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# Treatment of operating leases

## Draft decision paper

Submission to the Commerce Commission

Final

From the Electricity Networks Association

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# 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: Draft decisions and reasons paper, 28 August 2019**, (the Draft decisions paper). In responding to the Draft decisions paper we have also considered the draft determination amendments in the **Draft Electricity Distribution Services Input Methodologies Amendments Determination (No. 2) 2019, 11 September 2019**, (the Draft determination).
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 Draft decisions 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' (ROU) assets, valued at the present value of remaining lease payments at the date of capitalisation. The Draft decisions paper responds to submissions on the June 2019 Issues paper<sup>1</sup>, including the ENA's submission<sup>2</sup>.
4. The Draft decisions paper proposes that:
  - Price-quality regulation and information disclosure (ID) regulation is aligned with NZ IFRS 16 with limited exceptions
  - The capitalisation treatment would not apply to ROU assets which reflect charges which are specified as pass-through or recoverable costs
  - The input methodologies (IMs) are amended so that operating leases are treated as opex for IRIS purposes, and ROU assets are excluded from the capex IRIS

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<sup>1</sup> Commerce Commission, Treatment of operating leases: Issues Paper, 6 June 2019

<sup>2</sup> ENA, Treatment of operating leases, Submission to Commerce Commission, 10 July 2019

- Future negative effects on revenues for EDBs which adopt the standard early will be addressed with adjustments to forecast opex allowances for DPP3
- The IMs will also be amended to allow GAAP lives for right of use assets for information disclosure (ID) purposes but not for price-quality purposes
- The IMs will be amended to allow a GAAP based opening deferred tax balance to be included at the time the ROU asset is commissioned. This will apply for any RAB asset commissioned where there is no corresponding regulatory tax asset value
- The IM amendments will apply from 1 April 2020.

### 3. Analysis supporting the draft decision

5. We acknowledge the comprehensive analysis and discussion set out in the Draft decisions paper. We appreciate the additional modelling which was undertaken in support of the Draft decision. We note that this modelling has focussed on equivalence with reference to worked examples for EDBs and Transpower, including for EDBs which may have adopted the lease standard in 2019. As acknowledged in the Draft decisions paper, the actual impacts on individual EDBs will differ to the worked examples, particularly where the relative scale and expected lives of ROU assets differ to those assumed.
6. However, we are disappointed that the analysis included in the Draft decisions paper does not provide more explicit illustration of the impact of the proposals on the EDB DPP revenue paths to be set at 1 April 2020. As the Draft decisions paper focusses mainly on the IM impacts, there are components of the EDB DPP, specifically the capex and opex allowances, which are not fully addressed in the Draft decisions paper.
7. This is a particular issue in the short term because it is not entirely clear what information, in respect of operating leases, the Commission plans to use when setting the DPP3 revenue allowances. The complexity arises because different EDBs have adopted the lease standard at different times, and because the DPP3 revenue path relies on historical (including RAB) and forecast information which is derived from the transitional period.
8. We acknowledge that an updated draft DPP decision is due to be released later this month. We anticipate that that decision will reveal the proposed treatment for operating leases and ROU assets for DPP3. We encourage the Commission to provide sufficient clarity in this respect in its updated draft decision papers and financial models.
9. We also note that the Draft decision addresses materiality of the proposals throughout the paper, but there is no clear definition of materiality. It appears to us that the proposed changes

address some impacts but ignore other impacts which are at least as material (eg; deferred tax balance and DPP depreciation)<sup>3</sup>.

10. We also note our earlier submission that there should be a high threshold for changing IMs prior to the next scheduled IM review. It is not clear to us the analysis provided fully justifies the changes at this time, given the low value of operating leases quantified in the Draft decision paper.
11. In the remainder of this submission we comment on specific aspects of the proposed amendments.

## 4. Response to proposed amendments

12. Given the decision to change the regulatory methods at this time, we support achieving as much alignment with GAAP as possible.

### **ROU assets exclude operating leases recovered as recoverable and pass through costs**

13. We note the draft decision to exclude from ROU assets any operating leases which are recovered as recoverable and pass through costs. The primary rationale for this is that charges payable to Transpower should continue to be passed directly through to consumers, and excluded from allowable revenue. We agree with this proposal.
14. This will introduce a departure from GAAP for any EDBs which capitalise certain Transpower charges (such as NICs) as finance leases. This practice is not necessarily a consequence of the changes to NZ IFRS 16, and therefore there may be existing finance lease assets in RABs. The Commission may wish to clarify the process for transitioning to the new definition, to address this instance.

