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Project	**Rate-regulated Activities**
Paper topic	Total allowed compensation—regulatory returns on an asset not yet available for use

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Purpose of this paper

1. In March 2020, the Board tentatively decided that regulatory returns on a construction work-in-progress base form part of total allowed compensation only during the period when the asset is in operation and is being used to supply goods or services. This paper discusses when that period should end.

2. Based on the analysis carried out in this paper, the staff make an overall recommendation for the treatment of regulatory returns on an asset not yet available for use (paragraph 14). [1] This paper does not ask questions to the Board. Questions to the Board relating to discussion in this paper are in Agenda Paper 9 *Sweep issues*.

Structure of this paper

3. This paper is structured as follows:

   (a) background (paragraphs 4–8);

   (b) staff analysis and recommendation (paragraphs 9–16); and

[1] For clarity in drafting of the Exposure Draft and in the rest of this paper, the staff refer to returns on a construction work-in-progress base as those relating to an asset not yet available for use for the supply of goods or services. Therefore, applying the Board's tentative decision in March 2020, these returns form part of total allowed compensation starting from when the related asset is available for use.

(c) appendices that include numerical examples for regulatory returns on an asset not yet available for use that are included in the regulated rates charged to customers during the operating period of the asset and during the construction period of the asset.

Background

4. Total allowed compensation for goods or services supplied is the full amount of compensation for goods or services supplied that a regulatory agreement entitles an entity to charge customers through the regulated rates in either the period when the entity supplies those goods or services, or a different period. If part of the total allowed compensation for goods or services supplied in one period is charged to customers through the regulated rates for goods or services supplied in a different period (and thus recognised as revenue in a different period by applying IFRS 15), a difference in timing arises and consequently, the regulatory agreement creates a regulatory asset or regulatory liability.

5. Table 1 summarises the Board’s tentative decisions on how an entity would determine whether components included in the regulated rates charged to customers in a period, and hence included in the revenue recognised in the period—are components of total allowed compensation for goods or services supplied in the same period, or for goods or services supplied in a different period—and thus whether those components affect profit in the same period or a different period:

Table 1—Components included in regulated rate	
Component	*When the component affects profit or loss*
Amount to recover allowable expenses less chargeable income	In the period when an entity recognises the expense or income applying IFRS Standards
Any component of target profit not listed below	In the period when the regulatory agreement entitles an entity to add that component in determining a regulated rate for goods or services supplied in that period
Margin on allowable expenses	In the period when an entity recognises the expense applying IFRS Standards
All regulatory returns, except those on assets not yet available for use	In the period when the regulatory agreement entitles an entity to add that return in determining a regulated rate for goods or services supplied in that period
Regulatory returns on assets not yet available for use	*Staff recommendation (paragraph 14)*: Only once the asset is available for use and then over the remaining periods in which the carrying amount of the asset is recovered through the regulated rates
Performance incentives (ie bonuses or penalties)	In the period in which an entity provides the performance that gives rise to the incentive
Regulatory interest income and regulatory interest expense	As the discount unwinds until recovery of the regulatory asset or fulfilment of the regulatory liability

6. Paragraphs BC96–BC99 of the staff's latest draft of the Basis for Conclusions to accompany the forthcoming Exposure Draft *Regulatory Assets and Regulatory Liabilities* state [commentary in footnotes and **emphasis** added]:

BC96 Regulatory agreements may provide entities with regulatory returns on a base containing a balance relating to an asset not yet available for use for the supply of goods or services to customers. The Board found two approaches commonly used by regulatory agreements for regulatory returns on such balances:

(a) under the first approach, those regulatory returns accumulate while the asset is not yet available for use and are included in the regulated rates charged to customers only once the asset is available for use (paragraph BC97)[2]; but

(b) under the second approach, those regulatory returns are included in the regulated rates charged to customers during periods when the asset is not yet available for use (paragraphs BC98–BC100).

