



**Date:**

10 July 2019

**Name of submitter:**

Electricity Networks Association

**Industry/area of interest:**

Utilities/infrastructure

**Contact details**

David de Boer. Principal Advisor

**Address:**

Level 5, Legal House

101 Lambton Quay

WELLINGTON 6011

**Telephone:**

64 4 471 1335

**Email:**

david@electricity.org.nz

# Treatment of operating leases

## Issues paper

Submission to the Commerce Commission

**Final**

From the Electricity Networks Association

# Contents

1. INTRODUCTION.....	3
2. THE PROPOSAL.....	3
3. ENA ANALYSIS OF THE PROPOSAL .....	4
4. AD-HOC IM CHANGES .....	4
5. ENA SUGGESTIONS AND COMMENTS .....	6
6. SUMMARY OF SUBMISSION.....	7
APPENDIX- MEMBER SUPPORT .....	9

# 1. Introduction

1. The Electricity Networks Association (ENA) appreciates the opportunity to make a submission to the Commerce Commission (Commission) on the consultation paper, **Treatment of operating leases: Issues paper. 6 June 2019**, (the Issues paper).
2. The ENA represents all of New Zealand's 26 electricity distribution businesses (EDBs) or lines companies, who provide critical infrastructure to NZ residential and business customers. Apart from a small number of major industrial users connected directly to the national grid and embedded networks (which are themselves connected to an EDB network) electricity consumers are connected to a distribution network operated by an ENA member, distributing power to consumers through regional networks of overhead wires and underground cables. Together, EDB networks total 150,000 km of lines. Some of the largest distribution network companies are at least partially publicly listed or privately owned, or owned by local government, but most are owned by consumer or community trusts.

# 2. The proposal

3. The Issues paper responds to a new financial reporting standard (NZ IFRS 16 Leases) which changes the accounting treatment of operating leases and requires the capitalisation of operating leases as 'right of use' assets, valued at the present value of remaining lease payments at the date of capitalisation.
4. The Issues paper proposes that:
  - Price-quality regulation and information disclosure (ID) regulation is aligned with NZ IFRS 16
  - The input methodologies (IMs) are amended so that operating leases are treated as opex for IRIS purposes, as a transitional measure
  - A notional tax asset for right of use assets is introduced
  - A permanent difference is included for the DPP regulatory tax allowance
  - GAAP life for right of use assets is used for DPP purposes
  - Income from sub-leases is recognised
  - Further changes may be required for ID regulation.
5. We note that the Issues paper presents the analysis of the problem and proposed solutions in the abstract. There are no illustrative examples of the potential impact of the proposals or the alternatives considered. Subsequent to the publication of the Issues paper, a model has been

provided which includes indicative IRIS impacts, and DPP RAB and tax RAB impacts of the proposals.

6. The model has assisted us to understand the proposals described in the Issues paper. However, we note that the model does not fully reflect the impact of the proposals because it does not explicitly model the impact of changes to the DPP opex building block on BBAR.
7. In this respect we note that the Issues paper does not explicitly consider whether there are any issues that need to be addressed for those that have early adopted the new standard, such as the DPP opex allowance.

### 3. ENA analysis of the proposal

8. We have gathered information from EDBs to assist us in understanding the scale of the lease opex and assets, and the expected lives of the right of use assets. This helps us understand the problem the Issues paper is attempting to solve.
9. Our research indicates that the opex, capex and RAB impacts of the changes to the lease standard are unlikely to be material for EDBs, and therefore a reasonable and principled regulatory approach will be to align with GAAP. Based on the sample data we have collected we note that:
  - operating lease opex is between 0% - 2.3% of total annual opex for the five EDBs surveyed
  - right of use assets are between 0% - 0.6% of RAB and 0% - 2.8% of RAB depreciation
  - the terms of the leases for depreciation purposes range from 2 – 99 years, and typical terms are less than 10 years
  - the present value calculation of lease payments is based on each EDB's cost of debt.
10. Based on our initial analysis, we observe that the financial impacts of four implementation scenarios, compared to the status quo, are very small and are dependent on the magnitude of the opex leases relative to total opex, the right of use asset relative to capex and RAB, and the terms of leases. Because the impacts are so small, and that different components offset each other, the present value of the net impact on regulated revenue may be slightly positive or slightly negative.

