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Treatment of operating leases

Final decisions paper

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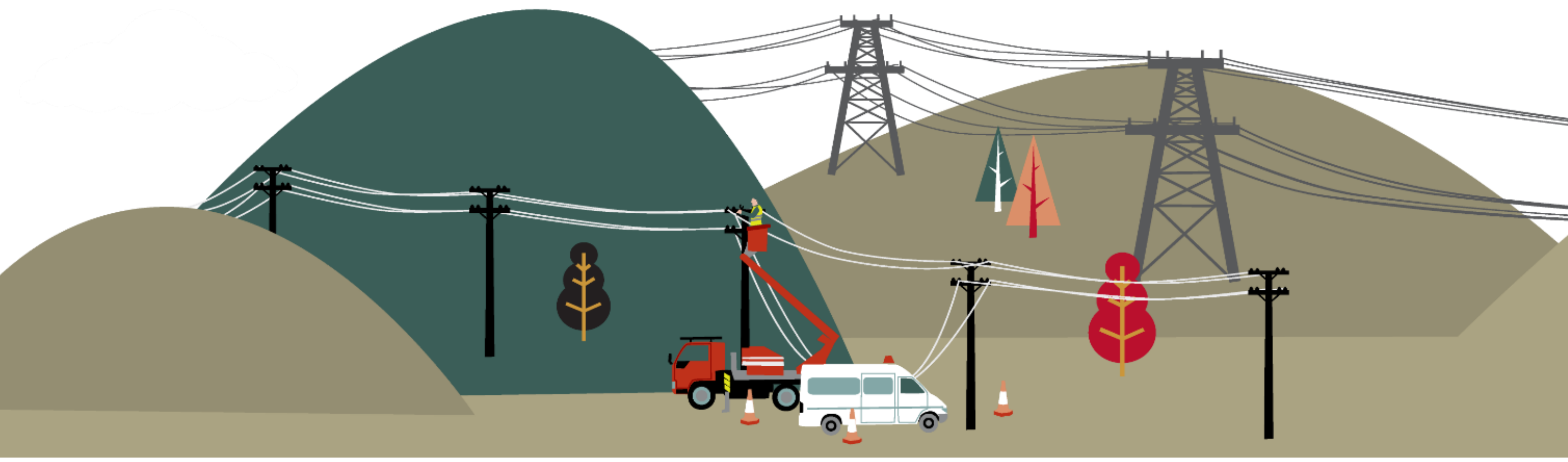

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Associated documents

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13 November 2019	ISSN 1178-2560	Electricity Distribution Services Input Methodologies Amendments Determination 2019 [2019] NZCC 18

Commerce Commission
Wellington, NEW ZEALAND

Contents

Executive Summary

X1 The purpose of this paper is to communicate our final decisions and supporting reasons on how we addressed the issues raised in relation to the EDB and Transpower input methodologies (IMs) by a new financial reporting standard - New Zealand Equivalent to International Financial Reporting Standard 16 Leases (NZ IFRS 16).[1]

X2 In 2016, NZ IFRS 16 was issued by the New Zealand Accounting Standards Board, for reporting periods beginning on or after 1 January 2019 (although early adoption was permitted). The new standard constitutes generally accepted accounting practice (GAAP) under the Financial Reporting Act 2013. 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). Under NZ IFRS 16, 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.

X3 The suppliers we regulate under Part 4 of the Act 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 were not anticipated when we set the current IMs and ID requirements. This gives rise to the potential for unintended outcomes.

X4 We have decided to generally accept alignment with NZ IFRS 16 for price-quality and ID regulation purposes, with some specific exceptions (see X5.1.3 and X5.3 below), and we have made changes to the IMs to reflect these decisions. Our decisions must ensure outcomes are consistent with the purpose of Part 4 of the Commerce Act 1986 (Act) and the purpose of the IMs.

X5 In our Treatment of operating leases: Draft decisions and reasons paper (draft decisions paper), published on 28 August 2019[2] we set out our draft decisions for how to address the issues raised by NZ IFRS 16 and accounting for operating leases for electricity distribution businesses (EDBs) and Transpower New Zealand Limited (Transpower) for regulatory purposes. With one exception, our final decisions confirm our draft decisions and are:

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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: Draft decisions and reasons paper" (28 August 2019). Accessible at: https://comcom.govt.nz/__data/assets/pdf_file/0013/170140/Treatment-of-operating-leases-Draft-decision-28-August-2019.pdf.

X5.1 to generally accept alignment with NZ IFRS 16 for price-quality and ID regulation purposes, except in relation to costs that are pass-through costs and recoverable costs. This means that allowable revenue and returns on investment under ID will be calculated using capitalised 'right of use' asset values.[3] Specifically, we have decided to:

X5.1.1 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;

X5.1.2 allow a GAAP-based life to be assigned to network 'right of use' assets under ID; but

X5.1.3 an exception will apply in respect of right of use assets capitalised under NZ IFRS 16 from costs specified as pass-through costs or recoverable costs. We have decided that these costs will continue to be treated as pass-through costs or recoverable costs for price-quality and ID regulation purposes;

X5.2 amend the IMs so that operating leases continue to be treated as opex for the purposes of the incremental rolling incentive scheme (IRIS).

X5.2.1 These amendments do not affect the price paths for Transpower or EDBs in the current regulatory periods. Rather, it requires 'carry forward' amounts already calculated under IRIS in the current paths to be restated before they affect the path in the next regulatory period.

X5.2.2 For opex, this has the effect of converting what would otherwise be treated as a 'permanent saving' into a 'temporary saving'. In other words, the IRIS opex saving resulting from the changed accounting treatment will only last for the duration of the remainder of the current price path regulatory period. The effects of applying the existing capex IRIS IM rules will also only last for the duration of the remainder of the current price path regulatory period.

X5.2.3 This decision also means that we will make 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 was used as the basis

3 Subject to annual indexed revaluations for EDBs under the EDB IMs. 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 Chapter 3 of this paper for further discussion on how right of use assets are capitalised under NZ IFRS 16.

of forecasts and compared with future actual expenditure that treated operating lease payments as opex.

X5.3 We have decided to modify our draft decision, which was no change in respect of the 45-year standard life assumption that applies to additional right of use assets under the *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26 (EDB IMs). Our final decision is to retain the 45-year standard life assumption but allow a 'capex wash-up' of any differences between the 45-year standard life and the GAAP lives for right of use assets to deal with any non-recovery of depreciation as a result of applying the standard 45-year life assumption.[4]

X6 To implement these decisions, we have made amendments to the following IMs:

X6.1 EDB IMs;

X6.2 *Transpower Input Methodologies Determination 2010* [2012] NZCC 17 (Transpower IMs); and

X6.3 *Transpower Capital Expenditure Input Methodology Determination 2012* [2012] NZCC 2 (Transpower Capex IM).

