INSURANCE COUNCIL OF AUSTRALIA

Submission to the NSW Government Discussion Paper

Funding our Emergency Services (July 2012)

September 2012

EXECUTIVE SUMMARY

The release of the NSW Government's Discussion Paper "*Funding our Emergency Services*" (hereafter referred to as the Discussion Paper) takes place as policy makers more broadly are revisiting national and State taxation arrangements and in particular, the efficiency of taxation on insurance premiums. Over recent periods, several official reviews and reports, including the Federal Government's Review of Australia's Future Tax System (otherwise known as the Henry Tax Review), the NSW Independent Pricing & Regulatory Tribunal (IPART) Review into State Taxation and the Victorian Royal Commission into the 2009 Bushfires Royal Commission have recommended the abolition of insurance statutory contributions to the fire services in favour of a broad based property tax. Indeed, the Victorian Government, who together with the NSW Government retains insurance statutory contributions[1], has announced that from 1 July 2013 statutory contributions to the fire services will be abolished in favour of a property charge. [2] The *Fire Services Property Levy Bill 2012* abolishes insurer statutory contributions from 1 July 2013.[3]

The Insurance Council of Australia (ICA) welcomes the release of the NSW Government's Discussion Paper and looks to the Discussion Paper process as being the basis under which the NSW government joins other jurisdictions in abolishing statutory insurance contributions. The ICA fundamentally agrees with the objectives of the Discussion Paper that funding the NSW emergency services requires a measure that is "better, fairer and more efficient" than which exists currently. The ICA contends that the current system of funding NSW emergency services does not meet the tests set out in the Discussion Paper of efficiency or fairness. The Discussion Paper appropriately puts the case for reform, emphasising that the current system for funding the fire services has a "number of weaknesses" including that it acts to discourage people from taking out insurance; it is unfair to the extent that the public good of fire and emergency protection is funded only by those that take out insurance (ie the free rider problem) and that statutory contributions are being phased out in other jurisdictions and NSW remains out of step in this regard. The ICA suggests that the inadequacies of the current system are not only comprehensively documented in the Discussion Paper but that these same inadequacies have been well versed in other reviews such as those mentioned above.

Although the Discussion Paper provides a comprehensive account of the issues and provides supporting evidence of the current state of play, the ICA submission will look to add to this body of evidence in support of reform of the current system. In particular, in highlighting the weakness of the current system, the ICA submission will remark upon the distribution of the non insured population by household income and examine where the burden of the current system is falling. The ICA submission will also provide an outline of research on the distributional consequences of reforming statutory contributions in NSW based on research commissioned in June 2011. The ICA submission will also directly address a key question in the reform of the current system, namely the transition to a new approach, including providing an outline of the transition pathways adopted in other jurisdictions or suggested in other

[1] Tasmania still retains a charge on insurance policies for the purposes of funding the fire services under Section 77C of the *Tasmanian Fire Service Act, 1979*. However, in Tasmania the rate is fixed at 28% in accordance with the Tasmanian *Fire Service (Finance) Regulation 2006*.

[2] See the Hon Ted Baillieu MP, Premier; the Hon Peter Ryan MP Deputy Premier & the Hon Kim Wells MP, Treasurer Media Statement (28 August 2012) "*Coalition to introduce fairer system to fund Victoria's fire services*" .

[3] The *Fire Services Property Bill 2012* was introduced into the Victorian Parliament on the 28 August 2012.

reviews/forums. [4] Finally, the ICA submission will discuss preferred arrangements for any potential monitoring of insurance premiums post reform.

THE CURRENT STATUTORY CONTRIBUTIONS FRAMEWORK

NSW Emergency Services (namely the Fire & Rescue Service of NSW; the Rural Fire Service and the State Emergency Services) secure their funding through statutory contributions made by insurance companies, local governments and the State government. Under the *Fire Brigades Act 1989*, the *Rural Fires Act 1997* and the *State Emergency Services Act 1989*, insurance companies are required to meet 73.7% of the Emergency Services budgets with the balance of funding met by local government contributions (11.7%) and the State government (14.6%). In the case of insurance contributions, each year insurance companies are required to declare to the respective Service commissioners, the audited amount of gross premiums for certain classes of insurance according to a prescribed form. These gross premiums are then "weighted" according to the relevant Schedule [5] to determine the amount of an insurer's premium subject to contribution. Individual insurer contributions are then allocated according to a specific formula with payments made in instalments in advance over the course of the financial year. [6] This process effectively ensures that all revenue risk for the funding of the NSW emergency services is transferred to the insurance sector.

Insurers recover the contributions payable to the NSW emergency services from policy holders through a levy colloquially known as the Emergency Services Levy (ESL). If arrangements were to any way circumvent insurers recovering their statutory contributions to the fire services from individual policyholders, such contributions would require payment to be paid from insurer capital, with the resultant prudential impacts [7]and with the potential risk to the provision of insurance in NSW for such classes.

Disclosure provisions apply to recoveries made by insurers for their statutory contributions. Under Section 80 of the *NSW Fire Brigades Act 1989*, insurance companies are required to disclose on any insurance premium statement or invoice the amount attributable in the premium estimated to be accrued for the purposes of contributions payable to the NSW Fire Brigades and the NSW Rural Fire Service. The actual process of determining the appropriate recovery amount for individual insurer fire contributions from policyholders is particularly complex. Given that contributions are sought in advance (leaving insurers with the task of forecasting the market going forward) and given recoveries are limited to using the applicable insurance premium as their base, fluctuations in the insurer's market share (i.e. their mix of business) and the actual premium levels attained (i.e. whether the market is hardening or softening) can result in differing recoveries across insurers, notwithstanding consumer/public sentiment expectation that a single, or fixed statutory rate applies irrespective. Further, the current system is designed with revenue risk for the revenue collected being transferred to insurers, leaving the insurance sector to bear any burden of under collection or the gains of over collection. [8]

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[4], See NSW Parliamentary Public Accounts Committee (2004) "*Review of Fire Services Funding: Report No 5/53"*

[5] The Schedule is reproduced on page 35 of the Discussion Paper

[6] The formula is set out on page 36 of the Discussion Paper.

[7] Insurers are subject to prudential supervision from the Australian Prudential Regulation Authority.

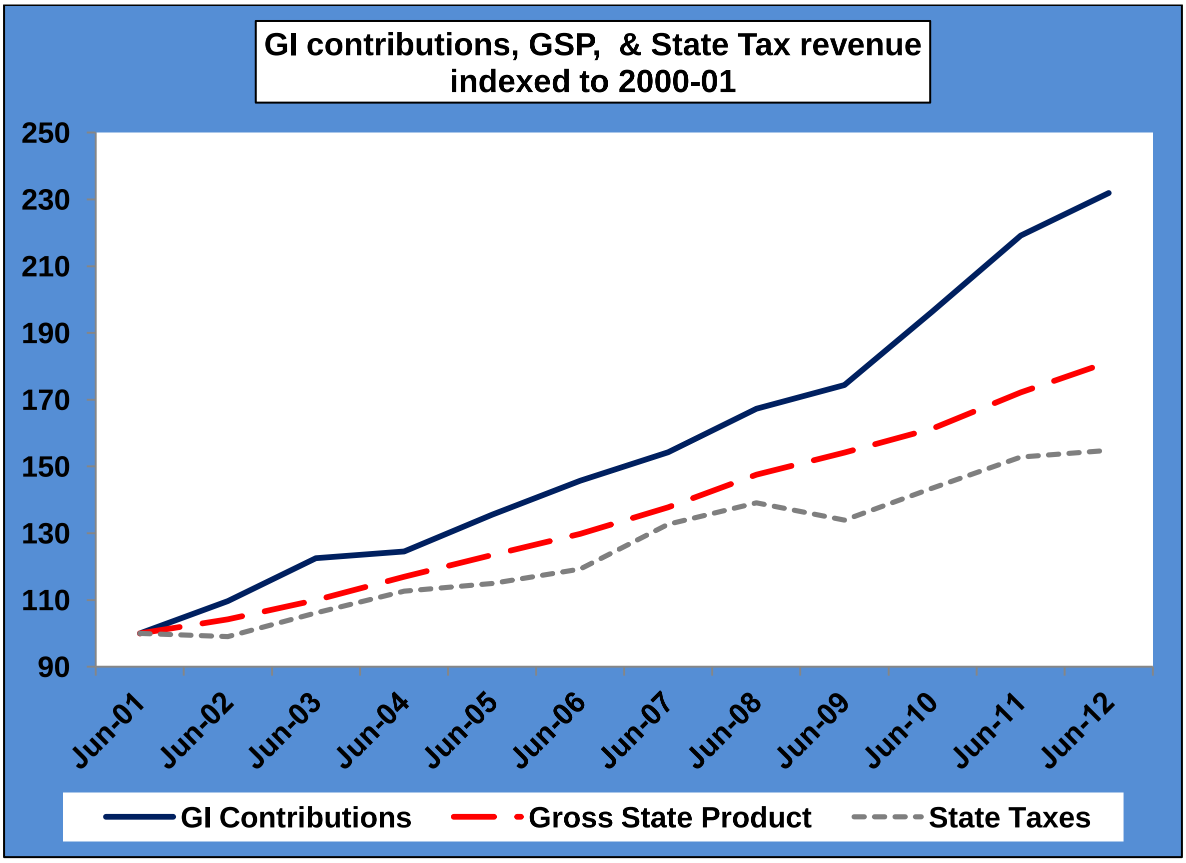
[8] The matter of system transparency and over and under collections was considered in detail by the Victorian Royal Commission into the 2009 bushfires.

