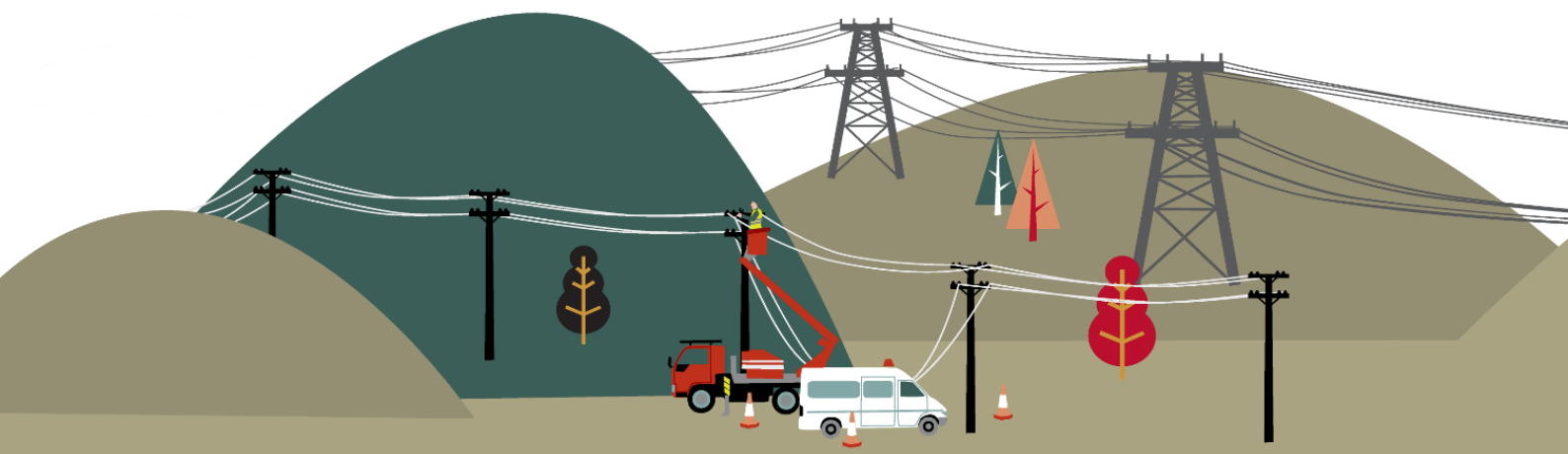


Treatment of operating leases

Draft decisions and reasons paper

Date of publication: 28 August 2019



Associated documents

Publication date	Reference	Title
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Commerce Commission
Wellington, NEW ZEALAND

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Executive Summary

- X1 The purpose of this paper is to seek views of interested parties on our draft decisions on how to address the issues raised by a new financial reporting standard for our regulated suppliers - New Zealand Equivalent to International Financial Reporting Standard 16 Leases (NZ IFRS 16).¹
- X2 Our decisions must ensure outcomes are consistent with the purpose of Part 4 of the Commerce Act 1986 (Act) and the purpose of input methodologies (IMs).
- X3 In 2016, NZ IFRS 16 was issued by the New Zealand Accounting Standards Board. The new standard constitutes generally accepted accounting practice (GAAP) under the Financial Reporting Act 2013.
- X4 NZ IFRS 16 fundamentally changes the accounting treatment of operating leases for lessees, by requiring operating lease payments to be capitalised and be reported as capital expenditure (capex). These were previously recognised as operating expenditure (opex). The capital asset will be shown on businesses' balance sheets as a 'right of use' asset, with a value based on the present value of the remaining lease payments.
- X5 The suppliers we regulate under Part 4 often hold operating leases over assets like buildings and property, vehicle fleets and IT infrastructure. The information disclosure (ID) requirements and IMs that we set draw on GAAP where appropriate, to minimise compliance costs. As the regulatory definitions that help to determine allowable revenues refer to GAAP, the new accounting treatment of operating leases affects the businesses we regulate—in ways that we could not have anticipated when we set the current IMs and ID requirements. This gives rise to the potential for unintended outcomes.
- X6 In our *Treatment of operating leases: Issues Paper* (issues paper), published on 6 June 2019² we identified some issues that may have ongoing effects for regulated suppliers' revenue allowances and outcomes under our incremental rolling incentive scheme (IRIS) arising from the change in financial reporting standard if we maintain our regulatory rules as they are.
- X7 Our draft decisions for dealing with these issues and accounting for operating leases for EDBs and Transpower for regulatory purposes are:

¹ New Zealand Equivalent to International Financial Reporting Standard 16 Leases (NZ IFRS 16). Accessible at <https://www.xrb.govt.nz/accounting-standards/for-profit-entities/>

² Commerce Commission "Treatment of operating leases: Issues Paper" (6 June 2019). Accessible at: https://comcom.govt.nz/data/assets/pdf_file/0017/152108/Treatment-of-operating-leases-Issues-paper-6-June-2019.pdf.

- X7.1 generally accept alignment with NZ IFRS 16 for price-quality and ID regulation purposes. This would mean that allowable revenue and returns on investment under ID would be calculated using capitalised 'right of use' asset³ values. This aspect of our decision would not require IM changes, other than to also align the deferred tax treatment with GAAP for EDBs;
- X7.2 this capitalisation treatment will not apply for right of use assets capitalised under NZ IFRS 16 from charges specified as pass-through or recoverable costs. These charges will continue to be treated as pass-through or recoverable costs. This will require a change to the asset valuation IMs;
- X7.3 amend the IMs so that operating leases continue to be treated as opex for IRIS purposes.
- X7.3.1 This amendment will not affect the price paths in the current regulatory period. Rather, it requires 'carry forward' amounts already calculated under IRIS in the current path to be restated before they affect the path in the next regulatory period.
- X7.3.2 For opex this has the effect of converting what would otherwise be treated as a permanent saving into a temporary saving, lasting only for the duration of the remainder of the current regulatory period. The capex effects of applying the existing IRIS rules for the remainder of the current regulatory period will also remain as they stand.
- X7.3.3 This will give rise to material gains for EDBs adopting the standard early and those EDBs on a Customised Price Path (CPP), for whom IRIS benefits of the transition will continue to be carried forward into the future. Nonetheless we consider this approach is consistent with applying the IRIS rules as they stand to the current period.
- X7.3.4 This proposed amendment would mean making adjustments to opex forecasts to reverse future negative IRIS effects in the next price path for early adopters (ie those EDBs who have adopted NZ IFRS 16 in the base year or earlier of the current regulatory period). These negative effects would otherwise arise if the nil operating lease expenditure disclosed in the base year were carried forward into forecasts and compared with future actual expenditure treated as opex.
- X7.3.5 We are concerned that the early adopter EDBs may gain an IRIS benefit solely as a result of the change in accounting rules, given

³ In general terms, 'right of use' assets are a novel instrument for our regulatory regime, since they are generally contracts for the temporary use of an asset, rather than ownership of the underlying asset itself. See paragraphs 2.6 and 2.11-2.14 of this paper for further discussion of right of use assets.

that the IRIS benefit is not the result of the businesses achieving efficiency improvements. However, changing the IMs to prevent them from gaining this benefit, would risk undermining the certainty that is otherwise provided by the IRIS IM.

- X8 The alternative option we have considered to deal with the introduction of NZ IFRS 16 is to amend the IMs so that operating leases would continue to be treated as opex for all regulatory purposes. This would essentially aim to maintain the rules as they were before the new standard was introduced.
- X9 Having considered that alternative, we consider that our draft decisions are more consistent with setting fit for purpose DPP and ID requirements in a way that reduces compliance costs and complexity, without detracting from the promotion of the Part 4 purpose.
- X10 The change in GAAP by NZ IFRS 16 affects all regulated businesses that have operating leases that must be capitalised. Our response to the change will therefore be of interest to all the businesses we regulate that are or may become subject to ID or price-quality regulation under Part 4 of the Act or Part 6 of the Telecommunications Act 2001. This includes Transpower, all EDBs, suppliers of gas pipeline services, suppliers of specified airport services, and providers of regulated fibre services.
- X11 However, these draft decisions apply to the treatment of NZ IFRS 16 for Transpower and EDBs. The new financial reporting standard has a particular importance for these suppliers because of decisions we are currently making on price-quality paths for the next regulatory periods - DPP3⁴ and Transpower's individual price-quality path (IPP) for the next regulatory period commencing 1 April 2020 (RCP3)⁵.
- X12 Table X1 sets out indicative dates for next steps in this process.

Table X1 - Indicative dates

What	When
Draft determination	11 September
Submissions on draft decisions	18 September
Cross-submissions on draft decisions and technical submissions on draft determination	2 October
Final decision	November

⁴ Commerce Commission "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision – Reasons paper" (29 May 2019).

⁵ Commerce Commission "Transpower's individual price-quality path from 1 April 2020 – Draft decisions and reasons paper" (29 May 2019).

Chapter 1. Introduction

Purpose of paper

- 1.1 The draft decisions outlined in this paper are in respect of the regulatory treatment of operating leases. The purpose of this paper is to:
 - 1.1.1 explain our draft decisions on how to address the issues raised by NZ IFRS 16 for our regulated suppliers;
 - 1.1.2 explain how our draft decisions promote the Part 4 purpose and the purpose of the IMs we set; and
 - 1.1.3 seek submissions from interested parties on our draft decisions, which will inform our final decisions on the treatment of operating leases for regulatory purposes.

Why we are undertaking this consultation now

- 1.2 We are undertaking this consultation now because we are proposing to build the forecast price paths for Transpower's IPP for RCP3 and EDBs DPP for DPP3 using, in accordance with our draft decisions, NZ IFRS 16 GAAP treatment of operating leases. This means operating leases will continue to be treated as opex for IRIS purposes.

Process we are following

Our process to date

- 1.3 On 16 May 2019, we published a notice of intention advising that the Commerce Commission (Commission) was beginning work to consider and consult on potential changes to some of the IMs⁶ in response to NZ IFRS 16.
- 1.4 On 6 June 2019, we published our issues paper discussing our understanding of the issues that this new financial reporting standard could create for our regulated suppliers. We received submissions on our issues paper on 10 July 2019.
- 1.5 We issued s 53ZD notices to EDBs on 19 July 2019 and to Transpower on 24 July 2019, seeking further information on the extent of their operating leases to enable the effect of the NZ IFRS 16 changes to be properly taken into account in respect of forecast opex and capex for decisions we are now making in respect of DPP3/RCP3.

Structure of paper

- 1.6 This paper sets out:
 - 1.6.1 our decision-making framework (Chapter 2);
 - 1.6.2 background on NZ IFRS 16 change to operating leases (Chapter 3);

⁶ https://comcom.govt.nz/__data/assets/pdf_file/0029/146648/Notice-of-intention-for-potential-amendments-to-IMs-for-EDBs-and-Transpower-16-May-2019.pdf

- 1.6.3 summary of our draft decisions (Chapter 4);
- 1.6.4 summary of submissions on our issues paper (Chapter 5);
- 1.6.5 accounting for operating leases in setting price quality paths under a DPP or IPP (Chapter 6); and
- 1.6.6 accounting for IRIS effects of the change in treatment of operating leases (Chapter 7).

Submissions on this paper

- 1.7 We welcome your written views on the matters raised in this paper, within the following timeframes:
 - 1.7.1 submissions due by 5pm on Wednesday, 18 September 2019; and
 - 1.7.2 cross-submissions due by 5pm on Wednesday, 2 October 2019.
- 1.8 You should address your responses to:
Matthew Clark (Acting Manager, Regulatory Developments)
c/o regulation.branch@comcom.govt.nz
- 1.9 Please include “Treatment of operating leases – Draft Decisions Paper” in the subject line of your email. We prefer submissions in both a format suitable for word processing (such as a Microsoft Word document), as well as a ‘locked’ format (such as a PDF) for publication on our website.
- 1.10 While we discourage requests for non-disclosure of submissions so that all information can be tested in an open and transparent manner, we recognise that there may be cases where parties that make submissions wish to provide information in confidence.⁷ We offer the following guidance:
 - 1.10.1 If it is necessary to include confidential material in a submission, the information should be clearly marked, with reasons why that information is confidential.
 - 1.10.2 Where commercial sensitivity is asserted, submitters must explain why publication of the information would be likely to unreasonably prejudice

⁷ Parties can also request that we make orders under s100 of the Act in respect of information that should not be made public. Any request for a s100 order must be made when the relevant information is supplied to us, and must identify the reasons why the relevant information should not be made public. We will provide further information on s100 orders if requested by parties. A key benefit of such orders is to enable confidential information to be shared with specified parties on a restricted basis for the purpose of making submissions. Any s100 order will apply for a limited time only as specified in the order. Once an order expires, we will follow our usual process in response to any request for information under the Official Information Act 1982.

their commercial position or that of another person who is the subject of the information.

