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Treatment of operating leases

Issues paper

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Contents

Executive Summary

Purpose of this paper

X1 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.

X2 This paper discusses and seeks stakeholder views on our understanding of the issues that this new financial reporting standard could create for our regulated suppliers. It also discusses our preliminary view about how best to address those issues, to ensure outcomes remain consistent with the purpose of Part 4 of the Commerce Act 1986 (the Act).

The generally accepted accounting practice for operating leases has changed

X3 The new financial reporting standard fundamentally changes the accounting treatment of operating leases for lessees, by requiring the capitalisation of operating lease expenditure. These were previously recognised as an operating expense (opex). However, they will now be captured on businesses' balance sheets as a 'right of use' asset, with a value based on the present value of the remaining lease payments, as at the date of capitalisation.

Regulated sectors are potentially affected

X4 Our response to the new financial standard will be of interest to all the businesses we regulate that are, or may become, subject to information disclosure or price-quality regulation.

X5 However, this paper has as its primary focus on the effects of the new financial reporting standard for Transpower New Zealand Limited (Transpower) and electricity distribution businesses (EDBs). The new financial reporting standard has a particular importance for these suppliers because of decisions we are making now on price quality paths for Transpower[1] and EDBs.[2]

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

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

There are possible consequential impacts on our input methodologies

X6 We have identified six issues that may arise from the change in financial reporting standard if we maintain our regulatory rules as they are. Two of these issues would be transitional, while the others may have ongoing effects for regulated suppliers' revenue allowances and outcomes under IRIS. More specifically, we see the potential for:

X6.1 The initial capitalisation of operating leases to create a one-off cost for regulated suppliers under IRIS, and a smaller one-off benefit from the standard being adopted before the next default price-quality path (DPP) reset or individual price-quality path (IPP) reset.

X6.2 Suppliers to receive a tax allowance that is different to their tax costs based on tax rules.

X6.3 Suppliers to benefit from a difference in the weighted average cost of capital (WACC) used to calculate returns on right of use assets and their incremental cost of debt used to discount forecast operating lease cashflows in creating the right of use assets. This, however, may be largely negated by tax effects.

X6.4 Spikes in allowable revenue that could be difficult for suppliers to manage, as the depreciated value of the right of use assets within the regulated asset base are reset to the GAAP depreciated values at future price-quality path resets.

X6.5 Regulated suppliers to obtain IRIS benefits on the basis of provisional outcomes.

We have considered options for related amendments to our rules

X7 One option we have considered is to amend the input methodologies (IMs) so that operating leases would continue to be treated as operating expenditure for regulatory purposes. This would essentially aim to maintain the rules as they were before the new standard was introduced.

X8 However, at this stage, we think we should do the following.

X8.1 Accept alignment with new financial reporting standard for price-quality regulation and ID purposes, as it maintains consistency with a reporting framework that helps to keep compliance costs low for suppliers. This would mean that allowable revenue and returns on investment under information disclosure would be calculated using capitalised right of use asset values.

X8.2 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 avoid the potential for suppliers to skew their IRIS outcomes.

We received some submissions through our price-quality reset projects

X9 We received some preliminary feedback on our response to the new financial reporting standard via recent consultations on our resets of Transpower's IPP and the DPP for EDBs. That feedback indicated support for us retaining alignment with the new financial reporting standard within our regulatory regime.

We have issued a notice of intention to consider amendments to our input methodologies

X10 On 16 May 2019 we published a notice of intention to consider amendments to our IMs in response to the new financial reporting standard.[3]

X11 At this stage, we are considering amendments to the IMs that would:

X11.1 allow us to continue treating operating leases as operating expenditure for IRIS purposes;

X11.2 introduce a notional tax asset for right of use assets, to ensure regulated suppliers are not over or under-compensated for their tax costs;

X11.3 allow us to use the generally accepted accounting practice (GAAP) life for right of use assets, as the 45-year default life for newly commission assets will not be appropriate for most right of use assets; and

X11.4 recognise income from subleases.

X12 We are also considering what amendments would be appropriate to make to the information disclosure (ID) requirements.

[3] Notice of Intention: Proposal to Consider Amending to Input Methodologies for Electricity Distribution Services and Transpower New Zealand Limited (16 May 2019).

Chapter 1. Introduction

1.1 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. The standard fundamentally changes the accounting treatment of operating leases for lessees by requiring the capitalisation of operating lease expenditure.

1.2 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 in the absence of alternative regulatory rules and definitions. As the regulatory definitions that help to determine allowable revenues refer to GAAP,[4] the new accounting treatment of operating leases affects the businesses we regulate—in ways that we could not have anticipated when we set the current IMs and ID requirements. This gives rise to the potential for unintended outcomes.