In an effort to assist both consumers and the industry in determining fire contribution recoveries, up until February 2012 the ICA published a Fire and Emergency Services Levy rate for the information of members, noting that the actual recovery rate on insured's remained an individual commercial matter for insurers. However, and as the Discussion Paper notes, the ICA no longer publishes such an ESL calculation. The absence of a universally applied ESL recovery charge has particular implications for the transition away from statutory insurance contributions to a property based charge (for more detail see later). In brief, in the event that in the interests of consumer policy, policy makers were of a mind to set a clear and unambiguous "tapering" of fire levies according to policy term, then the absence of a settled industry recovery instrument necessarily requires the NSW government to legislate such an instrument. This situation is recognised in the Discussion Paper wherein it is observed that "*a compulsory scheme would require a defined methodology under which insurance companies would pass on the ESL to consumers. No such methodology currently exists in NSW*".[9]

THE BURDEN OF INSURANCE STATUTORY CONTRIBUTIONS

Over the last decade, insurer statutory contributions to the NSW Fire and Emergency Services have increased from \$376 million in 2001/02 to \$711 million in 2011/12. This represents a real increase in insurer contributions of 25% over the period. As the chart below indicates, over the last decade, insurer statutory contributions to the NSW fire and emergency services has considerably outpaced growth in Gross State Product and overall State taxation.

Chart 1

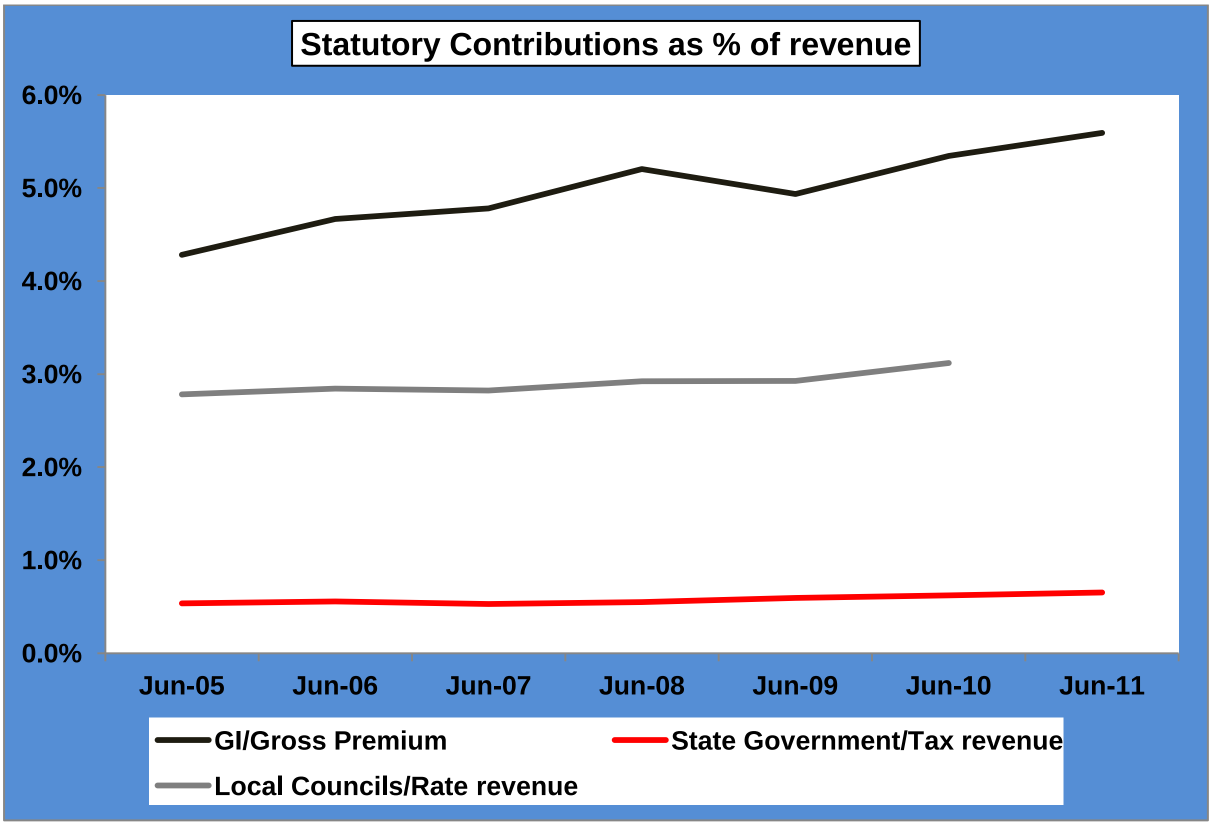


[9] See page 25-26 Discussion Paper

Source: Insurance Council of Australia, ABS & NSW Budget Papers

Moreover, the burden for the funding of NSW Fire and Emergency Services has disproportionately fallen on the general insurance industry vis-a-vis other statutory contributors. Statutory contributions by all contributors measured as a ratio of their primary revenue source (i.e. a contributor's capacity to pay), indicates that the general insurance sector is bearing a greater burden for the funding of the NSW services and that this burden has increased at rate greater than for other contributors.