### 4. Ad-hoc IM changes

11. In principle we consider that there should be a high threshold for changing IMs prior to the next scheduled IM review. Any IM changes must meet the thresholds specified by the Commission for changing the IMs, namely whether the change is in accordance with section 52A, provides

certainty in accordance with section 52R and minimises regulatory complexity and compliance obligations.

12. We are concerned at the number of proposed changes to the Part 4 regulations, especially the IMs. We consider that the IMs in their present form can accommodate the change in the accounting treatment of operating leases. This is sufficient for the next regulatory period and until the next IM review, where the impacts can be assessed with more certainty.
13. We do not support substantial changes to the IMs at this time because this is contrary to the predictability and regulatory certainty objectives of the IMs. Changes to the IRIS IMs in particular would have the effect of retrospectively changing regulatory incentives and introduce additional complexity to an already complex mechanism.
14. The ENA submits that the current regulatory rules can accommodate the change to the lease standard, and no modifications to the IMs are required. This is desirable and acceptable because:
  - it avoids retrospective changes to regulation, which are contrary to the purpose of IMs which are to provide regulatory certainty, particularly for the IRIS IMs
  - the current IMs adequately accommodate the change between opex and capex, and the right of use assets
  - the value of leases are not material for EDBs
  - it is neutral for those that have adopted the standard during RY19
  - information disclosures can be used to monitor the impacts
  - the issue can be considered during the next IM review, once the initial impacts have been quantified.
15. We also submit that it is critical that the linkage between the IRIS IM and the DPP revenue allowance is kept whole. This occurs through the opex base year approach adopted for the DPP<sup>1</sup>. The proposals disrupt this linkage for opex and as a result they penalise those EDBs which have adopted the lease standard during RY19. If the proposal is pursued, the Commission must make sure that any changes to the IRIS do not disrupt the symmetrical properties with actual expenditure adopted for setting RCP3 opex allowances.
16. Accordingly, if the change to the RCP2 opex IRIS is retrospectively introduced as suggested, then the same change must be made to the RY19 base year opex to maintain the incentive outcomes of the IRIS. We request that these impacts are explicitly examined by the Commission before the draft decision is made.

---

<sup>1</sup> Refer para 5.40 of the DPP Draft Decision Paper, 29 May 2019

17. The remainder of this submission responds to the discussion in the Issues paper.

## 5. ENA suggestions and comments

18. The capitalisation of operating leases is unlikely to be a material change to the capex, opex, depreciation and RAB components of regulatory financial statements.
19. However, aligning regulation with the GAAP treatment of operating leases is supported by ENA members. This maintains consistency between information sources, will assist understanding of regulatory financial measures (by aligning with GAAP), and avoid undue compliance complexity and cost. This can be achieved without substantial changes to the IMs.
20. Members note that right of use assets must be valued in accordance with NZ IFRS 16, and are audited. This provides an independent check on the ‘incentives’ on EDBs to seek certain outcomes, as suggested in the Issues paper.
21. We note that once in the RAB, right of use assets will not be revalued, other than annual CPI revaluations. The value on commissioning is the value that enters the RAB, and subsequent use of the asset is largely ignored. This is consistent with the treatment of other assets in the RAB.
22. The services provided by the asset will be provided over the remaining life of the right of use asset. This is consistent with other capex and should not be a concern. If the Commission is concerned about situations where the services are no longer provided within the asset’s term, additional provisions for disposals could be included in the IMs.
23. 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.
24. This also applies for DPP depreciation. 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.
25. This was a clear policy decision at the time the DPP IMs were determined. The right of use assets do not require special treatment, particularly as they are not material. The swings in allowable revenue referred to in the Issues paper are already a feature of the RAB correction at the beginning of each DPP – the GAAP lease standard won’t change this feature of price-quality path resets.
26. DPPs and CPP IMs are able to accommodate movement of costs between opex and capex. They also accommodate changes in the measurement of opex and capex (for example as a result of changes to the cost allocation and related party rules). The regulatory framework must be

sufficiently durable to apply across regulatory periods, where modifications in measurement occur.

