

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

August 2017



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 2017.

As at the end of July 2017, the nominal discount rate is 4.3% and the real discount rate is 1.8%.



WHY

We recommend councils use this 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*.¹

We have estimated the discount rate, to be used in NPV models, based on an estimate of the council's cost of debt to compensate councils for their risk of providing infrastructure ahead of levying contributions to fund that provision. Key advantages of our approach are that:

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

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.

As part of our methodology, we also recommend that the contributions rate be

escalated each year at the discount rate which represents the council's opportunity cost of capital funds.

The aim of this approach is to reduce the revenue risk to the council from development delays, assuming relevant land is eventually developed as envisaged in the plan.



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 the costs of raising debt.

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%) over nine years.



WHEN

IPART will next update the discount rate for local government development contribution plans in February 2018.

¹ IPART, February 2016, available on our website.

Current discount rate

Since the publication of our last Fact Sheet in February 2017, the nominal and real discount rates have decreased from 4.6% and 2.1% respectively, or by around 30 basis points for both discount rates.

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	4.102	6.254	
Average 2 months	2.562	3.923	
Midpoint	3.332	5.089	1.757
Calculating the discount rates			
Commonwealth 10-year bond yield	3.332		
+ Half of spread	0.879		
+ Debt-raising costs	0.125		
= Nominal discount rate	4.336		
Inflation forecast	2.500		
Real discount rate	1.791		
Nominal discount rate (rounded to 1 decimal place)	4.3		
Real discount rate (rounded to 1 decimal place)	1.8		

Note: The periods over which the averages are calculated are to 31 July 2017.

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