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15 June 2012

Modelling local development contributions
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 2130

Your Ref:
Our Ref: FP53

Dear Ms Blackwell

Modelling local development contributions – selection of a discount rate for councils that use an NPV methodology.

I refer to the draft technical paper issued for comment in relation to the selection of an appropriate discount rate when preparing a contributions plan using the NPV method. The paper was prepared in response to the IPART recommendations arising from the review of Council's Contributions Plans for the Balmoral Road Release Area and North Kellyville Precinct.

Council notes that the IPART no longer support the use of a discount rate that reflects Council's risk related rate of return. Alternatively, the paper now recommends that Council's use a risk free discount rate and account for risk by way of contingency allowances and plan review at least every five years. In response to this proposal, the following comments are provided:

1. Council's preference is to retain the nominal NPV method on the grounds that it calculates the value of contributions on a whole of life basis providing certainty to Council and developers of the applicable rate.

   NSW Treasury recommends that the discount rate using the Financial Appraisal Guidelines should use the long term bond rate adjusted by a market risk premium. The guideline also recommends that all cash flows should be estimated in nominal terms (ie, cash flow estimates should include inflationary escalations) and not in 'real' terms.

   The NSW Treasury Corporation recommends that the discount rate be expressed in nominal terms using the 10 year Commonwealth Government Bond yield. In order to smooth short-term volatility, a 20-day average of the historical daily yield should be used. A market risk premium of 6% is recommended by Treasury.

   This guideline is relevant to Council's role in provide local infrastructure of which significant risk can apply to elements such as land acquisition, water management and road construction.

2. Another relevant example of an appropriate risk premium for local government relates to Circular No 12-17 issued by the Division of Local Government on 6 June

2012. The method applied to calculate the interest rate is the Supreme Court methodology which is the Reserve Bank cash rate plus 6%.

It is not appropriate that a risk-free rate of return apply when under current conditions the bond rate adjusted for inflation is significantly below the rate applicable to Council's investment portfolio.

3. The proposition that Council can account for risk in other ways such as contingency allowances is not supported by the recommendations arising from the review of Council's contributions plans. A maximum contingency of 15% is not reflective of the level of assessment undertaken to prepare Council's contributions plans which occur absent of any detailed assessment of facility design requirements or site constraints.

   Council has argued in previous submissions that a contingency allowance of 25% was appropriate and could be reduced upon the completion of full concept designs. The current limit of 15% makes now allowance for an alternative method to account for risk when using a risk free discount rate.

4. The proposition that it is difficult to calculate a single risk free adjustment margin for all Councils as justification for a risk free rate is not supported. The risks face by Council are applicable irrespective of whether or not contributions are received prior to or after expenditure. Further investigation is warranted to establish the feasibility of preparing an average risk premium that could apply to all Council's.

5. As Council has demonstrated in the recent review of its contributions plans, development levies are very sensitive to the discount rate. A review period of 5 years is insufficient and will require that Council frequently review its plans in response to movements in the bond rate, timing of expenditure and revenue receipts. This process is likely to add further uncertainty to the existing method adopted by Council.

6. Council has no concern with selecting either the Reserve Bank of Australia or NSW Treasury Corporation 10 year bond yield using a 20 day average. However, the method of adjusting for inflation however using inflation indexed swaps is not supported. Council's preference would be to retain Council's existing inflation measure of 2.5% being the mid-point of the Reserve Bank of Australia's target range for inflation over the cycle.

7. The IPART should consider the merit of applying an average bond yield and risk premium. As Council's are required to prepare contributions plans that apply over periods of more than fifteen years, this method would assist in reducing (but not remove) the need to undertake frequent plan reviews.

Thank you for the opportunity to comment on the draft Technical Paper. Should you have any questions in relation to the matters raised in this latter, please contact me on 9843 0258.

Yours faithfully

[redacted]

FLETCHER RAYNER
PRINCIPAL FORWARD PLANNER