Services Limited:  
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**Purpose of Report**

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1. This report provides a summary and analysis of Southern Response Earthquake Services Limited's (SRES's) draft 2015 Statement of Intent (SOI), Statement of Performance Expectations (SPE) and Business Plan.

**Strategic Context and Scope of Business**

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2. SRES is a Schedule 4A company which operates as a run-off insurer in relation to covered insurance claims arising from the Canterbury earthquake events between 2010 and 2012. SRES endeavours to be proactive in finding industry-leading initiatives to achieve equitable, cost-effective customer insurance settlements within its targeted timeframes. It also seeks to adapt as needed to meet changing demands through its life-cycle.
3. SRES's purpose will have been achieved once the claims have been settled and the company has performed all of its obligations, including rebuilds. It is now expected that this will take until the end of 2018 for all but a minor proportion of very complex claims. This is 24 months later than expected two years ago. The expected timeframe to settle claims has been lengthening, primarily due to the flow of newly reported overcap claims coming from EQC but also due to the complexity of many claim situations.
4. We consider that SRES's scope, objectives and outcomes in its 2015/16 SOI, SPE and Business Plan accurately reflect its purpose and scope.

**Analysis**

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5. SRES produced a new SOI this year. Its strategic objectives more firmly emphasize:
  - repair and rebuild programme modification to recognize changing technical and social demands, optimise timely delivery and quality, and ensure staff health and safety
  - the company's efforts to prevent or reduce disputes with customers through open and effective communications with them in a manner that delivers outcomes consistent with SRES's policy obligations, and
  - application of the company's modified approach to settlements since early 2014. This includes broader consideration of credible customer evidence and greater flexibility in completing settlements.
7. In our view SRES's board, management and operating team are firmly focused on its core objectives, but the challenges in terms of time and cost to settle claims remain substantial for a number of reasons including the following:
  - the relatively easier claims tend to be settled earlier, so those that remain are likely to include more difficult ones

- there appears to be a growing minority who are more resistant to making a decision, or will make decisions in their own time – although additional resources have been applied to vulnerable customers and to settling disputes
  - customers with claims which have recently been transferred from EQC are new to SRES but are often weary and distrustful
  - assessments of more complex claims – especially those relating to foundations – may determine that it is more cost effective to rebuild than repair
  - it is difficult to get agreements to move forward between customers in multi unit properties – especially where some are under-insured – and given limited enthusiasm from other insurers
8. SRES's draft SOI recognises these challenges. It notes the already strong and increasingly seamless relationship with project manager Arrow International which provides an autonomous and dedicated team on the one site along with initiatives to address the issues noted above.
9. As was the case last year, the draft SOI reports on the company's building management model through a volume group builder panel and a repair builder contractor panel. The volume builder panel and monitoring processes associated with this appear to be working very well with group home builds now moving toward the wind down phase. Panel members' financial challenges which emerged have been dealt with effectively minimising disruption for customers and sub-contractors.
10. The repair builder programme – which represents approximately 50% of the repair capacity in Canterbury – has also been delivering but the pace of new repair project starts is slipping further behind initial projections. Progress with rebuilds and repairs is discussed further in paragraphs 14 and 15.

