FACT SHEET

Modelling local development contributions

Selection of a discount rate for councils that use an NPV methodology
7 September 2012

IPART has released a final technical paper about the financial modelling of local development contributions. The final technical paper explains how councils should select a discount rate when they use a Net Present Value (NPV) methodology.

Why has IPART published the final technical paper?

In October 2011, IPART reviewed 3 contributions plans for areas in western Sydney. Two of the plans we reviewed used an NPV methodology for calculating the contributions rate.

Our assessment of these plans showed that councils needed clearer guidance on the use of an NPV methodology, particularly the selection of a discount rate.

What is an NPV methodology?

Councils may use an NPV methodology to calculate section 94 contributions. It is not compulsory.

An NPV methodology requires the use of a discounted cash flow model. In a discounted cash flow model for local development contributions, the contributions rate is calculated so that the present value of anticipated expenditure is equal to the present value of anticipated revenue. This helps to ensure that a council collects sufficient revenue to cover its anticipated expenditure.

What is the discount rate?

An important assumption in the application of an NPV methodology is the choice of the discount rate.

The discount rate is the percentage rate applied to each future period's cash flow to determine its value in today's dollars.

We noted in particular that the existing guidelines for preparing contributions plans do not prescribe how councils should choose the discount rate.

Key factors in choosing an appropriate discount rate are the council's method of financing contributions plans and the risks they incur in implementing contributions plans. The final technical paper discusses these factors further.

What are we recommending?

We are recommending that councils use a discount rate based on a bond that trades at a premium to the risk-free rate and to account for risk in other ways.

We recommend that the discount rate be based on the NSW Treasury Corporation 10-year bond rate, adjusted for inflation (real discount rate). The adjustment for inflation requires the use of swaps market data from Bloomberg.

To account for risk, we recommend that councils:

- adjust project cash flows using contingency allowances to account for the risk of increases in the real cost of infrastructure items in a contributions plan
- revise plans at least every 5 years, unless a significant change in circumstances prompts an earlier review, to account for the risk of changes to the planned timing of revenue receipts and expenditure outlays.

Our recommendations for the use of reasonable cost contingencies and revision of plans also apply to councils that do not use an NPV methodology. Some councils already follow these approaches.

What happens next?

We have forwarded our recommendations to the Minister for Planning and Infrastructure.

If the Minister for Planning and Infrastructure accepts our recommended approach, IPART will make available on its website the discount rate that councils should use in their NPV models.

Want more information?

The Final Technical Paper is available on the IPART website www.ipart.nsw.gov.au.

Further information about IPART's local government functions is also available on the website.

Inquiries regarding this fact sheet should be directed to a staff member:

Michael Seery (02) 9290 8421

Sarah Blackwell (02) 9113 7763