- 1.10.3 Both confidential and public versions of the submission should be provided.
 - 1.10.4 The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.
- 1.11 We request that you provide multiple versions of your submission if it contains confidential information or if you wish for the published electronic copies to be 'locked'. This is because we intend to publish all submissions on our website. Where relevant, please provide both an 'unlocked' electronic copy of your submission, and a clearly labelled 'public version'.

Chapter 2. Framework for our draft decisions

Purpose of this chapter

- 2.1 This chapter explains the high-level framework we have applied in reaching our draft decisions on how we address the issues we have identified with the introduction of NZ IFRS 16.

Our decision-making framework

- 2.2 In considering changes necessary to implement these draft decisions, we have used a decision-making framework that we have developed over time to support our decision-making in respect of potential IM changes under Part 4 of the Act. This has been consulted on and used as part of prior processes, and helps provide consistency and transparency in our decisions.
- 2.3 Consistent with the decision-making framework adopted in our 2016 IM review and in the 2018 Transpower Capex IM⁸ review, we have considered each potential IM amendment by asking:⁹
- 2.3.1 whether it promotes the Part 4 purpose in s 52A of the Act more effectively than the current IM;
 - 2.3.2 whether it promotes the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose); or
 - 2.3.3 whether it significantly reduces compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s 52A purpose).
- 2.4 We have used this framework to inform our draft decisions on potential changes to the IMs discussed in this paper.
- 2.5 We have also considered the effect of simplifying assumptions made in respect of the Part 4 purpose to support a low-cost price quality path framework.¹⁰

⁸ *Transpower Capital Expenditure Input Methodology Determination 2012* [2012] NZCC 2.

⁹ Commerce Commission “Input methodologies review decisions: Framework for the IM review” (20 December 2016), at 66-67.

¹⁰ For example, the standard 45 year life assumption used for additional assets, as described in Chapter 4 of this paper.

Chapter 3. Background on changes to operating leases

Purpose of this chapter

- 3.1 This chapter explains our understanding of the change to the accounting treatment of operating leases, including the implications for our regulatory regime.

Overview of changes

- 3.2 In 2016, a new financial reporting standard, New Zealand Equivalent to International Financial Reporting Standard 16 Leases (NZ IFRS 16) was issued by the New Zealand Accounting Standards Board of the External Reporting Board (XRB). The standard fundamentally changes the accounting treatment of operating leases for lessees by requiring the capitalisation of operating lease expenditure.
- 3.3 The suppliers we regulate often hold operating leases over assets like buildings and property, vehicle fleets and IT infrastructure. The ID requirements and IMs that we set draw on GAAP, where appropriate, to minimise compliance costs. As the regulatory definitions that help to determine allowable revenues refer to GAAP,¹¹ the new accounting treatment of operating leases affects the businesses we regulate—in ways that we could not have anticipated when we set the current IMs and ID requirements. This gives rise to the potential for unintended outcomes.
- 3.4 Operating lease agreements generally create an obligation for a party to make payments for a period into the future in exchange for the right to use an asset. Historically under GAAP, these agreements have not been recognised as creating an asset and liability on the lease-holder's balance sheet. Rather, they have just been treated as opex.
- 3.5 The New Zealand Accounting Standards Board changed this via the release of NZ IFRS 16. The new standard is intended to ensure information is provided that faithfully represents operating lease agreements, so that users of financial statements can better assess the effect leases have on an entity's financial position, performance and cash flows.¹²

¹¹ Specifically, GAAP is referred to in clause 2.2.11 of the *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26 (EDB IM) and clause 2.2.7 of the *Transpower Input Methodologies Determination 2010* [2012] NZCC 17 (Transpower IM) for determining the 'value of commissioned assets', which is a component in determining the regulatory asset base on which suppliers can earn a regulated return. See clause 2.2.11 of the EDB IM and clause 2.2.7 of the Transpower IM. The definition of operating costs in these IMs excludes a cost that is treated as a cost of an asset by GAAP, and so operating lease costs will no longer fall into the definition of operating expenditure.

¹² XRB "New Zealand Equivalent to International Financial Reporting Standard 16 Leases (NZ IFRS 16)" (Amended as at 12 July 2018), at 1.

- 3.6 The new standard applies to entities that prepare financial statements under the requirements of New Zealand Equivalents to International Financial Accounting Standards (IFRS). It comes into effect for annual reporting periods beginning on or after 1 January 2019 — though businesses are able to adopt the standard earlier.¹³
- 3.7 The new standard removes previous distinctions between operating leases and finance leases for lessees, which meant the former did not previously appear on a lessee's balance sheet.¹⁴ Under NZ IFRS 16, lessees will now be required in GAAP accounts to record most new and existing leases on the balance sheet as:^{15, 16}
- 3.7.1 A lease liability: The new lease liability will be valued by recognising the present value of future lease payments. The discount rate used to determine the present value is the interest rate implicit in the lease contract—if able to be readily determined—or the lease-holder's incremental borrowing rate.
- 3.7.2 A corresponding 'right of use' asset. The right of use asset will have broadly the same value as the lease liability, though may be adjusted for things such as prepayments. The right of use asset can be presented separately on the balance sheet or combined with the line items of property, plant and equipment corresponding to the underlying assets.¹⁷
- 3.8 'Capitalising' the lease will also affect a lessee's income statement:
- 3.8.1 The initial transition to the new standard will mean recording the present value of existing leases as capex.
- 3.8.2 Any new lease entered into or increase in obligations under existing leases will similarly be recorded as capex.
- 3.8.3 There will be an enduring reduction in reported operating lease expenditure.

¹³ We are aware that some EDBs have adopted the standard earlier.

¹⁴ A finance lease was previously distinct from an operating lease if it granted ownership transfer, contained a bargain purchase option, covered more than 75% of the underlying asset's life, or 90% of the asset's fair market value. Finance leases are recorded as assets with associated liabilities on the balance sheet. They depreciate over time and incur interest expense.

¹⁵ XRB "New Zealand Equivalent to International Financial Reporting Standard 16 Leases (NZ IFRS 16)" (Amended as at 12 July 2018), at 23-27.

¹⁶ There are some exclusions. These include leases that are low-value or have a period of less than 12 months, and some specified assets including oil and gas exploration permits.

¹⁷ Disclosures are required of which line items include such right of use assets.

- 3.8.4 The reduced operating lease expenditure will be offset by an increase in interest expense on the lease liability, and depreciation expense on the right of use asset.
- 3.9 Under NZ IFRS 16, lease-holders are to remeasure the lease liability and adjust the right of use asset to reflect changes to the lease payments. Revisions could arise from changes to the term, amount payable, residual value, or a rate or index used to determine the payment.¹⁸
- 3.10 There is no regulatory equivalent of a balance sheet, and so only the asset side of the balance sheet treatment is recognised in regulatory accounts under ID requirements. The following discussion therefore deals only with the right of use asset.
- 3.11 Finance leases and ‘identifiable non-monetary assets’ are intangible assets that are included in a supplier’s RAB for the purposes of ID and price-quality paths.¹⁹ In our *2010 Input Methodologies for Electricity Distribution and Gas Pipeline Services: Reasons Paper*, we stated that regulated suppliers should be able to earn a return of, and on, intangible assets where:²⁰
- 3.11.1 this is consistent with the Part 4 purpose; and
- 3.11.2 the assets are used to supply electricity distribution services or gas pipeline services (it is not sufficient for intangible assets to merely be associated with an electricity distribution business or gas pipeline business).
- 3.12 Right of use assets constitute ‘identifiable non-monetary assets’ and so will enter the RAB under the current IMs.

¹⁸ XRB “New Zealand Equivalent to International Financial Reporting Standard 16 Leases (NZ IFRS 16)” (Amended as at 12 July 2018), at 39-43.

¹⁹ Commerce Commission “Input Methodologies (Electricity Distribution and Gas Pipeline Services): Reasons Paper” (December 2010), Attachment E3.1 and Commerce Commission “Input Methodologies (Transpower): Reasons Paper (22 December 2010)”, at 4.4.49.

²⁰ Commerce Commission “Input Methodologies (Electricity Distribution and Gas Pipeline Services): Reasons Paper” (December 2010), Attachment E3.3. We also expressed the same view for Transpower – Commerce Commission “Input Methodologies (Transpower): Reasons paper (22 December 2010)”, at 4.4.51.

- 3.13 It is important to note that right of use assets are a novel instrument for our regulatory regime, since they are generally contracts for the temporary use of an asset, rather than ownership of the underlying asset itself.²¹ Right of use assets are therefore likely to have much shorter lives than the majority of physical infrastructure assets used to supply the services we regulate under Part 4. Furthermore, NZ IFRS 16 requires that in certain circumstances right of use assets are periodically revalued, which is not generally permitted by the regulatory regime, except for airport land.²²
- 3.14 In some circumstances right of use assets may be capitalised under NZ IFRS 16 for financial reporting purposes, where the consideration is treated as a pass-through or recoverable cost rather than opex for regulatory purposes. These costs are currently excluded from the definition of opex and required to be disclosed separately. A possible example is a charge payable by an EDB to Transpower under a new investment contract.²³
- 3.15 Our current view is that retaining the existing IM treatment for pass-through costs and recoverable costs is appropriate given that there has been no change in the rationale for distinguishing these costs from opex. This rationale is that these costs should be allowed to pass-through to prices, rather than via allowable revenue before pass-through and recoverable costs, and there may be judgement involved as to how much should be passed through.²⁴
- 3.16 We note that there are already asset classes recognised under GAAP which are not recognised for regulatory purposes.²⁵ The exclusion of capitalised pass-through and recoverable costs is not likely to give rise to additional compliance costs.

²¹ The closest analogues are finance leases, which are also included in the RAB. However, finance leases generally cover the full life of an asset and/or involve the full transfer or ownership of the underlying asset.

²² The value of the RAB is revalued only by economy-wide inflation, ie, the RAB is indexed by the Consumer Price Index (CPI). See Commerce Commission “Input Methodologies (Electricity Distribution and Gas Pipeline Services: Reasons Paper” (December 2010), at 2.8.14 – 2.8.18.

²³ *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, clause 3.1.3(1)(c).

²⁴ Commerce Commission “Input Methodologies (Electricity Distribution and Gas Pipeline Services: Reasons Paper” (December 2010), Section 8.3 and Appendix J, Section J2.

²⁵ For example, certain intangible assets such as goodwill.

Chapter 4. Summary of our draft decisions

Purpose of this chapter

- 4.1 This chapter sets out our draft decisions in response to the change in accounting treatment of operating leases; and our proposed amendments to the EDB and Transpower IMs to reflect these decisions.
- 4.2 Chapters 6 and 7 provide further supporting analysis for our draft decisions.

Problem definition

- 4.3 The change to the accounting standard for operating leases does not merge seamlessly with our regulatory regime. As a result, the following risks are associated with the change:
 - 4.3.1 regulated suppliers might earn more or less than the normal rate of return that a supplier could ex ante expect to earn over the lifetime of its assets, such that this may be inconsistent with the profit outcomes that the Part 4 purpose seeks to promote;
 - 4.3.2 unnecessary compliance costs or complexity could be introduced as a result of differences in the treatment of operating leases between the IMs and the new accounting standard

Summary of our decisions

- 4.4 Our draft decisions regarding the treatment of operating leases for regulatory purposes are:
 - 4.4.1 Generally accept alignment with NZ IFRS 16 for price-quality and ID regulation purposes; this would mean that allowable revenue and returns on investment under ID would be calculated using capitalised 'right of use' asset values (see Chapter 6 for further discussion). This will not apply for right of use assets capitalised under NZ IFRS 16 from charges specified as pass-through or recoverable costs. These charges will continue to be treated as pass-through or recoverable costs.
 - 4.4.2 Amend the IMs so that operating leases continue to be treated as opex for IRIS purposes.
 - 4.4.2.1 This amendment will not affect the price paths in the current regulatory period. Rather, it requires 'carry forward' amounts already calculated under IRIS in the current path to be restated before they affect the path in the next regulatory period.
 - 4.4.2.2 For opex this has the effect of converting what would otherwise be treated as a permanent saving into a temporary saving, lasting only for the duration of the remainder of the current regulatory period. The capex effects of applying the existing IRIS rules for the

remainder of the current regulatory period will also remain as they stand.

