

10 July 2019

Dane Gunnell
Manager, Price-quality Regulation
Commerce Commission
By email to regulation.branch@comcom.govt.nz

Dear Dane

Treatment of operating leases – Issues Paper

1. This letter provides feedback by the Major Electricity Users' Group (MEUG) on the Commerce Commission issues paper "Treatment of operating leases" published 6th June 2019.¹
2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.
3. MEUG appreciates the Commission subsequently publishing on 3rd July two spreadsheets, one for Transpower and the other for Electricity Distribution Businesses (EDB), to illustrate the current and proposed treatment of operating leases.² Based on the illustrative tests in this submission there appears not to be an exact equivalence.
4. For example, for EDB the "degree of equivalence" being the present value (PV) of revenue from the proposed change (termed "right of use asset" in the spreadsheets) divided by the PV of remaining lease payments at 1st April 2021 will be 105%.³ A figure over 100% suggests EDBs would receive a greater return for a right of use asset than the equivalent operating expenditure. The PV difference of \$1,664,572 is material compared to the assumed annual operating lease payments of \$5,000,000 for the eight remaining years of the lease.
5. The issues paper considers two transitional implementation and four ongoing post-implementation issues in Table 1, paragraph 5.2. Below are additional points to consider on the issues in the paper and new issues:
 - a) NZ IRS16 requires the discount rate used to capitalise future operating lease expenditures to be the lease-holder's incremental borrowing rate. The Issues paper proposes the same apply to regulated line service providers. For MEUG to agree with the proposal in the issues paper we would require an analysis demonstrating

¹ https://comcom.govt.nz/_data/assets/pdf_file/0017/152108/Treatment-of-operating-leases-Issues-paper-6-June-2019.pdf.

² <https://comcom.govt.nz/regulated-industries/input-methodologies/projects/operating-leases?target=documents>.

³ EDB spreadsheet, Tab "Equivalence calculations", cell C125.

that under all circumstances the use of the regulated line service providers incremental borrowing rate rather than the incremental cost of debt set in the Input Methodologies results in NPV=0.

We tested the EDB spreadsheet for changes in the assumed EDB incremental cost of debt.⁴ A plus or minus 10% change on the assumed base case rate of incremental cost of debt of 4.5% changed the degree of equivalence by approximately minus and plus 3% respectively.

There are at least two other practical problems in using the regulated line service providers incremental borrowing rate. First, if the monopoly has no debt. Second, if there is no clear separation of the incremental borrowing rate for regulated services and unregulated services because the holding company has a single bundled cost of debt.

- b) Treatment of leases between related parties.
- c) Treatment of lease cashflows beyond 5-years. The accounting standards allow liabilities beyond 5-years to be disclosed as a single amount. That is insufficient for interested parties to replicate a NPV calculation before and after the changes. Part 4 disclosures should require annual cashflow information for the full term of the lease.
- d) Lease payments need not be uniform or follow a fixed formula every year. Hence, we need to view the cashflow before and after any amendments every year for the term of the lease. A regulated line service provider implementing a ruling by the Commission for the treatment of operating leases may decide to change the term and lease payment profile from the current term. Consumers are indifferent to that provided the NPV is unchanged.
- a) Should a right of renewal provision in a lease be accounted for in the regulatory requirements and if so, how and at what value?
- e) The scope for and incentive for regulated line services to engage in entrepreneurial strategies to exploit loopholes in the regulations governing leases cannot be underestimated. Listed below are examples of major sale and lease back transactions that have been proposed or entered into.
 - In New Zealand Transpower entered into a cross border lease for the majority of the HVAC transmission assets in the South Island in 2003.⁵ That arrangement was partially terminated in 2009/10. To this day we are unsure whether customers bore any risks from that arrangement and if so whether they received any benefit or whether the reported one-off fee of \$34.6m accrued solely to the Crown as shareholder. Media articles in 2005 reported the Airways Corporation entered a similar cross-border lease for a \$29.5m fee.

⁴ Ibid, cell C15.

⁵ Transpower Annual report 2020, Notes to the Financial statements, Note 2. Operating Revenue.

- In Australia the Victorian State Government in 2016 entered a 50-year lease of the Port of Melbourne for more than A\$9.7 billion. This wasn't without controversy and complexity.⁶ This illustrates how lease arrangements for infrastructure assets can be structured to serve asset owners in ways that will add complexity to how such arrangements can be incorporated into the Commerce Act Part 4 regime.
- Proposed Ausgrid lease.⁷

Novel use of sale and lease back arrangements could, for example, involve asset life arbitrage whereby assets with a 45-year standard life are sold and leased back on a shorter life resulting in acceleration of cashflow.

Given the risk of unintended consequences if asset owners propose arbitrage schemes likely to lead to outcomes contrary to the purpose of Part 4, the Commission may need to consider reserving powers to intervene.

6. In developing a preferred option to adapt the Part 4 regime to implement NZ IRS 16, MEUG recommends the Commission model a simple notional sale and lease back transaction to ensure that NPV=0 holds on a with and without basis.
7. The issues paper notes complementary new Information Disclosure requirements will be needed. MEUG agrees. We think that the implications for adequate information to be disclosed to cover the issues listed in paragraph 5 above should not be underestimated.
8. Feedback to the Commission in this consultation round may lead to the conclusion that the complexity, transaction cost, uncertainty of effectiveness and material risk bias harming the long-term benefit to consumers may be sufficiently greater than originally contemplated. In such case, more systemic changes to Part 4 need to be considered.
9. For example, a requirement that assets, liabilities and cashflows related to providing services regulated under Part 4 must be disclosed in separate accounting entities for the regulated and unregulated services provided by line businesses. MEUG is not suggesting that option should be on the table now. Nevertheless, we think an open mind should be kept on the pros and cons of that option as it would solve much of the problem linking GAAP accounting requirements and Part 4 requirements.

Yours sincerely



Ralph Matthes
Executive Director

⁶ Port of Melbourne lease transaction: <https://www.premier.vic.gov.au/port-of-melbourne-lease-transaction-finalised/>

⁷ Ausgrid proposed lease:

https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Foreign_Investment_Review/Supplementary%20Report/c02