Rate-regulated activities - Measurement of regulatory assets Issues Paper

Objectives of this paper

1 The ASAF discussion is expected to focus on the measurement of a simple 'base case' example of a regulatory asset that arises, when an entity incurs costs as it carries out a required activity delivering regulated goods or services to customers and the regulatory agreement gives the entity a right to recover those costs (by increasing the rate to be charged to customers). A series of variations to the fact pattern will also be considered. These are included as examples 1-5 in the Appendix to this paper; reproduced from agenda paper 12-05 (ASAF paper 6B).

2 The objective is to discuss whether (and how) the measurement of a regulatory assets should reflect:

(a) the time value of money;

(b) an agreed rate of return (a profit or return on its investment in the assets used to supply the regulated goods or services).

(c) accruingThe following further issues are also considered: Accruing of interest when invoicing to customers is delayed; and

(d) short-term reversals.

3 So far, examples considered in previous ASAF and IASB discussions have assumed that the time value of money does not contain a significant financing component and that the regulated rate is based on a 'cost recovery-basis' (i.e. nil return assumed).

4 The ASAF September papers will be considered by the IASB at its meeting on 20 September 2017. The IASB Staff will be asking the IASB for views, rather than decisions, on factors to be considered when developing measurement proposals for the accounting model.

5 Agenda paper 12-04 (ASAF paper 6A), paragraphs 19-29 outline the next steps in the rate-regulated activities project. We will be asking EFRAG TEG and EFRAG CFSS members for their views on the status of the project.

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Characteristics of a regulatory asset

7 A regulatory asset arises when an entity incurs costs as it carries out a required activity to deliver goods or services to customers and the regulatory agreement gives the entity a right to increase the rate charged to customers to the extent needed to recover those costs.

8 The accounting model being developed for rate-regulated activities is supplementary to the existing IFRS Standards. Consequently, the model will focus on the entity's right to recover any portion of costs incurred that are not covered by an existing IFRS Standard. Accordingly, a distinction is also made between trade receivables, contract assets and regulatory assets in order to provide users of financial statements with relevant information about the risks associated with the entity's rights in a contract.

9 The use of a supplementary approach to account for regulatory assets is demonstrated in the simple 'base case' scenario in example 1 of Appendix 1 to this paper when the time value of money is considered to have no material effect.

Measurement basis for regulatory assets

10 The IASB Staff explains that, in the base case where there is not a significant financing component, recognising and measuring the regulatory asset initially at the nominal amount of the future cash flows is assumed to provide a faithful representation of the entity's unconditional right to increase the rate charged to customers to the extent needed to recover the costs incurred.

11 Reversing the regulatory asset by continuing to measure it at the same amount, less amounts billed as goods or services are delivered and charged at the higher rate, is assumed to provide a faithful representation of the consumption of the asset and the effects on the amount and timing of future related cash flows.

12 One of the issues that the IASB papers are addressing is the appropriate treatment when there is a significant financing component.

Measurement guidance under IFRS 15 on time value of money

13 The EFRAG Secretariat notes that paragraph 60 of IFRS 15 *Revenue from Contracts with Customers* requires an entity to adjust the consideration price for the time value of money if the contract contains a significant financing component.

14 IFRS 15 (paragraphs 64 and 65) requires an entity to use the discount rate that would be used in a separate financing transaction between the entity and the customer at inception of the contract. This discount rate is generally not updated for a change in circumstances. The financing component is recognised as interest expense (when the customer pays in advance) or interest income (when the customer pays in arrears).

Base case (example 1)

15 Appendix 1 sets out a 'base case' of a regulatory asset that arises when an entity incurs costs of CU 100.000 for delivering regulated services to its customers and the regulatory agreement gives the entity the right to recover these costs in equal amounts over five years.

16 The base case assumes that the time value of money has no material effect and there is no uncertainty in recovering the costs. **At the end of year 1, the entity will recognise a regulatory asset of CU 80.000.** The regulatory asset, representing the costs to be recovered, equals both the nominal amount and the present value of the related cash flows.

Regulatory rate compensates for time value of money (example 2)

17 When the effects of the time value of money are material[1], the regulatory agreement typically gives the entity the right to charge customers a rate that provides compensation for these financing effects, including the risks associated with the

[1] For example when the customer or the entity has a significant benefit of financing the transfer of goods or services to the customer.

related cash flows. The regulatory agreement usually specifies the discount rate that should be applied to determine the charge to the customer. In this example, the regulatory discount rate, which is included in the rate the entity can charge its customers, is 2%. The discounting effect is CU3.800 over a five year period.

18 If the regulatory interest rate is reasonably close to the prevailing interest rates in the relevant market, using that regulatory interest rate to discount back the stream of expected cash inflows from the regulatory asset would result in a present value approximating the regulatory asset. Consequently, under these circumstances, using the regulatory interest rate to discount back the stream of expected cash inflows would faithfully represent the value of the regulatory asset at initial recognition as well as subsequently.

19 Example 2 of the Appendix illustrates the proposed initial and subsequent measurement of a regulatory asset when the regulatory interest rate used for discounting is similar to the prevailing market interest rate.

20 The discounting effect of CU3.800 is included in the amounts billed to customers and thus recognised as revenue under IFRS 15.

Regulatory rate does not compensate for time value of money (example 3)

21 In some cases, the regulatory agreement does not entitle an entity to reflect the time value of money in the regulated rate the entity can charge its customers, even if the effect is significant.

22 In this case, one can argue that the entity does not fully recover the costs incurred and which raises a question about whether the entity should recognise a loss for the shortfall. If a loss is to be recognised, it could be measured as the difference between the discounted cash inflows from the regulatory asset and the regulatory asset itself[2]. Example 3 of the Appendix (paragraphs 13 - 18 of the Appendix) illustrates this situation. The regulatory asset with a nominal value of CU 80.000 (see paragraph 16 above) has a discounted value of CU 76.200 at the end of year 1 using a market discount rate of 2%. This gives to a loss of CU 3.800 in year 1.

23 Alternatively, if the regulatory asset is measured at the present value of the future cash flows using the regulated discount rate of zero, the regulatory asset would be recognised for CU 80.000.

Questions for EFRAG TEG and EFRAG CFSS

24 Do EFRAG TEG and EFRAG CFSS members have any comments on whether a loss should be recognised on initial recognition of a regulatory asset when the entity is not expected to be fully compensated for the time value of money?

25 Do you have any comments on whether the nature of the regulatory asset is more appropriately reflected by measuring it at:

- the nominal amount of the costs incurred that will be included in the calculation of the future rate; or
- the present value of the related future cash flows? In this case, what discount rate should be used?

Regulatory rate compensates for time value of money and provides a return (example 4)

26 When the incurred costs are to be recovered over a longer period, defined rate regulation typically gives the entity the right to charge customers a rate that provides

[2] All of the examples assume that the rate-regulated entity will recover the total actual expenditure and any loss would only arise because the costs are not recovered as they are incurred.

a return for equity investors, as well as compensating the entity for the time value of money.

27 Usually, rate regulators use a weighted average cost of capital (WACC) as the basis of the regulatory return rate. In some cases, an estimate of the entity's actual WACC may be used or a 'deemed market WACC' to reflect the exposures to risks of different entities within the rate-regulated sector.

28 When the regulated rate compensates for both time value of money and provides a return on investment, the accounting model consider :

(a) whether the difference should to be recognised as a gain in profit or loss on 'day one' or over time; and

(b) if any gain is recognised over time, what the pattern of recognition should be.

29 Example 4 of Appendix 1 (paragraphs 19 - 27 of the appendix) illustrates the proposed initial and subsequent measurement of a regulatory asset when the regulatory rate compensates for time value of money plus return.

30 The EFRAG Secretariat notes that in example 4, the entity is entitled to earn interest at 2% equivalent to CU 3.800 and a rate of return of CU 3.200 (on the costs it incurred of CU100.000 in year 20X1). The example explains that the right to earn interest and a return is included in the regulated rate that the entity is entitled to charge its customers for goods or services delivered. In summary, the entity is entitled to three things (three rights):

(a) right to recover the costs incurred of CU100.000;

(b) interest of CU3.800 to compensate for the time value of money; and

(c) right to a rate of return of CU3.200.

31 The example informs that under the accounting model, the right to recover the costs of CU100.000 is recognised in 'year one' (20X1) by invoicing CU20.000 to customers and recognising a regulated rate adjustment income of CU80.000. The example suggests that the interest of CU3.800 should be recognised over time (four years in the example). With regards to the return of CU3.200 the example discusses two alternatives:

(a) recognise the entire return in 'year one' (20X1); or

(b) recognise it over time.

32 Under alternative (a) the return is recognised in the same period as the corresponding regulatory income and related expenses.

Question for EFRAG TEG and EFRAG CFSS

33 Do EFRAG TEG and EFRAG CFSS members have any comments on whether a gain should be recognised on initial recognition of a regulatory asset when the entity is expected to earn a return, as well as being fully compensated for the time value of money?

Further issues to consider

Accruing interest when billing is delayed (example 5)

34 So far, the examples discussed have been straightforward, with billings starting in the year that the costs were incurred and the amounts billed include the allowance for interest and a return.

35 In certain cases, the regulator may delay the start of billing to a later period and allow the entity to earn interest even though that interest **will not be included in the amounts billed to customers until a future period**.

36 Example 5 of Appendix 1 (paragraphs 29 - 34 of the appendix) illustrates the proposed initial and subsequent measurement of a regulatory asset when the regulatory rate compensates for time value of money and the billing to the customer is deferred.

37 The EFRAG Secretariat notes that in example 5 the customer pays in year 3 up to year 5 for work performed in year 1. The effect of the financial component is interest income of CU6.100 for the entity. The example presents two possible ways to recognise the interest income:

(a) as it accrues, that is interest income is recognised in profit or loss *before* the entity is allowed to bill it to its customers (starting in year 3); or

(b) when it is billed to customers, that is the entity recognises an increase in revenue when the interest is recovered through the amounts billed to customers.

Question for EFRAG TEG and EFRAG CFSS

38 Do you have any comments on whether accruing interest that will not be included in the rate until a later period should be recognised in profit or loss a**s it accrues or only when it is billed to customers in the regulated rate**?

Short-term reversals

39 Many regulatory assets are reversed within a relatively short time of their origination and so their measurement may not be materially impacted by the time value of money. Consequently, providing a practical expedient to measure the regulated asset at its nominal amount (i.e. the amount of the cost variance) could be considered when the model for rate-regulated activities is developed.

40 Short-term reversals of regulatory assets can be viewed as similar to trade receivables being measured at their transaction price under IFRS 9 *Financial Instruments* if:

(a) the regulatory asset does not contain a significant financing component; or

(b) if the period between delivery of the service and when the customers pay for that service will be one year or less.

Questions for EFRAG TEG and EFRAG CFSS

41 Do you agree with the consideration to measure the regulatory asset at its nominal amount when the conditions in paragraph 40 above are met?

42 Do you have any other comments on issues discussed in this paper?

Status of the rate-regulated activities project and next steps

43 Agenda paper 12-04 (ASAF paper 6A), paragraphs 19-29 outline the next steps in the rate-regulated activities project. Discussions at the IASB have so far covered aspects of:

(a) the objective, principles and general approach of the model;

(b) scope;

(c) an analysis of the rights and obligations arising from the rate-adjustment mechanism and the definitions of assets and liabilities, as those terms are expected to be defined in the forthcoming revised *Conceptual Framework for Financial Reporting*;

(d) recognition and reversal of regulatory assets and regulatory liabilities in conditions of certainty;

(e) recognition of regulatory assets and regulatory liabilities in conditions of uncertainty; and

(f) measurement of regulatory assets (to be discussed at the forthcoming IASB meeting in September 2017).

44 Topics expected to be discussed in Q4 2017 are:

(a) further measurement issues, including measurement of regulatory liabilities;

(b) presentation and disclosure;

(c) consolidation of discussions held so far and follow up on outstanding matters from previous discussions;

(d) interaction of the model with the requirements of IFRIC 12 *Service Concession Arrangements*;

(e) high-level comparison with FASB *Accounting Standards Codification® Topic 980 Regulated Operations*; and

(f) the form of the next consultation document, which could be either a Discussion Paper or an Exposure Draft.

EFRAG Secretariat comment

45 The EFRAG Secretariat has some concerns that key topics have not yet been fully developed, and do not appear to be in the list of future topics to be discussed. In particular, we are concerned that the scope of the project (pages 12-13 of agenda paper 12-04 (ASAF paper 6A) is not sufficiently developed for the determination of whether some regulated activities will be within the scope of the project.

46 Given the nature of this project, and acknowledging that there are some jurisdictions that do not support developing an IFRS Standard on rate-regulated activities, we are of the view that a second Discussion Paper would be a better way forward than moving immediately to an Exposure Draft.

Questions for EFRAG TEG and EFRAG CFSS

47 Do you consider that some aspects of the rate-regulated activities project that appear to be substantially completed still require further development? If so, what are the relevant issues?

48 Do you have a view, at this stage, as to whether the IASB should consult through a Discussion Paper or an Exposure Draft?

Appendix 1: Examples on initial and subsequent measurement of regulatory assets

These examples have been reproduced from agenda paper 12-05 (ASAF agenda paper 6B)

Example 1: *Base case*

1 Under the regulatory agreement with the regulator, Entity W has the right to charge a regulated rate to customers in order to recover specified actual input costs incurred for delivering regulated services to customers. In 20X1, Entity W incurs CU100.000 of costs above its level of allowable costs. The rate regulator approves these costs and gives Entity W the right to increase the rate charged to customers to the extent needed to recover those costs. However, Entity W is allowed to recover the CU100.000 costs in five equal instalments of CU20.000, starting in 20X1.

2 In this example, the time value of money has no material effect and the billing amounts and related cash flows are certain. Consequently, by the end of 20X5, Entity W recovers the CU100.000 costs incurred.

3 At the end of 20X1, the entity W has two assets:

(a) trade receivable - an unconditional right to CU20.000 to receive cash from customers which is accounted for using IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers*; and

(b) regulatory asset - an unconditional right to increase the rate charged to customers to the extent needed to recover the remaining CU80.000 costs incurred.

4 Using the model, the entity will, at 31 December 20X1, recognise a regulatory asset of CU80.000, together with the related regulated rate adjustment income in profit or loss. The regulatory asset will reverse over the four years 20X2-20X5 as it is consumed by Entity W including CU20.000 each year in its bills to customers.

5 In this case, the costs incurred and included in the regulatory asset approximately equal the present value of the related cash flows from billing the customers using the increased rate.

Example 2: *Regulatory rate compensates for time value of money*

6 The fact pattern is the same as in example 1, except that:

(a) the time value of money has a material effect; and

(b) in addition to the CU20.000 included in the rate charged to customers each year, Entity W has the right to include interest (discount effect) at the **regulatory interest rate of 2% each year** on the outstanding balance of the incurred costs not yet recovered through the rate.

7 The regulatory interest rate of 2% compensates the entity for the time value of money and the risks associated with the related cash flows, but does not provide any additional return for investors. Nonetheless, discounting back to the end of 20X1 the cash inflows from the four annual instalments to be billed in 20X2-20X5 gives a present value of CU80.000.

8 At the end of 20X1, the entity W has:

(a) has an unconditional right to receive cash for the CU20.000 billed during 20X1; and

(b) an unconditional right to include CU20.000 plus 2% interest in amounts billed each year during 20X2-20X5.

9 If the regulatory asset was to be measured at this present value, the regulatory asset would reverse over the next four years as the time value of money unwinds and the entity consumes its right to charge the higher rate, as follows:

Year to 31 December	**20X1**	**20X2**	**20X3**	**20X4**	**20X5**
	CU000	**CU000**	**CU000**	**CU000**	**CU000**
Regulatory asset					
Opening asset balance	0.0	80.0	60.0	40.0	20.0
Initial recognition	80.0	0	0	0	0
Included in amounts billed	0	(21.5)	(21.1)	(20.8)	(20.4)
Interest income at 2%	0	1.5	1.1	0.8	0.4
Closing asset balance	**80.0**	**60.0**	**40.0**	**20.0**	**0.0**

10 If the regulatory asset is measured using the present value of the future cash flows discounted using the 2% regulatory interest rate, at the end of 20X1 Entity W would reflect in its financial statements:

(a) CU100.000 costs incurred in profit or loss;

(b) CU20.000 billed to customers during the year as revenue in profit or loss;

(c) regulatory asset of CU80.000 which will reverse during each year 20X2-20X5 as Entity W includes the CU20.000 plus 2% interest in its bills to customers.

11 This is reflected as follows in the profit or loss account:

Year to 31 December	**20X1**	**20X2**	**20X3**	**20X4**	**20X5**	**Total**
	CU000	**CU000**	**CU000**	**CU000**	**CU000**	**CU000**
Recognising the regulatory asset at its present value of CU80,000 using a discount rate of 2%						
Revenue (amounts billed)	**20**	**21.5**	**21.1**	**20.8**	**20.4**	**103.8**
Regulated rate adjustment: income/ (expense)	80	(20)	(20)	(20)	(20)	0
Operating expenses	(100)	(0)	(0)	(0)	(0)	(100)
Profit/ (Loss)	**0**	**1.5**	**1.1**	**0.8**	**0.4**	**3.8**
Regulatory (liability)/ asset	80	60	40	20	0	

12 In this example, the CU3.800 reflects the interest earned on the outstanding regulatory asset. **As the interest is included in amounts billed to customers, it is recognised within revenue using IFRS 15, and not as a separate line item in profit or loss.**

Example 3: *Regulatory rate does not compensate for time value of money*

13 The fact pattern is the same as in example 2, except that Entity W has a right to include only the CU100.000 incurred actual costs on a straight-line basis over five years, ie CU20.000 per year, starting in 20X1.

14 At the end of 20X1, the entity W has:

(a) has an unconditional right to receive cash for the CU20.000 billed during 20X1; and

(b) an unconditional right to include CU20.000 in amounts billed each year during 20X2-20X5, with no interest.

15 Using the 2% original prevailing market interest rate to discount the four annual instalments of CU20,000 to be billed in 20X2-20X5 gives a present value of CU76,200 at the end of 20X1. Consequently, the present value of the cash flows intended to recover the costs is CU3,800 less than the actual costs incurred.

16 If the regulatory asset is to be measured at this present value, instead of the CU80,000 actual costs incurred, the regulatory asset would reverse over the next four years as follows:

Year to 31 December	**20X1**	**20X2**	**20X3**	**20X4**	**20X5**
	CU000	**CU000**	**CU000**	**CU000**	**CU000**
Regulatory asset					
Opening asset balance	0.0	76.2	57.7	38.8	19.5
Initial recognition	76.2	0	0	0	0
Included in amounts billed	0	(20.0)	(20.0)	(20.0)	(20.0)
Interest income at 2% (unwinding TVM)	0	1.5	1.1	0.8	0.4
Closing asset balance	**76.2**	**57.7**	**38.8**	**19.5**	**0.0**

17 If the regulatory asset is measured at the present value of the future cash flows using the original prevailing market interest rate, at the end of 20X1 Entity W would reflect in its financial statements:

(a) CU100.000 costs incurred;

(b) CU20.000 billed to customers during the year as revenue in profit or loss; and

(c) regulatory asset of CU76.200 as illustrated below:

Year to 31 December	**20X1**	**20X2**	**20X3**	**20X4**	**20X5**	**Total**
	CU000	**CU000**	**CU000**	**CU000**	**CU000**	**CU000**
Recognising the regulatory asset at its present value of CU76,200 using a discount rate of 2%						
Revenue (amounts billed)	**20**	**20**	**20**	**20**	**20**	**100**
Regulated rate adjustment: income/ (expense)	76.2	(20)	(20)	(20)	(20)	(3.8)
Regulated rate adjustment: interest income (unwinding of TVM @ 2%)	0	1.5	1.1	0.8	0.4	3.8
Operating expenses	(100)	(0)	(0)	(0)	(0)	0
Profit/ (Loss)	**(3.8)**	**1.5**	**1.1**	**0.8**	**0.4**	**0**
Regulatory (liability)/ asset	76.2	57.7	38.8	19.5	0	

18 If, instead, the regulatory asset is measured at the present value of the future cash flows using the original regulatory interest rate, at the end of 20X1 Entity W would reflect in its financial statements the regulatory asset at CU80.000. The regulatory asset reverses during each year 20X2-20X5 as Entity W consumes its right to charge the higher rate by including the CU20.000 in the amounts billed to customers.

Year to 31 December	**20X1**	**20X2**	**20X3**	**20X4**	**20X5**	**Total**
	CU000	**CU000**	**CU000**	**CU000**	**CU000**	**CU000**
Recognising the regulatory asset at its present value of CU80,000 using a discount rate of 0%						
Revenue (amounts billed)	**20**	**20**	**20**	**20**	**20**	**100**
Regulated rate adjustment: income/ (expense)	80	(20)	(20)	(20)	(20)	0
Operating expenses	(100)	(0)	(0)	(0)	(0)	(100)
Profit/ (Loss)	**0**	**0**	**0**	**0**	**0**	**0**
Regulatory (liability)/ asset	80	60	40	20	0	

Example 4: *Regulatory rate compensates for time value of money plus a return*

19 The fact pattern is the same as in example 2, except that Entity W has a right to include 'interest' at the regulatory return rate of 3.7% each year on the outstanding balance of the costs not yet recovered through the rate. The regulatory return rate of 3.7% is intended to compensate the entity for the time value of money and provide a return for investors.

20 Using the prevailing market interest rate of 2% to discount the four remaining annual instalments of CU20.000 to be billed in 20X2-20X5 back to the end of 20X1 gives a present value of CU83.200.

21 If the regulatory asset is to be measured at this present value, instead of the CU80.000 actual costs incurred, the regulatory asset would reverse over the next four years as follows:

Year to 31 December	**20X1**	**20X2**	**20X3**	**20X4**	**20X5**
	CU000	**CU000**	**CU000**	**CU000**	**CU000**
Regulatory asset					
Opening asset balance	0.0	83.2	61.9	41.0	20.3
Initial recognition	83.2	0	0	0	0
Included in amounts billed	0	(22.8)	(22.0)	(21.5)	(20.7)
Interest income at 2%	0	1.5	1.1	0.8	0.4
Closing asset balance	**83.2**	**61.9**	**41.0**	**20.3**	**0.0**

22 If the regulatory asset is measured at the present value of the future cash flows using the original prevailing market interest rate, at the end of 20X1 Entity W would reflect in its financial statements:

(a) CU100.000 costs incurred;

(b) CU20.000 revenue billed to customers during the year; and

(c) regulatory asset of CU83.200 as illustrated below:

Year to 31 December	**20X1** **CU000**	**20X2** **CU000**	**20X3** **CU000**	**20X4** **CU000**	**20X5** **CU000**	**Total** **CU000**
Recognising the regulatory asset at its present value of CU83,200 using a discount rate of 2%						
Revenue (amounts billed)	**20**	**22.8**	**22.0**	**21.5**	**20.7**	**107.0**
Regulated rate adjustment: income/ (expense)	83.2	(20)	(20)	(20)	(20)	3.2
Regulated rate adjustment: 'interest' expense (unwinding of return)	0	(1.3)	(0.9)	(0.7)	(0.3)	(3.2)
Operating expenses	(100)	(0)	(0)	(0)	(0)	(100)
Profit/ (Loss)	**3.2**	**1.5**	**1.5**	**0.8**	**0.4**	**7.0**
Regulatory (liability)/ asset	83.2	61.9	41.0	20.3	0	

23 The CU3.200 reflects the present value of the return for investors that the entity has a right to include in the rate. When deciding whether to recognise this return as a gain in 20X1, or recognise it over time, the reason for the return should be considered.

24 If this additional return is a reasonable proxy for the return that reflects the risks faced by investors in a rate-regulated market, this suggests that the additional return is provided to reflect the deferred recovery of the costs. In such a case, it would seem reasonable to recognise the return in profit or loss over the period in which there is a regulatory asset balance outstanding. This would result in Entity W reporting the following in its financial statements:

Year to 31 December	**20X1** **CU000**	**20X2** **CU000**	**20X3** **CU000**	**20X4** **CU000**	**20X5** **CU000**	**Total** **CU000**
Recognising the regulatory asset at its present value of CU80,000 using a discount rate of 3.7%						
Revenue (amounts billed)	**20**	**22.8**	**22.0**	**21.5**	**20.7**	**107**
Regulated rate adjustment: income/ (expense)	80	(20)	(20)	(20)	(20)	0
Operating expenses	(100)	(0)	(0)	(0)	(0)	(100)
Profit/ (Loss)	**0**	**2.8**	**2.0**	**1.5**	**0.7**	**7**
Regulatory (liability)/ asset	80	60	40	20	0	

25 In this case, the 'profit' in each year is made up of:

(a) the 2% interest that compensates the entity for the time value of money, and

(b) the additional return to investors.

26 In this example, the CU7.000 reflects the interest earned on the outstanding regulatory asset (CU3.800) and a rate of return (CU3.200). **Both these elements are included in the amounts billed to customers, and are recognised within revenue using IFRS 15, and not as a separate line item in profit or loss.**

Year to 31 December	**20X1**	**20X2**	**20X3**	**20X4**	**20X5**	**Total**
	CU000	**CU000**	**CU000**	**CU000**	**CU000**	**CU000**
Interest at 2%	0	1.5	1.1	0.8	0.4	3.8
Investor return	0	1.3	0.9	0.7	0.3	3.2
Profit/ (Loss)	**0**	**2.8**	**2.0**	**1.5**	**0.7**	**7.0**

27 If the additional return provided to investors is significantly higher than the return that reflects the risks faced by investors in a rate-regulated market, this suggests that some of the return may be for something other than the investment in the regulatory asset.

28 In such a case, it may be appropriate to recognise the gain in that period. However, when it is difficult to identify what the higher return relates to, it may be more appropriate to recognise the gain over time by discounting the asset using the regulatory return rate.

Example 5: *Regulatory rate compensates for time value of money when the billing to the customer is delayed*

29 The fact pattern is the same as in example 2, except that **Entity W cannot increase the rate to start to recover the costs incurred during 20X1 until 20X3.** Consequently, the costs incurred and the allowed interest is included in the amounts billed to customers during the three years 20X3-20X5.

30 Using the prevailing market interest rate of 2% to discount the amounts to be billed in 20X2-20X5 back to the end of 20X1 gives a present value of CU100.000. Using the same rate to discount the amounts to be billed in 20X2-20X5 back to the end of 20X2 gives a present value of CU102.000.

31 The regulatory asset of CU102.000 reverses over the three years 20X3-20X5. **In this case, the CU2.000 interest that accrues during 20X2 is not included in the amounts billed to customers in 20X2**. Instead, it is added to the outstanding costs incurred that have not been recovered by the end of 20X2.

Year to 31 December	**20X1**	**20X2**	**20X3**	**20X4**	**20X5**
	CU000	**CU000**	**CU000**	**CU000**	**CU000**
Regulatory asset					
Opening asset balance	0.0	100.0	102.0	68.1	34.0
Initial recognition	100.0	0	0	0	0
Included in amounts billed	0	0	(36.0)	(35.4)	(34.7)
Interest income at 2%	**0**	**2.0**	**2.1**	**1.3**	**0.7**
Closing asset balance	**100.0**	**102.0**	**68.1**	**34.0**	**0.0**

32 In this case, identifying the nature of the regulatory interest rate provided in the regulatory agreement and the nature of the regulatory asset, helps to identify whether the CU2.000 interest accrued during 20X2 should be recognised in profit or loss as it accrues in 20X2 or as it is billed in 20X3-20X5.

33 Using the regulatory interest rate of 2%, the regulatory asset will be measured at CU100.000 at the end of 20X1 and CU102.000 at the end of 20X2. Consequently, the CU2.000 interest accreted during 20X2 will need to be recognised in profit or loss during 20X2. Because the CU2.000 is included in the amounts billed on a straight-line basis in each of the three-years 20X3-20X5, a regulated rate 'unwinding' adjustment needs to be recognised in profit or loss to avoid double-counting this interest as shown in the following table:

Year to 31 December	**20X1** **CU000**	**20X2** **CU000**	**20X3** **CU000**	**20X4** **CU000**	**20X5** **CU000**	**Total** **CU000**
Regulatory asset at end of 20X1 and 20X2 measured at present value of future cash flows using a discount rate of 2%						
Revenue (amounts billed)	**0**	**0**	**36.0**	**35.4**	**34.7**	**106.1**
Regulated rate adjustment: income/ (expense)	100	0	(33.4)	(33.3)	(33.3)	0
Regulated rate adjustment: accrued interest income	0	2.0	0	0	0	2.0
Regulated rate adjustment: unwinding accrued interest income	0	0	(0.7)	(0.7)	(0.6)	(2.0)
Operating expenses	(100)	(0)	(0)	(0)	(0)	(100)
Profit/ (Loss)	**0.0**	**2.0**	**1.9**	**1.4**	**0.8**	**6.1**
Regulatory (liability)/ asset	100.0	102.0	68.1	34.0	0.0	

34 **Alternatively,** if the measurement of the regulatory asset focuses more on the 'recoverable costs', the regulatory asset could be measured at the nominal amount of the costs incurred (ie CU100.000) at the end of both 20X1 and 20X2. As a result, the CU2.000 interest accreted during 20X2 will be recognised in profit or loss as it is recovered through the amounts billed on a straight-line basis over the three years 20X3-20X5.

Year to 31 December	**20X1** **CU000**	**20X2** **CU000**	**20X3** **CU000**	**20X4** **CU000**	**20X5** **CU000**	**Total** **CU000**
Regulatory asset at end of 20X2 measured at nominal amount of costs incurred						
Revenue (amounts billed)	0	0	36.0	35.4	34.7	106.1
Regulated rate adjustment: income/ (expense)	100	0	(33.4)	(33.3)	(33.3)	0
Operating expenses	(100)	(0)	(0)	(0)	(0)	(100)
Profit/ (Loss)	**0.0**	**0.0**	**2.6**	**2.1**	**1.4**	**6.1**
Regulatory (liability)/ asset	100.0	100.0	66.6	33.3	0	