Chart 2



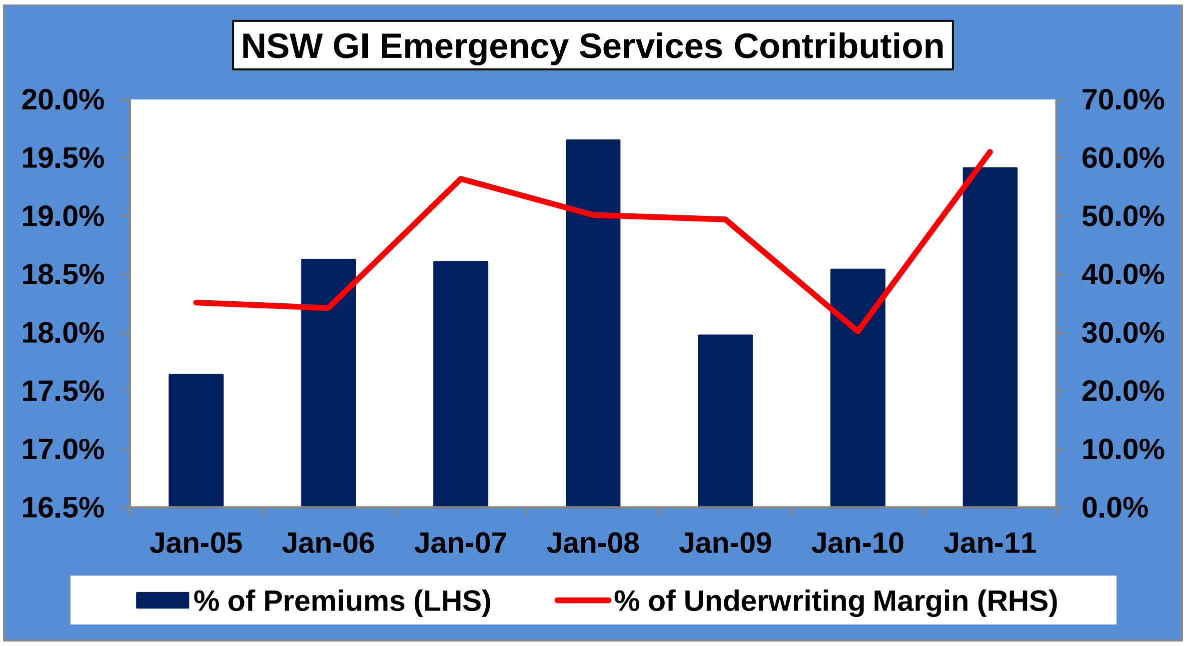
Source: Insurance Council of Australia & NSW Budget Papers

The impact of statutory contributions on general insurers can also be seen by examining the ratio of insurer contributions to an insurers underwriting result or margin. This is particularly relevant because contributions payable are determined by an insurer's gross premium notwithstanding that gross premiums necessarily contain a potential claim component payable in the event of a loss. That is to say, under the current arrangements insurers are taxed on the total premium an insured has voluntarily set aside in the event of a loss. This contrasts sharply with other risk and loss industries (such as gaming) wherein only the underlining margin or profit of the enterprise is considered for taxation purposes.

During periods of heavy losses (for example, during catastrophe events), the impact of statutory contributions on general insurers is heightened. For example, taken as a percentage of NSW gross premiums for property based classes (i.e. House owners & Industrial Special Risk) NSW general insurance contributions comprise around 17 to 19% of gross premiums. However, the impact of catastrophes can be seen when insurance contributions are measured against insurers margin, with the rate varying from 35% in a benign year to as much as 60% in a year characterised by heavy losses.

Chart 3 below outlines just how volatile the impact of statutory insurance contributions can be when assessed against a base of an insurers underlying insurance margin, as opposed to insurer gross premiums.

Chart 3



Notes:

1. *Premiums are for NSW property classes Home owners & Industrial Special Risks (ISR).*
2. *Underwriting margin is Gross Premium less Gross Claims*

Source: Insurance Council of Australia & APRA

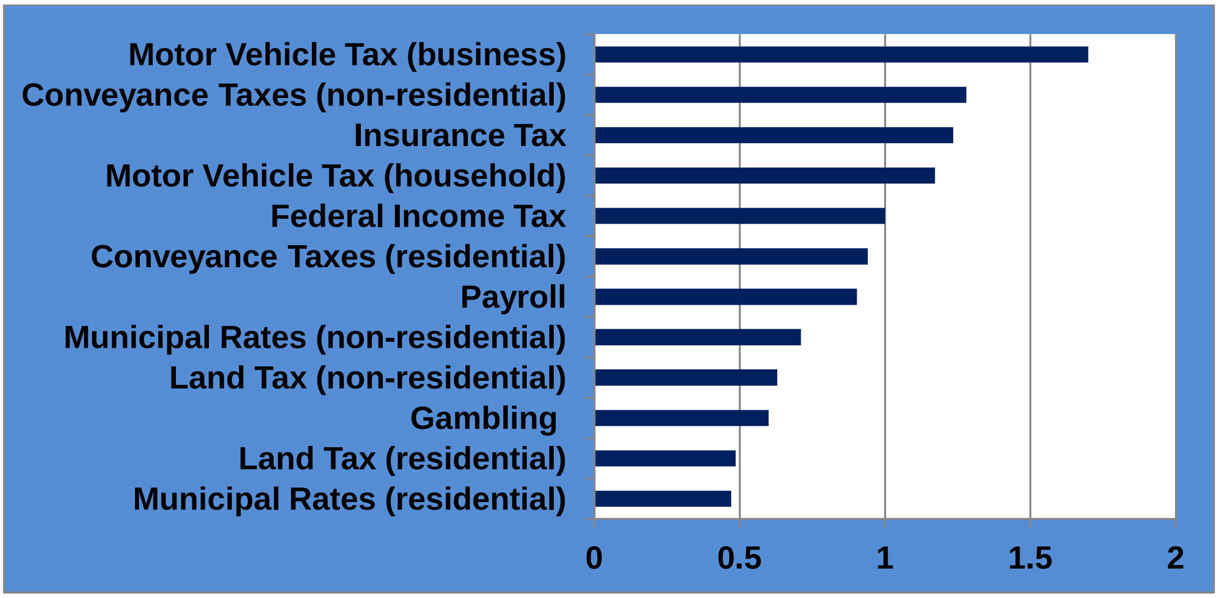
THE EFFICIENCY OF THE CURRENT STATUTORY CONTRIBUTIONS SYSTEM

The ICA supports the Discussion Paper when it states that "*the ESL is a highly inefficient tax, causing a significant loss of consumer welfare*". [10] The ICA also notes the reference in the Discussion Paper that the average excess burden of the emergency services levy is 60% of the revenue raised as indicated by modelling from KPMG Econtech [11]

For the purposes of this review, the ICA has also undertaken an analysis of the economic efficiency of the NSW insurer based emergency service levy and how the levy ranks vis a vis alternative State and local taxes. This analysis serves to assist NSW policy makers in examining the economic welfare improvements arising from a tax mix switch away from an inefficient tax (such as the emergency service levy) to a more efficient State tax (such as municipal based property taxes).[12]

[10] See page 16, Discussion Paper
[11] See page 16 at Footnote 6, Discussion Paper
[12] A municipal based property tax is a proxy for a broad based land tax wherein the base is unimproved land value and the tax includes in its base the principal place of residence.

Chart 4



Source: Deloitte Access Economics (2012)

Chart 4 above clearly suggest that a broad based land tax is highly efficient vis a vis other possible sources of taxation revenue, including taxes on insurance. Indeed, the efficiency rankings highlight the scope for economic "upside" if State policy makers were to shift their sources of revenue away from transaction taxes (such as those on insurance and conveyancing) to taxes of a more immobile nature (such as land and payroll taxes). [13] Indeed, the ICA suggests that the abolition of insurance statutory contributions and the introduction of a broad based tax on property would represent the effective implementation of a key recommendation of the Henry Tax Review.

In addition to ranking NSW State taxes by their relative economic efficiency, Deloitte Access Economics (DAE) were also instructed by the ICA to examine the economic welfare benefit and the resultant economic efficiency "dividend" that would accrue from abolishing insurer fire levies with a broad based property charge. DAE were asked to undertake this analysis under two scenarios, the first where only insurance contributions were replaced with a property based charge, and the second where all statutory contributions were removed and replaced with a property based charge. The purpose of examining the gains from reform under the two scenarios is to assist NSW policy makers in deciding upon which revenue sources for NSW emergency services should be replaced with a property levy. [14]

The findings of the Deloitte's modelling are shown in the table below. The maximum welfare gain and revenue benefits arise from the transfer of all statutory contributions to a land based tax.

[13] This is consistent with the understanding in the Henry Tax Review and the IPART State Tax Review. The policy objective of shifting State taxes away from transaction style taxes to taxes on immobile bases was also discussed at the Commonwealth Taxation Forum in October 2011. For transcripts and submissions provided to the Commonwealth Taxation Forum see www.futuretax.gov.au

[14] See page 17, Discussion Paper. The amounts modelled were as follows. The insurance component of $612 m (2010/11 dollars) and all statutory contributions of $912 m (2010/11 dollars). The results shown are for NSW only and assume the policy shift occurs in NSW only.