X7 The change in GAAP by the implementation of NZ IFRS 16 will have effects for other regulated businesses that have operating leases, and we will address these through our formal processes for each sector in due course.

[4] For DPP purposes, the EDB asset valuation IM treats 'right of use' assets forecast to be commissioned as 'additional assets', with a standard remaining asset life of 45 years at the time they are forecast to enter the RAB. *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, as amended, clause 4.2.2(3)(b).

Chapter 1. Introduction

Purpose of paper

1.1 The final decisions set out 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 final decisions on how to address the issues raised by NZ IFRS 16 for our regulation of electricity lines businesses; and

1.1.2 explain how our final decisions promote the Part 4 purpose and the purpose of the IMs we set.

1.2 This Chapter sets out:

1.2.1 the process we have followed to reach our final decisions;

1.2.2 what materials have been released alongside this paper;

1.2.3 effective dates for the IM amendments; and

1.2.4 the structure of this paper.

Process to implement final decisions

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 IMs in response to NZ IFRS 16.[5]

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 electricity lines businesses. Illustrative models supporting the analysis in our issues paper were published on 3 July 2019. We received submissions on our issues paper on 10 July 2019.

1.5 We issued section 53ZD notices[6] to EDBs on 19 July 2019 and to Transpower on 24 July 2019, seeking further information on 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 on price-quality paths for the next regulatory periods – EDB's default price quality path (DPP) commencing 1 April 2020 (DPP3) and Transpower's individual price-quality path (IPP) for the next regulatory period commencing 1 April 2020 (RCP3).

1.6 On 28 August 2019, we published our draft decisions paper. Submissions on our draft decisions paper were received on 18 September 2019.

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5 Available on the Commission's website here: 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.

6 This is a notice issued by the Commerce Commission under section 53ZD of the Commerce Act 1986.

1.7 On 11 September 2019, we published three draft determinations that proposed amendments to the IMs to implement the draft decisions in our draft decisions paper. The determinations proposed amendments to the EDB IMs, Transpower IMs and Transpower Capex IM.[7]

1.8 On 25 September 2019, as part of the DPP3 setting process, we published updated draft DPP models incorporating the treatment of operating leases as if our draft decisions were implemented.

1.9 On 2 October 2019, we received cross-submissions on our draft decisions paper and submissions on our draft determinations published on 11 September 2019.

1.10 We have considered submissions and cross-submissions on our issues paper, draft decisions paper and draft determinations in reaching our final decisions.

Materials released alongside this paper

1.11 Alongside this paper, we have published three determinations that amend the EDB IMs, Transpower IMs and Transpower Capex IM. These are:

1.11.1 *Transpower Input Methodologies Amendments Determination (No. 2) 2019* [2019] NZCC 16;[8]

1.11.2 *Transpower Capital Expenditure Input Methodology Amendments Determination (No. 2) 2019* [2019] NZCC 17;[9] and

1.11.3 *Electricity Distribution Services Input Methodologies Amendments Determination 2019* [2019] NZCC 18.[10]

1.12 We have also published a paper titled 'Non-material amendment to input methodologies for Transpower New Zealand Limited'[11] dated 13 November 2019, which notes a non-material amendment we have made to the Transpower IMs in conjunction with the IM changes discussed in this paper. The amendment makes an error correction to the formula for calculating the IRIS 'baseline adjustment term' in clause 3.6.4(3) of the Transpower IMs.

Effective dates for the IM amendments

1.13 The IM amendments specified in the three determinations listed in paragraph 1.11 above will apply from the dates specified in those determinations.

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7 Copies of the three draft determinations are accessible via the Commission's website here: https://comcom.govt.nz/regulated-industries/input-methodologies/projects/operating-leases?target=documents&root=171545.

8 Accessible via the Commission's website here: https://comcom.govt.nz/regulated-industries/input-methodologies/projects/operating-leases.

9 Accessible via the Commission's website here: https://comcom.govt.nz/regulated-industries/input-methodologies/projects/operating-leases.

10 Accessible via the Commission's website here: https://comcom.govt.nz/regulated-industries/input-methodologies/projects/operating-leases.

11 Accessible via the Commission's IMs project page here: https://comcom.govt.nz/regulated-industries/input-methodologies/projects.

1.14 Regarding price paths, the IM amendments will apply for:

1.14.1 any IPP for Transpower, from 1 April 2020 onwards;

1.14.2 any DPP for EDBs, from 1 April 2020 onwards; and

1.14.3 any customised price path (CPP) application that is made after the commencement date described in the *Electricity Distribution Services Input Methodologies Amendments Determination 2019* [2019] NZCC 18. [12] The IM amendments do not apply to any CPPs currently in force.

Structure of paper

1.15 This paper sets out:

1.15.1 our decision-making framework for our final decisions (Chapter 2);

1.15.2 background on NZ IFRS 16 changes to operating leases and their impact on the operation of the IMs (Chapter 3);

1.15.3 summary of our final decisions (Chapter 4);

1.15.4 summary of submissions and cross-submissions on our draft decisions paper and draft determinations (Chapter 5).

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12 See clauses 2.2.1(b) and 2.2.3 of the *Electricity Distribution Services Input Methodologies Amendments Determination 2019* [2019] NZCC 18.

Chapter 2. Framework for our final decisions

Purpose of this chapter

2.1 This chapter describes the high-level framework we have applied in reaching our final decisions on how to address the issues raised by the introduction of NZ IFRS 16 in relation to our regulation of electricity lines businesses. To do this, the chapter explains:

2.1.1 our framework for decision-making on whether IM changes are required to retain the original policy intent under Part 4 of the Act; and

2.1.2 why we have decided to make these IM changes now, outside of our section 52Y IM review cycle.[13]

Our decision-making framework

2.2 Under section 52R of the Act, the purpose of the IMs is to promote certainty for suppliers and consumers in relation to the rules, requirements and processes applying to regulation under Part 4, including the price-quality paths for electricity lines services. Section 52T(2) obliges the Commission to ensure that the IMs, as far as is reasonably practicable, are expressed in sufficient detail so that each affected supplier is reasonably able to estimate the material effects of the methodology on the supplier.