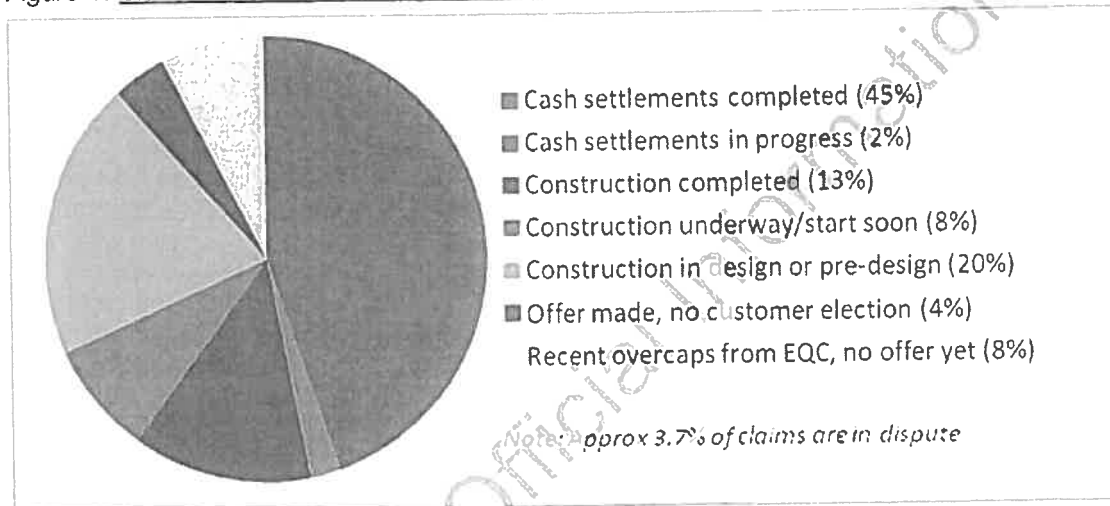
#### **SPE and Business Plan**

11. The draft SPE and Business Plan are consistent with the SOI and substantiate it. The format is largely similar to last year emphasising six primary objectives, Key Performance Indicators (KPIs) and targets. The primary objectives are:
- to operate efficient, cost effective, consistent and fair claims management and rebuild programmes
  - to manage the business and associated risk consistent with minimising the net cost to the Crown
  - to manage investments and liquidity in accordance with the investment management policy
  - to maintain effective relationships with key stakeholders
  - to operate the business within operational budgets, and
  - to promote healthy and safe workplaces
12. There are some specific differences from last year to reflect both the heightened emphasis on effective customer engagement and the additional consideration of assets (including intellectual property) which need to be dealt with prior to the eventual wind-down of the company.

**Operational performance and plans**

13. All overcap assessments originally notified to SRES have been finalised. However, the flow of claims recently determined by EQC as being overcap necessitates specific new strategies which are informed by a pilot project relating to repairs work. These are discussed in paragraphs 15 and 16.
14. SRES's current overriding objective is to build and repair rather than to cash settle damage to houses as part of the company's commitment to contribute to Christchurch's recovery. However, SRES also facilitates cash settlements for customers where that is their preference. Of claims originally notified as being overcap, 66% have been cash settled (or will be shortly) or have seen agreed repairs and rebuilds completed. The state of the 7,388 cumulative claims notified to SRES as overcap at 31 March 2015 is summarised in Figure 1 (overleaf).

Figure 1: Claims status as at 31 March 2015



15. SRES's rebuild work-stream appears to have progressed relatively well. The build rate is now declining, in part because most home-builds are underway or completed. However, the reduced pace of starts likely also reflects the fact that remaining customers are taking longer to agree terms. The repairs work-stream continues to trend up, but progress remains slower than previously projected and there has been further slippage during calendar 2015. Builder capacity does not appear to be the problem, and reliance on outside parties (sub-contractors or inspectors) appear less important than challenges in the consenting process and customer reluctance to agree repair plans. Based on recent data, Treasury considers this latter factor is emerging as the most significant.
16. SRES's assessment and customer engagement process has evolved over time in light of a changing (and challenging) technical and social environment. Recognising that the claims flow from EQC will include many frustrated customers and given the positive results of a pilot project for repairs settlements, the company is making modifications to its process and teams.
17. In future, an Arrow project manager, in consultation with a structural engineer and a geotechnical engineer will jointly review the property damage. Treasury understands that SRES's team-based approach to increase customer trust and confidence will involve joint on-site attendance by technical and claims specialists. This enables both sides of the claims process to be done simultaneously with the customer. SRES has also asked independent actuaries, Finity, to examine monitoring tools for measuring



project manager effectiveness and to consider possibilities for a cost-increase-oriented risk-sharing approach with Arrow.