Table 1		
	Welfare Increase	Revenue Upside
Insurer statutory contributions transferred	0.138%	$24.06m
All statutory contributions transferred	0.187%	$33.16m
Source: Deloitte Access Economics (August 2012)		

Notes:

1. *Welfare increase is the increase in household consumption*
2. *Revenue upside demonstrates the increase in Government revenue from changes in taxation bases due to taxation reform.*

Source: Deloitte Access Economics (August 2012)

NON INSURANCE IN THE NSW COMMUNITY

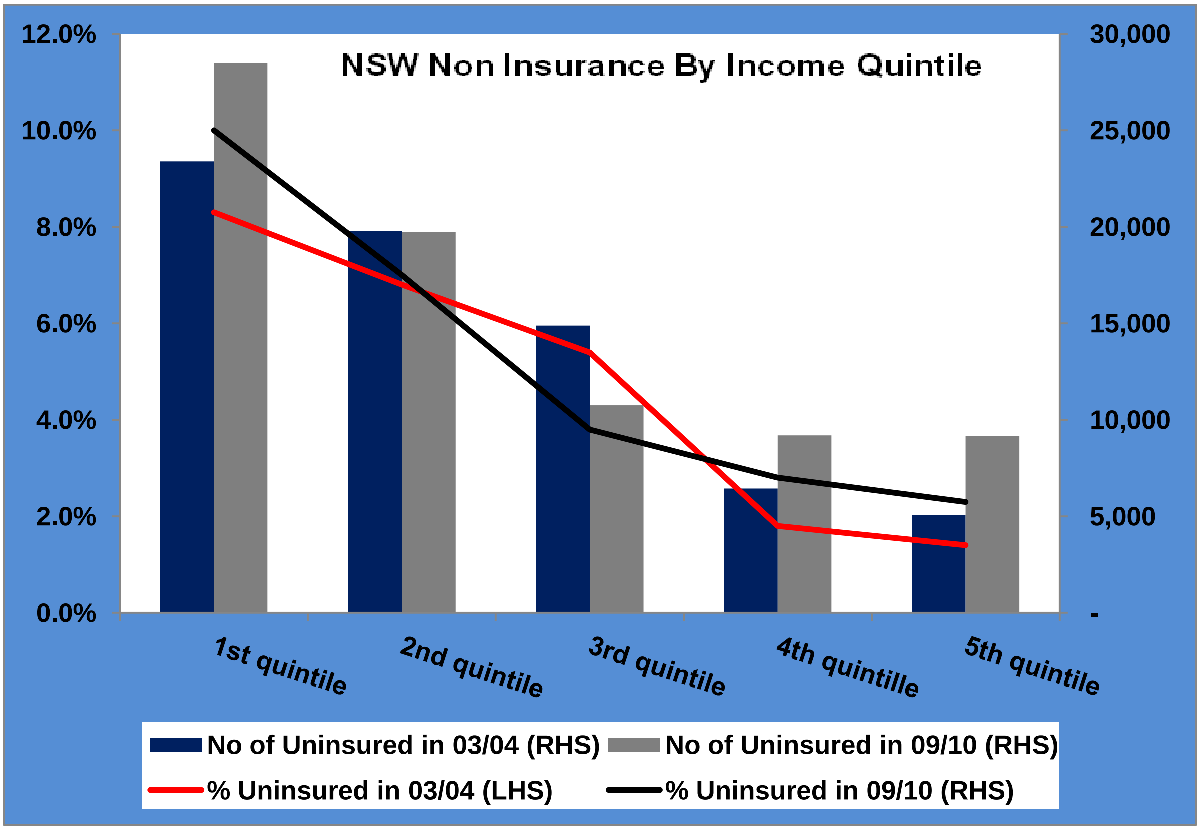
The ICA agrees with the remarks in the Discussion Paper that a principle objection to the current statutory contributions arrangements remains that "*the majority of funding is provided by people who insure their properties, while people who do not insure their properties enjoy the same benefits.*" [15] The issue of "free riders" in the system was identified by the NSW IPART as being a key reason why the horizontal equity of the current arrangements was particularly poor. [16] Typically, fire and emergency services are defined as pure "public goods" to the extent that the use of the fire service by any one party does not (and should not) ration the availability of the service for another. [17] This fundamental characteristic of fire and emergency services lends itself to a funding model that seeks to share the burden of funding across the broader community,

In drawing attention to the challenge of non insurance, the Discussion Paper uses data from the Australian Bureau of Statistics Household Expenditure Survey to provide the empirical evidence for non insurance in NSW. The ICA concurs with such a methodology given the use by the ICA of the same data sources.

The Discussion Paper provides a series of charts on the proportion of non insurance in the Australian community. Drawing further from the ABS HES data, the ICA has been able to examine the distribution of building non insurance by income quintile. The purpose of this analysis is to analyse those sections of the NSW community who remain uninsured for buildings.

[15] See page 13, Discussion Paper.
[16] See NSW IPART (2008) "*Review of State Taxation: Final Report to the Treasurer*" at page 69
[17] A "public good" is described as a good where the use by one person does not reduce the consumption possibility for another. See Australia's Future Tax System (2009) "*Report to the Treasurer: Part Two; Detailed Analysis, Volume 2: Glossary*"

Chart 5



Notes:

1. *Data is for non insurance for buildings defined as owner occupiers not paying body corporate fees.*
2. *Income quintiles are for total household income*

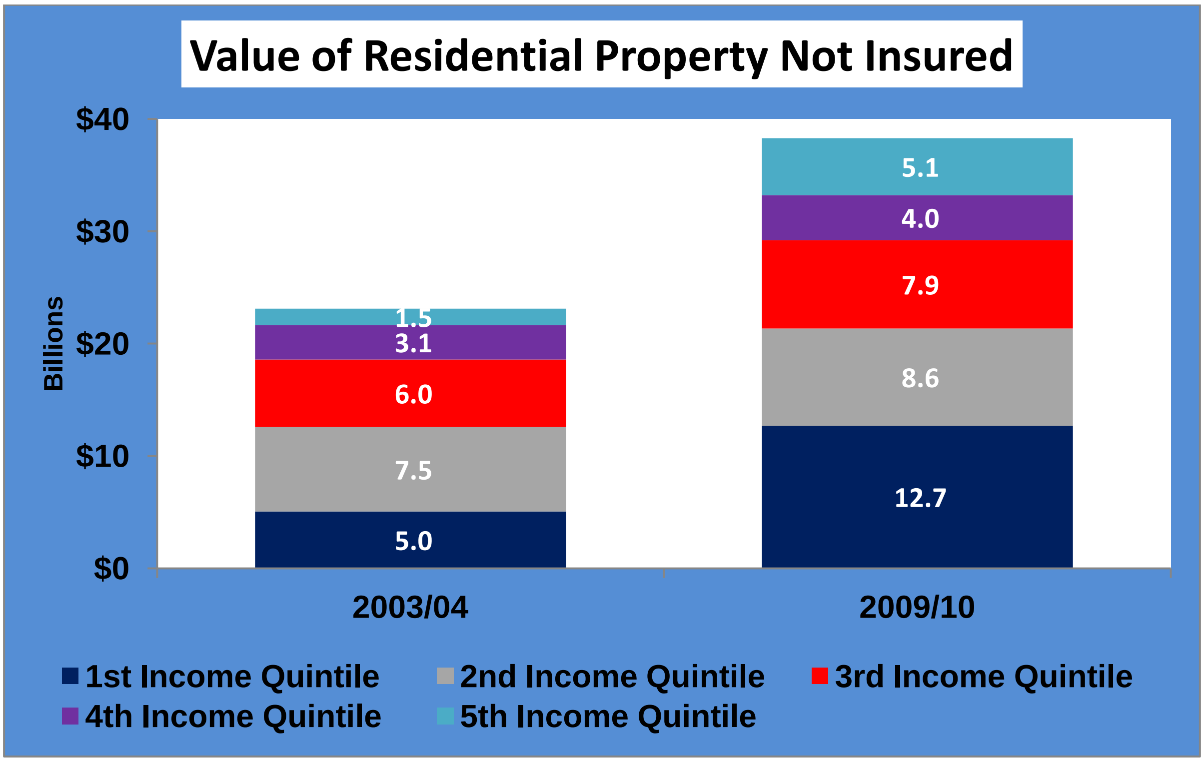
Source: Insurance Council of Australia applying data from the Australian Bureau of Statistics Household Expenditure Surveys.

Although the overall rate of building non insurance in NSW is just under 5%, the proportion of building non insurance is greater for those households in the bottom two income quintiles. Given that such households are less likely to be able to meet the financial losses arising from a large catastrophic event, measures that serve to improve access to insurance (such as taxation relief) would assist in building self reliance and reduce potential dependency on government assistance in the event of a significant event.

Further, the evidence above suggests that households in the top income quintiles have also increased their non insurance rates. Between 2003/04 and 2009/10, the number of households in the 5th income quintile without building insurance increased from around 5100 to around 9,200, with the rate of non insurance in this cohort increasing from 1.4% to 2.3%. Although self insurance may well be rational for high income households given their ability to self fund potential losses, given the current funding arrangements for the fire services, equity concerns remain to the extent that this cohort is able to avoid contributing to the costs of NSW emergency services.

The Insurance Council estimates that the value of NSW household residential assets not insured to be $38 billion in 2009/10, up from $23 billion in 2003/04, with the largest increase taking place for those households in the bottom income quintile. The value of residential property assets not insured is seen in Chart 6 overleaf.

Chart 6



Source: Insurance Council of Australia applying data from the Australian Bureau of Statistics Household Expenditure Surveys.

THE DISTRIBUTIONAL IMPACTS OF ABOLISHING THE NSW FIRE SERVICES LEVY

In June 2011, the ICA commissioned Deloitte Economics Australia to examine the distributional impacts of removing NSW fire levies and replacing them with charges on property and motor vehicles (under various scenarios). A copy of that study accompanies this submission.

Insurance data for the study included postcode level data from major insurers in NSW, with the data containing information on the insured value of all building and contents, the total ESL collected and the number of policies applicable in the post code. Given constraints on the availability of property data, data on land values was obtained from the NSW Valuer General, with Deloitte Australia classifying land data according to their rateable characteristics and their predominate use.

In undertaking the analysis, the study modelled three different approaches to replacing the current ESL with a property based charge. These were:

- Scenario 1 – A flat rate. Under this scenario, ESL was replaced with a flat property based charge based on land value and property type/use (i.e. residential, commercial or rural) with this charge applied evenly across NSW.

- Scenario 2 – Service Level. This approach also replaced ESL with a property based charge (based on land value and property type) but varied amounts payable by local government areas (LGA's) according to their share of ESL funding. Under the current arrangements, LGA's contribute a fixed proportion of fire services funding with the amounts contributed by a respective LGA reflecting the cost of providing fire services in each LGA as well as the level of service provision.

- Scenario 3 – Fire Risk. Under this approach, ESL was also replaced by a property based charge based on land value and property type, but the amounts to be collected across NSW varied according to fire risk, determined on the basis of fire incidence data provided by the NSW Fire Services.

In turn, Deloitte Economics modelled all the above approaches under differing iterations of funding obligation. The options examined were:

(a) Only insurance statutory contributions are transferred to a new property based charge
(b) Insurance contributions and State government statutory contributions are transferred to a property based charge
(c) All statutory contributions (i.e. insurance, State and local government) are transferred to a new property based charge
(d) Insurance contributions are transferred to a combination of a motor vehicle charge [18] and a property based charge
(e) Insurance contributions and the State government contributions are transferred to a combination of a motor vehicle and property based tax.

It should be noted that Deloitte Economics were asked to undertake the distributional analysis on the assumptions that the reform proposals were revenue neutral. Further the apportionment or allocation across the property classes was determined according to the proportion of fire services levy collected by general insurers.[19]

The outcomes for residential and commercial properties under Scenario 1 are summarised in the table overleaf.

[18] The per motor vehicle charge was set at $25.
[19] The allocations were residential classes 45%, commercial classes 49% and rural classes 6%.These allocations are consistent with the Discussion Paper at page 20.

Table 2							
	Insurance	Local Govt	State Govt	Motor Vehicles	Average net saving for the average property	% of LGAs where the average property has a net saving	Estimated rate of tax per $1000 of rateable land
Residential properties							
Option A	Yes	No	No	No	$41	81%	$0.44
Option B	Yes	No	Yes	No	$26	76%	$0.52
Option C	Yes	Yes	Yes	No	$14	70%	$0.59
Option D	Yes	No	No	Yes	$54	87%	$0.36
Option E	Yes	No	Yes	Yes	$42	81%	$0.44
Commercial Properties							
Option A	Yes	No	No	No	-$502	38%	$2.63
Option B	Yes	No	Yes	No	-$748	35%	$3.15
Option C	Yes	Yes	Yes	No	-$945	34%	$3.57
Option D	Yes	No	No	Yes	-$293	42%	$2.19
Option E	Yes	No	Yes	Yes	-$498	38%	$2.62
Rural Properties							
Option A	Yes	No	No	No	-$219	42%	$0.36
Option B	Yes	No	Yes	No	-$310	34%	$0.43
Option C	Yes	Yes	Yes	No	-$387	27%	$0.48
Option D	Yes	No	No	Yes	-$142	52%	$0.30
Option E	Yes	No	Yes	Yes	-$217	43%	$0.35

Source: Deloitte Economics for the Insurance Council of Australia

The findings suggest that in the case of residential properties, the savings tend to be greater for rural LGA's that are located inland, compared with those located by the coast. In the case of the greater Sydney metropolitan area, residential properties located in the west and outer suburbs of Sydney secure greater savings vis a vis those in the north and east.

In the case of commercial and rural properties, the average commercial and rural property owner incurs a net cost under all options modelled. A key factor in these results is the allocation of the revenue burden across the respective property types (ie 45% residential, 49% commercial classes and 6% rural classes). Further, the results for these classes are influenced by the significant variations in the average values applied for commercial and rural properties and as a result, the outcome for the average property in a LGA may not be the appropriate indicator of the outcome for most properties. In this regard, both the ICA and Deloitte Australia were constrained by access and availability of more complete property data.

The Deloitte Economics analysis assists in informing the discussion on the reform of the statutory contributions arrangements in NSW. As Deloitte conclude in their report *"all of the scenarios modelled overcome the limitations associated with an insurance based fire services funding based scheme, however none of the three scenarios modelled presents an obvious choice for the future of a property* *based charge to fund fire services. In terms of equity there are advantages and disadvantages associated with each*".[20]

The ICA concurs with the remarks by Deloitte Economics to the extent that they highlight the need for reform of the current system and for careful decision making by policy makers on the replacement property arrangements. Further, the ICA contend that at a very minimum for the efficiency and equity reasons alone, any reform proposal must abolish as a minimum insurer statutory contributions to the fire services.

TRANSITIONAL ARRANGEMENTS

The Discussion Paper raises the important consideration of transitional arrangements as funding arrangements migrate away from statutory contributions to a property based system. Although the Discussion Paper does not preference a timetable for reform, the ICA contends that policy makers are able to achieve a timetable wherein a property based system for the funding of fire services commences in full from 1 July 2014, leaving any transitional arrangements to apply from 1 July 2013. Nevertheless, to meet this timetable, the ICA contends that close collaboration with the general insurance industry is needed to ensure a successful implementation to any property based system.

The Discussion Paper highlights some of the key issues that need attention when considering the transition to a property based system. In summary, these issues include:

- The scope, given timing issues (council levies are paid in arrears while statutory contributions are collected in advance), that consumers may respond adversely to the possibility of paying for the fire services "twice". (ie once on their insurance premiums and shortly thereafter through the property based charge).