2.3 As we discuss in more detail in Chapter 3, NZ IFRS 16, introduced by the New Zealand Accounting Standards Board, fundamentally changes the accounting treatment of operating leases for lessees by requiring the capitalisation of operating lease expenditure. GAAP fundamentally changes as a result. If the content of GAAP changes, then so does the meaning of our IMs, because regulatory definitions in our IMs, which help to determine allowable revenues and returns on investment, draw on and apply GAAP. This review considered the impact of these changes to GAAP, to check their impact on the way the IMs give effect to the original policy intent and implementation of the Part 4 purpose in section 52A of the Act.

2.4 In addition to the sections 52A and 52R purpose statements, and the requirements in section 52T, we have used a 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. Applying this framework, we ask whether the change would:[14]

2.4.1 promote the Part 4 purpose in section 52A of the Act more effectively than the current IM;

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[13] Section 52Y(1) of the Act provides that the Commission must review each input methodology no later than 7 years after its date of publication and, after that, at intervals of no more than 7 years.

[14] Commerce Commission "Input methodologies review decisions: Framework for the IM review" (20 December 2016), at 66-67.

2.4.2 promote the IM purpose in section 52R of the Act more effectively (without detrimentally affecting the promotion of the section 52A purpose); or

2.4.3 significantly reduce compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the section 52A purpose).

2.5 We have used this framework to inform our final decisions on changes to the IMs discussed in this paper.

2.6 We have decided to make the IM changes discussed in this paper now, outside of our section 52Y IM review cycle, because the change to GAAP was not an issue we considered as part of our 2015/16 IM review, and the change will affect the decisions we are currently making on setting price-quality paths for the next regulatory periods for EDBs and Transpower, which commence on 1 April 2020. Undertaking this review now, and implementing changes in accordance with our decision-making framework, promotes certainty through maintaining the workability and effectiveness of the IMs in a way that is consistent with their original policy intent and section 52A purpose.

Chapter 3. Background on NZ IFRS 16 changes to operating leases and their impact on the operation of the IMs

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 and returns on investment refer to GAAP, the new accounting treatment of operating leases affects the businesses we regulate—in ways that were not anticipated when we set the current IMs and ID requirements. This gives rise to the potential for unintended outcomes. The issues raised by NZ IFRS 16 for our regulation of electricity lines businesses is discussed further at paragraphs 3.20-3.21 below.

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 leaseholder'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.[15]

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.[16]

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

[16] We are aware that some EDBs have adopted the standard earlier.

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.[17] Under NZ IFRS 16, lessees will now be required in GAAP accounts to record most new and existing leases on the balance sheet as:[18, 19]

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.[20]

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.

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 The treatment of lease costs before and after the implementation of NZ IFRS 16 for financial reporting purposes and under our final decisions for regulatory purposes is shown in Appendix 2.

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17 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.

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

19 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.

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

3.10 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.[21]

3.11 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.

3.12 Finance leases and 'identifiable non-monetary assets' are intangible assets that are included in a supplier's regulatory asset base (RAB) for the purposes of ID and price-quality paths.[22] 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:[23]

3.12.1 this is consistent with the Part 4 purpose; and

3.12.2 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).

3.13 Right of use assets constitute 'identifiable non-monetary assets' and so would have entered the RAB under the definitions in the previous IMs (ie before the changes we have made to the IMs).

3.14 It is important to note that right of use assets in respect of operating leases 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.[24] 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.

3.15 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.[25]

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

22 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.

23 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.

24 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.

25 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.

3.16 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 cost 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. An example is a charge payable by an EDB to Transpower under a new investment contract.[26]

3.17 As explained in paragraph 4.5.1 below, our decision is to continue to treat these costs as pass-through costs and recoverable costs.

3.18 The most significant change occurs on transition to the new accounting standard, as a result of all existing operating leases being required to be capitalised as right of use assets at the date of initial application of the new standard. The varied timing of adoption by regulated businesses complicates the assessment of transition effects.

3.19 After transition, the effects are more straightforward and will likely have a lesser impact, as the IMs only apply to new leases entered into and the renewal of existing leases. The proportion of right of use assets to the total assets forecast to be commissioned in each year after the transition year is likely to be smaller, except where a regulated supplier has a large number of leases with a common renewal date.

Issues raised by NZ IFRS 16 for our regulation of electricity lines businesses

3.20 As discussed in our draft decisions paper, we identified that the accounting changes implemented through NZ IFRS 16 created potential workability and effectiveness issues with the IMs. These issues stem from the fact that the IMs draw on and apply GAAP, and GAAP fundamentally changed as a result of NZ IFRS 16.

3.21 Potential IM workability and effectiveness issues that we have considered in this review include:

3.21.1 The definitions in the IMs that help us to determine allowable revenues and returns on investment for our suppliers refer to GAAP and, if we accepted alignment with NZ IFRS 16, these would be calculated using capitalised 'right of use asset'[27] values.[28] Potential IM issues are:

3.21.1.1 The EDB IMs set out an approach to deferred tax (which adjusts the Regulated Asset Base (RAB) for the tax effect of cumulative temporary differences between tax on regulatory income and tax payable on taxable income) that, among other aspects, differed from the GAAP approach to deferred tax with respect to the value of the opening deferred tax balance. The effect of this difference would mean that the tax effect of the value of the regulatory

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

27 As per fn 3 above, 'right of use' assets are generally contracts for the temporary use of an asset, rather than ownership of the underlying asset itself.

28 For example, the definitions in the Transpower IMs and EDB IMs of "identifiable non-monetary asset", "physical asset life" and "value of commissioned assets", and for the EDM IM only, "opening deferred tax". Further discussion of these definitions can be found in paragraphs 3.12-3.13 and Chapter 4 of this paper.

depreciation in each year relating to new ‘right of use assets’ would be added to the supplier’s RAB, without being offset by an initial ‘opening deferred tax’[29] liability (on recognition of the asset) as would be calculated under GAAP.[30]

3.21.1.2 Both the Transpower IMs and the EDB IMs apply a definition of ‘physical asset life’[31] that, in general terms, provides the basis for annual depreciation. This definition has a provision for ‘non-network’ assets, whereby those assets have a life as determined under GAAP. However, for these new ‘right of use’ assets, which may be network assets, there was no equivalent provision in the IMs, and the remaining physical asset life IM provisions did not make sense for this type of asset.[32]

3.21.2 The change in treatment of operating lease payments from opex to capex gave rise to issues under IRIS, whereby, solely as the consequence of an external accounting standards change, regulated suppliers could receive net IRIS rewards that were not reflective of actual opex and capex efficiencies. These issues are not consistent with the original policy intent of the IRIS, which 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.[33]

3.21.3 The accounting change would mean that ‘right of use assets’ would constitute ‘identifiable non-monetary assets’ under the EDB and Transpower IMs, so would enter the supplier’s RAB for the purposes of ID and price-quality paths. If treated as regulatory assets for IRIS purposes this would allow operating leases to be forecast and structured in a way that could undermine the policy intent of the incentive scheme.[34]

3.21.4 The GAAP definition of operating leases would automatically allow the capitalisation of some pass-through and recoverable costs for the purpose of calculating allowable revenue. Previously these have been intentionally separated from allowable revenue to enable the extent of their recovery from consumers to be re-evaluated if necessary to preserve incentives to contain costs.[35]

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29 This is term defined in the EDB IMs at cl 1.1.4(2).