4.4.2.3 This will give rise to material gains for EDBs adopting the standard early and those EDBs on a Customised Price Path (CPP), for whom benefits will continue to be carried forward into the future. We consider this approach is consistent with applying the IRIS rules as they stand to the current period.

4.4.2.4 We are concerned that the early adopter EDBs may gain an IRIS benefit solely as a result of the change in accounting rules, given that the IRIS benefit is not the result of the businesses achieving efficiency improvements. However, changing the IMs to prevent them from gaining this benefit, would risk undermining the certainty that is otherwise provided by the IRIS IM.

4.4.2.5 This proposed amendment would mean making adjustments to opex forecasts to reverse future negative IRIS effects in the next price path for early adopters (ie those EDBs who have adopted NZ IFRS 16 in the base year or earlier of the current regulatory period). These negative effects would otherwise arise if the nil operating lease expenditure disclosed in the base year were carried forward into forecasts and compared with future actual expenditure treated as opex (see paragraphs 7.16 to 7.17 of Chapter 7 for further discussion).

4.5 Our current view is that there are two reasons for why we should accept alignment between our regulatory rules and GAAP for price-quality and ID regulation purposes:²⁶

4.5.1 As a general principle, we apply GAAP in setting values under the price paths or IMs in such a way that the difference between the values used for regulatory purposes (ie, for costs or assets) and the equivalent values used for financial reporting are minimised. This is consistent with setting fit for purpose DPP and ID requirements that promote the Part 4 purpose in a way that reduces compliance costs and complexity.

4.5.1.1 If we do not accept the capitalisation of operating leases for regulatory purposes, there will be a mismatch between the suppliers' regulatory asset values and opex, and asset values and opex under GAAP. This could lead to increased compliance costs for suppliers, as they will need to manage the ongoing differences.

4.5.1.2 In respect of right of use assets capitalised under NZ IFRS 16 from charges specified as pass-through or recoverable costs, our view is

²⁶ To the extent that the asset is used in the provision of the regulated service.

that retaining the existing IM treatment in respect of pass-through or recoverable costs is appropriate given that there has been no change in the rationale for allowing them to be passed through directly to prices, rather than via allowable revenue before pass-through and recoverable costs. We think that this treatment is consistent with the Part 4 purpose of the Act and will not detract from promoting that purpose in a way that reduces compliance costs and complexity.²⁷

- 4.5.2 We consider the rationale for allowing suppliers to include finance leases in their regulatory asset base (RAB) is even more applicable to the treatment of operating leases. Our rationale for including finance leases in the RAB is that it is efficient for regulated suppliers to choose leases over the option of owning the asset, where it minimises the cost over the asset life. Compared to operating leases, finance leases typically apply to lower value and shorter-lived assets and, therefore, we consider there are greater efficiency implications for operating leases in the decision of whether to enter right of use leases or to purchase assets.

Amend the IMs so that operating leases continue to be treated as opex for IRIS purposes

- 4.6 Our current view is that operating leases should continue to be treated in the IMs as opex for IRIS purposes as an opex approach avoids the issues discussed in Chapter 7, whereby regulated suppliers could:
- 4.6.1 be rewarded/penalised for provisional outcomes; and
 - 4.6.2 set forecasts specifically to obtain IRIS rewards.²⁸
- 4.7 These outcomes are not consistent with promoting incentives to improve efficiency and share with consumers the benefits of efficiency gains, nor with limiting the ability of suppliers to extract excessive profits.

²⁷ Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons paper, December 2010, paragraphs 8.3.25 to 8.3.27. These costs are currently excluded from the definition of opex and required to be disclosed separately. We note that there are already asset classes recognised under GAAP which are not recognised for regulatory purposes. The additional exclusion of capitalised pass-through and recoverable costs is not likely to give rise to additional compliance costs.

²⁸ Paragraphs 7.6 to 7.8

- 4.8 Our draft decision is to allow the opening GAAP deferred tax balance to be applied to right of use assets and any other assets that may not have a corresponding regulatory tax asset value. This removes the overcompensation arising from applying a nil opening balance with no reversal of temporary depreciation differences, as discussed in Chapter 6.²⁹ We believe this promotes the Part 4 purpose in a way that reduces compliance costs and complexity, as it would avoid the need to retain a separate regulatory notional tax asset record.

Scope of IM changes needed to implement draft decisions

- 4.9 Accordingly, our draft decision is to amend the IMs to:
- 4.9.1 ensure the 'opex incentive amount' for the purposes of the IRIS calculation in the *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26 (**EDB IM**) and the *Transpower Input Methodologies Determination 2010* [2012] NZCC 17 (**Transpower IM**) allows us to include the impact from operating lease payments;
 - 4.9.2 ensure the 'capex incentive amount' for the purposes of the IRIS calculation in the EDB IM and the calculation of the base capex expenditure adjustment in the *Transpower Capital Expenditure Input Methodology Determination 2012* [2012] NZCC 18 (**Transpower Capex IM**) exclude the impact from 'right of use assets';
 - 4.9.3 amend the asset valuation IMs to retain the existing EDB IM and Transpower IM treatment of pass-through costs and recoverable costs so that these costs are not capitalised as right of use assets for regulatory purposes; and
 - 4.9.4 ensure the EDB IM and Transpower IM allow for a GAAP-based life to be assigned network 'right of use' assets.
 - 4.9.5 Amend the taxation IM to assign a GAAP-based opening deferred tax balance.
- 4.10 The Transpower IM and the EDB IM set out a calculation for 'opex incentive amounts', which are recoverable costs for Transpower and EDBs, applied in each year of a regulatory period. This is commonly referred to as the opex IRIS calculation. For the purpose of calculating the 'opex incentive amount' under IRIS, the Transpower IM and the EDB IM require, amongst other things, a calculation of:³⁰

²⁹ Paragraphs 6.18 to 6.22

³⁰ See clauses 3.6.3(7)-(8) of the *Transpower Input Methodologies Determination 2010* [2012] NZCC 17 and clauses 3.3.3(8)-(9) of the *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26.

- 4.10.1 the 'forecast opex', which looks at the amount of forecast 'opex'³¹ the Commission has specified for the relevant disclosure year; and
- 4.10.2 the 'actual opex', which is the amount of 'operating costs'³² allocated to electricity transmission or distribution services for the relevant disclosure year.
- 4.11 To ensure that operating lease payments are treated as opex for the purposes of IRIS, our draft decision is to amend the EDB IM and the Transpower IM to ensure the 'opex incentive amount' for the purposes of the IRIS opex calculation allows us to include the impact from operating lease payments.
- 4.12 In addition to the opex IRIS calculation, the EDB IM also sets out a calculation for 'capex incentive amounts', which are recoverable costs for EDBs applied from the second year of a DPP regulatory period. This is commonly referred to as the capex IRIS calculation. This calculation takes into account the value of certain assets, including the value of 'identifiable non-monetary assets'. Importantly for our purposes, this would include right of use assets (see Chapter 6 below for a discussion of right of use assets). To ensure that operating lease payments are treated as opex (ie they are not included in the IRIS capex calculation), our draft decision is to amend the EDB IM to ensure the 'capex incentive amount' for the purposes of the IRIS calculation in the EDB IM excludes the impact from right of use assets. In respect of the Transpower Capex IM our draft decision is to make a similar adjustment to exclude the effect of 'right of use' assets from the calculation of the base capex expenditure adjustment.
- 4.13 Both the Transpower IM and the EDB IM apply a definition of 'physical asset life' which, for non-network assets, is the asset's life as determined under GAAP. Where right of use assets are network assets there is no equivalent provision in the IMs, and the remaining physical life provisions do not make sense for this type of asset. Our draft decision is to amend the EDB IM and the Transpower IM to ensure network right of use assets are assigned their GAAP life.
- 4.14 We welcome views on these draft decisions, including any views as to how the associated issues could otherwise be addressed.

³¹ The definition of 'operating expenditure' in clause 1.1.4(2) of the *Transpower Input Methodologies Determination 2010* [2012] NZCC 17 and clause 1.1.4(2) of the *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26 refers back to the definition of 'operating costs'. The definition of 'operating costs' excludes a cost that is treated as a cost of an asset by GAAP.

³² The definition of 'operating costs' in clause 1.1.4(2) of the *Transpower Input Methodologies Determination 2010* [2012] NZCC 17 and clause 1.1.4(2) of the *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26 excludes a cost that is treated as a cost of an asset by GAAP.

Chapter 5. Summary of submissions on issues paper

Purpose of this chapter

- 5.1 This chapter summarises submissions we received on our issues paper, and our response to those submissions. We have grouped the submissions we received in line with:
- 5.1.1 our draft decision to accept alignment with the new financial reporting standard for price-quality regulation and ID purposes;
 - 5.1.2 our draft decision to amend the EDB and Transpower IMs so that operating leases continue to be treated as opex for IRIS purposes; and
 - 5.1.3 implementation issues related to our draft decisions.

Submissions on Commission's preliminary views on potential IM and ID changes identified in our issues paper

Accept alignment with new financial reporting standard for price-quality regulation and ID purposes

- 5.2 Our preliminary view expressed in our issues paper was to accept alignment with new financial reporting standard for price-quality regulation and ID purposes, as it maintains consistency with a reporting framework that helps to keep compliance costs low for suppliers. This would mean that allowable revenue and returns on investment under information disclosure would be calculated using capitalised right of use asset values.
- 5.3 Submissions were generally supportive of adopting the GAAP approach to operating lease payments for price-quality and ID purposes. Reasons given included:
- 5.3.1 maintains consistency between information sources (ENA, Aurora, Transpower, Vector);
 - 5.3.2 assists understanding of regulatory financial statements (ENA);
 - 5.3.3 avoids undue compliance complexity and cost (ENA, Aurora, First Gas, Transpower, Vector);
 - 5.3.4 supports the low-cost purpose of price-quality regulation (Aurora); and
 - 5.3.5 disallowing capitalisation would require significant amendments to the IMs (Vector).

- 5.4 While Wellington Electricity did not submit in this instance, we note their preliminary feedback on the issue under the EDB 'DPP Issues Paper.' This supported alignment of our regulatory regime with GAAP, encouraging us to treat operating leases consistently with NZ IFRS 16 to avoid two sets of audited calculations, keeping compliance costs low.³³
- 5.5 MEUG expressed its concern that EDBs would receive a greater return for a capitalised right of use asset than the equivalent lease payment opex. It considered a present value difference of \$1.6m between the two to be material.³⁴
- 5.6 MEUG also stated that for it to agree with our proposed approach, it would require an analysis demonstrating that under all circumstances the use of the regulated line service providers incremental borrowing rate rather than the incremental cost of debt set in the IMs results in NPV=0.³⁵
- 5.7 Our current view is that we do not think it is meaningful to consider the effect of the use of the EDBs' incremental borrowing rate in isolation, given the number of moving parts that must be considered, as illustrated in our discussion of overall equivalence in Chapter 4. Nor is it necessary for precise NPV =0 to be achieved in respect of right of use assets to achieve the overall promotion of the Part 4 purpose.
- 5.8 When the overall impact of all of these moving parts is placed in the context of the total RAB and allowable revenue, as discussed in Chapter 6, we consider the \$1.6m arising from the particular scenario used by MEUG to be immaterial.
- 5.9 This is supported by ENA's submission on total materiality that, based on the sample data it has collected for lease terms ranging from 2-99 years, with the present value of lease payments based on each EDB's cost of debt:³⁶
- 5.9.1 operating lease opex is between 0% - 2.3% of total annual opex for the five EDBs surveyed; and
 - 5.9.2 right of use assets are between 0% - 0.6% of RAB and 0% - 2.8% of RAB depreciation.