- The risk that insureds either delay or avoid renewing their insurance arrangements to "avoid" meeting fire levy obligations until such time as these levies are abolished.

- Similar to the above, the risk that insureds either independently or through their intermediaries, seek to "game" arrangements by "shorting"[21] their policies at or close to the end of any transition year and renewing thereafter in the post transition year so as to benefit from the remittance of any unearned fire contribution.

- The risk that significant shifts in market shares by industry participants occur potentially resulting in large collection variations and the paradox of the "winners curse". (i.e where a collapsing market would artificially inflate market shares and as a consequence, contributions payments for some individual insurance providers adjusts sharply).

- The trade off between tapering of insurance premiums and full funding of the fire services. As the Discussion Paper emphasises, a taper which phases down on a daily basis would reduce

[20] See Insurance Council of Australia (June 2011) "*Property based funding options for the NSW Fire Services Levy: A report by Deloitte Economics*".

[21] "Shorting" of an insurance policy refers to the practice under which an insurance policy is cancelled or terminated prior to the conclusion of its term for the purposes of avoiding fire contributions recoveries or fire and emergency service levies

the amount collected from the insurance industry by 50%, leaving a funding shortfall or "gap" to be funded. [22]

- The nature of the tapering instrument itself. That is to say, as the Discussion Paper points out, the ICA no longer provides calculations of applicable rates to be applied to insurance policies for the purposes of collecting for statutory contributions. Recovery rates for statutory contributions are the domain of individual insurance companies and are applied according to an individual insurer's commercial settings and market conditions. In the event that tapering was deemed desirable, then a compulsory scheme with a defined and agreed methodology would need to be arranged and legislated across the general insurance sector.

- Consideration of the effect of Section 80 of the *NSW Fire Brigades Act 1989* which mandates that where an insurance company recovers an amount from insureds for the purposes of retaining for statutory contributions payments, then this recovery requires disclosure.

The Discussion Paper notes that the Victorian government is confronting these issues as it migrates to a property based system from1 July 2013. Following the announcement of the Victorian government on the funding of the Victorian fire services and with the subsequent introduction into the Victorian Parliament of the *Fire Services Property Bill 2012*, NSW policy makers are in the unique position to be informed by the Victorian reform experience. In that regard, the Discussion Paper provides a worthy summary of the transition issues and the considerations before policy makers in migrating to a property based scheme.

Nevertheless, and following the Victorian experience with respect to transition arrangements, the ICA contends that three broad transition frameworks are available for consideration by NSW policy makers. They are:

Framework 1: The introduction of a taper/insurance premium surcharge that phases down over the transition year.

This option would look to introduce a legislated mandated taper/surcharge on insurance premiums according to a defined methodology in the transition year. Collections from this taper/surcharge would be remitted to the NSW government for the purposes of fire funding replacing the statutory contributions arrangements. Although the Discussion Paper emphasises a taper/surcharge on a daily basis (i.e phased down by 1/365th per day), as mentioned above, such a daily taper results in a fire funding gap equivalent of 50% of the budget. To overcome this constraint, a number of alternative tapers could also be considered including:

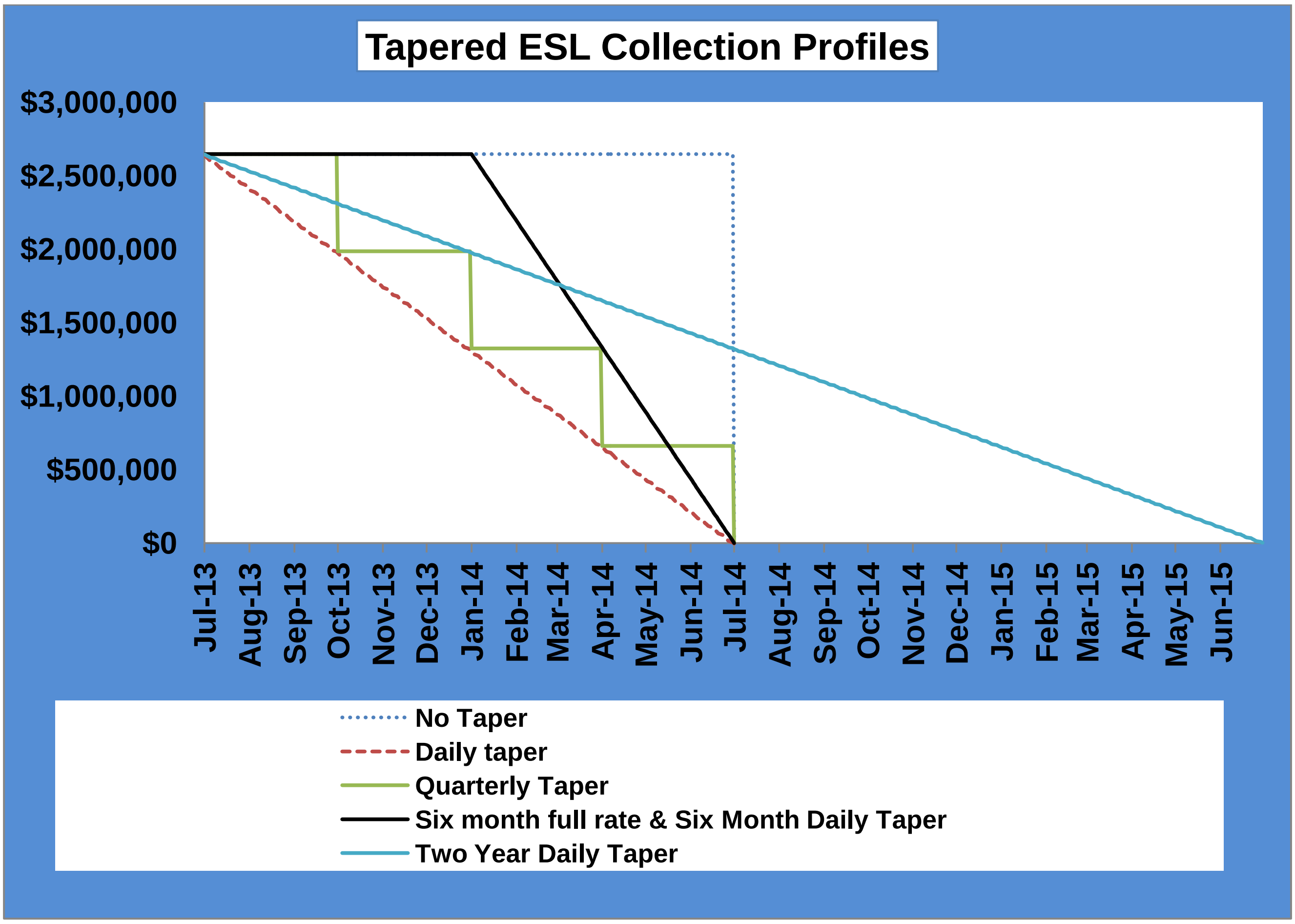
- Tapering on a "block" quarterly basis thereby collecting an additional 12.5% (i.e total collection 62.5% of the budget)
- Tapering on a daily basis from a six month interval after the start of the transition year. For example, if the transition year is 1 July 2013 through to 30 June 2014, then the daily taper would apply for the six months commencing 1 January 2014 through to 30 June 2014

[22] The shortfall assumes an evenly distributed renewal profile. See page 40 of the Discussion Paper.

- Extending the taper period beyond the transition year to include an additional nominated period. In effect, this option would see the insurance transition period extend beyond a twelve month period (for example, for 24 months) and would "overlap" with the collection from the property charge.

These taper profiles are outlined graphically in Chart 7 below.

Chart 7



Notes:

1. *Estimated on the basis of statutory contributions of $691 million in 2013/14*
2. *Assumes uniform monthly distribution of renewals*

Source: Insurance Council of Australia

The Insurance Council has estimated the revenue recovered from these tapers over the period in transition. These are reproduced in Table 3 overleaf:

Table 3				
	Amount collected in 2013/14	Amount collected in 2014/15	Total Amount Collected	Percentage of Total Contributions
No taper	$691m	0	$691m	100%
Daily taper	$345m	0	$345m	50%
Quarterly taper	$433.5m	0	$433.5m	62.7%
Six month full rate & Six month daily taper	$521.9m	0	$521.9m	75.5%
Two year daily taper	$518.2m	$172.8m	$691m	100%

Notes:

1. *Estimated on the basis of statutory contributions of $691 million in 2013/14*
2. *Assumes uniform monthly distribution of renewals*

Source: Insurance Council of Australia

It should be emphasised that the decision on where to set the taper profile is inextricably linked to the question of the fiscal gap and in particular, the tolerance of the NSW policy makers to fund any resultant revenue shortfall. As the ICA reinforced in its submission to the Victorian government [23], the insurance sector cannot meet the funding shortfall arising from tapering. An obligation to fund any funding shortfall arising from tapering (however designed) has marked implications for the prudential strength of the industry and potentially the availability of insurance cover in NSW. Moreover, and as highlighted above, in any given year the gap between premiums collected and claims payable for property classes varies according to the claims environment[24]. This fundamental feature of insurance ensures that the insurance sector is unable to meet funding deficits without such arrangements having a profound effect on the prudential strength of the industry and the market provision of insurance itself.

In the absence of an available industry wide instrument to universally apply a taper, as the Discussion Paper well notes, NSW legislators would be required to introduce a compulsory scheme based on a defined methodology under which insurance companies would pass on the ESL to consumers. [25] Although the Discussion Paper refers to the transition in Western Australia as applying a tapered transition, it should be noted that in that case, at the time of the transition, the insurance industry (through the ICA) maintained an advisory ESL under which a tapering methodology was applied. Given that the industry no longer issues ESL advisory calculations for application across the industry, then a taper of whatever designed profile would necessarily have to be legislated/mandated.

Concerns with respect to the fiscal strength of NSW policy makers to meet funding shortfalls arising from tapering may be addressed by combining a legislated taper with a number of additional measures. For example, to minimise revenue risk [26] to the NSW government, a legislated taper could

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[23] See ICA (September 2011) "*Submission to the Victorian Government's Option Paper: Victorian Fire Services Levy*".

[24] For example, a "benign" claims environment would see a lower claims outlay for the industry while for a year of major catastrophes, the reverse would be true. The basic nature of insurance is that those who purchase insurance are providing for their future contingencies themselves, rather than being reliant on other parties (i.e. government

[25] See page 26 of the Discussion Paper

[26] In a legislated taper, the revenue risk is transferred to the NSW government as the taper would be a charge on the ad valorem premium and this may vary according to market circumstances resulting in revenue estimate error. Under statutory contributions, given the

be enhanced with an obligation to remit a minimum amount from insurance companies to the NSW government consistent with the taper profile. [27] Compatible with this measure would be an obligation to return to the NSW government all collections received under the ESL taper on a "pass through" basis. This measure would ensure that any potential "upside" in collections arising from premium growth [28] would be retained by the NSW government thereby potentially lessening the funding shortfall.

Framework 2: No Tapering with a "handover" to the property based charge

Again, the Discussion Paper notes that there is scope for policy makers to undertake an "abrupt change" [29]to a property based system without a transition year/period under which a taper would be applied. In effect, this approach would look to the market and the insurance industry to apply their own methods and commercial undertakings to ensure that renewal and insurance cover is maintained in the run up to a property based system. This approach is broadly consistent with the current arrangements wherein fire contributions recoveries are the preserve of each individual insurer.

It should be noted that the Victorian experience provides a useful gauge as to the efficacy of such an approach, especially given that the Victorian government has announced its position and has introduced legislation into the Victorian Parliament. [30] The legislative arrangements introduced by the Victorian government will see the insurance sector meet statutory contributions for the year 2012/13 with full abolition from 2013/14. To support the risks associated with this abrupt break in contributions (such as gaming and/or renewal delays/withdrawals) the insurance industry implemented a series of measures designed to manage such risks explicitly. [31] The ICA contends that with these measures underway in Victoria, the industry is able to respond adequately to any risks of an abrupt end to statutory contributions in NSW should NSW policy makers consider adopting such an approach.

Nevertheless to support the industry in managing the risks of an abrupt change in NSW, the ICA contends that several measures require policy attention in order to manage the risk of renewal delay and gaming. These measures would include:

- The introduction of a legislative inability to cancel and/or "short" [32] an insurance policy for the purposes of avoidance of statutory charges or levies.

- The introduction of a quarterly assessment process [33] for insurers declared premiums to be undertaken by the Fire and Emergency Services. The introduction of such a process allows

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contributions budget is fixed, the revenue risk is borne by the insurance industry vis a vis their ability to match recoveries from consumers to the contributions amounts payable to the fire services.

[27] For example, under a daily taper, the commitment could be for insurers to remit no less 50% of the fire services budget based on the government assuming responsibility for the balance of funding. Similarly, on a stepped down block taper, the commitment would be for insurers to remit no less than 62.5% of the fire services budget with the government assuming responsibility for the balance.

[28] Under the statutory contributions arrangements, if premium growth improves fire funding recoveries vis a vis the amounts to be remitted, then this collection "upside" or over collection is retained by insurers. In other words, potential under or over collections is a feature of the system although insurer systems and practices are designed to minimise such collection variations.

[29] See page 40 of the Discussion Paper

[30] It should be noted that the NSW Discussion Paper was issued prior to the Victorian government's announcement and introduction of legislation.

[31] For example, these measures have included changes to contracts and product disclosure statements that reduce the incentive to "short" policies for the purposes of avoiding FSL as well as undertaking ongoing pricing and collection recovery reviews.

[32] "Shorting" of an insurance policy refers to the practice of cancelling an insurance policy for the purposes of explicitly avoiding statutory charges or levies reasons

insurers to "track" market declared premiums over the course of the pre property charge year so as to minimise the revenue risk to insurers arising from changes in market condition/shares.

- The fixing by statute/regulation of the NSW Fire and Emergency Services budget prior to the commencement of the final year of statutory contributions. [34]

The ICA submits that NSW policy makers have the clear advantage of closely observing the Victorian experience when deciding upon the merits of a no taper solution with an abrupt handover to a property based charge. In this regard, the ICA respectfully suggests that NSW policy makers maintain an ongoing discussion with the general insurance industry on the transition issues in Victoria and their scope for replication in the NSW settings.

Framework 3: Decoupling as suggested by the Public Accounts Committee.

In 2004, the NSW Parliamentary Accounts Committee (PAC) reviewed NSW fire funding arrangements with the inquiry considering transition issues. [35] The PAC made a number of recommendations with respect to transitioning to a property based system. For the purposes of the current discussion, the relevant recommendation was 7.2 which stated inter alia:

> "*If a property-based system is introduced, there should be a transitional period where both the old and new funding systems operate concurrently. During this period, the property levy should be paid at half the required rate, as well as any insurance policy that is renewed during the transitional period, up to and including the last day of the transitional period. Any part of the annual premium that spans the end of transitional period should be charged FSL.*"[36]

The PAC settled on the above recommendation following their finding that "*special arrangements to ensure stability of revenue for the fire services and to minimise the costs to the public during the transition are required.*" [37]

In their consideration of the transition issues arising from a move to a property based funding formula for the Victorian Fire Services, the Victorian Department of Treasury suggested an option consistent with the PAC approach naming it as the "Decoupling Model". [38]

It should be noted that both the recommendation of the PAC and the Victorian DTF Options Paper predated the abandonment by the ICA of its fire service advisory calculations. [39]

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[33] Currently under Section 58 of the *NSW Fire Brigade Act*, declared industry premiums are undertaken on an annual basis in September. The *Victorian Fire Services Property Bill 2012* introduces quarterly premium declarations.

[34] Sections 45 and 46 of the *NSW Fire Brigades Act* govern the arrangements under which the Minister responsible estimates and adjust fire service budgets. Prior to the start of the 2012/13 year and prior to the introduction of the *Victorian Fire Services Bill 2012*, the Victorian government announced the contributions budget for insurers.

[35] See NSW Public Accounts Committee *op cit,* at pages 101 to 109.

[36] See NSW Public Accounts Committee, *op cit*, at page 108

[37] See NSW Public Accounts Committee, op cit, at page 108

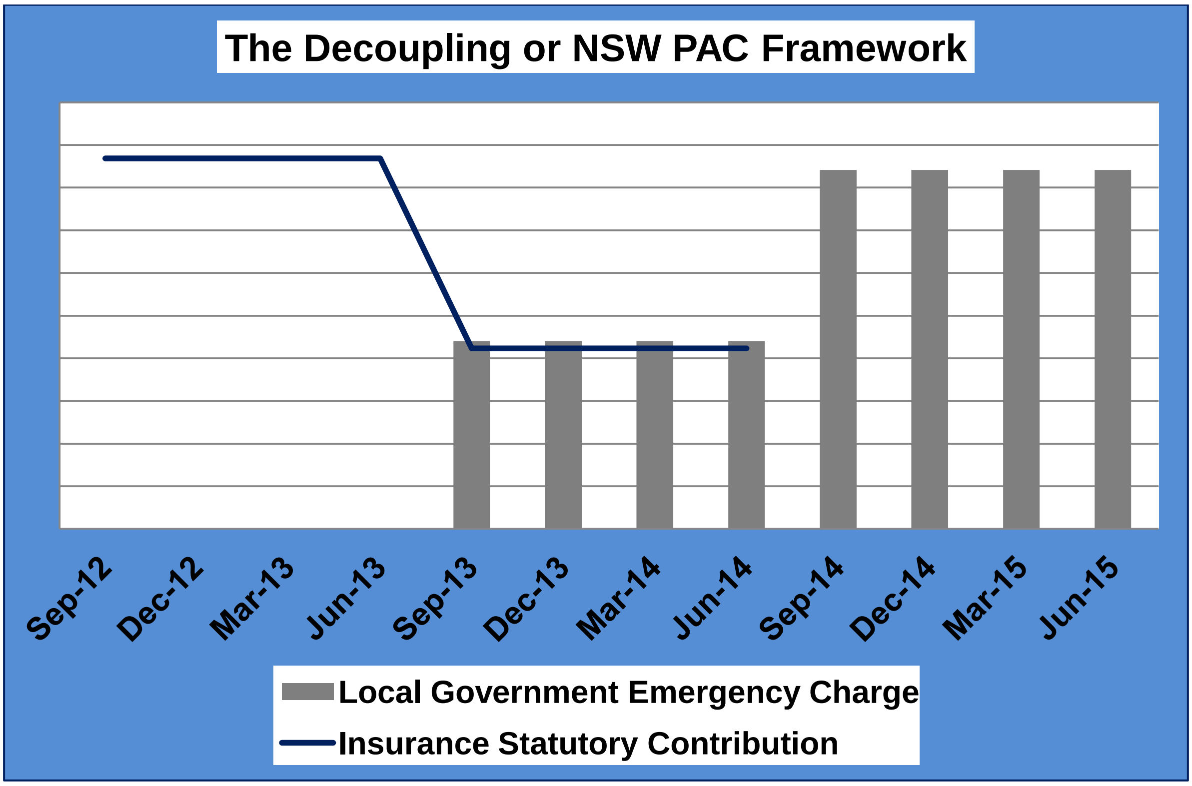
[38] See Victorian Department of Treasury & Finance (June 2011) "*Victorian Fire Services Property Levy: Options Paper*" at page 24.

[39] The Insurance Council of Australia ceased to issue Fire and Emergency Service Calculations for NSW and Victorian jurisdictions from February 2012.

The term decoupling has been used to describe the understanding that the ESL recovery is "Decoupled" from the insurance contract and as such, bears no relationship to the insurance agreement. In other words, the starting point for Decoupling is the understanding that the emergency services levy represents an annual payment for what is a hitherto public good and it is this payment that is used to fund the fire services. Seen this way, any levy recovered from the insured bears no relationship to the insurance contract, and depending on when the insurance policy is taken out, the payment is either paid in arrears (i.e. when payable at year end) or in advance (when payable at the beginning of the year).

Decoupling facilitates a transition arrangement as preferred by the PAC under which a 50% discount to insurance statutory contributions would take place in the transition year with the shortfall being met by the property contribution. In other words, together with the 50% reduction in the insurer statutory contributions, the implementation of the property- base charge would be introduced to the equivalent of the remaining 50% of the statutory contributions budget, increasing to 100% in the full implementation year. The framework is represented in Chart 8 below.

Chart 8



Source: Insurance Council of Australia

The advantage of the Decoupling approach is that it avoids any funding deficit that may arise from tapering. Nevertheless, the ICA contends that the same risks identified with second framework identified above (i.e. the "abrupt end") would similarly apply albeit of a lesser scale. The ICA also submits that the challenges with respect to incentives and policy arbitrage remain equally for the Decoupling model as well as the added requirement that the collections system for the property-based charge needs to be also available in the transition year.

MONITORING OF INSURANCE PRICES

Question 10 of the Discussion Paper poses the issue of what price monitoring arrangements should apply to insurers to ensure that any reductions in statutory contributions are passed through to consumers. In this regard, the insurance industry fundamentally agrees with the position in the Discussion Paper that "*abolishing emergency services levy on insurance companies will result in lower costs of insurance for many consumers. In a competitive market, it is generally expected that any reductions in the cost of supplying a service would be passed on to consumers in the form of lower prices.*" [40]The ICA also agrees with the remarks in the Discussion Paper that the general insurance industry is competitive with multiple providers and that the available evidence from the Western Australian and South Australian abolition of statutory contributions indicated that the benefits of reform were passed through to consumers in either lower prices or additional cover.

Notwithstanding the above, the insurance industry understands stakeholder and policy makers may still desire to put in place effective monitoring measures in order to improve transparency. With this in mind, the ICA contends that in the event of such a monitoring regime, that such a process is best undertaken independently of government and the Parliament, with the agency best positioned for such a task being the NSW Independent Pricing & Regulatory Tribunal (IPART). However, the ICA contends that in developing the terms of reference for a monitoring exercise, allowances must be made for premium adjustments arising from the normal course of the insurance cycle and specific events. The ICA respectfully cautions against the risk that policy makers and/or stakeholders seek to deploy any monitoring process as a de facto price/premium setting arrangement.

The ICA also notes that the Discussion Paper refers to the monitoring of insurance prices in the event that insurer statutory contributions are abolished. In the event that policy makers were of a mind to abolish all statutory contributions (including those of local government) it is appropriate for policy makers to consider whether monitoring arrangements should be applied in such cases as well. [41]

CONCLUSION

The ICA welcomes the release of the NSW government's Discussion Paper and the goal expressed in the paper to abolish insurance statutory contributions with a property based levy. The ICA agrees fundamentally that the current system suffers from considerable weaknesses, including both on equity and efficiency grounds. The ICA also suggests that for NSW, together with Victoria, reform of insurer contributions to the fire services is a long overdue State taxation reform project.

Nevertheless, the ICA submits that replacing insurer statutory contributions with the preferred broad based property charge opens up important implementation and transitional issues. The ICA submission outlines three transition pathway frameworks for consideration by NSW policy makers, noting also that Victorian policy makers have settled upon their transition arrangements. The ICA submits that irrespective of the transition model adopted, that close collaboration with the industry is fundamental both prior and during the implementation stage. The ICA respectfully suggests that the Victorian experience provides a

[40] See Discussion Paper at page 26.

[41] In the case of local government, the abolition of insurer statutory contributions can be considered as part of local government rating applications reviewed currently by the NSW IPART.

useful case study for NSW policy makers and urges NSW policy makers to ensure that ongoing industry consultation remains the bedrock of any transitional year.