30 See paragraphs 6.17 to 6.22 of our draft decisions paper for further discussion.

31 This is term defined in the EDB IMs at cl 1.1.4(2) and the Transpower IMs at cl 1.1.4(2).

32 See paragraph 4.13 of our draft decisions paper.

33 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). Further discussion of the IRIS effects of the accounting change can be found at paragraphs 7.2 to 7.5 of our draft decisions paper.

34 See paragraphs 7.6 to 7.10 of our draft decisions paper for further discussion.

35 See paragraphs 3.14 to 3.16 of our draft decisions paper and paragraphs 4.5.1-4.5.3 of this paper for further discussion.

Chapter 4. Summary of our final decisions

Purpose of this chapter

4.1 This chapter sets out:

4.1.1 our final decisions in response to the change in accounting treatment of operating leases; and

4.1.2 our amendments to the EDB IMs, Transpower IMs and Transpower Capex IM to reflect these decisions.

Problem definition

4.2 The change to the accounting standard for operating leases does not merge seamlessly with the regulatory regime in the IMs. As a result, the following risks are associated with the change:

4.2.1 applying NZ IFRS 16, in accordance with the requirements of GAAP, may result in electricity lines businesses earning more or less than the normal rate of return that a supplier could ex ante expect to earn over the lifetime of its assets, and the calculation of efficiency incentive adjustments for operating leases changing, such that this may promote outcomes that are not consistent with the purpose of Part 4 of the Act;[36]and

4.2.2 in making decisions to address the change, 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.

4.3 Chapter 3 describes the impact of these risks, with more detailed analysis contained in our draft decisions paper. As Diagrams 1 and 1a of that paper illustrate, prior to our final IM decisions, there would have been various effects of applying the existing EDB IM rules to the new right of use assets, some of which would have provided a significant ongoing benefit. In order to assess the impact on consumers of the change to GAAP, we sought data from the EDBs in July 2019, which EDBs were in a good position to supply to us at that time, since they either had already implemented NZ IFRS 16 or were in the process of doing so. In weighing up these effects and making our decisions regarding IM changes, in the round, we believe we have come to a position for DPP3 where suppliers are overall slightly better off than if we had decided not to generally align with the NZ IFRS 16 treatment. Appendix 1 of this paper illustrates the impacts of our final decisions based on the data provided by EDBs.[37]

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[36] Section 52A(a) and (d) of the Act. See also paragraph 2.4 of this paper.

[37] The impact of the benefit given to the EDBs by allowing a capex wash-up for the 45-year standard life is taken into account by the removal of the change in average asset life adjustment (which was included in the version of this table that was presented in Attachment A of our draft decisions paper).

4.4 All electricity lines businesses will continue to receive the benefit from the return on WACC on the new right of use assets over the incremental cost of debt used to establish their value, which will be greater for right of use assets with longer lives. We intend to monitor the durations of new leases through ID to identify whether excessive benefits are accruing as a result of lease terms being extended.

Summary of our decisions

4.5 Our final decisions regarding the treatment of operating leases for regulatory purposes are:

4.5.1 To generally accept alignment with NZ IFRS 16 for price-quality and ID regulation purposes except in relation to costs that are pass-through costs and recoverable costs. This means that allowable revenue and returns on investment under ID will be calculated using capitalised 'right of use' asset values.[38] Specifically, we have decided to:

4.5.1.1 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;

4.5.1.2 allow a GAAP-based life to be assigned to network 'right of use' assets under ID; but

4.5.1.3 an exception will apply in respect of right of use assets capitalised under NZ IFRS 16 from costs specified as pass-through costs or recoverable costs. We have decided that these costs will continue to be treated as pass-through costs or recoverable costs for price-quality and ID regulation purposes.

4.5.2 We have decided to modify our draft decision, which was no change in respect of the 45-year standard life assumption that applies to additional right of use assets under the EDB IM. Our final decision is to retain the 45 year standard life assumption but allow a capex wash-up of any differences between the 45-year standard life and the GAAP lives for right of use assets to deal with any non-recovery of depreciation as a result of applying the standard 45-year life assumption.

4.5.3 We have decided to amend the IMs so that operating leases continue to be treated as opex for IRIS purposes.[39]

4.5.3.1 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.

[38] Subject to annual indexed revaluations for EDBs under the EDB IMs.
[39] Refer to Appendix 2 for an illustration of the effects of these changes.

4.5.3.2 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.

4.5.3.3 We are concerned that some early adopter EDBs (ie those EDBs who have adopted NZ IFRS 16 in the base year or earlier of the current DPP regulatory period) may gain a residual 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.

4.5.3.4 In applying the IM change we will adjust opex forecasts to reverse future negative IRIS effects in the next price path for early adopters. These negative effects would otherwise arise if the nil operating lease expenditure disclosed in the base year was used as the basis of forecasts and compared with future actual expenditure that treated operating lease payments as opex.

Reasons for our decisions

Generally accept alignment with NZ IFRS 16 for price-quality and ID regulation purposes

4.6 Our view is that there are two reasons for why we should generally accept alignment between our regulatory rules (IMs) and GAAP for price-quality and ID regulation purposes, subject to some specific exceptions:[40]

4.6.1 As a general principle, we assess consistency with the Part 4 purpose when applying GAAP in setting values under the price paths or IMs and, when it is consistent, use it 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 also consistent with setting fit for purpose price-quality paths and ID requirements that promote the Part 4 purpose in a way that reduces compliance costs and complexity. In this particular instance:

4.6.1.1 Allowing 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 removes the overcompensation arising from applying a nil opening balance with no reversal of temporary depreciation differences, as discussed in Chapter 6 of the draft decisions paper. This promotes the Part 4 purpose in a way that reduces compliance costs and

[40] To the extent that the asset is used in the provision of the regulated service.

complexity, as it avoids the need to retain a separate regulatory notional tax asset record.

4.6.1.2 Both the Transpower IMs and the EDB IMs in respect of ID 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.

4.6.1.3 In respect of making an exception for right of use assets capitalised under NZ IFRS 16 from costs specified as pass-through or recoverable costs, our view is that retaining the existing IM treatment in respect of pass-through or recoverable costs is appropriate. This is because there has been no change in the rationale for allowing these costs to be passed through directly 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.