### **Operating leases treated as opex for IRIS purposes**

15. The draft decision to adopt an alternative treatment of operating leases for IRIS purposes, ie: retain them as opex, helps preserve the incentive impacts of the opex and capex IRIS schemes for DPP2, subject to ensuring the base year opex for DPP3 is determined on a consistent basis.
16. The key reasons for adopting a non-GAAP approach for IRIS appear to be that:
  - if a GAAP approach is applied for IRIS, there will be a transitional benefit to suppliers from permanent opex savings under the opex IRIS, which is not fully offset by capex IRIS penalties

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<sup>3</sup> As illustrated in Diagram 1 of the Draft decision paper

- ROU assets reflect forecasts which go beyond the current regulatory period, and there may be opportunities for regulated suppliers to benefit from future changes to these forecasts, after the ROU asset has been capitalised.

17. In principle we support preserving the IRIS incentives over time because certainty is necessary to ensure the incentives operate effectively. We note that the proposal introduces more complexity into an already complex mechanism, because different measures of opex and capex will be required solely for IRIS purposes. This will lead to future reconciliation tasks and, we anticipate, more complex disclosures.

### **Depreciation recovery**

18. We note that the draft decision to exclude ROU assets from the capex IRIS results in a systematic under recovery of depreciation of ROU assets under price-quality paths. This is because ROU assets are expected to have asset lives which are materially shorter than the default 45 year life applied in the DPP. The differences between ID and DPP depreciation rates are not washed-up, if these assets are excluded from the capex IRIS.
19. A ROU asset with a ten year GAAP life, commissioned in the first year of a regulatory period, and depreciated from the second year can expect 40% (4/10) of the asset value to be depreciated within the first regulatory period using GAAP lives, but only 9% using the DPP life (4/45). The depreciation difference, which in this example is more than 30% of the asset value, will never be recovered under the proposal.
20. This outcome is inconsistent with all other assets in the RAB, where depreciation differences during a regulatory period are washed up via the capex IRIS.
21. Accordingly the ENA submits that an additional wash-up mechanism to address this under recovery should be included in price-quality paths. This is consistent with the s52A purpose, and consistent with the remainder of the amendments proposed in the Draft decision paper which are designed to achieve NPV equivalence.

### Opening deferred tax adjusted for ROU assets

22. The Draft decision paper also proposes to allow for opening deferred tax assets for ROU assets, where there is no equivalent regulatory tax asset. This differs to the Issues paper which proposed a notional tax asset solution. We support the proposal because it is more consistent with GAAP.
23. At this stage we have no further comments on the Draft determinations, although we may provide additional feedback once the updated draft DPP3 decision is released.

## 5. Summary of submission

24. The ENA acknowledges the comprehensive analysis and discussion set out in the Draft decisions paper. However, we are disappointed that the analysis included in the paper does not provide more explicit analysis of the impact of the proposals on the EDB DPP revenue paths to be set at 1 April 2020.
25. Accordingly it is requested that the Commission clarify the treatment of leases in the updated draft EDB DPP decision due to be released before the end of September.
26. We have previously submitted that there should be a high threshold for changing IMs prior to the next scheduled IM review. It is not clear to us that the analysis in the Draft decision paper fully justifies the changes at this time, given the low value of operating leases.
27. Our key comments on the proposed amendments are:
  - we support achieving as much alignment with GAAP as possible.
  - we support excluding from ROU assets any operating leases which are recovered as recoverable and pass through costs
  - the proposal to adopt an alternative treatment of operating leases for IRIS purposes, helps preserve the incentive impacts of the opex and capex IRIS schemes
  - this is conditional on ensuring the base year opex for DPP3 is determined on a consistent basis, particularly for those which adopted the new standard prior to RY20
  - the draft decision to exclude ROU assets from the capex IRIS results in a systematic under recovery of depreciation of ROU assets under price-quality paths. Accordingly an additional wash-up mechanism to address this under recovery should be included in price-quality paths
  - we support the proposal to include an opening deferred tax asset for ROU assets with no equivalent regulatory tax asset.

28. We may provide further comments on the Draft determinations once the updated draft DPP decision is released.



## 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