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Matthew Clark
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Commerce Commission
By email: regulation.branch@comcom.govt.nz

Dear Matthew

Treatment of operating leases - Draft Decisions Paper

1. This is Vector's submission to the Commerce Commission's (Commission) draft decision on the treatment of operating leases.

2. This submission makes the following key points -

   - **Additional models are needed**: We request the Commission publish worked examples of how its draft decision relating to the IRIS model applies for the operating expenditure (opex) and capital expenditure (capex) IRIS calculations, including a model/scenario for Electricity Distribution Businesses (EDB) who adopted IFRS 16 in Regulatory Year (RY) 2019. The Commission should use the data provided by EDBs in response to its request for information on operating leases under s53ZD of the Commerce Act 1986 (the s53ZD Notice) (the Act) to produce these models.

   - **The Commission should introduce an EDB specific Right of Use (RoU) asset category in its financial models for the default price-quality path beginning 1 April 2020 (DPP3)**: The draft decision will cause EDBs to under-recover depreciation for RoU assets. Introducing a RoU asset category to address this under-recovery would better promote the purpose of Part 4 of the Act by ensuring the impact of the IM amendment is NPV neutral.

3. We have expanded on these points and provided further comments on the draft decision below.

The Commission should publish models illustrating how the draft decision applies

4. We are currently unclear how to interpret aspects of the Commission's draft decision to amend the Input Methodologies (IM) to continue to treat operating leases as opex for IRIS purposes and the impact these decisions will have on EDBs.

5. We appreciate the analysis contained in the attachments to the draft decisions. However, we consider worked examples of how the IRIS model applies to DPP2 are also needed. We note our results when we replicated the approach in the attachments appeared to contradict certain impacts described in the Commission's draft decision.

6. We request the Commission publish financial models using data provided by EDBs in response to its s53ZD Notice that demonstrate how its IRIS model works for DPP2 for the opex IRIS calculation and for the capex IRIS calculation. This will require separate models/scenarios for -
   - EDBs who adopted IFRS 16 in RY19; and
   - EDBs who adopted in RY20.

7. In the absence of these models, it is difficult to comment substantively on the Commission's draft decision to treat operating leases as opex for IRIS purposes as we are not certain of the impact. Accordingly, we request they are published in time for EDBs to review prior to the deadline for cross-submissions.

RoU asset life

8. The Commission's draft decision notes the following in respect of depreciation for RoU assets -

   - The EDB asset valuation IM treats newly commissioned RoU assets as 'additional assets' with a standard remaining life of 45-years;

   - There will likely be a large discrepancy between the accounting life of an operating lease RoU asset under GAAP and the 45-year RAB life; and

   - Under the draft decision, the difference in asset lives would not be washed up at the end of the regulatory period through the IRIS mechanism because the Commission proposes to amend the EDB IM to exclude the impact of RoU assets from the capex incentive amount under the IRIS calculation.

9. The Commission states it does not expect removing the wash up provision will have a significant impact on revenue and that, having considered the effects, retaining the 45-year asset life assumption is consistent with a low cost DPP.

10. We disagree with the Commission's conclusions. The proposed approach will cause EDBs to under-recover depreciation for RoU assets and our analysis indicates the impact on revenue would be material.

11. We also note the timing of cost recovery is critical for EDBs such as Vector which has a significant capital programme required to support Auckland growth. An outcome involving under-recovery in DPP3 with the expectation of partial recovery in future regulatory periods is not in the long-term interests of consumers as it could compromise Vector's ability to deliver this much needed investment.

12. As discussed in our submissions to the Commission's DPP3 draft decision, the current IMs and draft DPP3 do not provide enough upfront funding to deliver the outcomes our stakeholders expect. We have significant concerns with any decision that could exacerbate this issue.

The Commission should introduce a RoU asset category in the financial model to address this issue

13. The Commission's current decision will cause EDBs to under-recover depreciation in DPP3 solely due to an accounting rule change. This is not consistent with the Part 4 purpose nor s52R of the Act. EDBs will not be incentivised to invest to deliver outcomes for the long-term benefit of consumers if the Commission pursues IM amendments that prevent cost recovery in a regulatory period contrary to the expectation created by the rules in force at time the investments were made. Furthermore, given the draft decision treats RoU assets differently from other RAB assets, EDBs will have reduced certainty and confidence in the rules and requirements that apply.

14. Accordingly, we support the Electricity Networks Association's (ENA) submission to introduce an additional wash-up mechanism to address this.

15. We also request the Commission introduce an EDB specific RoU asset category in the financial model for DPP3. This is needed to address under-recovery for early adopters of IFRS 16 - such as Vector - who may not be captured in an additional wash-up mechanism.

16. We consider introducing an EDB specific RoU asset category in the Commission's financial model will -

- **Better promote the purpose of Part 4**: By ensuring the impact of the IM amendments is NPV neutral EDBs will be incentivised to invest to deliver outcomes that promote the long-term benefit of consumers;

- **Better promote 52R**: Cost recovery of RoU assets will remain consistent with cost recovery of other RAB assets so stakeholders will have more certainty about how the rules relating to depreciation apply; and

- **Is consistent with the intent of a low cost DPP**: Introducing an EDB specific RoU asset category should only require a minor change to the existing financial model. EDBs have already provided the necessary information to the Commission through their responses to the Commission's s53ZD Notice.

Alignment with GAAP

17. We support the Commission's decision to generally accept alignment with GAAP for price-quality and Information Disclosure (ID) regulation purposes. This will best promote the purpose of Part 4 by minimising compliance costs and avoid introducing further complexity in the regime.

IM amendment to continue to treat operating leases as opex for IRIS purposes

18. We support the Commission's decision to make appropriate adjustments so base year opex for early adopters includes operating leases to ensure that forecast opex for the next regulatory period is consistent with opex forecasts used for IRIS purposes.

19. As recognised in the draft decision, this will best promote the purpose of Part 4 by maintaining symmetry between IRIS incentives and the DPP3 opex allowance.

Yours sincerely
For and on behalf of Vector

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