4.6.1.4 The exclusion of pass-through costs and recoverable costs from the cost of right of use assets also preserves our ability to reconsider the list of pass-through costs and recoverable costs in the future and whether they are appropriate to continue to be fully passed through to consumers. This would not be the case if these costs were able to be capitalised either wholly, or as part of, right of use assets, because they would automatically enter the RAB.

4.6.1.5 We think that excluding pass-through costs and recoverable costs from the cost of right of use assets is consistent with the purpose of Part 4 of the Act and will not detract from promoting that purpose in a way that reduces compliance costs and complexity.[41]

4.6.1.6 To deal with any non-recovery of depreciation as a result of applying the standard 45-year life assumption for additional assets under the EDB IMs, we have decided to allow a wash-up of any differences between the '45 year life standard assumption' and the GAAP lives for right of use assets. This will ensure EDBs are able to fully recover the capitalised value of these investments.

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[41] Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons paper, December 2010, paragraphs 8.3.25 to 8.3.27 and Appendix J, Section J2. 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, for example goodwill. The additional exclusion of capitalised pass-through and recoverable costs is not likely to give rise to significant additional compliance costs as the annual costs must already be disclosed separately in detail under ID.

4.6.2 Subject to the specific exceptions discussed, we consider the rationale for allowing suppliers to include finance leases in their RAB, as provided for under the existing IMs, is equally applicable to the capitalisation of operating leases, as now provided for by GAAP. Our rationale for including finance leases in the RAB is that it is efficient for electricity lines businesses 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 even greater efficiency implications for operating leases in the decision of whether to enter right of use leases or to purchase assets.

4.6.3 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.

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

4.7 Treating operating leases as opex for IRIS purposes avoids the possibility that electricity lines businesses subject to price-quality regulation could:

4.7.1 be rewarded/penalised for capex outcomes that might change if the GAAP asset values subsequently changed; and

4.7.2 set forecasts specifically to obtain IRIS rewards.[42]

4.8 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.

Scope of IM changes needed to implement final decisions

4.9 Our final decision is to amend the IMs to:

4.9.1 amend the taxation IM to assign a GAAP-based opening deferred tax balance;

4.9.2 ensure the EDB IMs and Transpower IMs allow for a GAAP-based life to be assigned to network 'right of use' assets under ID;

4.9.3 retain the existing EDB IMs and Transpower IMs treatment of pass-through costs and recoverable costs so that these costs are not capitalised as right of use assets for regulatory purposes;

[42] See 7.8 to 7.10 of draft decisions paper.

4.9.4 ensure the ‘opex incentive amount’ for the purposes of the IRIS calculation in the EDB IMs and the Transpower IMs allows us to include the impact from operating lease payments as defined under GAAP;

4.9.5 ensure that, for the purposes of calculating the IRIS 'capex incentive amount' in the EDB IMs:

4.9.5.1 the calculation of the ‘retention adjustment’ component of the IRIS capex incentive amount excludes the impact from 'right of use assets'; and

4.9.5.2 the calculation of the ‘capex wash-up’ component of the IRIS capex incentive amount will include right of use assets; and

4.9.6 ensure the calculation of the base capex expenditure adjustment in the Transpower Capex IM excludes the impact from 'right of use assets'.

4.10 The Transpower IMs and the EDB IMs 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 IMs and the EDB IMs require, amongst other things, a calculation of:[43]

4.10.1 the ‘forecast opex’, which looks at the amount of forecast ‘opex’[44] the Commission has specified for the relevant disclosure year; and

4.10.2 the ‘actual opex’, which is the amount of ‘operating costs’[45] 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 final decision is to amend the EDB IMs and the Transpower IMs to ensure the ‘opex incentive amount’ for the purposes of the IRIS opex calculation allows us to include the impact from operating lease payments.

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[43] 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.

[44] 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.

[45] 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.

4.12 In addition to the opex IRIS calculation, the EDB IMs 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 calculation is made up of two components – the 'capex wash up' and the 'retention adjustment'. Taken together, this is commonly referred to as the capex IRIS calculation. As they are currently specified, both components of this calculation take into account the value of certain assets, including the value of 'identifiable non-monetary assets'. Importantly for our purposes, this GAAP term encompasses right of use assets (see Chapter 3 of this decisions paper for a discussion of right of use assets).

4.13 To marry our decisions to (a) treat operating lease payments as opex (ie they are not included in the IRIS capex calculation) and (b) to allow a capex wash-up of any differences between the '45 year life standard assumption' for additional assets provided under the EDB IMs and the GAAP lives for right of use assets, our final decision is to amend the EDB IMs to ensure the calculation of the 'retention adjustment' component of the capex IRIS calculation excludes the impact from 'right of use assets'.

4.14 This means that right of use asset values will flow through to the 'capex wash up' component of the calculation, but not the 'retention adjustment' component. They will therefore not be included in the part of the calculation that applies the IRIS incentive rewards and penalties to under/over expenditure of capex, but will allow EDBs to wash up any differences between the 45-year life standard assumption and the GAAP lives of their right of use assets.

4.15 This change has no impact on the Transpower IMs, as the Transpower IMs do not have the same 45-year life standard assumption, and therefore this depreciation recovery issue does not arise.

4.16 In respect of the Transpower Capex IM, our final decision is to make an adjustment to exclude the effect of 'right of use' assets from the calculation of the base capex expenditure adjustment.

4.17 In the IMs relating to ID, both the Transpower IMs and the EDB IMs 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 final decision is to amend the EDB IMs and the Transpower IMs definition of physical asset life to ensure network right of use assets are assigned their GAAP life under ID.

Summary of changes from draft to final decisions

4.18 After consideration of submissions and cross-submissions we have decided to make one change from our draft decisions to our final decisions.

4.19 Table 1 below summarises each draft decision (as provided in our draft decisions paper), notes the nature of any changes from our draft decision to our final decision, and provides references to the relevant paragraph(s) within this paper that discuss the final decision in more detail.