27. Modifying the opex IRIS is not supported. Opening up the IRIS IM during the regulatory period is retrospective, and contrary to the intent of the incentive scheme. It is also inconsistent with the objective of aligning opex and capex reporting with GAAP, as non-GAAP data would need to be maintained to effect this change.
28. The Issues paper is unclear on the longer-term consequences for IRIS of the proposed adjustment. It is not clear whether the proposal is a transitional one, or a permanent decision, and as stated above it is critical that the linkage between DPP expenditure allowances and the IRIS IM is maintained.
29. Disrupting the opex and (by definition) the capex IRIS introduces significant compliance complexity. We assume, although this is not mentioned in the Issues Paper<sup>2</sup>, that the proposed opex IRIS treatment will affect the capex IRIS which will require a BBAR wash-up with and without the 'right of use' asset impacts. This has the potential to disrupt the incentive properties of IRIS, which is harmed if the operation of the schemes cannot be easily understood.
30. Further consideration of including a notional tax asset is recommended, but only if the impacts are sufficiently material to justify the change.
31. Members support recognition of income from sub-leases.
32. We recommend that more comprehensive worked examples are provided as part of the Decision Paper, so that interested parties can better understand the likely magnitude of the various impacts and the options, including for those EDBs which have adopted the standard during the RY19 year
33. We also recommend that the Commission clarify to what extent lease opex and right of use assets are reflected in RY19 information disclosures and AMP forecasts, prior to determining the RCP3 DPP.

## 6. Summary of submission

34. The ENA submits that the current regulatory rules can accommodate the change to the lease standard, and no modifications to the IMs are required. This is desirable and acceptable because:
  - it avoids retrospective changes to regulation, which are contrary to the purpose of IMs which are to provide regulatory certainty, particularly for the IRIS IMs

---

<sup>2</sup> We note that the capex IRIS impact is included in the model provided on 3 July.

- the current IMs adequately accommodate the change between opex and capex, and the right of use assets
- the value of leases are not material for EDBs
- it is neutral for those that have adopted the standard during RY19
- information disclosures can be used to monitor the impacts
- the issue can be considered during the next IM review, once the initial impacts have been quantified.

35. If the change to the RCP2 opex IRIS is retrospectively introduced as suggested, then the same change must be made to the RY19 base year opex to maintain the incentive outcomes of the IRIS. Otherwise the RCP3 DPP opex allowance is reduced without any opex IRIS saving benefit. This affects those EDBs which have adopted the standard during the RY19 year.
36. We request that these impacts are explicitly examined by the Commission before the draft decision is made.
37. Before the RCP3 DPP revenue is set, it is recommended that the Commission clarify the treatment of leases in RY19 disclosures and RY19 AMP forecasts of non-exempt EDBs.

## Appendix- member support

The Electricity Networks Association makes this submission along with the explicit support of its members, listed below.

1. Alpine Energy
2. Aurora Energy
3. Buller Electricity
4. Counties Power
5. Eastland Network
6. Electra
7. EA Networks
8. Horizon Energy Distribution
9. Mainpower NZ
10. Marlborough Lines
11. Nelson Electricity
12. Network Tasman
13. Network Waitaki
14. Northpower
15. Orion New Zealand
16. Powerco
17. PowerNet
18. Scanpower
19. The Lines Company
20. Top Energy
21. Unison Networks
22. Vector
23. Waipa Networks
24. WEL Networks
25. Wellington Electricity Lines
26. Westpower