Amend the IMs so that operating leases continue to be treated as opex for IRIS purposes

- 5.10 Our preliminary view was to amend the IMs so that operating leases continue to be treated as operating expenditure for IRIS purposes as this would be simpler to administer and avoids the potential for suppliers to skew their IRIS outcomes.

³³ Wellington Electricity "Default price-quality paths for electricity distribution businesses from 1 April 2020 Issues Paper" (21 December 2018), at 21.

³⁴ MEUG, "Submission on the treatment of operating leases issues paper" (10 July 2019), at 1.

³⁵ MEUG, "Submission on the treatment of operating leases issues paper" (10 July 2019), at 2.

³⁶ ENA, "Submission on the treatment of operating leases issues paper" (10 July 2019), at 4.

- 5.11 Aurora and Transpower supported amending the IMs so that operating leases continue to be treated as opex for IRIS purposes. For Aurora, this approach will be simpler to administer and is more desirable than introducing a complex wash-up mechanism.³⁷ Transpower submitted that this approach is the most straightforward and delivers the least volatile pricing outcomes.³⁸
- 5.12 Against this treatment were submissions from ENA, Vector and Powerco. ENA submitted that the proposals disrupt the link between the IRIS IM and the DPP revenue allowance and, as a result, they penalise those EDBs which have adopted the lease standard during the 2019 disclosure year. ENA submitted that if there is a change that affects the opex IRIS in the current regulatory period (RCP2), which they describe would be ‘retrospective’, then the same change must be made to the RY19 base year opex to maintain the incentive outcomes of the IRIS.³⁹ Vector agreed that if the IMs are amended to treat operating leases as opex, the RY19 base year opex figures will need to be repopulated to include operating leases.⁴⁰
- 5.13 Vector did not support the Commission’s proposals to amend the IMs to depart from GAAP in a manner that it describes as ‘retrospective’. Its primary concern relates to the proposal to amend the IM to treat operating leases as opex which it says involves retrospectively opening up the IRIS IM during the current regulatory period, undermining its use of the penultimate year as the base year for projecting step and trend opex. Vector submits that this is contrary to the purpose of the scheme to provide an ex ante incentive.
- 5.14 Powerco did not support changing the IMs during the regulatory period due to the costs outweighing the benefits because it considered:
- 5.14.1 an initial analysis carried out for Powerco by pwc suggested the combined effect of the regulatory amendments considered is very low, and therefore “unlikely to affect the approach taken by EDBs to leases, nor materially distort incentive payments across the sector”;⁴¹ and
- 5.14.2 it will create material compliance complexity because “the compliance costs to maintain two sets of account data to meet GAAP accounting and regulatory accounting will increase.”
- 5.15 Vector also disagrees with the reasoning that treating operating leases as opex for IRIS purposes will be simpler to administer, as it considers deviating from GAAP will inevitably add further complexity to the regulatory framework.

³⁷ Aurora, “Submission on the treatment of operating leases issues paper” (10 July 2019), at 3.

³⁸ Transpower, “Submission on the treatment of operating leases issues paper” (10 July 2019), at 1.

³⁹ ENA, “Submission on the treatment of operating leases issues paper” (10 July 2019), at 16.

⁴⁰ Vector, “Submission on the treatment of operating leases issues paper” (10 July 2019), at 6.

⁴¹ Powerco, “Submission on the treatment of operating leases issues paper” (10 July 2019), at 1.

- 5.16 In response, we believe that the maintenance of separate opex and capex forecasts under our IRIS proposal will not add significant complexity. The opex forecast will require operating lease payment cashflows, as disclosed under GAAP to be added, while the capex forecast will require right of use assets to be deducted.⁴²
- 5.17 Treating operating leases as opex for IRIS calculation purposes will also remove the calculation of rewards/penalties based on provisional outcomes and potential opportunities for gaming as discussed in Chapter 7.
- 5.18 Our current view is that we would make appropriate adjustments to base year expenditure for early adopters to ensure that forecast expenditure for the next regulatory period is consistent with the opex forecasts used for IRIS purposes. The adjustments would ensure there are no IRIS effects in DPP3 relating to the adoption of the GAAP approach. This is the change suggested by Vector to ensure the symmetry between the DPP3 opex allowance and IRIS incentives is maintained. Our approach to IRIS is discussed in more detail in Chapter 7.⁴³
- 5.19 ENA and Vector submitted that right of use assets must be valued in accordance with NZ IFRS 16, and are audited. They considered this provides an independent check on the ‘incentives’ on EDBs to seek certain outcomes as suggested in paragraphs 5.21-5.25 of the issues paper.
- 5.20 We acknowledge that the setting of right of use asset values in accordance with NZ IFRS 16 and auditing of those values provides some assurance regarding the valuation of the assets under lease contracts entered into. It does not, however, provide any check to suppliers forecasting long term leases and entering into short-term leases to obtain additional benefits under IRIS, as described in paragraphs 5.24-5.25 of the issues paper and paragraphs 7.6 to 7.8 below.

Submissions on implementation issues

Potential for suppliers to receive a tax allowance that is different to their tax costs based on tax rules.

- 5.21 ENA submitted that further consideration of introducing a notional tax asset was recommended but only if the materiality warrants a change.⁴⁴
- 5.22 First Gas supported an approach to regulatory tax that keeps the regulatory regime as simple as possible.⁴⁵

⁴² Additional disclosures similar to the GAAP requirements are likely to be specified under ID.

⁴³ Vector, “Submission on the treatment of operating leases issues paper” (10 July 2019), at 6.

⁴⁴ ENA, “Submission on the treatment of operating leases issues paper” (10 July 2019), at 7.

⁴⁵ First Gas, “Submission on the treatment of operating leases issues paper” (10 July 2019), at 1.

- 5.23 Vector considered it is not clear the impact of tax differences would be sufficiently material to justify making an IM change, and that it considers that such a complicated approach does not meet the Commission's own criteria for change and will impose additional complexity for very little benefit to end-users.⁴⁶
- 5.24 We consider that the materiality of this issue warrants a change, as discussed in Chapter 6, but acknowledge the additional compliance costs that would arise from the introduction of a notional tax asset.⁴⁷
- 5.25 Our draft decision is therefore to amend the EDB IMs to apply the opening deferred tax balance as it is calculated under GAAP for right of use assets and any other regulatory assets that do not have a corresponding tax asset value.

Potential for suppliers to benefit from the difference between the WACC and their incremental cost of debt

- 5.26 MEUG raised a concern that a plus or minus 10% change on the assumed base case incremental cost of debt of 4.5% changed the degree of equivalence by approximately +/- 3%. MEUG also pointed to the practical problems of determining the rate if the EDB has no debt or if it has unregulated services and a bundled cost of debt.
- 5.27 We consider that the Commission's response is that the reason for allowing the use of the EDB's incremental cost of debt is that it will promote alignment of the regulatory asset values with the GAAP asset values, which are likely to be calculated on the same basis.
- 5.28 It is our current view that the materiality of the differences in asset values arising from the use of the EDB's incremental cost of debt does not warrant departing from the general principle of achieving alignment with GAAP, particularly given the presence of other impacts that may offset such differences. Practical problems such as there being no debt, or of clear separation of a cost of debt for electricity lines services where there is bundled debt must be resolved in a GAAP context.⁴⁸

⁴⁶ Vector, "Submission on the treatment of operating leases issues paper" (10 July 2019), at 8.

⁴⁷ Paragraphs 6.18 to 6.22.

⁴⁸ NZ IFRS 16 defines the lessee's incremental borrowing rate as the rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.

Undesirable swings in allowable revenue as depreciated RAB value corrects to depreciated GAAP value.

5.29 The issues paper identified that the largest potential impact of applying the EDB IMs as they stand relates to the simplifying 45-year life assigned to all additional assets. Because right of use assets generally have a much shorter life than physical assets, this could give rise to a significant non-recovery of depreciation on these assets when they are treated as additional assets. This is because of the rolled forward DPP asset value being reset to the much lower GAAP value in the next base year.⁴⁹

5.30 ENA has submitted:

The RAB IM accommodates asset lives suitable for right of use assets, and no changes to the depreciation components of the RAB IM are required. Modified DPP depreciation rates for right of use assets are not required. Differences between GAAP rates and the DPP default rate are washed up at the beginning of each regulatory period. This mechanism is acceptable for all other assets which have depreciation lives that differ to the DPP default assumption (as now explicitly recognised in the capex IRIS), and therefore should be retained for right of use assets.⁵⁰

5.31 While it is true that differences in asset lives are washed up under the existing IRIS IMs, this would not be the case under our proposed IRIS changes, which would remove the capex wash-up IRIS effects for right of use assets. This means that an under-recovery of depreciation will likely occur under the proposed changes given ENA's observation that typical terms of right of use assets are less than 10 years and the relatively high value of these assets as a component of total additional assets in the transition period.

5.32 We have assessed the effect of 45-year simplifying assumption in our analysis of all the impacts of adopting NZ IFRS 16 in Chapter 4.

5.33 Having taken this effect into account we think that retaining the simplifying 45-year asset life assumption is consistent with the low-cost intent of a DPP.

Roll-forward of right of use asset

5.34 The issues paper identified that regulated suppliers under price-quality regulation may benefit from the depreciated value of the right of use asset being higher than the present value of the remaining lease payments when the asset is first recognised for the calculation of allowable revenue. This arises because the annual depreciation of the asset is less than the present value of another lease payment made as the asset and stream of operating lease payments are both rolled forward from the date of first application of the new standard. In particular, there is no depreciation on the asset in 2020, as it is the year of commissioning for those not adopting early. The effect of this is shown in Diagram 1a in Chapter 6 below.

5.35 There were no submissions on this issue.

⁴⁹ Our modelling suggests the non-recovery could be as high as 49% of the asset cost for a 10 year asset capitalised in the last year of a regulatory period.

⁵⁰ ENA, "Submission on the treatment of operating leases issues paper" (10 July 2019), at 23 to 24.

Regulated suppliers may enjoy opex rewards that exceed capex penalties under IRIS when right of use assets are initially capitalised

- 5.36 As described in paragraphs 5.13 to 5.15 above, ENA and Vector submitted that we should not introduce changes to the IRIS that would have a ‘retrospective effect’ (ie, opening up the IMs to change the basis of forecasting opex for DPP3, without adjusting the RY19 base year opex to maintain the incentive outcomes of the IRIS).
- 5.37 As noted in paragraph 5.18 our draft decision is to adjust the DPP3 opex forecasts for the effect that ENA and Vector describe to remove any IRIS calculation differences arising from the adoption of base year numbers for step and trend purposes.
- 5.38 Transpower submitted that our proposed changes will provide an approach that is the most straightforward and delivers the least volatile pricing outcomes. This issue is summarised in paragraphs 5.11 to 5.20 above.

Other matters raised in submissions

- 5.39 MEUG also raised other concerns regarding:
- 5.39.1 treatment of leases between related parties;
 - 5.39.2 disclosure of lease payments beyond 5 years to enable interested parties to replicate NPV calculations;
 - 5.39.3 the EDB’s incremental cost of debt rather the cost of debt included in the WACC being used to derive the present value of the right of use asset;
 - 5.39.4 whether a right of renewal provision should be accounted for in the regulatory requirements, and if so, how and at what value; and
 - 5.39.5 the scope for regulated line service to engage in entrepreneurial activities such as sale and leaseback transactions.⁵¹
- 5.40 We note that the treatment of lease transactions between related parties is dealt with by the existing IMs, which require a related party transaction to be valued at a value no greater than if it had the terms of an arms-length transaction.
- 5.41 We will consult on ID disclosure requirements, including the disclosure of lease payments, in respect of operating leases at a later date.
- 5.42 Similarly, right of renewal provisions will be accounted for in valuations of right of use assets as prescribed by NZ IFRS 16.