1.3 This paper discusses and seeks stakeholder views on:

1.3.1 our understanding of the effects of the change in GAAP for Transpower and EDBs, which we regulate under Part 4 of the Act.

1.3.2 our preliminary view on amendments we should make to the IMs and ID requirements for Transpower and EDBs, to ensure outcomes are consistent with the purposes of the IMs and ID requirements, and the purpose of Part 4 of the Act.

1.4 Any feedback we receive will assist us in forming our draft decisions on the treatment of operating leases later this year.

This paper will be of interest to all businesses we regulate

1.5 The change in GAAP will affect all regulated businesses that have operating leases that must be capitalised. Our response to the change will therefore be of interest to all the businesses we regulate that are, or may become subject to ID or price-quality regulation under Part 4 of the Act or Part 6 of the Telecommunications Act 2001. This includes Transpower, all EDBs, suppliers of gas pipeline services, suppliers of specified airport services, and providers of regulated fibre services.

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

1.6 This paper has as its primary focus the effects of the change in GAAP for Transpower and EDBs, and the regulations we set for them under Part 4 of the Act. This is because of decisions we are making now on price quality paths for these suppliers. The effects include changes in the amounts of operating expenditure (opex) and capital expenditure (capex) for the calculation of allowable revenue and the amounts reported under ID. They also include the amounts used to calculate regulatory incentives. This is particularly pertinent for Transpower and EDBs because it can affect how their performance is measured under the IRIS and may hence impact their costs and revenue.

1.7 We will carry out a separate consultation process for any proposed amendments to the ID requirements and IMs for suppliers of gas pipeline services, suppliers of specified airport services, and providers of regulated fibre services necessary because of the new financial reporting standard.

Structure of this paper

1.8 The subsequent sections of this paper:

1.8.1 Explain how stakeholders can provide feedback on the issues we discuss, and how we manage confidential submissions (section Chapter 2);

1.8.2 Outline the decision-making framework we apply when considering changes to the IMs or ID requirements (section Chapter 3);

1.8.3 Explain the changes introduced by the new financial reporting standard (section Chapter 4);

1.8.4 Outline the issues we have identified that might arise from the new financial reporting standard under our regulatory regime (section Chapter 5); and

1.8.5 Outline our preliminary views about the IM and ID changes that may be appropriate in response to the new financial reporting standard (section Chapter 6).

We have already received some preliminary feedback from stakeholders

1.9 We have already received some preliminary feedback from stakeholders on our response to the new financial reporting standard.[5] Stakeholders provided this feedback in response to:

1.9.1 our November 2018 Issues Paper relating to the EDB 1 April 2020 DPP reset;[6]

1.9.2 our February 2019 Issues Paper relating to Transpower's 1 April 2020 IPP reset.[7]

1.10 Both papers noted the new financial reporting standard and our intention to address it via a separate, cross-sector consultation process.

1.11 We have referred to the specific comments received in this paper.

5 See: Wellington Electricity "Default price-quality paths for electricity distribution businesses from 1 April 2020 Issues Paper" (21 December 2018), p 21; Powerco "Submission on DDP reset issues paper" (21 December 2018), p 10; Vector "Cross submission on EDB DPP3 reset issues paper" (31 January 2019), p 7.

6 Commerce Commission, "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Issues Paper" (15 November 2018), available at: https://comcom.govt.nz/__data/assets/pdf_file/0022/106078/Default-price-quality-paths-for-electricity-distribution-businesses-from-1-April-2020-Issues-paper-15-November-2018.PDF.

7 Commerce Commission, "Transpower's individual price-quality path for the next regulatory control period – Issues Paper" (7 February 2019), available at: https://comcom.govt.nz/__data/assets/pdf_file/0023/120785/Transpower-IPP-reset-Issues-paper-7-February-2019.PDF.

Chapter 2. We invite stakeholder feedback

2.1 We welcome submissions on our assessment of the issues arising from the change in accounting treatment of operating leases, and our preliminary view about how we should respond.

2.2 Submissions are due by 5pm 27 June 2019.

2.3 You should address your responses to:

Dane Gunnell (Manager, Price-Quality Regulation)
c/o regulation.branch@comcom.govt.nz

2.4 Please include "Treatment of operating leases – Issues Paper" in the subject line.

2.5 We prefer responses to be provided in a file format suitable for word processing, in addition to PDF file format.

Requests for confidentiality

2.6 While we discourage requests for non-disclosure of submissions so that all information can be tested in an open and transparent manner, we recognise that there may be cases where parties that make submissions wish to provide information in confidence.

2.7 We offer the following guidance:

2.7.1 If it is necessary to include confidential material in a submission, the information should be clearly marked, with reasons why that information is confidential.

2.7.2 Where commercial sensitivity is asserted, submitters must explain why publication of the information would be likely to unreasonably prejudice their commercial position or that of another person who is the subject of the information.

2.7.3 Both confidential and public versions of the submission should be provided.

2.7.4 The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.[8]

2.8 We request that you provide multiple versions of your submission if it contains confidential information or if you wish for the published electronic copies to be 'locked'. This is because we intend to publish all submissions on our website. Where relevant, please provide both an 'unlocked' electronic copy of your submission, and a clearly labelled 'public version'.

Proposed next steps

2.9 We intend to publish a draft decisions paper on the treatment of operating leases in August 2019. Having regard to any views received from interested persons on our draft decisions paper, we aim to issue our final decision in November 2019 prior to our setting of the DPP determination for EDBs from 1 April 2020 and our setting of the IPP determination from 1 April 2020.

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[8] Parties can also request that we make orders under section 100 of the Act in respect of information that should not be made public. Any request for a section 100 order must be made when the relevant information is supplied to us, and must identify the reasons why the relevant information should not be made public. We will provide further information on section 100 orders if requested by parties. A key benefit of such orders is to enable confidential information to be shared with specified parties on a restricted basis for the purpose of making submissions. Any section 100 order will apply for a limited time only as specified in the order. Once an order expires, we will follow our usual process in response to any request for information under the Official Information Act 1982.

Chapter 3. Our decision-making framework for amending input methodologies and information disclosure requirements

Amending our input methodologies

3.1 In considering whether our current IMs in relation to right of use assets remain appropriate in light of the introduction of NZ IFRS 16, we intend to use a decision-making framework that we have developed over time to support our decision making under Part 4. This has been consulted on and used as part of prior processes, and helps provide consistency and transparency in our decisions.

3.2 Consistent with the decision-making framework adopted in our 2016 IM review and in the 2018 Transpower Capex IM review, we intend to consider each potential IM amendment by asking the questions:[9]

3.2.1 does it promote the Part 4 purpose in s 52A of the Act more effectively than the current IM;

3.2.2 does it promote the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose); or

3.2.3 does it significantly reduce compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s 52A purpose).[10]

3.3 We have used this framework to inform our views in this paper on our options for the treatment of operating leases.

Amending our information disclosure requirements in relation to operating leases

3.4 Under s 53A of the Act, the purpose of ID regulation is to ensure that sufficient information is readily available to interested persons to assess whether the purpose of Part 4 of the Act is being met.

3.5 In relation to operating leases, where we consider that sufficient information is not readily available to interested persons to assess whether the purpose of Part 4 of the Act is being met, we intend to propose amendments to our ID requirements.

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

10 Commerce Commission "Input methodologies review decisions: Framework for the IM review" (20 December 2016), para 59.

Chapter 4. Recent changes to financial reporting standards affect regulated suppliers

A new financial reporting standard for leases has been issued

4.1 Operating lease agreements generally create an obligation for a party to make payments for a period into the future in exchange for the right to use an asset. Historically under GAAP, these agreements have not been recognised as creating an asset and liability on the lease-holder's balance sheet. Rather, they have just been treated as opex.

4.2 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.[11]

4.3 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.

4.4 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.[12] Under NZ IFRS 16, lessees will now be required in GAAP accounts to record most new and existing leases on the balance sheet as: [13, 14]

4.4.1 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.

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

12 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.

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

14 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.

4.4.2 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.[15]

4.5 'Capitalising' the lease will also affect a lessee's income statement:

4.5.1 The initial transition to the new standard will mean recording the present value of existing leases as capex.

4.5.2 Any new lease entered into, or increase in obligations under existing leases will similarly be recorded as capex.

4.5.3 There will be an enduring reduction in reported operating lease expenditure.

4.5.4 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.

4.6 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.[16]

4.7 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. The following discussion therefore deals only with the right of use asset.

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

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

Right of use assets are intangible assets that will enter the RAB under the current IMs

4.8 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.[17] 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:[18]

4.8.1 this is consistent with the Part 4 Purpose; and

4.8.2 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).

4.9 Right of use assets constitute 'identifiable non-monetary assets' and so will enter the RAB under the current IMs.

4.10 It's important to note that right of use assets are a novel instrument for our regulatory regime, since they are generally contracts for the temporary use of an asset, rather than ownership of the underlying asset itself.[19] Right of use assets are therefore likely to have much shorter lives than the physical infrastructure assets we typically regulate. 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.[20]

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17 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)", para 4.4.49.

18 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)", para 4.4.51.

19 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.

20 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), paras 2.8.14 – 2.8.18.

Chapter 5. The new accounting treatment will not merge seamlessly with our regime

We have identified six potential issues

5.1 We have identified six issues that will arise from the change in the financial reporting standard if we maintain our regulatory rules as they are. Two of these issues would be transitional, while the others may have ongoing effects for regulated suppliers' revenue allowances and outcomes under IRIS. All are summarised in Table 1. We explain each in turn in more detail below.

5.2 We welcome stakeholder feedback on the issues we have identified, as well as any issues we may not have identified.

Table 1: Summary of issues arising

	Issue	Impact	Ref
Revenue allowance issues	The right of use asset is an accounting construct that does not exist for tax purposes. This results in differences between the tax allowance we would provide, and what a supplier would pay to Inland Revenue based on tax rules. The effect is complicated further by timing differences under a deferred tax approach.	Potential for suppliers to receive a tax allowance that is different to their tax costs based on tax rules.	Para 5.3-5.8
	The present value of revenue allowances may not be equivalent to the present value of operating lease payments used to establish asset values. The equivalence depends upon tax effects, and the difference between the regulatory WACC rate and suppliers' incremental cost of debt.	Potential for suppliers to benefit from a difference in the WACC and their incremental cost of debt—though this may be largely negated by tax effects.	Para 5.9-5.16
	Applying the default 45-year life to right of use assets in calculating total depreciation (EDBs) creates differences between the amount of depreciation calculated under GAAP and the amount calculated for rolling forward asset values under DPPs.	Undesirable swings in allowable revenue as the depreciated RAB value corrects to the depreciated GAAP value at future price-quality path resets.	Para 5.17-5.20
Issue	Regulated suppliers would receive IRIS rewards/penalties for cashflows relating to lease payments to be made in future regulatory periods.	IRIS rewards/penalties will be calculated based on provisional outcomes.	Para 5.21-5.25
Transitional issues	Regulated suppliers may face capex penalties that exceed opex rewards under IRIS when right of use assets are initially capitalised.	Potentially significant unrecoverable cost for regulated suppliers.	Para 5.26-5.29
	Regulated suppliers under price-quality regulation may benefit from the depreciated value of the right of use asset being higher than the present value of the remaining lease payments when the asset is first recognised for the calculation of allowable revenue.	Potential for relatively small unintended benefit for some regulated suppliers.	Para 5.30-5.34

Revenue allowance issues

Our tax allowance may differ from the tax suppliers pay

5.3 Because right of use assets are a financial reporting construct, there are no corresponding assets recognised for tax purposes.[21] This will affect regulated suppliers' allowable revenues under price-quality regulation for the following reasons:

5.3.1 When calculating tax payable under tax rules, operating lease payments will continue to be recognised as a real-world tax-deductible expense. The IMs attribute the benefit of this tax relief when calculating tax costs for the tax building block under an allowable revenue approach.[22] The total tax relief from the stream of operating lease payments is greater than the tax relief represented by the value of the capitalised asset (i.e. the present value of the operating lease payments), giving rise to a reduction in allowable revenue equal to the tax effect of the difference. This applies whether a tax payable or deferred tax approach is used.

5.3.2 Under a GAAP deferred tax approach, as applies to EDBs, the opening deferred tax balance is a combination of the deferred tax on the asset (tax liability) and the deferred tax on the liability (tax asset) which largely offset. However, as noted in paragraph 4.7 above, no operating lease liability is recognised in the regulatory accounts. This means that the opening deferred tax balance in the regulatory accounts will be just the difference between the regulatory book value and the nil tax book value multiplied by the tax rate (a tax liability).[23]

5.3.3 In calculating tax expense, the deferred tax approach substitutes tax depreciation with regulatory depreciation and then adjusts for temporary differences between the two. This is done by way of adding the tax allowed on the difference between the closing deferred tax balance and the opening deferred tax balance (the temporary difference component) to the tax allowed on the regulatory depreciation. Over the life of an asset the

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

22 Electricity Distribution Services Input Methodologies Determination 2012, as amended, clause 4.3.1. The generic equation for allowable revenue before tax is given by the equation of building blocks allowable revenue before tax in clause 5.3.2. Transpower Input Methodologies Determination 2010 (28 February 2017) clauses 2.3.1 and 3.4.1

23 Electricity Distribution Services Input Methodologies Determination 2012, as amended, clauses 4.3.4 – 4.3.5.

temporary differences will generally reverse so that the tax effects of the regulatory asset base and the tax asset base are the same.[24] If there is no tax asset recognised, suppliers will be overcompensated by the tax allowance on the difference between the closing and opening deferred tax balance less the effect of deducting the opening deferred tax balance from the RAB when calculating the return on investment.

5.3.4 Creating a notional tax asset that is the equivalent of the value of the right of use asset will give rise to a nil opening deferred tax balance. This would remove the overcompensation arising under a deferred tax approach. This could be easily achieved with some adjustments to the existing notional tax asset value IM provisions.

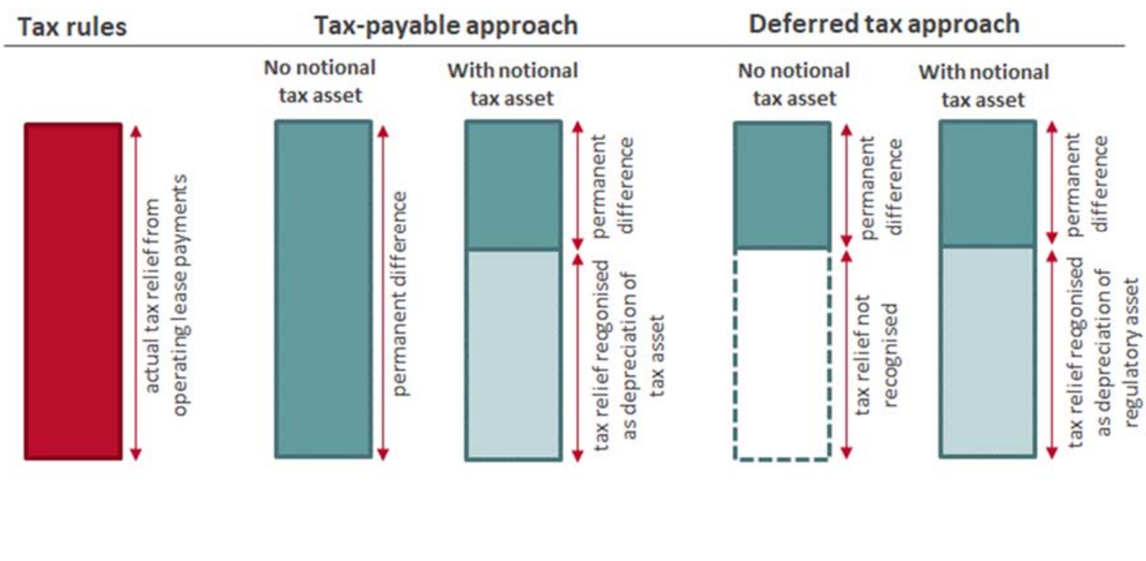
5.4 We do not propose to address the effect of paragraph 5.3.1. This is simply a consequence of the real tax benefits suppliers receive from continuing to deduct operating lease payments for tax purposes.

5.5 The indicative effect of these issues is shown diagrammatically in Figure 1. It compares the actual tax relief that suppliers realise (red bar), with the tax relief that the IMs would recognise—either as a 'permanent difference' between the tax paid and expensed (dark green bars), or as tax relief from depreciation expense (light green bars). It shows this for:

5.5.1 tax-payable and deferred tax approaches to tax accounting; and

5.5.2 a situation (as now) in which there would be no notional tax asset, and a situation where a notional tax asset was introduced through the IMs.

Figure 1: Tax relief recognised under different approaches to tax accounting



24 Ignoring the effect of revaluations.

5.6 Figure 1 highlights that, with no notional tax asset, our revenue allowance would overcompensate suppliers using a deferred tax approach.

5.7 Our modelling of an indicative stream of operating lease payments suggests the tax effects under a deferred tax approach are likely to be material but will depend on the circumstances of each supplier, including the terms of lease agreements and values of operating lease payments.

5.8 We may need to seek further detailed information from suppliers, but this will depend upon feedback received and our consideration of that feedback.

Our revenue allowance may not be equivalent under the new financial reporting standard

5.9 We have considered how the revenue we allow regulated suppliers to earn might change by capitalising operating leases, compared to treating them as opex.

5.10 The net present value (NPV) of the revenue from the capitalisation approach for new right of use assets can be equivalent to the NPV of revenue under the current opex approach. This NPV equivalence depends on a number of factors including the cost of debt used to discount the future stream of lease payments, the term of the lease, and the value of the operating lease payments.

5.11 Under GAAP rules, suppliers will discount the lease payment stream at their incremental cost of debt.[25] This will give rise to asset values that are different from asset values implied by the returns on regulatory WACC. Suppliers therefore benefit from any difference between the WACC and their incremental cost of debt.

5.12 This benefit will may be largely offset by changes in the tax allowance we provide for under the IMs—as we discussed in paragraphs 5.3-5.8.

5.13 Overall, the precise extent to which outcomes are equivalent will depend on each individual suppliers' circumstances, and the different tax methodologies applied.

5.14 There are also challenges to achieving NPV equivalence in allowable revenue for right of use assets that suppliers are forecasting to have in the future. To achieve equivalence, the present value calculation needs to be done at the same time the assets are forecast to enter the RAB. Therefore, if the lease is forecast to start halfway through a future year of the regulatory period, then the present value of the cashflows must be calculated at this date using the appropriate discount rate.

5.15 However, suppliers will not know what the incremental borrowing rate of the future lease is at this time. They would therefore need to forecast their incremental borrowing rate for this purpose. Alternatively, the present value of the cashflows at

[25] XRB "New Zealand Equivalent to International Financial Reporting Standard 16 Leases (NZ IFRS 16)" (Amended as at 12 July 2018), para 23-27. For many of these assets it is unlikely an implicit rate of interest will be able to be determined.

the date of setting the revenue allowance could be rolled forward to the date of commissioning, using suppliers' existing incremental borrowing rate.

5.16 Asset values could be monitored, as the cashflows for right of use assets may be readily extracted from operating cashflow reporting, which would need to be disclosed under ID.

The short life of right of use assets could create swings in allowable revenue

5.17 Under GAAP, the life of a right of use asset is the life of the lease contract, and not the life of the underlying physical assets it provides for use of.[26]

5.18 However, under our asset valuation IM for DPPs, right of use assets will have their remaining asset life set at 45 years at the time they are forecast to enter the RAB.[27] There will likely be a large discrepancy between the 45-year RAB life of the right of use asset and the accounting life under GAAP, which is likely to be considerably shorter than 45 years.

5.19 If we apply a 45-year life, the right of use asset will depreciate at a slower rate within the RAB than in the GAAP-based ID disclosures that we use when we reset suppliers' price-quality paths. This would result in 'catch-up' depreciation being recorded in the next regulatory period, which could create spikes in a supplier's revenue allowance at each DPP reset.

5.20 This may mean that we should require that a forecast remaining useful life, based on the GAAP life, be specified under the asset valuation IMs. There might also be a need to categorise the right of use assets as network or non-network assets according to the nature of the underlying assets for ID purposes.

Issues under IRIS

Potential for unwarranted IRIS outcomes

5.21 Regulated suppliers could face IRIS penalties/rewards for cashflows in future regulatory periods that are not yet locked in by way of contractual agreements. This might occur because their incentive payments would be based on the difference between two numbers, both of which rely on forecast estimates:

5.21.1 Forecasts of the present value of operating lease costs that were expected at the beginning of a regulatory period;

5.21.2 The present value of operating lease costs that were expected at the time the calculation of the value of commissioned assets occurs.[28]

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[26] XRB "New Zealand Equivalent to International Financial Reporting Standard 16 Leases (NZ IFRS 16)" (Amended as at 12 July 2018), para 30-32.

[27] Electricity Distribution Services Input Methodologies Determination 2012, as amended, clause 4.2.2(3)(b).

[28] Subject to any revaluation adjustments.

5.22 A portion of the stream of future operating lease costs that are included in a present value calculation will likely relate to future regulatory periods, and there may not yet be any firm commitment over these amounts.

5.23 Once the incentive adjustment has been calculated in the period in which the asset is commissioned, there is no further incentive adjustment in the following regulatory periods under existing IM rules if the asset value subsequently changes. The value of the asset at the end of the period in which it is commissioned will simply roll forward into the opening value of RAB at the beginning of the next period.

5.24 Furthermore, we consider that there is a possibility that this dynamic could be exploited in a way that comes at the expense of consumers. This could occur if regulated suppliers forecast based on a longer lease duration than they end up contracting for, to obtain additional benefits under IRIS.

5.25 For example, a nine-year lease might be split into a four-year lease and a five-year lease, with the second lease being capitalised in the next regulatory period. In the next regulatory period the long forecast could be repeated to avoid any incentive penalty from an un-forecast capex spend on the second lease. It would be very difficult to distinguish this behaviour from value-enhancing decisions to adopt shorter term leases.

Transitional issues

Suppliers will face IRIS penalties from adding the full present value as capex

5.26 The effect of the new financial reporting standard is to remove operating lease payments from opex, and record a one-off capital expense reflecting the present value of the lease payments over the full lease term. Therefore, at the time of capitalisation (in the 2019 financial year or earlier), there will be a large, single-year increase in capex but a smaller decrease in opex (reflecting only the lease payments remaining in the current regulatory period). This outcome could not have been forecast when the current EDB DPP and Transpower IPP were set in 2014.

5.27 IRIS incentivises regulated suppliers to improve opex and capex efficiency by having them share in any costs or savings they realise against forecasts. IRIS does this through ‘retention factors’, which allow our regulated suppliers to keep a set proportion of any efficiency savings in opex and capex, or bear a set proportion of efficiency losses.