Table 1: Changes from Draft to Final Decisions

Draft Decision	Nature of change	Final Decision Ref.
Generally accept alignment with NZ IFRS 16 for price-quality and ID regulation purposes, subject to certain specified exceptions; this means that, save for the specified exceptions, allowable revenue and returns on investment under ID will be calculated using capitalised 'right of use' asset values.	No change	Para 4.5.1
Amend the taxation IM to assign a GAAP-based opening 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.	No change	Para 4.5.1 (first bullet-point)
Ensure the EDB IM and Transpower IM allow for a GAAP-based life to be assigned to network 'right of use' assets	No change	Para 4.5.1 (second bullet-point)
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,	No change	Para 4.5.1 (third bullet-point)
Retain the simplifying 45-year asset life assumption consistent with the low-cost intent of a DPP. Not make an adjustment to asset lives for right of use assets or wash up any differences.	Change. We have decided to modify our draft decision. Our final decision is to retain the 45-year standard life assumption but allow a capex wash-up of any differences between the 45 year standard life and the GAAP lives of right of use assets to deal with any non-recovery of depreciation as a result of applying the standard 45-year life assumption.	Para 4.5.2
Amend the IMs so that operating leases continue to be treated as opex for IRIS purposes: a) 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; and b) 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.	No change	Para 4.5.3
Make appropriate adjustment to opex forecasts to reverse future negative IRIS effects in the next price path for early adopters.	No change	Para 4.5.3 (fourth bullet-point)

Chapter 5. Summary of submissions on our draft decisions and draft determinations

Purpose of this chapter

5.1 This chapter summarises submissions we received on our draft decisions paper, and our response to those submissions. We have grouped the submissions we received in line with:

5.1.1 our final decision to generally accept alignment with NZ IFRS 16 for price-quality regulation and ID purposes, subject to some specified exceptions;

5.1.2 our final decision to amend the EDB IMs, Transpower IMs and Transpower Capex IM so that operating leases continue to be treated as opex for IRIS purposes; and

5.1.3 submissions on our draft determinations to implement these decisions.

Submissions on Commission's draft decisions on potential IM changes identified in our draft decisions paper

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

5.2 Our draft decision was to generally accept alignment with the 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 We received four submissions on our draft decisions paper - from ENA, Vector, Powerco and Transpower. All four submitters supported adopting the GAAP approach to operating lease payments for price-quality and ID purposes, although ENA stated that there should be a high threshold for changing IMs prior to the next scheduled IM review and it was not clear to them that "the analysis provided fully justifies the changes at this time, given the low value of operating leases quantified in the Draft decisions paper".[46]

5.4 In response to this, we consider that in the absence of the IM changes we have made, issues might have arisen with the workability and effectiveness of the IMs in meeting the original policy intent of giving effect to the section 52A purpose. Based on estimated commissioning values, some EDBs would enjoy a substantial windfall gain simply as the result of a change in accounting rules.[47] This outcome is 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.

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46 ENA "Submission on treatment of operating leases – draft decisionpaper" (18 September 2019) at 5.

47 The effect of the reduction in operating lease expenditure being treated as a permanent gain under the IRIS IMs, as would occur absent IM changes, is shown in Diagrams 1 and 1a in our draft decisions paper.

5.5 Now is an appropriate time to make these changes because of the coincidence of the introduction of NZ IFRS 16, taking effect for annual reporting periods beginning on or after 1 January 2019 if not adopted earlier, and decisions we are currently making on price-quality paths for the next regulatory periods.

5.6 ENA also considered that the draft decisions paper "addresses materiality of the proposals throughout the paper, but there is no clear definition of materiality" and that "the proposed changes address some impacts but ignore other impacts which are at least as material (eg; deferred tax balance and DPP depreciation)".[48] ENA also noted its disappointment that the analysis included in the draft decisions paper did not provide more explicit illustration of the impact of the proposals on the EDB DPP revenue paths to take effect from 1 April 2020.

5.7 We have decided to make the IM changes discussed in this paper now, outside of our section 52Y IM review cycle, for the reasons discussed in Chapter 2 above.

5.8 ENA's submission suggests we have ignored 'other impacts' that are material.[49] In terms of the two impacts the ENA provides as examples (deferred tax balance and DPP depreciation), we note we have decided to adopt the opening GAAP deferred tax balance as described at paragraph 4.5.1 above. The reference to 'DPP depreciation' could mean either or both of the effects of no depreciation in the year of commissioning and the depreciation under-recovery as a result of applying the standard 45-year life to additional assets, as shown in Diagram 1 of our draft decisions paper, to which ENA's submission refers. The IM rule that gives rise to the first effect applies to all newly commissioned regulatory assets, and we have decided not to make any change for the reason that this rule was implemented consistent with the low-cost intent of a DPP. In any case, it is only a transitional effect, as our draft decision paper noted, and is captured in our assessment of the overall impacts for DPP3.[50]

5.9 In respect of the depreciation effect of the 45-year standard life, we have decided to address the impact as discussed in paragraphs 5.13 to 5.21 below.

5.10 In cross-submissions, Vector requested worked examples of how our draft decision relating to the IRIS model applies for the IRIS calculations.[51] Powerco requested that the Commission publish worked examples to reflect its specific circumstances rolling off the CCP onto DPP3.[52]

48 ENA "Submission on treatment of operating leases – draft decision paper" (18 September 2019) at 4.

49 ENA "Submission on treatment of operating leases – draft decision paper" (18 September 2019) at 5

50 At paragraphs 6.46 and 6.52 to 6.53.

51 Vector"Cross-submission on Treatment of operating leases – draft decision paper" and Vector "Cross-submission and technical submission to the Operating leases determination"((2 October 2019) at 1.

52 Powerco "Cross-submission on Treatment of operating leases – draft decision paper" (2 October 2019).

5.11 To assist businesses to evaluate the revenue impact of the changes, using their own data, we published updated draft models and a companion paper on 25 September 2019. Businesses wishing to assess the expected impact of the change in treatment of operating leases on their DPP3 opex and capex forecasts as used in the financial and IRIS models should insert the section 53ZD data they have provided to the Commission into the input sheet of the operating lease model.[53]

5.12 Regarding Powerco's current price path, as discussed at paragraph 1.13.3 above, the IM changes do not apply to any CPPs currently in force (ie Powerco's CPP). When Powerco rolls off its current CPP and onto a DPP in April 2023, the IM changes will apply for that DPP. In respect of base year numbers used to construct forecasts for 2024 onward, we would make adjustments to take into account the effects of the NZ IFRS 16 change, so that the forecast and actual opex expenditure for operating leases are on a like-for-like basis.

Standard 45-year life for additional assets

5.13 Concerns were expressed in submissions by ENA and Vector with respect to the 45-year life standard assumption applied to additional assets in the IMs.

5.14 ENA observed that more than 30% of the value of the example asset would not be recovered by depreciation and proposed an additional wash-up mechanism. Vector supported the introduction of an additional wash-up mechanism.

5.15 Vector requested that the Commission introduce an EDB-specific right of use asset category in the financial model for DPP3 to address under-recovery for early adopters of IFRS 16 - such as Vector - who may not be captured in an additional wash-up mechanism.