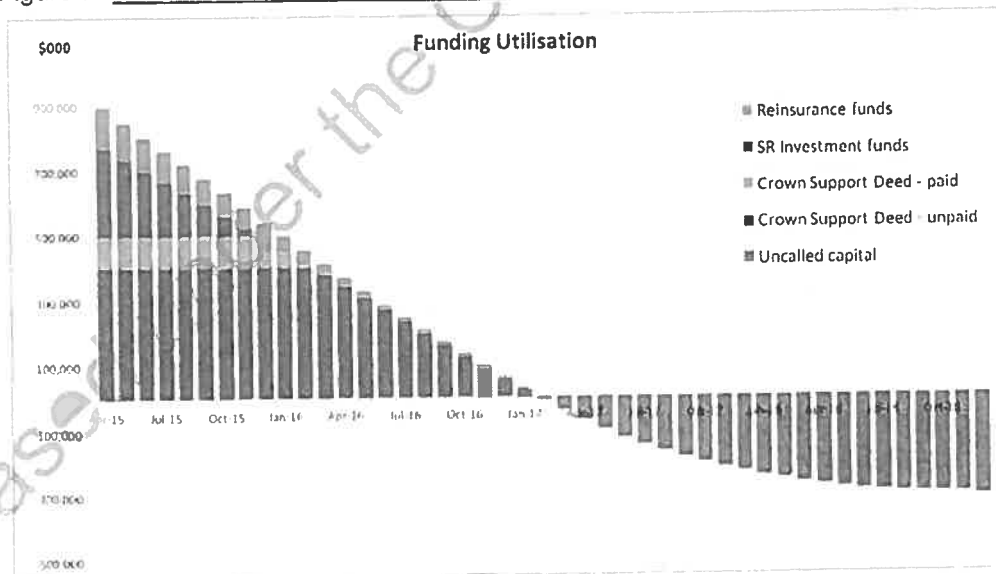
18. SRES is taking a market-leading approach to shared property claims which usually involve multiple insurers and policy types as well as owners. There is increasing acceptance for one insurer per building to take the lead – effectively as a project arranger – although many insurers another insurer to take on that role.
19. SRES has also investigated approaches to achieve settlement at multi-unit properties where some owners are under-insured or uninsured. Treasury understands that potential options include a ‘white knight’ intervention into a financial arrangement with the underinsured to allow the entire rebuild to proceed. Mechanisms to effect the white knight solution include requiring builders who have been successful in tendering for the complex’s build to source the necessary funding.

**Cash flow and investments**

20. SRES’s funding is from:

- reinsurance recoveries, which will have been received by February 2016, with less than \$50 million remaining at that point
- cash and investments expected to be utilised by the end of November 2015
- the first \$100 million under the Crown Support Deed – paid on 5 April 2012
- \$400 million of called but unpaid Convertible Preference Shares that make up the Crown Receivable arising in March 2011, and, once that is exhausted
- \$500 million of uncalled capital as per the Crown Support Deed in January 2013.

*Figure 2: SRES utilisation of funding based on the central estimate (Crown accounting)*



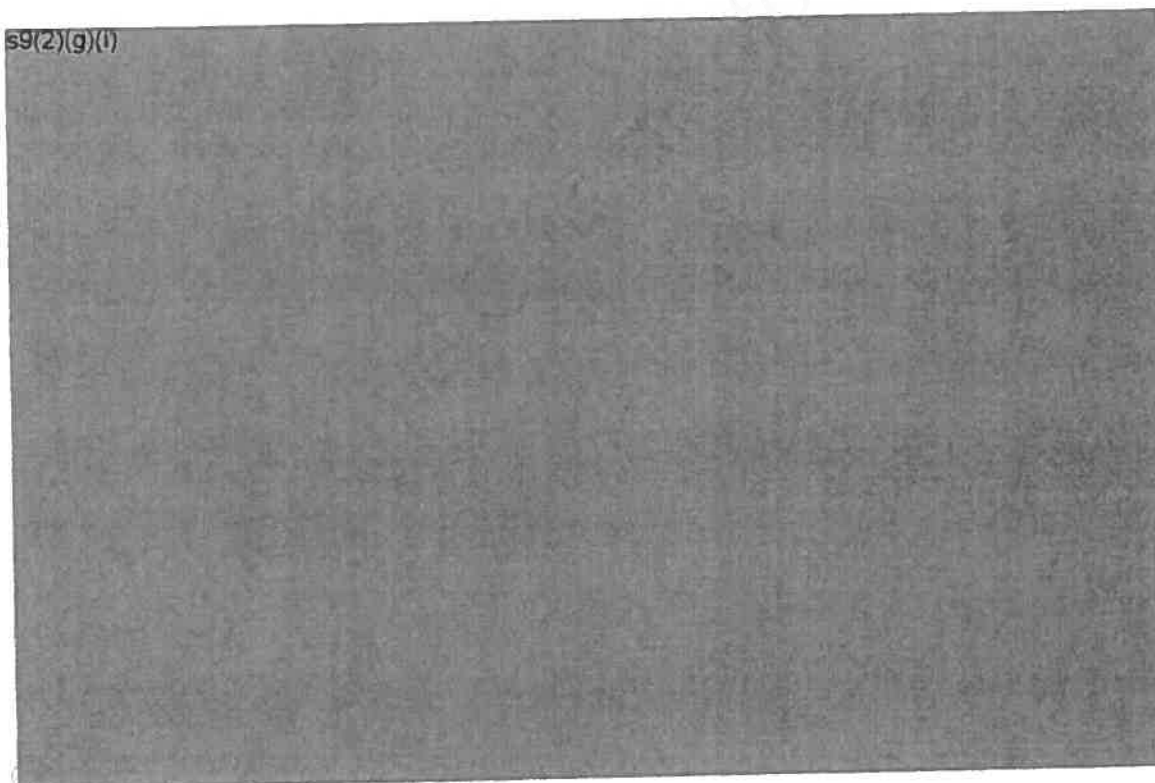
21. Figure 2 illustrates the forecast runoff of the various funding sources during the forecast period, from the Crown’s perspective and based on the most recent actuarial valuations.