⁵¹ MEUG, “Treatment of Operating leases - Issues Paper submission to the Commerce Commission” (10 July 2019), at 2

- 5.43 Entering into sale and leaseback transactions is unlikely to give rise to any significant acceleration of cashflows through depreciation (on a higher value asset). This is because NZ IFRS 16 applies specific adjustment rules to sale and leaseback transactions where the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or if the payments for the lease are not at market rates. In any case, this can be monitored through ID and addressed, if necessary, in future IM changes in time for the next DPP/IPP reset.
- 5.44 We note that under our draft decision to treat operating lease payments as opex for IRIS purposes, penalties arising from additional opex relative to forecast opex are likely to have a dampening effect on sale and leaseback behaviour, where it has not already been dampened by the GAAP requirement to bring such leases onto the balance sheet.
- 5.45 On a separate matter, ENA has submitted that its members support recognition of income from sub-leases.⁵²
- 5.46 Our current view is that no decisions are required to recognise income from sub-leases, as we consider this income would be captured by existing IM provisions relating to the recognition of other regulated income.

⁵² ENA, "Submission on the treatment of operating leases issues paper" (10 July 2019), at 7.

Chapter 6. Accounting for operating leases in setting price-quality paths under a DPP or IPP

Purpose of this chapter

- 6.1 This chapter sets out our analysis of the materiality of our decision to continue alignment with GAAP for the purpose of setting price-quality paths for EDBs and Transpower. The chapter includes our analysis of:
- 6.1.1 asset life differences;
 - 6.1.2 tax allowance;
 - 6.1.3 timing of adoption of NZ IFRS 16; and
 - 6.1.4 benefit of return on WACC over incremental cost of debt
- 6.2 This chapter discusses each of these issues. We have also considered the materiality of their collective effect.

Accounting for the asset life of right of use assets

- 6.1 Under NZ IFRS 16, the life of a right of use asset is the life of the lease contract, and not the life of the underlying physical assets it provides for the use of.⁵³
- 6.2 Both the Transpower and EDB IMs apply a definition of ‘physical asset life’ which, for non-network assets, is the asset’s life as determined under GAAP.⁵⁴ Where right of use assets are network assets there is no equivalent provision in the IMs, and the remaining physical life provisions do not make sense for this type of asset. Our current view is that an IM change will be needed to ensure network right of use assets are assigned their GAAP life, subject to the effect of simplifying assumption discussed in the next paragraph.
- 6.3 Unlike the Transpower IM, the EDB asset valuation IM for a DPP treats newly-commissioned right of use assets as ‘additional assets’, with a standard remaining asset life of 45 years at the time they are forecast to enter the RAB.⁵⁵ We consider that there will likely be a large discrepancy between the 45-year RAB life of the right of use asset and the accounting life under GAAP, which is likely to be considerably shorter than 45 years.

⁵³ XRB “New Zealand Equivalent to International Financial Reporting Standard 16 Leases (NZ IFRS 16)” (Amended as at 12 July 2018), at 30-32.

⁵⁴ *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, clause 2.2.8(1)(f) and *Transpower Input Methodologies Determination 2010* [2012] NZCC 17, clause 2.2.6(1)(h).

⁵⁵ For DPP purposes they are treated as additional assets with a default life of 45 years. *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, as amended, clause 4.2.2(3)(b).

- 6.4 If we apply a 45-year life, the right of use asset will roll-forward at a lower depreciation rate within the RAB than in the GAAP-based ID disclosures that we use when we reset suppliers' price-quality paths. This would result in a significant proportion of depreciation not being fully recovered when the more heavily depreciated ID value (based on a much shorter life) is used as the starting value for the next regulatory period.
- 6.5 Under the existing EDB IM IRIS provisions, the difference in asset lives would be 'washed up' at the end of the next regulatory period,⁵⁶ as the IRIS mechanism provides for the forecast capex stream to be replaced with the actual capex stream from ID in calculating IRIS benefits. This effect will not occur under our draft decision, because we propose to amend the EDB IM to ensure the 'capex incentive amount' for the purposes of the IRIS calculation excludes the impact from 'right of use assets' (see paragraph 4.4.2 above).
- 6.6 We do not expect the effect on allowable revenue of not having this wash-up provision to be significant, as the proportion of right of use assets capitalised to other assets capitalised in the future is not likely to be high.
- 6.7 Existing right of use assets are rolled forward at the aggregate RAB remaining life. Their contribution to this aggregate life value will be their remaining life as disclosed under ID and determined under GAAP.⁵⁷
- 6.8 While not being sufficient to fully recover the depreciation foregone, the higher annual depreciation for the adjusted remaining life of the asset on resetting its value from ID in the base year will result in a short period of 'catch-up' depreciation being recorded in the next regulatory period. If this is sufficiently material, it could create a spike in a supplier's revenue allowance at each DPP reset.
- 6.9 However, because the asset life rolled forward is an aggregate life, the effect of any under-recovery of depreciation on additional right of use assets may be offset by an over recovery of depreciation on other additional assets that have a useful life of greater than 45 years. The net difference will be small if the true aggregate life of all additional assets closely approximates the 45-year life assumption.

Setting the tax allowance for revenue on right of use assets

- 6.10 There are no tax consequences of treating operating lease payments as opex in calculating allowable revenue. This is because they are fully deductible for tax purposes and so no provision needs to be made for tax payable on this component of revenue.

⁵⁶ That is, it washes up differences for the preceding DPP regulatory period.

⁵⁷ Existing assets are those for which an aggregate closing RAB value is calculated for a base year in a regulatory period.

- 6.11 On the other hand, tax is payable on the allowable revenue generated by a right of use asset, and therefore permanent and timing differences, as well as notional deductible interest, need to be taken into account when calculating tax costs.
- 6.12 Because right of use assets are a financial reporting construct, there are no corresponding assets in the EDB or Transpower IMs recognised for tax purposes.⁵⁸ This affects the calculation of the regulatory allowance for tax.

Recognition of deductibility of operating lease payments

- 6.13 When calculating tax payable under tax rules, operating lease payments will continue to be recognised as a tax-deductible expense. The EDB and Transpower IMs take into account the cash benefit of this tax relief when calculating tax costs for the tax building block under an allowable revenue approach.⁵⁹
- 6.14 The total tax relief from the stream of operating lease payments is greater than the tax relief represented by the value of the capitalised asset which is calculated from the discounted value of that stream. The difference between the two is a permanent difference, tax effect of which is deducted from allowable revenue. This applies whether a tax payable approach under the Transpower IM or a modified deferred tax approach under the EDB IM is used, and is simply a consequence of the real tax benefits suppliers receive from continuing to deduct operating lease payments for tax purposes.
- 6.15 The EDB IM for calculating the regulatory tax allowance for a DPP does not recognise permanent differences.⁶⁰ Therefore, in calculating allowable revenue no consideration is given to the tax benefit EDBs receive from the operating lease deductions that are in excess of the depreciation on the right of use assets.

⁵⁸ At present, the tax IMs provide for notional tax asset values where there are differences between the tax assets and the regulatory assets (for example that may have arisen under previous regulatory asset valuation adjustments or asset grouping differences). However, they do not provide for the determination of a regulatory tax asset value where there is no corresponding adjusted tax value. Therefore, under the existing IMs, there is no equivalent tax asset for right of use assets.

⁵⁹ *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, clause 4.3.1. The generic equation for allowable revenue before tax is given by the equation of building blocks allowable revenue before tax in clause 5.3.2. *Transpower Input Methodologies Determination 2010*, consolidated as at 10 June 2019, clauses 2.3.1 and 3.4.1.

⁶⁰ *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, clause 4.3.1(3) and (4). This is a simplifying assumption. Generally, these differences are not material.

Notional deductible interest

6.16 The EDB and Transpower IMs provide for a deduction for notional deductible interest when calculating the tax allowance. This is because when using a vanilla WACC, the corporate tax shield provided by debt capital is ignored in the WACC estimation, and firms are remunerated for their levered tax liabilities through a cash flow allowance. The calculation assumes a leverage of 42% and a cost of debt value that is the cost of debt incorporated in the cost of capital determined by the Commission. This is applied to the regulatory investment value, which is the RAB value of the right of use asset plus or minus the related opening deferred tax balance, to derive the deduction amount.⁶¹

Recognition of deferred tax

6.17 In calculating tax expense, the modified deferred tax approach that applies to EDBs for regulatory purposes substitutes tax depreciation with regulatory depreciation and then adjusts for the difference between the two, known as depreciation temporary differences, in each year.⁶² This is done by way of adding the opening deferred tax balance, which records cumulative temporary differences, to the opening RAB in calculating the return on capital. This recognises the time value of money effect of the difference. Over the life of an asset the temporary differences, as reflected in the deferred tax balance, reverse so that the net present value of the tax effects of the regulatory asset base and the tax asset base are the same.⁶³

6.18 Under a GAAP deferred tax approach, as applies for financial reporting purposes, the opening deferred tax balance is a combination of the deferred tax on the right of use asset (tax liability) and the deferred tax on the remaining lease liability (tax asset) which largely offset. However, no operating lease liability is recognised in the regulatory accounts. This means that if GAAP were fully applied, the opening deferred tax balance in the regulatory accounts will be just the difference between the regulatory book value and the nil tax book value multiplied by the tax rate (a tax liability).⁶⁴

⁶¹ The deferred tax balance adjustment only applies for EDBs.

⁶² As tax depreciation is calculated on an accelerated diminishing value basis and regulatory depreciation is calculated on a straight-line basis there will be a difference in each year between the depreciation expense calculated under the two methods, but over the life of the asset these will reverse so that the total nominal value of depreciation is the same under each method. Hence, they are called temporary differences.

⁶³ Ignoring the effect of revaluations.

⁶⁴ *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, as amended, clauses 4.3.4 – 4.3.5.

- 6.19 The EDB IM does not, however, recognise any initial deferred tax balances on new right of use assets when they enter the RAB, as it rolls forward from the closing balance in the previous disclosure year.⁶⁵ In the year of capitalisation this opening balance is nil. This means that the forecast depreciation temporary difference in each year relating to new right of use assets (i.e. the full value of the regulatory depreciation) is added to the RAB, without being offset by an initial opening deferred tax liability (on recognition of the asset) as would be calculated under GAAP. At the end of a right of use asset's life the closing positive balance remains in perpetuity as there is no IM mechanism for reversing it out⁶⁶. Because this positive balance is added to the RAB in calculating the return on capital it overcompensates EDBs for their tax costs.
- 6.20 As far as we are aware, this situation is unique to right of use assets as they do not have a corresponding tax asset.
- 6.21 The effect of this is material as shown in Diagrams 1 and 1a below, and so in our view requires an IM change. There are options for dealing with this issue:
- 6.21.1 Creating a notional tax asset that would be the equivalent of the value of the right of use asset would give rise to an offsetting tax depreciation in calculating the depreciation temporary difference in each year. This would progressively remove the overcompensation arising under a deferred tax approach; or
- 6.21.2 Allow a GAAP-based opening deferred tax balance to be applied for right of use assets.
- 6.22 Our draft decision is to allow the opening GAAP-based balance to be applied. This will be implemented so as to apply the same treatment for any other assets that may not have a corresponding regulatory tax asset value. We believe this promotes the Part 4 purpose in a way that reduces compliance costs and complexity, as it would avoid the need to retain a separate regulatory notional tax asset record.

⁶⁵ *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, Clause 4.3.4. This partially corrects in a base year of a regulatory period, when the depreciation temporary differences calculated consistent with GAAP as disclosed under ID are included in the deferred tax balance to be rolled forward.

⁶⁶ Under GAAP, any closing balance remaining would simply be assessed for recoverability and written down.

