

# Fact Sheet – Latest discount rate for use in local development contributions plans

18 August 2016



## WHAT

This fact sheet provides an update of the discount rate for use in net present value (NPV) models for contributions plans based on historical data to the end of July 2016.

As at July 2016, the nominal discount rate is 4.3% and the real discount rate is 1.9%.



## WHY

We recommend councils use the updated discount rate in NPV models for contributions plans, consistent with the methodology in our Technical Paper *Modelling local development contributions in a present value framework*.<sup>1</sup>

We have estimated the discount rate used in NPV models based on an estimate of the cost of debt.

We do not recommend the use of a commercial, risk-adjusted rate of return, largely because council services are less contestable than market-based services.



## HOW

The methodology 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, including debt raising costs.

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 measure is the average of the Reserve Bank of Australia's inflation forecast for the next year and nine years of the midpoint of its target inflation range (2.5%).



## WHEN

IPART will next update the discount rate for local government development contribution plans in February 2017.

<sup>1</sup> IPART, February 2016, available on our website.

## Current discount rate

Since the publication of our last Fact Sheet in February 2016, the nominal and real discount rates have decreased from 5.0% and 2.4%, or by around 66 and 51 basis points, respectively.

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

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

Averaging relevant rates	Commonwealth 10-yr bond yield	Corporate A-rated 10-yr yield	Spread
Average 10 years	4.437	6.550	
Average 2 months	2.010	3.857	
Midpoint	3.222	5.204	1.982
<b>Calculating the discount rates</b>			
Commonwealth 10-year bond yield	3.222		
+ Half of spread	0.991		
+ Debt-raising costs	0.125		
<b>= Nominal discount rate</b>	<b>4.338</b>		
Inflation forecast	2.400		
<b>Real discount rate<sup>a</sup></b>	<b>1.893</b>		
<b>Nominal discount rate</b> (rounded to 1 decimal place)	<b>4.3</b>		
<b>Real discount rate</b> (rounded to 1 decimal place)	<b>1.9</b>		

**a** This figure has been corrected from 1.793 in an earlier version of the Fact Sheet.

**Note:** The periods over which the averages are calculated are to July 2016.

**Source:** Bloomberg (10 year bond rates); Reserve Bank of Australia, Statistical Tables F3 (corporate yields).