- 22. SRES will begin to draw on Crown support once it has fully utilised its own investments and cash reserves, and reinsurance recoveries, to meet claim payments and operating costs.
- 23. The profile for SRES, based on the company's accounting policies assumes that the risk margin of \$119 million is also fully utilised to meet customer claims. This would increase expected calls on the uncalled capital facility to total \$419 million.

Figure 3: Projected draw-downs under the Crown Support Deed (SRES basis)

(\$ millions)	FY 2016	FY2017	FY2018	Total
Crown Receivable	182	218	-	400
Uncalled Capital Facility	-	242	177	419
Total	182	460	177	819

- 24. The process, information requirements and format for submission of Shortfall Forecasts for draw-downs of the Crown Receivable are detailed in the Crown Support Deed. Draw-downs are made quarterly in advance for the forecast funds shortfall for that quarter. Treasury will prepare advice to shareholding Ministers about the likely timing and flow of draw-downs on the Crown Receivable – which are currently projected to begin in January 2016 – and calls on uncalled capital – projected to begin in January 2017. The process for calls is similar to that for the Crown Receivable.

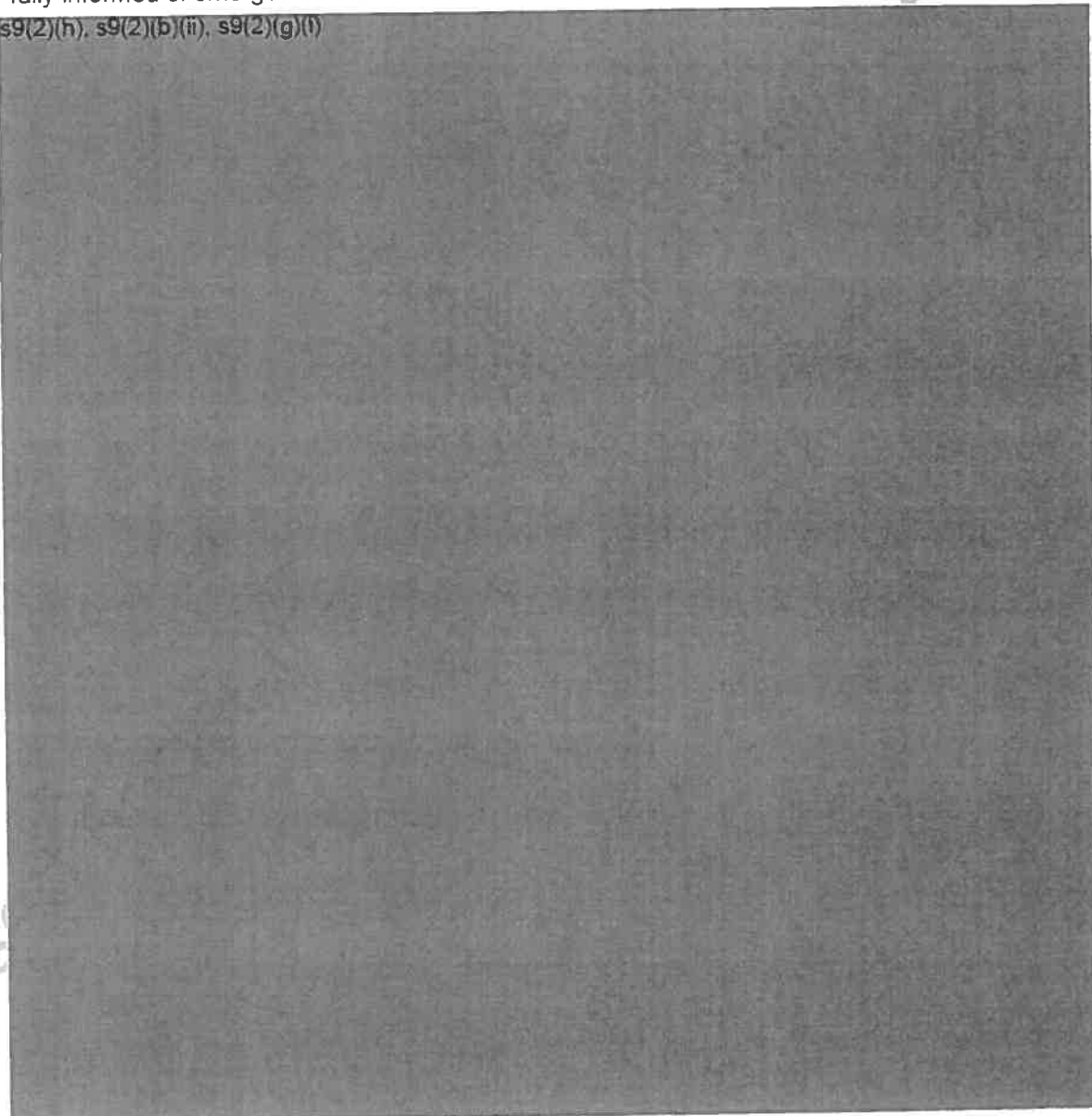


**Risks**

- 28. Considerable uncertainty still remains regarding the final value of SRES's earthquake liabilities. Finity has developed a model which more easily allows for sensitivity analysis and stress-testing. SRES will shortly assist officials to gain a better understanding of the order-of-magnitude exposure under different scenarios with 90% confidence levels. Risks not included in Finity's assessment include low probability, high impact outcomes associated with potential litigation.