5.16 These concerns were also raised in cross-submissions by Vector and Powerco.

5.17 To provide for an additional asset category as suggested by Vector would require setting a forecast aggregate weighted life for additional right of use assets. According to the ENA, the lives of these assets range between 2 and 99 years, with a typical life of 10 years.[54] The 45-year life standard assumption in the EDB IM is itself a simplifying approximation of the aggregate weighted life of the much larger portfolio RAB assets (excluding right of use assets) with lives ranging between 15 and 70 years. We consider that providing for an additional weighted life for right of use assets would involve an unnecessary level of additional analysis and modelling contrary to the simplifying intent of the 45 year assumption for DPP purposes.

5.18 We agree however with ENA and Vector's suggestion that a wash-up mechanism can be implemented to deal with the depreciation under-recovery.

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[53] At https://comcom.govt.nz/regulated-industries/electricity-lines/electricity-lines-price-quality-paths/electricity-lines-default-price-quality-path/2020-2025-default-price-quality-path?target=documents&root=165544

[54] ENA "Submission on the treatment of operating leases issues paper" (10 July 2019) at 9.

5.19 Our decision is that the existing 'capex wash-up' component of the IRIS capex incentive amounts calculation will therefore include right of use assets, as originally suggested by ENA in its submission on our issues paper. This is consistent with the treatment that applies to other regulatory assets to wash up the difference between their physical asset lives and the 45 year standard life assumption. [55]

5.20 The wash-up mechanism applies to all EDBs for DPP2 and future regulatory periods and so addresses Vector's concern that a particular mechanism implemented to deal with the issue might not include early adopters of NZ IFRS 16 - such as Vector.[56]

5.21 This depreciation recovery issue does not affect Transpower, as the Transpower IMs do not include the 45-year simplifying assumption.

5.22 For existing assets, 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 final decision is to amend the EDB IM and the Transpower IM to ensure network right of use assets are assigned their GAAP life. There were no submissions received on this matter.

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

5.23 ENA and Powerco agree with our draft decision to assign a GAAP-based opening deferred tax balance for right of use assets. ENA notes that this is more consistent with GAAP than the alternative adoption of a notional tax asset.

5.24 Our final decision is to amend the EDB IM 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.

5.25 This treatment removes the potential overcompensation of tax costs and promotes the Part 4 purpose in a way that reduces compliance costs and complexity, as it avoids the need to retain a separate regulatory notional tax asset record.

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

5.26 Our draft decision 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.

5.27 We also expressed our intention to 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.

5.28 Powerco, Vector, ENA and Transpower supported treating operating leases as opex for IRIS purposes, subject to making appropriate adjustments to base year opex for early adopters.

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55 ENA "Submission on the treatment of operating leases issues paper" (10 July 2019) at 24.

56 The issue does not affect the transitional assets for early adopters as their actual asset values are rolled forward from ID in the base year (2019). It would, however, potentially affect future commissioned right of use assets in the absence of a wash-up mechanism.

5.29 Vector and ENA requested more explicit illustration of the impact of the proposals on the EDB DPP revenue paths to be set at 1 April 2020.

5.30 Powerco expressed its desire to work with the Commission to clarify Powerco's effective date and our modelling approach and assumptions as there could be material costs depending on the interpretation. As discussed in paragraphs 1.13.3 and 5.12 above, the IM changes we have made will not apply to Powerco's current CPP. When Powerco rolls off its current CPP and onto a DPP in April 2021, the IM changes will apply for that DPP.

5.31 While supporting the draft decision, Powerco noted the cumulative impact of incremental changes, particularly those that require a different treatment between ID and IRIS. ENA too, noted that the draft decision 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, ENA anticipates, more complex disclosures.

5.32 Our final decision confirms our draft decision to continue to treat operating leases as operating expenditure for IRIS purposes. This avoids the possibility that electricity lines businesses subject to price quality regulation could:

5.32.1 be rewarded/penalised for capex outcomes that might change if the GAAP asset values subsequently changed; and/or

5.32.2 set forecasts specifically to obtain IRIS rewards.

5.33 Such outcomes would not be 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, under section 52A.

5.34 Appropriate adjustments will be made to base year expenditure for DPP early adopters to ensure that the opex forecasts used for IRIS purposes for the next regulatory period are consistent with the recognition of actual expenditure. We would apply similar adjustments for Powerco in respect of its IRIS forecasts in transitioning from a CPP to a DPP to ensure that it is not unfairly penalised as a result of the timing of its transition to NZ IFRS 16.

Submissions on Commission's draft determinations to implement draft decisions

The amount recognised as opex for IRIS purposes

5.35 Transpower submitted that the opex amount to be used in the IRIS calculations should be the operating 'lease payments' as defined under GAAP, rather than 'lease expense' as proposed in our draft determinations.[57] This was supported by Powerco and Vector.

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[57] Transpower, *Operating leases draft decision and IMs determinations*, (18 September 2019), at 4.1

5.36 This treatment would exclude other costs capitalised as part of the right of use asset under NZ IFRS 16, which would therefore not be brought to account for IRIS purposes.[58] However, as these costs are unlikely to be significant, based on operating lease data we have received from EDBs and Transpower[59], we have decided to incorporate Transpower's proposed change and specify the IRIS calculations in terms of operating lease payments as defined under GAAP.

Excluding capitalisation of pass-through and recoverable costs

5.37 Vector also supported Transpower's submission that the proposed drafting to exclude pass-through and recoverable costs from capitalisation would exclude an entire right of use asset - even where only a small component was funded through pass-through costs or recoverable costs - and that the drafting should be amended to exclude only the component funded through the pass-through costs or recoverable costs. We agree with this drafting change and have incorporated the change into our IM amendments.

Simplification of definition of opex for IRIS purposes

5.38 It was also suggested by Transpower that proposed draft clause 3.6.3(8) of the Transpower IMs[60] could be simplified by using its proposed amended definition of "operating expenditure". Transpower also suggested the same change be made to clause 3.6.5(2) of the Transpower IMs. We disagree with this drafting change. The current definition of 'actual opex' has been expressed in terms of operating costs to ensure this correctly flows through to the cost allocation IMs in clause 2.1.1 of the EDB IMs and Transpower IMs, respectively.

5.39 We also disagree with Transpower's submission that the definition of 'actual opex', as drafted, incorrectly includes system operator costs. This is because the definition requires that the sum be any operating costs "allocated to electricity transmission services for the relevant disclosure year calculated in accordance with Part 2".[61] This means that clause 2.1.1(1) in Part 2 of the Transpower IM must be applied. The application of this clause excludes any costs that are system operator costs. We have, however, revised the drafting of the definition to ensure that "lease payments" allocated to system operator costs are also excluded.

