## Latest discount rate for local infrastructure contributions plans



February 2018



This fact sheet provides an update of the discount rate for use in net present value (NPV) models for contributions plans. It is based on historical data to the end of January 2018.

As at the end of January 2018, the nominal discount rate is 4.3% and the real discount rate is 1.7%.



We recommend councils use this updated discount rate in NPV models for contributions plans, consistent with the method in our 2016 Technical Paper *Modelling local development contributions in a present value framework.* 

Our approach to calculating the discount rate:

- is consistent with IPART's WACC method (in determining the cost of debt for utilities)
- has a strong market basis (based on an assumed credit rating for the sector)
- ▼ is relatively simple to administer, and
- is derived from the available historical data on the relevant debt margin.

The Technical Paper also recommends that councils escalate contribution rates each year by the discount rate. This is so councils do not bear the cost of any decision by developers to delay development.



The method uses a market-based estimate of the cost of debt for the local government sector. We calculate this by taking the risk free rate (10-year Commonwealth bond yield) and adding our estimate of the debt margin.

Councils have the flexibility to model contributions rates using either nominal or real values. If councils use real values, they should use a real discount rate.

We adjust the nominal discount rate for inflation in order to derive a real discount rate. Our inflation estimate is the geometric average of the Reserve Bank of Australia's inflation forecast for the next year, and the midpoint of its target inflation range (2.5%) for the following nine years.

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IPART will next update the discount rate for local infrastructure contribution plans in August 2018.

IPART is reviewing its WACC method. Prior to the next biannual update we will consider whether we should change our approach to the discount rate calculation for consistency with any changes to the WACC method.



## **CURRENT DISCOUNT RATE**

The current nominal discount rate is 4.3% and the real discount rate is 1.7%. Since the publication of our last Fact Sheet in August 2017, the real and nominal rates have both decreased by around 8 basis points. However when rounded to 1 decimal place, the decrease is only evident in the real discount rate.

Table 1 shows the nominal and real discount rates and the various components that make up the rates.

Averaging relevant rates	Commonwealth 10- yr bond yield	Corporate A-rated 10-yr yield	Spread
Average 10 years	3.931	6.058	
Average short term <sup>a</sup>	2.697	3.834	
Midpoint	3.314	4.946	1.632
Calculating the discount rates			
Commonwealth 10-year bond yield	3.314		
+ Half of spread	0.816		
+ Debt-raising costs	0.125		
= Nominal discount rate	4.255		
Inflation forecast	2.500		
Real discount rate	1.712		
Nominal discount rate (rounded to 1 decimal place)	4.3		
Real discount rate (rounded to 1 decimal place)	1.7		

## Table 1 Calculating nominal and real discount rates – IPART method

**a** For short term averages, the Commonwealth 10-year bond yield is based on 40 trading days of data and the Corporate A-rated 10-year yield is based on 2 months of data.

**Note:** The periods over which the averages are calculated are to 31 January 2018. **Source:** Bloomberg (10 year bond rates); Reserve Bank of Australia, Statistical Tables F3 (corporate yields).