Accounting for timing of when right of use assets are capitalised

Timing of recognition and NPV equivalence

- 6.23 The timing of initial recognition of right of use assets affects the net present value (NPV) equivalence. In this context, the ‘NPV equivalence’ means: the NPV of the allowable revenue on the right of asset value calculated at the beginning of the next regulatory period for Transpower and EDBs (DPP3/RCP3) for the next five years is *equal to* the NPV of the operating lease payments should we have continued to calculate these payments as opex. NPV equivalence is an aid to assessing the extent to which adopting the GAAP treatment may cause an under or over recovery of operating lease costs by suppliers over the life of the leases.
- 6.24 Accordingly, differences in the NPV equivalence could potentially indicate changes to the normal rate of return that a supplier could ex ante expect to earn over the lifetime of its assets, such that this may be inconsistent with the financial capital maintenance (FCM) principle. The FCM principle underpins the profit outcomes that the Part 4 purpose seeks to promote. We also note that the NPV equivalence in respect of right of use assets is only one aspect of assessing whether the overall NPV equivalence of all the elements in the allowable revenue calculation promote the purpose.⁶⁷
- 6.25 Under GAAP, the present value of future lease payments is determined at the outset of the lease contract, or at the first application date of the new standard for existing leases.⁶⁸
- 6.26 Regulated suppliers will apply NZ IFRS 16 for their annual reporting periods beginning after 1 January 2019, unless they have chosen to adopt earlier (as NZ IFRS 16 provides for). The next DPP and IPP periods will begin on 1 April 2020. Therefore, the time when EDBs and Transpower capitalise their operating leases will not coincide with the time that we reflect the accounting change in their price-quality paths.
- 6.27 The right of use asset value capitalised in 2019 and 2020 will be equal to the discounted value of the operating lease payments, using the suppliers’ incremental cost of debt at the date of capitalisation, but will be rolled forward to 1 April 2020 after deducting depreciation. At the same time, operating lease payments will drop out of the stream used to derive the initial asset value. Because the annual value of the depreciation and the annual operating lease payments are different, the asset value will no longer be equivalent to the remaining stream of future operating lease payments at 1 April 2020, discounting at the same cost of debt. When the revenue streams for the DPP3/RCP3 are then discounted at WACC, an additional difference will arise.

⁶⁷ The FCM principle and its relevance is explained in *Commerce Commission, Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons paper*, December 2010, at 36 to 37.

⁶⁸ XRB “New Zealand Equivalent to International Financial Reporting Standard 16 Leases (NZ IFRS 16)” (Amended as at 12 July 2018), Appendix C.

- 6.28 This could mean that the revenue we allow a supplier to recover on the capitalised right of use assets will be different from the revenue we would have provided for if the remaining lease payments were still recorded as opex at the start of the next regulatory period. For EDBs, this is complicated by the fact that regulatory depreciation is not applied to assets in the year of commissioning. This would mean, for example, that the undepreciated cost for an asset capitalised at 1 April 2019 will be in the opening RAB value at 1 April 2020, while at this time one year of operating lease payments has expired.

Timing of forecast commissioning

- 6.29 To achieve NPV equivalence in allowable revenue for right of use assets that suppliers are forecasting to commission in the future, the present value calculation needs to be done at the same time the assets are forecast to enter the RAB. Therefore, if the lease is forecast to start halfway through a future year of the regulatory period, then the present value of the cashflows must be calculated at this date using the appropriate discount rate.
- 6.30 Suppliers will therefore need to forecast an appropriate incremental borrowing rate for the purpose of disclosing forecast right of use asset capex.

Benefit of return on WACC over incremental cost of debt

- 6.31 Under NZ IFRS 16, suppliers discount the forecast operating lease payment stream at their incremental cost of debt. Under our draft decision to adopt the GAAP capitalisation treatment the resultant right of use asset will then earn a rate of return based on the higher WACC determined by the Commission for the relevant regulatory period. Suppliers therefore benefit from any difference between the WACC and their incremental cost of debt relative to the previous situation where the IMs simply allowed recovery of the operating lease payments.
- 6.32 This benefit may be largely offset by changes in the tax allowance that arise as a consequence of the taxable revenue derived from these assets, as provided for under the existing IMs and discussed at paragraphs 6.10 to 6.22 above.

Achieving overall NPV equivalence

- 6.33 Diagrams 1 and 1a illustrate the impact of the effects on EDBs using an example capitalisation of \$38m of right of use assets in 2020 and 2019 respectively, the two disclosure years in which the majority of these assets have been capitalised under GAAP.⁶⁹ In Attachment A, we then convert these into illustrative materiality effects in terms of dollars as a percentage of revenue for each EDB.
- 6.34 Diagram 2 illustrates the impact of the effects on a capitalisation value of around \$130m as they apply to Transpower, for whom some of the simplifying assumptions made under a DPP do not apply.

⁶⁹ This value was considered to be at the high end of likely values based on Vector's capitalisation of approximately \$40m of right of use assets in its financial reporting balance sheet as at 1 July 2018. *Vector Interim Report 2019*, Note 9.

- 6.35 In each of the diagrams we compare the impact of the effects to a counterfactual where operating lease payments continue to be treated as opex for regulatory purposes.
- 6.36 For each of the effects described above, we have considered the NPV impact relative to a counterfactual NPV =0, representing the case where operating lease payments continue to be treated as opex for regulatory purposes.
- 6.37 We have also considered their collective effect, the materiality of which we have considered in making our draft decisions.
- 6.38 Overall, the precise extent to which outcomes are equivalent between allowable revenue on the capitalised right of use assets and the present value of operating lease payments for the next regulatory period will depend on each individual suppliers' circumstances, including the value of their capitalised right of use assets and the year in which they first adopt the new accounting standard.
- 6.39 Our current analysis, based on illustrative examples, is summarised in Diagrams 1 and 1a below for those adopting respectively in 2020 and 2019.⁷⁰ The effects relevant to Transpower are shown in Diagram 2. How these diagrams work is explained further below.
- 6.40 Diagrams 1, 1a and 2 also include the effects of rewards/penalties calculated under the regulatory incentive framework for opex and capex for EDBs, as described in more detail in Chapter 7.

⁷⁰ We are aware that Powerco adopted NZ IFRS 16 in the disclosure year ended 31 March 2018. We have not specifically modelled illustrative effects for a supplier adopting in this year but base our draft decisions on our analysis of adoption in 2019.

Diagram 1 – Effects of applying EDB IM to the equivalence of right of use assets and opex – EDBs adopting NZ IFRS 16 in 2020

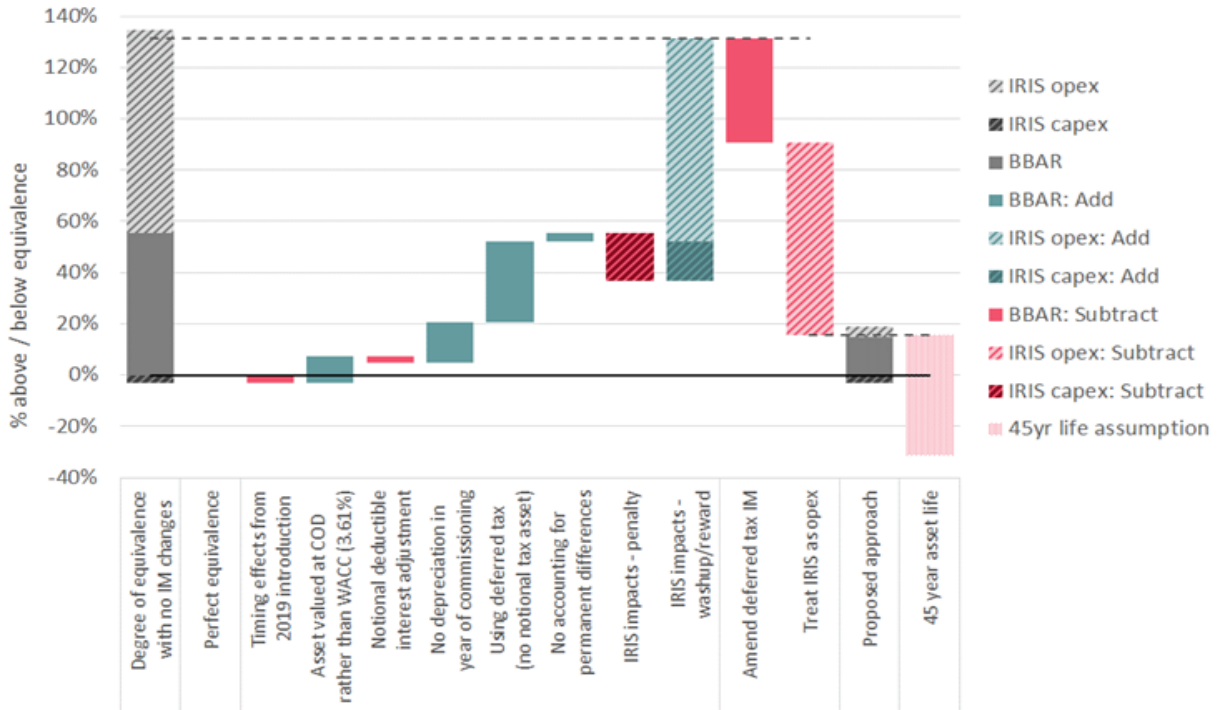
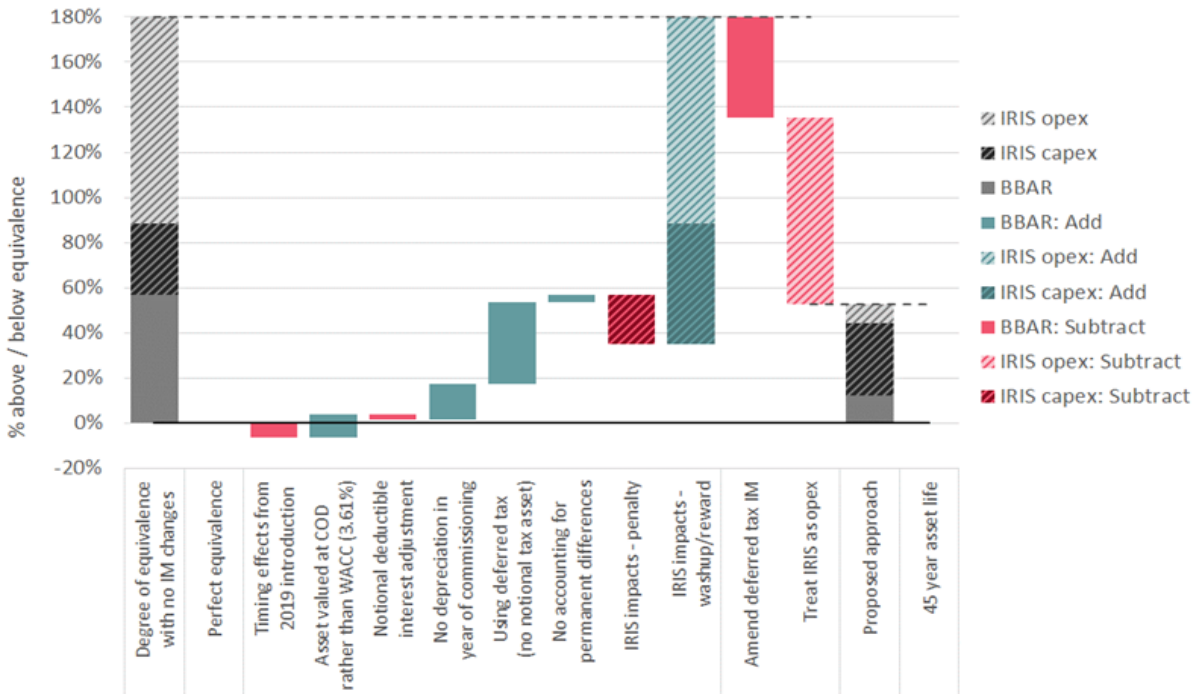


Diagram 1a – Effects of applying EDB IM to the equivalence of right of use assets and opex – EDBs adopting NZ IFRS 16 in 2019