Other drafting suggestions

5.40 We also received other suggested technical drafting changes on the draft determination made by Transpower. We agree with these suggested changes and have incorporated them into our IM amendments. These are:

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[58] Paragraph 23 of NZ IFRS 16 includes as costs lease payments made before the commencement date less any lease incentives received, initial direct costs incurred by the lessee and an estimate of costs to dismantle and remove the underlying asset.

[59] This information was provided in response to the section 53ZD notices discussed at paragraph 1.5 above.

[60] See paragraph 4.5 of the '[DRAFT] *Transpower Input Methodologies Amendments Determination (No. 2) 2019 [2019] NZCC XX'* (published 11 September 2019), accessible here: https://comcom.govt.nz/__data/assets/pdf_file/0023/173732/Draft-Transpower-input-methodologies-amendments-determination-No.-2-2019-11-September-2019.pdf .

[61] See paragraph 4.5 of the *Transpower Input Methodologies Amendments Determination (No. 2) 2019* [2019] NZCC 16.

5.40.1 The definition of "identifiable non-monetary asset" in clause 1.1.4(2) of the Transpower IM and clause 1.1.4(2) of the EDB IM should expressly include a reference to a 'right of use asset' to avoid any doubt.

5.40.2 The reference to 'network' before 'right of use asset' in the amendment to clause 2.2.6(1)(h) of the Transpower IMs and clause 2.2.8(1)(f) of the EDM IMs should be deleted to avoid any implication that the underlying asset must be part of a network.

5.40.3 Clause 3.6.5(2) of the Transpower IMs should expressly state that it is operating costs allocated to electricity transmission services after the application of clause 2.1.1(1).

Appendix 1: Updated table of impacts for EDBs (stated as % of revenue)

						Before amendment to deferred tax IM		After amendment to deferred tax IM		DPP2 IRIS impacts	
EDB	Assets commissioned 2018 ($000)	Assets commissioned 2019 ($000)	1st year of capitalised leases	Est. commissioning value in 1st year of capitalised leases ($000)	Line charge revenue 2018 ($000)	Inequivalence factor	Estimated impact	Inequivalence factor	Estimated impact	Capex IRIS estimated impact (=wash up - penalty)	Opex IRIS estimated impact
Alpine Energy	30,906	17,962	–	–	60,481	N/A	–	N/A	–	–	–
Aurora Energy	50,335	63,004	2020	3,576	96,272	55.00%	2.04%	15.00%	0.56%	(0.11%)	0.15%
Centralines	1,846	5,064	–	–	14,232	N/A	–	N/A	–	–	–
EA Networks	14,921	16,376	2020	8,748	48,524	55.00%	9.91%	15.00%	2.70%	(0.54%)	0.72%
Eastland Network	7,061	11,756	2020	17	36,850	55.00%	0.03%	15.00%	0.01%	(0.00%)	0.00%
Electricity Invercargil	5,907	4,533	–	–	20,384	N/A	–	N/A	–	–	–
Horizon Energy	10,144	12,884	2020	270	33,964	55.00%	0.44%	15.00%	0.12%	(0.02%)	0.03%
Nelson Electricity	934	1,659	2020	64	10,138	55.00%	0.35%	15.00%	0.10%	(0.02%)	0.03%
Network Tasman	6,386	6,557	2020	10	45,046	55.00%	0.01%	15.00%	0.00%	(0.00%)	0.00%
Orion NZ	77,003	63,637	–	–	251,787	N/A	–	N/A	–	–	–
OtagoNet	12,346	12,937	–	–	37,062	N/A	–	N/A	–	–	–
Powerco	123,688	185,313	2018	8,155	390,821	57.00%	1.19%	12.00%	0.25%	Not calculated	Not calculated
The Lines Company	12,035	23,463	2020	35	42,323	55.00%	0.05%	15.00%	0.01%	(0.00%)	0.00%
Top Energy	19,745	15,378	2020	1,614	51,150	55.00%	1.74%	15.00%	0.47%	(0.09%)	0.13%
Unison Networks	27,802	53,881	2020	3,432	152,768	55.00%	1.24%	15.00%	0.34%	(0.07%)	0.09%
Vector Lines	156,889	203,460	2019	12,485	631,706	57.00%	1.13%	12.00%	0.24%	0.63%	0.18%
Wellington Electricity	31,469	37,191	2020	3,168	174,966	55.00%	1.00%	15.00%	0.27%	Not calculated	Not calculated

Note 1: This is an update of the table included as Attachment A in our draft decisions paper. The inequivalence factor and estimated impacts are explained at paragraphs 6.33 to 6.49 and Attachment B of our draft decisions paper. The update uses assets commissioned in 2019 to derive the proportion of capitalised right of use assets to total assets commissioned. It also reflects corrections of data based on discussions with EDBs following their responses to our section 53ZD requests for information regarding their operating leases. For example, the estimated commissioning value of capitalised leases has been revised for some businesses and Alpine Energy and Eastland Network were previously incorrectly shown as early adopters of NZ IFRS 16.

Note 2: The right of use asset to revenue ratios used to translate the equivalence effects from Diagrams 1 and 1a of our draft decisions paper to the impact on allowable revenue here 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 3: The estimated impact of the difference between the standard 45-year asset life and the 45-year life modified by the weighted average life of the capitalised leases for EDBs adopting in 2020 shown at Attachment A of our draft decisions paper is not included here. This is consistent with our final decision to wash up the difference.

Note 4: 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.

Appendix 2: Illustration of Treatment of Operating Lease Costs

TREATMENT OF OPERATING LEASES

Nature of costs	Treatment Prior to NZ IFRS 16	Treatment Under NZ IFRS 16		Annual lease expense under NZ IFRS 16	Annual lease expense under IPP/DPP/ID	Annual lease expense under IRIS
1. Initial direct costs incurred by lessee*	**Capex**	**Right of use asset (Capex) = NPV of remaining lease payments plus other lease costs**	**Lease Liability = NPV of remaining lease payments**	**Depreciation on right of use asset**	**Depreciation on right of use asset**	**Lease payments**
2. Estimate of lessee costs to dismantle and remove underlying asset.				**+ Annual interest expense on lease liability**		
3. Lease payments made before the lease commencement date less any lease incentives received						
4. Lease payments	**Opex**	If no other lease costs then right of use asset will equal lease liability		**Reported Cashflows** **Lease payments** = reduction in lease liability + annual interest expense on lease liability		

* Examples are commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease.