VECTOR SUBMISSION ON THE TREATMENT OF OPERATING LEASES - ISSUES PAPER

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EXECUTIVE SUMMARY

1. This is Vector Limited's (Vector) submission to the Commerce Commission's (Commission) issues paper on the treatment of operating leases following the issue of a new financial reporting standard in January 2016, New Zealand Equivalent to International Financial Reporting Standard 16 Leases (NZ IRFS 16).

2. We recommend the Commission rigorously apply its decision-making framework before it considers making changes to the IMs. Accordingly, we encourage the Commission to demonstrate whether each of its proposed changes:

    a) Promote the purpose of Part 4 in s52A of the Act more effectively than making no amendment;

    b) Is consistent with the purpose of s52R of delivering certainty in relation to rules, requirements and processes;

    c) Will reduce compliance costs, other regulatory costs, or complexity.

3. Vector does not support the Commission's proposals to amend the Input Methodologies (IM) Determination to depart from GAAP retrospectively especially since the changes to the IFRS accounting standard were first announced in January 2016 so organisations have been aware of, and preparing to implement, the standard for some time. We do not consider these amendments are justified under the Commission's decision-making framework.

4. Our primary concern relates to the proposal to amend the IM to treat operating leases as operating expenditure (opex) which involves retrospectively opening up the IRIS IM during the regulatory period. This is contrary to the purpose of the scheme to provide an *ex-ante* incentive.

5. Further comments on the Commission's proposals are set out below.

PROPOSALS TO AMEND IM DETERMINATION TO DEPART FROM GAAP

6. We do not support any of the Commission's proposed amendments to depart from the GAAP approach retrospectively.

7. The New Zealand Accounting Standards Board issued the NZ IRFS 16 in January 2016 so organisations have been aware of, and preparing to implement, the new standard for some time.

8. NZ IFRS 16 provides an implementation date at the beginning of the annual reporting period in which an entity first applies it. Accordingly, EDBs could adopt the standard for the financial year ended 30 June 2019 - making the implementation date 1 July 2018. Therefore, entities with a financial year commencing in July are likely to have adopted the change in that year which will affect their 2019 regulatory year information disclosures and IRIS balances.

9. We do not consider proposals to amend the IMs to depart from GAAP retrospectively are justified under the Commission's decision-making framework, particularly given adopting the standard early was an option under GAAP.

10. These proposals would retrospectively penalise early adopters of NZ IFRS 2016 by imposing an additional compliance burden, as well as reducing certainty in the regime.

11. For completeness, this submission has focussed on the impact on the opex IRIS for early adopters such as Vector but these issues are also relevant to the treatment of capital expenditure (capex).

PROPOSAL TO TREAT OPERATING LEASES AS OPEX FOR IRIS PURPOSES

12. In particular, the proposal to amend the IM to treat operating leases as opex is contrary to the purpose of the IRIS, which was introduced to provide suppliers with an ex-ante incentive to pursue efficiency gains throughout the period. These incentives will only be effective if EDBs have certainty as to how the IRIS will be calculated at the end of the period. Where an EDB has adopted the IFRS reporting standard during the 2019

regulatory year it will also have to retrospectively adjust its opex IRIS incentive for that year.

13. The decision to amend the opex IRIS retrospectively will undermine the basis upon which the Commission has settled on using penultimate year as the “base year” upon which to project forward its step-and-trend view of opex for the DPP3 period.

14. According to the Commission:

> *Using year four as the base year ultimately has no impact on the gross revenues a distributor will be able to recover over the DPP3 period: it only affects the balance between starting prices and the adjustment component of the IRIS.*[1]

15. Should the Commission continue to adopt its proposal to retrospectively amend the opex IRIS which will affect the 2019 opex IRIS incentives of EDBs then it must also allow a retrospective change to opex for the period. This will ensure the symmetry between DPP3 opex allowance and IRIS incentives are maintained.

16. Accordingly, we disagree with the Commission’s reasoning that treating operating leases as opex for IRIS purposes will be simpler to administer, as deviating from GAAP will inevitably add further complexity to the regulatory framework.

17. The Commission raised concerns at paragraphs 5.21-5.25 of the Issues Paper that EDBs could seek to obtain benefits under IRIS where lease costs are not locked in by way of contractual agreements. However, given EDBs follow GAAP to value right of use assets and this is subject to audit as part of ID, the Commission should have sufficient confidence in the approach EDBs take to capitalisation, consistent with the s52A requirement that EDBs are limited in their ability to extract excessive profits.

[1] Commerce Commission, *Default price-quality paths for electricity distribution businesses from 1 April 2020 - draft decision* (29 May 2019) page 128

IF THE COMMISSION AMENDS THE IMS RY2019 REGULATORY DISCLOSURES WILL NEED TO BE ADJUSTED TO RETAIN THE POLICY FOR SETTING OPEX FOR DPP3

18. If the Commission does pursue its proposed IM amendments for operating leases, the impact of any amendment should allow Information Disclosure filings for RY2019 to be adjusted for the change.

19. If the IM is amended to treat operating leases as opex, the RY19 base year opex figures will need to be repopulated to include operating leases. This is because EDBs such as Vector have capitalised right of use assets in RY19 disclosure and have adopted this approach to ensure their opex IRIS position for the period does not unwittingly contribute to perceived expenditure inefficiency. However, the retrospective action to amend IRIS balances for RY2019 will result in the Commission's policy for base year expenditure to be symmetrically linked with IRIS efficiencies to be broken and result in EDB expenditures being calibrated at a lower level without any benefit being recognised in the opex IRIS.

20. Failure to make this consequential change would penalise EDBs for applying the regulatory rules as they were in force at the time and the expectation provided by the Commission to stakeholders. This would be a perverse outcome contrary to the Part 4 purpose.

REGULATORY RULES SHOULD BE ALIGNED WITH GAAP

21. We support the Commission's proposal to accept the alignment of the regulatory rules with GAAP for price-quality regulation and information disclosure (ID).

22. We agree with the Commission's reasoning in the issues paper that -

    - Maintaining consistency with GAAP provides a low-cost accounting framework.

- Diverging from GAAP would lead to a mismatch between asset values and opex for regulatory purposes; and asset values and opex under GAAP. This would impose unnecessary complexity and compliance costs for EDBs.

- In line with the Commission's reasoning for the treatment of finance leases, capitalising operating leases can promote efficiency where choosing a lease rather than owning an asset minimises cost over the asset life.

- Disallowing capitalisation would require significant amendments to the IM.

23. Accordingly, we consider maintaining alignment of the regulatory rules with GAAP best promotes the long-term benefit of consumers by minimising compliance costs and complexity in the Part 4 regime.

THE COMMISSION SHOULD AVOID IMPOSING ADDITIONAL INFORMATION BURDEN ON EDBS

24. We note the Commission is considering issuing a request for information under s53ZD of the Act. We would urge the Commission to avoid imposing any additional information burden on EDBs, given the extensive workload the sector is undertaking during the transition to DPP3. Given the IFRS16 changes were announced in early 2016 we consider the late changes to the GAAP led approach to the IMs is an unnecessary complication for EDBs for the transition to DPP3.

25. However, we acknowledge that if the Commission does pursue the proposed IM amendments it may need to seek further information to incorporate these changes in its DPP3 decision.

26. We would also caution the Commission against imposing additional information disclosure requirements, as it is not clear to us how additional information disclosed in this area would assist an interested party assess whether Part 4 is being met.

PROPOSAL TO INTRODUCE A NOTIONAL TAX ASSET

27. We note the Commission's reasoning around introducing a notional tax asset. However, it is not clear the impact of tax differences would be sufficiently material to justify making an IM change. Indeed, our initial view is that such a complicated approach does not meet the Commission's own criteria for change. We are concerned the proposal will impose additional complexity for very little benefit to end-users.