FACT SHEET

Latest discount rate for use in local development contributions plans

September 2015

IPART recommends that councils that employ a present value framework for their contributions plans use a nominal discount rate of **4.9**% or a real discount rate of **2.3**% based on IPART's methodology and data available to July 2015.

In our June 2015 Technical Paper[1], we recommended that councils adopt a specific method to calculate the discount rate for use in net present value (NPV) modelling of contributions plans. This Fact Sheet uses the methodology in that paper to update the discount rate for historical data to the end of July 2015.

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

The debt margin was defined in two parts. First, we took half of the rate spread between the 10-year Commonwealth bond and non-financial corporate A-rated 10-year debt. Secondly, we added a margin of 12.5 basis points to allow for the cost of raising debt.

We then adjusted this resulting 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 1-year inflation forecast and nine years of the midpoint of its target inflation range. It is unchanged at 2.50%.

In the Technical Paper, for illustration, we derived a nominal and real discount rate based on Reserve Bank of Australia data available to April 2015. At that stage, the nominal discount rate was 4.64% and the real discount rate was 2.09%. Since April, interest rates have risen across the board so that both the latest nominal and real discount rates are 22 to 23 basis points higher than they were.

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

1 IPART, *Modelling local development contributions in a present value framework – Technical Paper*, June 2015, available on our website.

Table 1 Calculating nominal and real discount rates – IPART method

Averaging relevant rates	C/w 10-yr bond yield	Corporate A-rated 10-yr yield	Spread
Average of 10 years	4.72	6.69	
Average of 2 months	2.94	4.64	
Midpoint	3.83	5.66	1.83
Calculating the discount rates			
Commonwealth 10-year bond yield	3.83		
+ Half of spread	0.92		
+ Debt-raising costs	0.13		
= Nominal discount rate	**4.87**		
Inflation forecast	2.50		
Real discount rate	**2.31**		
Nominal discount rate (rounded to 1 dec place)	**4.9**		
Real discount rate (rounded to 1 dec place)	**2.3**		

Note: The period over which the 10-year averages have been measured is August 2005 to July 2015. Data may not add due to rounding.

Source: Reserve Bank of Australia, Bulletin, Tables F2 and F3 to July 2015; and *Statement of Monetary Policy*, August 2015, Table 6.1.

We have rounded the final discount rates to one decimal place, consistent with the rounding in our 26 August 2015 WACC Update.

The next update of the discount rate for local government development contribution plans will be released in February 2016.