BC97 When the regulatory agreement uses the first approach, the Board's proposed treatment for target profit in paragraph B10 of the Exposure Draft would result in those returns forming part of total allowed compensation once the asset is available for use.[3] The Board considers that outcome appropriate because it is aligned with the principle underlying the model.[4]

BC98 When the regulatory agreement uses the second approach, the Board's proposed treatment for target profit would, if applied, result in those regulatory returns forming part of total allowed compensation for goods or services supplied when the asset is not yet available for use. The Board considers such an outcome inappropriate because it:

(a) would contradict the model's principle in paragraph BC30—no goods or services are being supplied using that asset before it is available for use;[5] and

(b) could result in lack of comparability between entities, or within the same entity, if some regulatory agreements use the first approach and others use the second approach.

BC99 Thus, for consistency with the principle underlying the model (paragraph BC30) and regardless of whether the regulatory agreement uses the first approach or the second approach, the Board proposes that regulatory returns on a balance relating to an asset not yet available for use form part of total allowed compensation for goods or services supplied **once the asset is available for use** (paragraph B15 of the Exposure Draft). Thus, if the regulatory agreement uses the second approach, a regulatory liability would arise for these returns during the period when the asset is not yet available for use.

7. The Board tentatively decided at its meeting in March 2020 to propose the approach described in paragraph BC99. That approach specifies the beginning of the period when those returns form part of total allowed compensation for goods or services supplied.

[2] This approach is commonly referred to as an 'allowance for funds used during construction' or 'AFUDC'.

[3] Paragraph B10 of the Exposure Draft states: Target profit that a regulatory agreement entitles an entity to add in determining a regulated rate for goods or services supplied in a period forms part of total allowed compensation for goods or services supplied in the same period, unless this section specifies a different treatment.

[4] Staff note: The principle underlying the model is that an entity should reflect the total allowed compensation for goods or services supplied as part of its reported financial performance for the period in which those goods or services are supplied.

[5] The model's principle is that an entity shall reflect the total allowed compensation for goods or services supplied as part of its reported financial performance for the period in which those goods or services are supplied.

8. This paper analyses when that period should end. The staff's recommendation is captured in paragraph BC100 of the draft Basis for Conclusions, together with arguments for and against it [**emphasis** added]:

> BC100 The Board also proposes that those regulatory returns on a balance relating to an asset not yet available for use form part of total allowed compensation for goods or services supplied **over the remaining periods in which the asset is recovered through the regulated rates**, once the asset is available for use. This proposal could be inconsistent with the principle underlying the model if the last of those periods does not end at the same time as the asset's useful life determined by applying IFRS Standards. Nevertheless, the Board considers this proposal appropriate on cost-benefit grounds because:
>
> (a) it would apply consistently regardless of the approach the regulatory agreement uses.
>
> (b) if the regulatory agreement uses the first approach, the regulatory returns would form part of total allowed compensation for goods or services supplied in the same period as when those returns are included in the regulated rates (paragraph BC97) and, thus, there would be no need to allocate those regulatory returns to a different period.
>
> (c) if the regulatory agreement uses the second approach, allocating regulatory returns accumulated before the asset is available for use would be less complex if they are allocated over the remaining periods in which the asset is recovered through the regulated rates rather than over the asset's remaining useful life. Allocation over the remaining useful life could be particularly complex if assets, or components of assets, have various useful lives.

Staff analysis and recommendation

9. The issue discussed in this paper arises only if the regulatory agreement uses the second approach discussed in paragraph BC96(b) of the draft Basis for Conclusions. That is because only the second approach allows an entity to charge customers a regulatory return on an asset before the asset is available for use.

10. The first approach (AFUDC) accumulates the returns on an asset before it is available for use but does not entitle the entity to start charging those returns to customers until the asset is available for use. The outcome of applying the Board's tentative decisions for target profit (row 2 of Table 1) to the first approach is captured by paragraph BC97 of the draft Basis for Conclusions. This outcome is also illustrated in Appendix A, which demonstrates that these regulatory returns form part of total allowed compensation for goods or services supplied over the period in which the

corresponding asset is recovered through the regulated rates (ie the regulatory life of the asset).

11. When the regulatory agreement applies the second approach, staff considered two potential requirements for **the period** over which those regulatory returns should form part of total allowed compensation for goods or serviced supplied:

    (a) the remaining period in which the asset is recovered through the regulated rates, once the asset is available for use (**Potential Requirement 1**); or

    (b) the asset's useful life determined by applying IFRS Standards (ie for purposes of determining the depreciation or amortisation period) (**Potential Requirement 2**).

12. The two periods (in subparagraphs (a) and (b) of paragraph 11) may be the same, in which case both potential requirements 1 and 2 would lead to the same answer.

13. Appendix B presents an example of applying each potential requirement in paragraph 11 if the regulatory agreement applies the second approach described in paragraph BC96.

Staff recommendation

14. Staff recommend that the regulatory return on a balance relating to an asset not yet available for use forms part of the total allowed compensation for goods or services supplied **over the remaining periods in which an entity recovers the carrying amount of the asset through the regulated rates, once the asset is available for use** (ie Potential Requirement 1) for the reasons given in paragraph BC100 of the draft Basis for Conclusions.

15. As illustrated in Table 2, this recommendation will result in comparable financial reporting outcomes regardless of whether the regulatory agreement uses approach 1 (illustrated in Appendix A) or approach 2 (illustrated in Appendix B).

16. Staff do not recommend that the Board specify the pattern in which these regulatory returns form part of total allowed compensation for goods or services supplied over the period described in paragraph 14 of the paper (paragraph BC100), because the appropriate pattern will depend on the specific facts and circumstances.

Table 2—Profit for two fact patterns using the potential requirements in paragraph 11							
In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Total**
	Asset not yet available for use	**IFRS Useful life**					
	Regulatory recovery period						
Regulatory approach 1 (Appendix A)	-	93	70	49	-	-	212
Regulatory approach 2 (Appendix B)							
Potential requirement 1 (*Staff recommendation*)	-	87	67	46	-	-	200
Potential requirement 2	-	76	56	36	16	16	200

Appendix A—Illustration of first approach in paragraph BC96(a) applied by the regulatory agreement (AFUDC)

A1. Entity A supplies goods or services to customers pursuant to a regulatory agreement.

A2. At the beginning of Year 1, Entity A completed the construction of an item of plant that will be available for use in the supply of goods or services to customers from the start of Year 2. The cost of the item of plant both for regulatory purposes and as determined applying IAS 16 *Property, Plant and Equipment* was CU1,000. The asset is available for use on the first day of Year 2. Depreciation, determined in accordance with IAS 16, is recognised from that date over the asset's five-year useful life using the straight-line method (ie Years 2–6).

A3. The regulatory agreement stipulates that Entity A shall add the construction costs into the 'regulatory capital base' as they are incurred and that Entity A is entitled to recover those costs evenly over four years, starting from the date when the costs are added into that base (ie Years 1–4). Therefore, the entity is entitled to recover part of its construction costs before the item of plant is available for use (ie in Year 1).

A4. In addition, a regulatory return of 8% is provided on the unrecovered balance of the regulatory capital base at the beginning of each year, with:

(a) regulatory returns arising before the item of plant is available for use (ie in Year 1) to be added to the regulatory capital base and included in the regulated rates only once the item of plant is available for use and thereafter evenly over the same period as any unrecovered construction costs of the plant (ie Years 2–4); and

(b) regulatory returns arising when the item of plant is available for use included in the regulated rates as they arise.

A5. Thus, the amounts to be included in the regulated rates to be charged to customers relating to the item of plant are:

Figure A1—Amounts included in the regulated rates to be charged to customers relating to the item of plant constructed in Year 1

	Not available for use	**Item of plant available for use**			
In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Total**
Opening balance	1,000	830	553	277	-
Regulatory return	80	66	44	22	212
Amounts expected to be included in the regulated rates, of which:	(250)	(343)	(320)	(299)	(1,212)
Recovery of construction costs (note (a))	*(250)*	*(250)*	*(250)*	*(250)*	*(1,000)*
Regulatory return (note (b))	*-*	*(93)*	*(70)*	*(49)*	*(212)*
Closing balance	**830**	**553**	**277**	**-**	**-**

(a) Amounts expected to be included in the regulated rates in Year 1 are amounts expected to be charged to customers for goods or services supplied using other assets.

(b) Determined by the regulatory agreement as recovery of the CU80 regulatory return, accumulating during construction in Year 1, evenly over Years 2–4 plus the regulatory return amount on the unrecovered balance of the opening balance of the regulatory capital base—both amounts Entity A is entitled to add in determining the regulated rates to be charged in the Years 2–4.

Application of proposed requirements (summarised in Table 1 in this paper)

A6. The total allowed compensation for Years 1–6 consists of:

(a) the amount that recovers allowable expenses recognised when supplying the goods or services—in this case the depreciation expense of CU200 per year recognised for the item of plant for Years 2–6.

(b) the regulatory return of 8%, which consists of the regulatory return in Figure A1. In accordance with the Board’s tentative decisions summarised in Table 1, the regulatory return forms part of the total allowed compensation for goods or services supplied in the same year in which the regulatory agreement entitles the entity to add it in determining the regulated rates.

Figure A2—Total allowed compensation for goods or services supplied in Years 1–6							
In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Total**
Allowable expenses – depreciation expense	-	200	200	200	200	200	1,000
Regulatory return	-	93	70	49	-	-	212
Total allowed compensation	**-**	**293**	**270**	**249**	**200**	**200**	**1,212**
Revenue	250	343	320	299	-	-	1,212
Regulatory income (regulatory expense)	**(250)**	**(50)**	**(50)**	**(50)**	**200**	**200**	**-**

Figure A3—Profit for Years 1–6							
In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Total**
Revenue	250	343	320	299	-	-	1,212
Regulatory income (regulatory expense) (Figure A5)	(250)	(50)	(50)	(50)	200	200	-
	-	293	270	249	200	200	1,212
Depreciation	-	(200)	(200)	(200)	(200)	(200)	(1,000)
Profit	**-**	**93**	**70**	**49**	**-**	**-**	**212**

A7. The profit in Years 1–6 equals the regulatory return on the regulatory capital base that the regulatory agreement entitles the entity to charge to customers when supplying goods or services during these years, consisting of the following components:

Figure A4—Composition of profit for Years 1–6

In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Total**
Regulatory return on the regulatory capital base before deducting regulatory liability (note (a))	-	86	68	50	32	16	252
Regulatory interest expense (Figure A5)	-	(20)	(24)	(28)	(32)	(16)	(120)
		66	44	22	-	-	132
Regulatory agreement applies first approach in paragraph BC96 (note (b))	-	27	26	27	-	-	80
		93	**70**	**49**	**-**	**-**	**212**

(a) Represents the regulatory return the entity would have earned had the regulatory agreement required the item of plant to be recovered through the regulated rates to be charged to customers over the asset's five-year useful life considering an initial cost of CU1,080 (construction costs of CU1,000 plus CU80 of regulatory returns Entity A is entitled to for Year 1).

(b) That is, the regulatory agreement specifies that the regulatory returns which accumulate during the construction period can be recovered evenly through the regulated rates to be charged to customers only when the asset is available for use (in this case on a straight-line basis over Years 2–4).

Figure A5—Reconciliation of carrying amount of regulatory liability

In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Opening carrying amount (1)	-	250	300	350	400	200
Amount recognised (note (a))	250	50	50	50	-	-
Regulatory interest expense	-	20	24	28	32	16
Fulfilment (note (b))	-	(20)	(24)	(28)	(232)	(216)
Subtotal: Regulatory expense (regulatory income) (2)	250	50	50	50	(200)	(200)
Closing carrying amount (1 + 2)	**250**	**300**	**350**	**400**	**200**	**-**

(a) CU250 charged to customers in Year 1 creates a regulatory liability. There are further additions to the regulatory liability in Years 2–4 resulting from the increasing amount of Entity A's obligation to deduct an amount in determining the regulated rates to be charged to customers in future years (Years 5–6).

(b) The amount fulfilled in the year is an amount relating to depreciation expense already recovered in earlier years (nil in Years 2–4; CU200 in each of the Years 5–6), plus the regulatory interest expense for that year.

Appendix B—Illustration of the potential requirements in paragraph 11 when a regulatory agreement applies the second approach in paragraph BC96

B1. Assume the same fact pattern as Appendix A, except that the regulatory agreement specifies that the regulatory returns to which Entity A is entitled for Year 1 can be included in the regulated rates to be charged to customers in that same period (ie applying the second regulatory approach in paragraph BC96).

B2. Thus, the amounts to be included in the regulated rates to be charged to customers relating to the item of plant are:

Figure B1—Amounts included in the regulated rates to be charged to customers relating to the item of plant constructed in Year 1

	Not available for use	**Item of plant available for use**			
In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Total**
Opening balance	1,000	750	500	250	-
Regulatory return	80	60	40	20	**200**
Amounts expected to be included in the regulated rates, of which (notes (a) and (b)):	(330)	(310)	(290)	(270)	**(1,200)**
Recovery of construction costs	*(250)*	*(250)*	*(250)*	*(250)*	*(1,000)*
Regulatory return	*(80)*	*(60)*	*(40)*	*(20)*	*(200)*
Closing balance	**750**	**500**	**250**	**-**	**-**

(a) Amounts expected to be included in the regulated rates in Year 1 are amounts expected to be charged to customers for goods or services supplied using other assets.

(b) Calculated as the sum of the CU250 per year recovery of the cost of the item of plant plus the regulatory return for the year.

(c) The total regulatory return of CU200 is less than the regulatory return of CU212 in the example in Appendix A (Figure A1) because the regulatory agreement applies the second regulatory approach in paragraph BC96(b). The additional CU12 arises in the example in Appendix A because of a compounding effect arising from the later recovery of returns for Year 1, as shown in Figure B4. The accounting does not cause or affect that difference.

Application of potential requirements in paragraph 11

Potential Requirement 1—the remaining period in which the asset is recovered through the regulated rates once the asset is available for use

B3. Applying Potential Requirement 1, the total allowed compensation for goods or services supplied in each of Years 1–6 is made up of:

(a) the amount that recovers allowable expenses incurred in in that year supplying the goods or services—in this case the depreciation expense of CU200 per year recognised for the item of plant for Years 2–6.

(b) the regulatory return of 8%. This regulatory return forms part of the total allowed compensation for goods or services supplied in the same year in which the regulatory agreement entitles the entity to add it in determining the regulated rates, except for the return that was provided in Year 1, when the asset was not yet available for use, as discussed in paragraph B3(c).

(c) the regulatory return included in the regulated rates during the period when the asset is not yet available for use (Year 1). In accordance with the Board's tentative decisions summarised in Table 1, that regulatory return forms part of the total allowed compensation for goods or services supplied only once the asset is available for use and – by applying **Potential Requirement 1** – over the remaining periods in which the asset is recovered through the regulated rates (that is Years 2–4).

Figure B2—Total allowed compensation for goods or services supplied in Years 1–6 (Potential Requirement 1)							
In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Total**
Allowable expenses – depreciation expense	-	200	200	200	200	200	1,000
Regulatory return	80	60	40	20	-	-	200
Regulatory return before the asset is available for use – **Potential Requirement 1**	(80)	27	27	26	-	-	-
Total allowed compensation	**-**	**287**	**267**	**246**	**200**	**200**	**1,200**
Revenue	330	310	290	270	-	-	1,200
Regulatory income (regulatory expense)	**(330)**	**(23)**	**(23)**	**(24)**	**200**	**200**	**-**

Figure B3—Profit for Years 1–6 (Potential Requirement 1)							
In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Total**
Revenue	330	310	290	270	-	-	1,200
Regulatory income (regulatory expense) (Figure B5)	(330)	(23)	(23)	(24)	200	200	-
	-	287	267	246	200	200	1,200
Depreciation	-	(200)	(200)	(200)	(200)	(200)	(1,000)
Profit	**-**	**87**	**67**	**46**	**-**	**-**	**200**

B4. The profit in Years 1–6 equals the regulatory return on the regulatory capital base that the regulatory agreement entitles the entity to charge when supplying goods or services during these years, after applying Potential Requirement 1 to the regulatory return recognised in revenue in Year 1:

Figure B4—Composition of profit for Years 1–6 (Potential Requirement 1)

In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Total**
Regulatory return applied to IAS 16 carrying amount (note (a))	80	80	64	48	32	16	320
Regulatory return on the CU80 regulatory return from before the asset is available for use	-	6	4	2	-	-	12
Regulatory interest expense (Figure B5)	-	(26)	(28)	(30)	(32)	(16)	(132)
	80	60	40	20	-	-	200
Regulatory return before the asset is available for use – **Potential Requirement 1**	(80)	27	27	26	-	-	-
	-	**87**	**67**	**46**	**-**	**-**	**200**

(a) Represents the regulatory return the entity would have earned considering an initial cost of CU1,000 had the regulatory agreement required the item of plant to be recovered through the regulated rates to be charged to customers over the asset's five-year useful life.

Figure B5—Reconciliation of carrying amount of regulatory liability (Potential Requirement 1)

In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Opening carrying amount (1)	-	330	353	376	400	200
Amount recognised (notes (a) and (b))	330	23	23	24	-	-
Regulatory interest expense	-	26	28	30	32	16
Fulfilment (note (c))	-	(26)	(28)	(30)	(232)	(216)
Subtotal: Regulatory expense (regulatory income) (2)	330	23	23	24	(200)	(200)
Closing carrying amount (1 + 2)	**330**	**353**	**376**	**400**	**200**	**-**

(a) Initial recognition of a regulatory liability of CU330 in Year 1 results from CU80 regulatory return plus CU250 for the cost of the item of plant, both amounts recognised in revenue as they had been charged to customers through the regulated rates in Year 1. Amounts recognised in each of Years 2–4 include CU50 resulting from recognising revenue of CU250 per year when the depreciation expense forming part of the total allowed compensation for goods or services supplied in those years is only CU200, less the amounts discussed in note (b). These amounts recognised for regulatory liability during Years 1–4 will provide part of the total allowed compensation for goods or services to be supplied during Years 5–6 when the item of plant is available for use, however no further amounts will be charged because the item of plant will have been fully recovered.

(b) Under **Potential Requirement 1**, the CU80 regulatory return charged in Year 1 forms part of total allowed compensation for goods or services supplied over the remaining periods in which the asset is recovered through the regulated rates (that is Years 2–4). Thus, measurement of the regulatory liability described in (a) is reduced by CU27, CU27 and CU26 in Years 2–4.

(c) The amount fulfilled in each of Years 2–4 is the regulatory interest expense for the year because the effect of the regulatory agreement is that it is deducted in determining the regulatory rates for goods or services supplied to customers in the same year. The amount fulfilled in each of Years 5 and 6 includes both the regulatory interest expense for the year and CU200 because the revenue of CU250 recognised in Year 1, and a further CU50 in each of Years 2–4, provides part of total allowed compensation for goods or services supplied in Years 5 and 6.

Potential Requirement 2—the useful life of the asset as determined for IFRS purposes

B5. The total allowed compensation for goods or services supplied in Years 1–6 is determined in the same way as under Potential Requirement 1, except for the regulatory return included in the regulated rates during the period when the item of plant was not yet available for use (Year 1), which instead forms part of the total allowed compensation over the useful life of the asset (that is Years 2–6) by applying **Potential Requirement 2**.

Figure B6—Total allowed compensation for goods or services supplied in Years 1–6 (Potential Requirement 2)

In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Total**
Allowable expenses – depreciation expense	-	200	200	200	200	200	1,000
Regulatory return	80	60	40	20	-	-	200
Regulatory return before the asset is available for use – **Potential Requirement 2**	(80)	16	16	16	16	16	-
Total allowed compensation	**-**	**276**	**256**	**236**	**216**	**216**	**1,200**
Revenue	330	310	290	270	-	-	1,200
Regulatory income (regulatory expense)	**(330)**	**(34)**	**(34)**	**(34)**	**216**	**216**	**-**

Figure B7—Profit for Years 1–6 (Potential Requirement 2)

In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Total**
Revenue	330	310	290	270	-	-	1,200
Regulatory income (regulatory expense) (Figure B9)	(330)	(34)	(34)	(34)	216	216	-
	-	276	256	236	216	216	1,200
Depreciation	-	(200)	(200)	(200)	(200)	(200)	(1,000)
Profit	**-**	**76**	**56**	**36**	**16**	**16**	**200**

B6. The profit in Years 1–6 equals the regulatory return on the regulatory capital base that the regulatory agreement entitles the entity to charge when supplying goods or services during these years, after applying Potential Requirement 2 to the regulatory return recognised in revenue in Year 1:

Figure B8—Composition of profit for Years 1–6 (Potential Requirement 2)

In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Total**
Regulatory return applied to IAS 16 carrying amount (note (a))	80	80	64	48	32	16	320
Regulatory return on the CU80 regulatory return from before the asset is available for use		6	5	4	3	1	19
Regulatory interest expense (Figure B9)	-	(26)	(29)	(32)	(35)	(17)	(139)
	80	60	40	20	-	-	200
Regulatory return before the asset is available for use – **Potential Requirement 2**	(80)	16	16	16	16	16	-
	-	**76**	**56**	**36**	**16**	**16**	**200**

(a) Represents the regulatory return the entity would have earned had the regulatory agreement required the item of plant to be recovered through the regulated rates charged to customers over the asset's five-year useful life.

Figure B9—Reconciliation of carrying amount of regulatory liability (Potential Requirement 2)

In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Opening carrying amount (1)	-	330	364	398	432	216
Amount recognised (notes (a) and (b))	330	34	34	34	-	-
Regulatory interest expense	-	26	29	32	35	17
Fulfilment (note (c))	-	(26)	(29)	(32)	(251)	(233)
Subtotal: Regulatory expense (regulatory income) (2)	330	34	34	34	(216)	(216)
Closing carrying amount (1 + 2)	**330**	**364**	**398**	**432**	**216**	**-**

(a) Initial recognition of a regulatory liability of CU330 in Year 1 results from CU80 regulatory return plus CU250 for the cost of the item of plant, both amounts recognised in revenue as they had been charged to customers through the regulated rates in Year 1. Amounts recognised in each of Years 2–4 includes CU50 resulting from recognising revenue of CU250 per year when the recovery of the depreciation expense forming part of the total allowed depreciation for goods or services supplied in those years is only CU200, less the amounts discussed in note (b). These amounts recognised for regulatory liability during Years 1–4 will provide part of the total allowed compensation for goods or services to be supplied during Years 5–6 when the item of plant is available for use, however no further amounts will be charged as the item of plant will have been fully recovered.

(b) Under **Potential Requirement 2**, the CU80 regulatory return charged in Year 1 forms part of total allowed compensation for goods or services supplied over the IFRS useful life of the asset (that is Years 2–6). Thus, measurement of the regulatory liability described in (a) in each of Years 2–4 is reduced by CU16 per year, and the fulfilment in each of Years 5–6 is increased by CU16 per year.

(c) The amount fulfilled in each of Years 2–6 is the regulatory interest expense for the year because the effect of the regulatory agreement is that it is deducted in determining the regulatory rates for goods or services supplied to customers in the same year. The amounts of the regulatory liability fulfilled in each of Years 5 and 6 also includes: (i) the CU16 described in note (b); and (ii) CU200 because the revenue of CU250 recognised in Year 1 and a further CU50 in each of Years 2–4, provide part of total allowed compensation for goods or services supplied in Years 5 and 6.