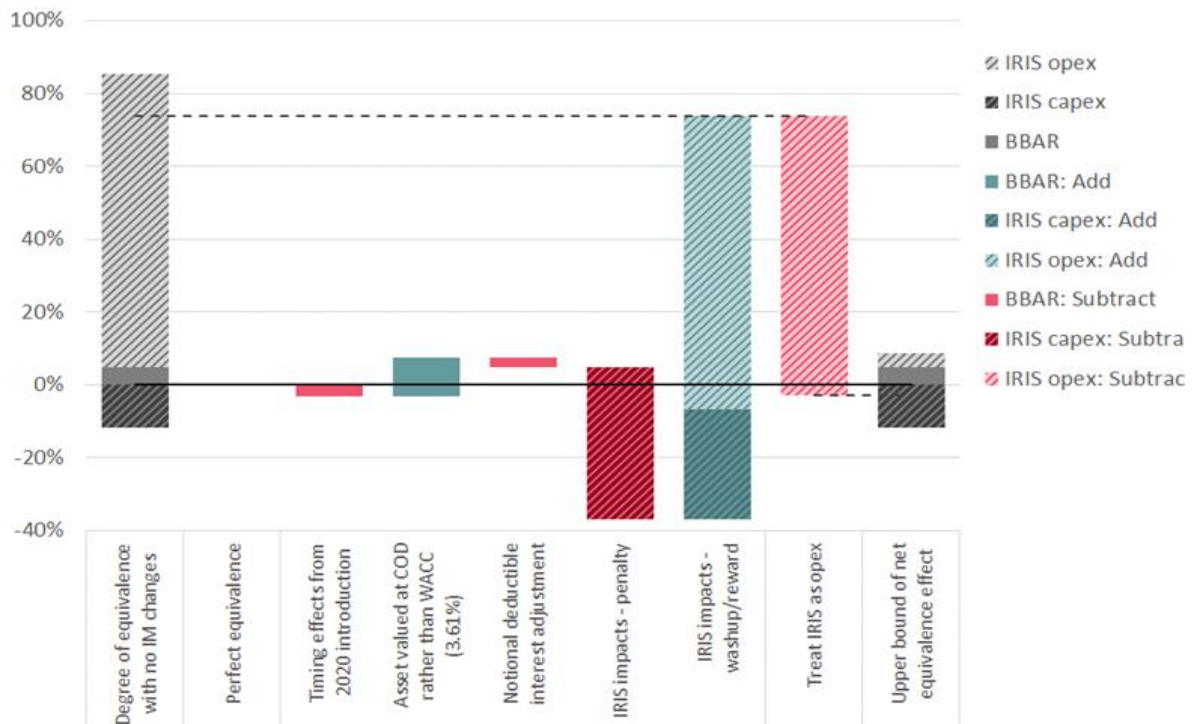
- 6.41 These diagrams show the position for an illustrative EDB including IRIS effects if the GAAP treatment were adopted with no IM changes at the left. They then show the effect of each of the IM assumptions from a position of NPV = 0 'perfect equivalence' to arrive at the upper bound of net equivalence effect, moving to the right.⁷¹ The impacts coloured red show a decrease from the previous boundary position on the Y-axis and those coloured green show an increase. Hatched lines indicate impacts arising from IRIS, both decreases and increases.
- 6.42 The upper bound of net equivalence effect shows the illustrative effect of our draft decisions, incorporating the net effect on BBAR or allowable revenue (grey), arising from the last step change in respect of no accounting for permanent differences. It also includes the net effect of IRIS (hatched) after taking into account the IRIS wash-up penalty and reward effects in the current period and then the downward effect of recalculating amounts carried forward under IRIS IM changes (the red hatched bar described as 'Treat IRIS as opex').
- 6.43 The Y-axis describes the percentage of equivalence, so a positive equivalence of 10% means that suppliers will receive 10% more by way of the NPV of allowable revenue on the capitalised asset than on the NPV of operating lease payments treated as opex.
- 6.44 The materiality of these equivalence changes can be converted to materiality stated in terms of dollars as a percentage of revenue. For example, a 10% change in equivalence equates to a change of \$3.8m in allowable revenue, given the right of use asset value in our illustrative example of \$38m. This dollar figure can be scaled by the value of an individual EDB's capitalised assets with respect to the illustrative \$38m and then expressed as a percentage of the value of the revenue for that EDB. We have given indicative estimates of this materiality in Attachment A.⁷²
- 6.45 To add further context for the materiality estimated for each EDB we note that the general materiality threshold for reconsideration of a price-quality path under the IMs is 1% of forecast net allowable revenue (1% of the aggregate amount of forecast MARs for Transpower).
- 6.46 The extent of the benefit arising from no depreciation in year of commissioning for EDBs is transitional, as it gives rise to a higher asset value at the start of DPP3/RCP3 without any revenue effect of the loss of depreciation in the year of commissioning prior to that date. This will not be the case looking forward, as capex forecasts will take this into account, reducing the revenue allowance in the disclosure year that assets are first commissioned.

⁷¹ The IM scenarios are contained in our illustrative models for treatment of operating leases at <https://comcom.govt.nz/regulated-industries/input-methodologies/projects/operating-leases?target=documents&root=158837>. See Attachment B for an explanation of how we have calculated the scenarios, including our assumptions.

⁷² For 2020 adopters we have also shown the indicative effect of the 45 year standard life assumption, as explained in paragraphs 6.49 to 6.50.

- 6.47 While the other effects will be ongoing, they will be considerably smaller in dollar terms in the future, as forecast commissioned right of use assets will likely be only a small proportion of the total value of right of use assets capitalised at the date of first application of the new financial reporting standard. The significant reduction in opex IRIS benefits arising from our draft decision to treat operating lease payments as opex for IRIS purposes is because, in restoring operating lease payments to opex for DPP3/RCP3, they will no longer be carried forward as permanent savings.
- 6.48 We do not consider that the remaining benefit of treating operating leases as right of use assets under NZ IFRS 16 is material, as in each case shown in Attachment A the effect is less than 1% of revenue.
- 6.49 Should this create an incentive for suppliers to enter into operating leases then this can be monitored through ID and addressed in future IM changes in time for the next DPP/IPP reset. At this point we are not seeing any significant increase in forecast capex due to the capitalisation of right of use assets.

Diagram 2 – Effects of applying Transpower IMs to the equivalence of right of use assets and opex



- 6.50 There are fewer IM effects shown for Transpower, as a number of the simplifying assumptions in the EDB IM do not apply to the Transpower IMs. In the Transpower example shown at Diagram 2, an equivalence change of 10% represents a revenue change of \$12.2m on the example asset base of \$122m. Substituting this for actual assets capitalised by Transpower in 2020 of around \$130m gives a 10% equivalence effect of \$13m.

- 6.51 Therefore the 4% equivalence effect on BBAR (maximum allowable revenue) shown at the far right represents a materiality of \$5.2m, or 0.52% of revenue of \$1b⁷³. We do not consider this to be material for Transpower.

Draft conclusions on overall materiality

EDBs adopting NZ IFRS 16 in 2020

- 6.52 The overall equivalence effect of around 15% for EDB 2020 adopters in Diagram 1 above is an upper bound which includes the transitional benefits of no depreciation in the year of commissioning and excludes the effect of any asset life difference between the aggregate life of the additional assets incorporating right of use assets, and the 45-year life standard assumption which is applied by the IMs.
- 6.53 Removing the transitional portion of depreciation in the year of commissioning would substantially shift the upper bound for a 2020 adopter towards zero equivalence. This would reflect the materiality of the effects applying to future right of use assets.
- 6.54 The extent to which the actual aggregate life of the additional assets may be lower than the 45-year life standard assumption is represented by the red shaded band in the far right column of Diagram 1, which has a lower bound of a 10-year life assumption. In our view:
- 6.54.1 given ENA's observation that typical terms of right of use assets are less than 10 years; and
 - 6.54.2 the relatively high value of these assets as a component of total additional assets in the transition period,
- we consider it is likely that the actual aggregate useful life of additional assets, on average, will be shorter than the standard 45 years, and that this means it is likely that the overall equivalence will be further reduced by the effect of actual differences in asset life falling somewhere within this band. In these circumstances, our current view is that this effect is not likely to be material.
- 6.55 In Attachment A we have shown the indicative effect of the 45-year life assumption on the base materiality.⁷⁴
- 6.56 The capex and opex IRIS effects for 2020 adopters, after applying our proposed change to the IRIS IM for DPP3 (the effect of which is labelled in the diagrams as 'Treat IRIS as opex'), are approximately equal, so that the remaining net benefit is also not material.

⁷³ Per Transpower, IPP Disclosures 2017/18, Detailed calculation of the 2017/18 washup.

⁷⁴ The adjustment is based on the combined weighted life of assets commissioned in 2018, assuming a 45 year life, and commissioned right of use assets, using the average weighted life of right of use assets capitalised in the year of adoption, based on individual EDB data.

EDBs adopting NZ IFRS 16 in 2019 or earlier and EDBs on a CPP

- 6.57 In this example we have modelled the effects for an EDB adopting in 2019, but the magnitude of the effects, except to the extent that IRIS benefits calculated for the current regulatory period will be one year greater, equally applies to Powerco, who adopted NZ IFRS 16 in 2018.
- 6.58 The upper bound of the overall equivalence effect for early adopters is around 12% excluding the transitional benefit effect of no depreciation in the year of commissioning.
- 6.59 We note that the transitional effect of the 'no depreciation in the year of commissioning' rule is greater for early adopters than for 2020 adopters, as it reflects additional compounding. In this example it fully offsets the 12% overall equivalence effect, reflecting the materiality of the effects applying to future right of use assets.
- 6.60 There is a significant difference in the IRIS capex effects between those businesses early adopting and those adopting in 2020. This is because under the capex wash-up mechanism, the right of use assets for early adopters earn a return on and of capital for one or more additional years.
- 6.61 Again, our draft decision to treat operating lease payments as opex would give rise in DPP3 to the effect labelled in the diagrams as 'Treat IRIS as opex.'
- 6.62 There will be residual material gains for EDBs adopting the standard early and those EDBs on a Customised Price Path (CPP), for whom IRIS benefits of the transition will continue to be carried forward into the future.
- 6.63 Nonetheless we consider this approach is consistent with applying the IRIS rules as they stand to the current period.

Transpower analysis

- 6.64 The overall equivalence effect excluding IRIS effects is around 4% or 0.52% of revenue. Our current view is that we do not consider this is material.
- 6.65 After the effect of our proposed IM changes to the IRIS, the remaining net IRIS effect is a detriment to Transpower of around 6% or \$7.8m (0.78% of revenue).
- 6.66 We do not propose to disturb the remaining IRIS effect. We consider this approach is consistent with applying the IRIS rules as they stand to the current period.

Chapter 7. Accounting for IRIS effects of the change in treatment of operating leases

Purpose of this chapter

- 7.1 This chapter sets out our detailed analysis in support of our draft decision to amend the EDB and Transpower IMs to continue treating operating leases as opex for IRIS purposes.

Potential for unwarranted IRIS outcomes

Transitional effects

- 7.2 IRIS provides a constant incentive rate for regulated suppliers to improve opex and capex efficiency by having them share in any costs or savings they realise against expenditure allowances. IRIS does this through 'retention factors', which allow regulated suppliers to keep a set proportion of any savings in opex and capex (or bear a set proportion of cost overruns).
- 7.3 The effect of NZ IFRS 16 is to remove operating lease payments from opex and record a one-off capital expense reflecting the present value of the lease payments over the full lease term. Therefore, at the time of capitalisation (in the 2019 financial year or earlier), there will be a large, single-year increase in capex and an NPV carry forward of opex savings into the next regulatory period. This outcome could not have been forecast when the current EDB DPP and Transpower IPP were set in 2014.
- 7.4 The changes to opex and capex resulting from the change in accounting treatment of operating leases will affect regulated suppliers' outcomes under IRIS. However, the rewards and penalties under IRIS will not offset each other because:
- 7.4.1 for EDBs, the retention factors that will apply when existing operating leases are initially capitalised are higher for opex (34%) than for capex (15%);⁷⁵ and
- 7.4.2 the savings from the opex reduction are treated differently to the capex, with the difference in magnitude depending on the lives, incremental cost of debt and values of forecast lease payments used to value the right of use assets.
- 7.5 This would mean regulated suppliers could see a large net positive (or negative) adjustment under IRIS from a regulatory transition to the new financial reporting standard.⁷⁶

⁷⁵ As the new standard comes into effect for the reporting period beginning on or before 1 January 2019, the initial capitalisation of existing operating leases will occur under the price-quality paths that apply until 2020. For Transpower the corresponding retention factors for capex and opex are equal.

⁷⁶ We note that a supplier may not see an opex reward or capex penalty if they were already over-spending/under-spending against their respective forecasts.