5.28 The changes in opex and capex resulting from the change in accounting treatment of operating leases will affect regulated suppliers’ outcomes under IRIS. However, the rewards and penalties under IRIS will not mirror each other because:

5.28.1 the retention factors that will apply when existing operating leases are initially capitalised are higher for opex (34%) than for capex (15%);[29]

5.28.2 the opex reduction will be small compared to the capex increase—with the difference in magnitude depending on the lives, incremental cost of debt and values of forecast lease payments used to value the right of use assets.

5.29 For longer leases, the effect of the latter is likely to more-than-offset the effect of the former. This would mean regulated suppliers could see a net-cost under IRIS from a regulatory transition to the new financial reporting standard.[30]

Suppliers can benefit from a delay between valuation and the start of the DPP/IPP period

5.30 Under GAAP, the present value of future lease payments is determined at the outset of the lease contract, or at the first application date of the new standard for existing leases.[31]

5.31 Regulated suppliers will apply NZ IFRS 16 for their annual reporting periods beginning after 1 January 2019, if they haven't already done so. The next DPP period will begin on 1 April 2020, and the next IPP period on 1 April 2020. Therefore, the time when EDBs and Transpower capitalise their operating leases will not coincide with the time that we reflect the accounting change in their price-quality paths.

5.32 Right of use assets will depreciate at a constant rate (assuming straight-line depreciation), while present value of the future lease payments will amortise more quickly according to the annual amounts of the lease payments. This means that the accounting book value of leases that have already been running for some time when they are first recognised under the capitalisation approach may be higher than the present value of the remaining lease payments at the same date.[32]

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29 As the new standard comes into effect for the reporting period beginning on or before 1 January 2019, the initial capitalisation of existing operating leases will occur under the price-quality paths that apply until 2020.

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

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

32 Put another way, the present value of the depreciation charge on the asset may be higher or lower than the present value of the annual lease payment depending on the term of the lease (ie life of the asset) and the value of the lease payments.

5.33 This means there will be a mismatch between the revenue we allow a supplier to recover on the capitalised assets, and the revenue we would have provided for if the remaining lease payments were still recorded as opex. The mismatch will likely be larger the earlier that suppliers capitalise their leases. While relatively modest, suppliers could benefit from this mismatch (at the expense of consumers) by receiving a higher revenue allowance, despite there being no change in their underlying costs.[33]

5.34 We may therefore want to consider an opening one-off revenue adjustment to offset this effect. We would need to seek accounting records to determine the value of this adjustment.

[33] An example calculation for a ten-year asset shows the amortised asset value is 3.5% higher than the present value of the remaining cash flows after one year.

Chapter 6. Some changes to our regulatory rules may be appropriate

We think we should align our rules with GAAP generally for price-quality regulation and ID purposes

Aligning our rules with GAAP does not require amendments to our regulatory regime

6.1 One option we have considered is to amend the EDB and Transpower IMs so that operating leases would be excluded from the RAB and continue to be treated as opex for regulatory purposes. This would essentially aim to maintain the rules as they were before the new standard was introduced.

6.2 However, at this stage, we do not prefer that option. Instead, we think we should accept alignment with GAAP for price-quality regulation and ID purposes. This would mean incorporating right of use assets within the RAB and treating their capitalisation in a broadly similar way to the capitalisation of finance lease assets.

6.3 There are four reasons we think we should maintain alignment between our regulatory rules and GAAP for price-quality regulation and ID purposes:[34]

6.3.1 We generally prefer to maintain consistency with GAAP to the extent possible, because it provides a low-cost accounting framework.

6.3.2 If we do not accept the capitalisation approach 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.

6.3.3 We consider the rationale for allowing suppliers to include finance leases in their RABs is even more applicable to the treatment of operating leases. Our rationale for including finance leases in the RAB was that it is efficient for regulated suppliers to choose leases over the option of owning the asset, where it minimises the cost over the asset life.[35] Finance leases typically apply to lower value and shorter-lived assets than are subject to operating leases. The decision of whether to enter right of use leases or to purchase assets therefore has greater efficiency implications than for finance leases.

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

[35] See "Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" (December 2010), para E3.18 and "Input Methodologies (Transpower): Reasons paper" (22 December 2010), para 4.4.65.

6.3.4 Disallowing the capitalisation of right of use assets would require more than minor amendments to the existing IMs.

6.4 Furthermore, stakeholders that provided preliminary feedback on the issue under the EDB DPP Issues Paper supported alignment of our regulatory regime with GAAP. Specifically:

6.4.1 Wellington Electricity Lines Limited encouraged us to treat operating leases consistently with the IFRS to avoid two sets of audited calculations, keeping costs low.[36] Wellington Electricity Lines Limited also suggested that recognising leases on the balance sheet reflects that the EDB will receive medium to long term benefits (more than a year) and will have a medium to long term financial commitment.