29. In our opinion, SRES's board and management are well aware of the risks in the business and we consider the company is taking (or is otherwise intending to take) appropriate actions where possible to mitigate their potential impact. In addition, SRES has a Risk Management Framework for the management of risks throughout the business. The framework consists of three elements:
- setting the risk tolerances beyond which risk mitigations are to be put in place
  - a risk register of identified risks and the mitigation or control strategies in place
  - quarterly risk monitoring and reporting to the board and senior management
30. Treasury will be monitoring the company's risks closely and expects SRES will keep it fully informed of emergent issues.

31. s9(2)(h), s9(2)(b)(ii), s9(2)(g)(i)



#### Governance

31. The board is unchanged after one modification last year to recognise the shift more firmly into the building phase and Bevan Killick's reinsurance skills being a factor in his

recent reappointment. With the lift in number of newly overcap properties transferred from EQC since June 2014, together with a greater appreciation of the time and resources likely to be required to achieve fair and reasonable settlements, SRES currently looks to be at a similar point in its life-cycle to that we thought it was at a year ago. On that basis the current board composition and attendant portfolio of skills appears appropriate. However, officials intend gaining a deeper understanding of prospective risks and workflows in coming months which may reveal whether any enhancements to the board's portfolio of skills could be appropriate.

## Conclusion

32. We consider that the SOI, together with the SPE and supported by the Business Plan, provides a good overview of the company, how it will meet the expectations set by shareholding ministers and how performance against those expectations will be measured. In our opinion, it provides a good basis for monitoring the business and so we consider the SOI is suitable for tabling in the House of Representatives.