Future effects on capex incentives

- 7.6 In circumstances where operating leases are treated as capex, under the current IMs they become subject to the capex IRIS calculation. Our current view is that we don't think this is appropriate because they will incorporate forecasts of future cashflows that may occur outside the current regulatory period. This could result in regulated suppliers facing IRIS penalties/rewards on the basis of the difference between two forecast capex estimates, rather than on the basis of the difference between forecast capex and capex cashflows that have actually occurred at the time the incentive payments are calculated.
- 7.7 Once the incentive adjustment has been calculated in the period in which the asset is commissioned, there is no further incentive adjustment in the following regulatory periods under existing IM rules if the GAAP asset value subsequently changes as a result of a change in forecast lease payments or in the lease term.⁷⁷
- 7.8 Furthermore, we consider that there is a possibility that this dynamic could be exploited at the expense of consumers. This could occur if regulated suppliers forecast based on a longer lease duration than they end up contracting for, to obtain additional benefits under IRIS.
- 7.9 For example, a forecast nine-year lease might be split into: (a) an actual four-year lease; and (b) a five-year lease, with the five-year lease being capitalised in the next regulatory period. In the first period IRIS rewards will be calculated for the apparent underspend on the four-year lease against the forecast nine-year lease. Then in the next regulatory period the nine-year lease forecast (or longer) can be repeated, and an IRIS reward calculated on the five-year lease underspend compared to the second period lease forecast.
- 7.10 This behaviour could continue to be repeated and would be very difficult to distinguish from value-enhancing decisions to adopt shorter term leases.

Effects on opex incentive amounts carried forward under changes to IRIS IMs

- 7.11 The opex IRIS mechanism distinguishes between temporary and permanent savings through incremental cost savings made year to year through the regulatory period.
- 7.12 Treating operating leases as capex for incentive purposes (ie, permanently removing them from opex forecasts for the purposes of IRIS), would mean the transitional 'saving' as a result of the reduction in opex in the current regulatory period would be treated as a permanent saving, the benefits of which get carried forward five years from the year in which the 'saving' is made into DPP3/RCP3.

⁷⁷ The change in lease term would affect the regulatory asset value as would alter the remaining useful life used to calculate the depreciation in the roll forward formula under ID. The roll-forward formula is specified in the *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26 at clause 2.2.4 and the *Transpower Input Methodologies Determination 2010* [2012] NZCC 17 at clause 2.2.3. This does not, however, affect the calculation of IRIS incentives.

- 7.13 The effect of treating operating lease expenditure as opex in the future, under our draft decision, would mean that operating lease payments are included in opex forecasts in DPP3/RCP3 and 'carry forward' amounts already calculated under IRIS in the current path would be restated before they affect the path in the next regulatory period.
- 7.14 For opex this has the effect of converting what would otherwise be treated as a permanent saving into a temporary saving, lasting only for the duration of the remainder of the current regulatory period. The capex effects of applying the existing IRIS rules for the remainder of the current regulatory period will also remain as they stand. We consider this approach is consistent with the Part 4 purpose in the Act.
- 7.15 At the same time, the changes would create an IRIS capex forecast excluding right of use assets and remove right of use assets from actual capex disclosed in each disclosure year.
- 7.16 Because the forecasting approach used for a DPP rolls forward opex disclosed in the base year (2019 for DPP3), an EDB that has already adopted NZ IFRS 16 for that year will have nil opex in relation to operating leases rolled forward. If, in accordance with our draft decision, we then include operating lease payments into the actual opex for DPP3 which is compared to this forecast opex, this will have the effect of creating immediate differences between the forecast and actual expenditure in the IRIS calculation.
- 7.17 This is the basis of concern expressed by Vector and ENA in their submissions (paragraphs 5.12 to 5.13 above). To remove this transitional effect and preserve the incentive intent of the IRIS mechanism, our current view is that it is necessary to make an adjustment to the opex forecasts to ensure they incorporate operating lease payments.
- 7.18 As explained in paragraph 5.31 above, the proposed changes to the IRIS IM provisions will remove the capex wash-up adjustment for EDBs whereby any difference between right of use asset lives and the standard 45-year life DPP IM assumption would be adjusted for at the end of the regulatory period.

Attachment A Illustrative table of materiality for EDBs (impacts stated as % of revenue)

EDB	Assets commissioned 2018 (\$000)	1st year of capitalised leases	Est. commissioning value in 1st year of capitalised leases (\$000)	Line charge revenue 2018 (\$000)	Before amendment to deferred tax IM		After amendment to deferred tax IM		After change in average asset life		IRIS impact	
					Inequivalence factor	Estimated impact	Inequivalence factor	Estimated impact	Av asset life with 1st year capitalised leases included (approx years)	Estimated impact after change in av. asset life	Capex IRIS estimated impact (net: ie. washup - penalty)	Opex IRIS estimated impact
Alpine Energy	30,906	2019	31	60,481	57.0%	0.03%	12.0%	0.01%	44.96	0.01%	0.02%	0.00%
Aurora Energy	50,335	2020	4,186	96,272	55.0%	2.39%	15.0%	0.65%	41.93	0.50%	(0.13%)	0.17%
Centralines	1,846	-	-	14,232	N/A	-	N/A	-	45.00	-	-	-
EA Networks	14,921	2020	18,481	48,524	55.0%	20.95%	15.0%	5.71%	30.25	(0.71%)	(1.14%)	1.52%
Eastland Network	7,061	2019	17	36,850	57.0%	0.03%	12.0%	0.01%	44.91	0.01%	0.01%	0.00%
Electricity Invercargill	5,907	-	-	20,384	N/A	-	N/A	-	45.00	-	-	-
Horizon Energy	10,144	2020	270	33,964	55.0%	0.44%	15.0%	0.12%	43.94	0.11%	(0.02%)	0.03%
Nelson Electricity	934	-	-	10,138	N/A	-	N/A	-	45.00	-	-	-
Network Tasman	6,386	2020	53	45,046	55.0%	0.06%	15.0%	0.02%	44.64	0.02%	(0.00%)	0.00%
Orion NZ	77,003	2020	2,333	251,787	55.0%	0.51%	15.0%	0.14%	44.76	0.14%	(0.03%)	0.04%
OtagoNet	12,346	2020	770	37,062	55.0%	1.14%	15.0%	0.31%	42.71	0.26%	(0.06%)	0.08%
Powerco	123,688	2018	8,155	390,821	57.0%	1.19%	12.0%	0.25%	44.22	0.25%	Not calculated	Not calculated
The Lines Company	12,035	2020	35	42,323	55.0%	0.05%	15.0%	0.01%	44.89	0.01%	(0.00%)	0.00%
Top Energy	19,745	2020	1,614	51,150	55.0%	1.74%	15.0%	0.47%	42.09	0.37%	(0.09%)	0.13%
Unison Networks	27,802	2020	3,814	152,768	55.0%	1.37%	15.0%	0.37%	42.90	0.31%	(0.07%)	0.10%
Vector Lines	156,889	2019	12,485	631,706	57.0%	1.13%	12.0%	0.24%	42.29	0.24%	0.63%	0.18%
Wellington Electricity	31,469	2020	3,168	174,966	55.0%	1.00%	15.0%	0.27%	42.05	0.21%	Not calculated	Not calculated

Note 1: The right of use asset to revenue ratios used to translate the equivalence effects in Diagrams 1 and 1a are calculated on the basis of disclosed 2018 line-charge revenue and data on right of use assets provided in response to our s53ZD notice published on our website on 24 July 2019. These may not precisely reflect the actual ratios in the year of capitalisation.

Note 2: For EDBs adopting before 2020 there is no impact on right of use assets capitalised arising from the adjustment for the difference between the actual aggregate weighted asset life and the standard life assumption of 45 years. This will not be the case for forecast commissioned right of use assets. Also, the estimated impact of the difference for EDBs adopting in 2020 has been subject to estimation in some cases where asset lives were not stated or were inconsistent with annual payments recorded in information provided.

Note 3: We have not separately modelled the equivalence effect for EDBs adopting in the 2018 year (Powerco) but for the purpose of our draft decision have assumed that it is similar to the 12% equivalence (after amendment to deferred tax IM) calculated for EDBs adopting in 2019. The IRIS effects for EDBs on a customised price path have not been calculated in our example.

Attachment B Calculating the equivalence effects in Diagrams 1, 1a and 2

- B1 The purpose of this attachment is to assist interested parties to understand and replicate the analysis performed and presented in Chapter 6 of this paper.
- B2 On 3 July 2019 we published two models illustrating how operating leases would be treated under the existing IMs, and the effects of some potential changes to the IMs. The analysis presented in Figures 1, 1a and 2 was produced using those models. However, we made two amendments to the EDB model. Specifically:
- B2.1 Under the “no notional tax asset/existing IMs” scenario, the published EDB illustrative model used the starting deferred tax balance that would be calculated in GAAP, and calculated a temporary difference adjustment in each year, except the year of commissioning, to ensure the tax balance would fully reverse out over the life of a right of use asset. We noted in the model this was inconsistent with the IM approach, which applies an opening deferred tax balance of nil.
- B2.2 To correctly assess the impact of the “existing IMs” assumption” it is necessary to set the opening deferred tax balance to nil, and add the positive depreciation temporary differences (ie the tax effect of regulatory depreciation) in each year, except the year of commissioning, to the opening deferred tax balance of nil, without reversal, as described in Chapter 6. The impact of the change from this scenario to our draft decision to apply a GAAP opening value is shown as “Amend deferred tax IM” in Diagrams 1 and 1a and implements the treatment that is actually used in our illustrative model, as described in B2.1.
- B2.3 The published illustrative model calculated the GAAP roll-forward value of the right of use asset, and took the GAAP value (cell J49) as the opening RAB value at the start of the next regulatory period (2026) on the assumption this was the value disclosed under ID. This is incorrect as the value taken from ID, while based on GAAP, should not include any depreciation in the year of commissioning, therefore the opening RAB value for the start of the next regulatory period should be the value shown in cell J58.
- B3 The analysis in Figures 1 and 1a was produced by manipulating the amended model as follows:
- B3.1 We ‘back-calculated’ the point at which perfect equivalence was achieved by changing the dynamic ‘switches’ included in the model, and removing or bypassing aspects of the calculations that describe the status quo scenario (no IM changes). The specific steps necessary to do this were:
- Setting the ‘What asset life do we apply to the right of use asset?’ switch to “Life specified in ID disclosures || Amended IMs”

- Setting the ‘Does the DPP account for permanent differences’ switch to “Yes || Amended IMs”
- Amending the regulatory investment value calculation to exclude any deferred tax adjustment
 - Amending the calculation of depreciation within the RAB so that depreciation is calculated in the year of commissioning
 - Excluding notional deductible interest from the regulatory tax allowance within the BBAR calculation
 - Setting the ‘EDB incremental cost of debt’ (used for calculating the value of the right of use asset) equal to WACC
 - Setting the ‘what is the disclosure year of first capitalisation (year-ending 31 March)’ input to 2021, to remove any effects of us being unable to account for revenue or expenses that occur in DPP2.

B3.2 We then incrementally unwound those changes and observed how each one affected the degree of equivalence between the present value of operating lease payments as operating expenditure and present value of revenue on the corresponding right of use asset. Reintroducing each incremental step resulted in a new bar in the waterfall charts. Each step was calculated separately for capitalisation in 2019 and 2020 for the example asset base.

B4 The model calculates the IRIS impacts using the hypothetical building blocks allowable revenue (BBAR) for years 2019 and 2020. This changes therefore depending on the broader model settings. We calculated the IRIS impacts that result under the status quo scenarios (both 2019 and 2020 capitalisation), whereby these would be considered permanent savings. We then re-ran the calculations with the opex savings being considered temporary savings. This effects the recalculation of benefits carried forward under our draft decision to continue treating right of use assets as operating expenditure for IRIS purposes.

B5 The analysis in Diagram 2 used the same fundamental approach, except that:

B5.1 We only considered capitalisation in year 2020, given Transpower will capitalise its operating leases in that year.

B5.2 Several steps in ‘back-calculating’ perfect equivalence are not required as, unlike the DPP IM, the Transpower IM:

- recognises permanent differences
- recognises depreciation in the year of commissioning
- does not use deferred tax accounting
- uses the remaining life of each individual asset when calculating depreciation

- B5.3 The base capex standard incentive rate for Transpower's base capex expenditure adjustment under the Transpower Capex IM is equal to the IRIS opex incentive rate in the Transpower IMs.