6.4.2 Powerco Limited considered that any move away from a GAAP based approach would add unnecessary complexity and burden to EDBs.[37]

6.4.3 Vector Limited, in its cross-submission, agreed with Powerco Limited and Wellington Electricity Lines Limited and added that creating specific rules for operating leases may unwind the approach of the IMs to follow accounting classifications for expenditure.[38]

Some changes to the input methodologies could address the revenue allowance issues

6.5 At this stage, we consider that some IM amendments may be appropriate to address the issues we discussed in paragraphs 5.3-5.20 and ensure outcomes consistent with the purpose of Part 4 of the Act (s 52A of the Act). Specifically, we think:

6.5.1 There may be justification for introducing a notional tax asset for right of use assets. As noted above, these do not have a corresponding tax asset under regulatory tax asset valuation rules. An adjustment might need to be made to the valuation of the regulatory tax assets in the treatment of taxation IMs to provide for the correct calculation of regulatory tax. This will ensure regulated suppliers are not over or under-compensated for their tax costs.

6.5.2 We should use the GAAP life for right of use assets. It would be appropriate to amend the asset valuation IM for DPPs, which assigns a remaining asset life for newly commissioned assets of 45 years at the time they are forecast to enter the RAB. Amending this to apply a forecast remaining useful life, based on the GAAP life, would avoid spikes in allowable revenue as the asset values are adjusted from GAAP based ID disclosures at each DPP reset.

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

37 Powerco "Submission on DDP reset issues paper" (21 December 2018), p 10.

38 Vector "Cross submission on EDB DPP3 reset issues paper" (31 January 2019), p 7.

6.5.3 We should recognise income from subleases. Income from subleasing regulatory right of use assets may need to be specified as other regulated income in the IMs for price-quality paths.

6.6 We welcome stakeholder views on these suggestions, including any views as to how the associated issues could otherwise be addressed.

We think we should continue to treat operating leases as opex for IRIS purposes

6.7 Notwithstanding the alignment of our rules generally with GAAP for price-quality regulation and ID purposes, we think it is appropriate to amend the IMs so that operating leases continue to be treated as opex for IRIS purposes.

6.8 The main reason we consider that an opex approach to IRIS is preferable is because it is simpler to administer and avoids the issues discussed in paragraphs 5.21-5.25, whereby regulated suppliers could:

6.8.1 be rewarded/penalised for provisional outcomes; and

6.8.2 set forecasts specifically to obtain IRIS rewards.

6.9 Treating operating leases as opex for IRIS purposes would reward/penalise the actual achievement of operating lease expenditure savings/over-runs, as measured by the operating lease payments, within the current regulatory period and would also reward/penalise savings/over-runs in subsequent periods as they occur. If we didn't treat operating leases as opex for IRIS purposes, IRIS calculations would be based on expectations about future expenditure that may not occur.

6.10 An alternative way to address this concern could be introduce a wash-up adjustment to take account of all the changes in asset value over the life of a right of use asset. However, this would require the creation of an adjustment mechanism and would introduce an aspect of uncertainty and possible clawback, and hence do not prefer that approach.

6.11 The existing IM definition of operating costs excludes a cost that is treated as a cost of an asset by GAAP. We would therefore need to amend the IMs so that we could include operating lease payments in the definition of opex and remove them from capex for IRIS purposes.

We may seek more information to assess the magnitude of the transitional issues

6.12 The transitional issues we have identified—discussed in paragraphs 5.26-5.34—will affect each of our regulated suppliers differently. The individual impact will depend on:

6.12.1 the number of leases the supplier holds, the periods they cover, the size of the payments, and their incremental cost of debt—as these factors will determine the capitalised value of the leases, and the impacts under IRIS;

6.12.2 when the supplier chooses to adopt the new financial reporting standard—as this will impact any mismatch between the value of the right of use asset and the present value of the remaining lease payments when we set the next DPP for EDBs or IPP for Transpower.

6.13 With the limited information we have, at this stage we are unable to make a fully informed decision about whether or how to address these transitional issues.

6.14 In due course, we may need to seek further information from suppliers via a request for information under section 53ZD of the Act. However, this will depend upon the feedback we receive in submissions and our consideration of that feedback.

We think we may need to amend some ID requirements

6.15 At this time, we consider that some future ID amendments may be appropriate to ensure interested persons can assess whether the purpose of Part 4 of the Act is being met.

6.16 Disclosures under ID would likely include:

6.16.1 cash outflows for operating lease payments;

6.16.2 remaining useful lives and depreciation charge for right-of-use assets by class of underlying asset;

6.16.3 additions and terminations of right of use assets;

6.16.4 the carrying amounts of right-of-use assets at the end of the reporting period by class of underlying asset;

6.16.5 income from sub-leasing right of use assets; and

6.16.6 explanations for revaluations.

6.17 We welcome stakeholder views on these suggested disclosures.