

## N8 Rate of Return

---

### Ideal Standard

The business activity has an appropriate return on capital equivalent to the weighted average cost of capital benchmark in the Full Cost Pricing Guidelines (lower standard - The business activity has a target rate of return on capital.).

### Outline/Summary

In making decisions and ensuring pricing decisions are based on the full cost, Councils need to incorporate a rate of return on the net assets in the business activity. Although consumers may have effectively paid for the assets through their payment of Council charges, this is no different to private sector pricing since the assets are owned by the organisation rather than the consumers. Unlike the private sector, the return on assets goes back to the Council and can offset general rates. Differential rating can be applied to adjust for the situation where some ratepayers are effectively paying a return on assets which reduces general rates, and other do not. Councils now may give relevant ratepayers a credit on their rates as a dividend from any profits in the business.

Traditionally Councils have tended to raise loans for non-income generating assets such as roads, and not for business activities like water and sewerage. Although not required, Councils can take the opportunity to review their 'capital structure' by raising a new (preferably interest only) loan in the water and sewerage activity and using the proceeds to repay existing road loans. The Queensland Treasury Corporation have established facilities to arrange appropriate debt financing instruments, subject to prudential covenants. However the Weighted Average Cost of Capital (WACC) calculations used to provide the government guidelines already impute a 50/50 Debt to Equity split, so a physical transfer is not necessary for pricing purposes.

The Government guidelines suggest that for small to medium businesses the pre-tax rate of return on assets may be taken to be 3.5% over the ten-year bond rate. (If a pre-tax rate of return is used for the required rate of return, there is no need to apply an income tax equivalent – see N10). This would currently give a rate of 9% (rounded to the nearest half percentage point). Larger businesses would apply the following returns:

- Water and sewerage 2.1 to 2.7% plus 10 year bond rate;
- Refuse Management 2.3 to 2.9% plus 10 year bond rate;
- Plant and Equipment Hire 2.4 to 3.0% plus 10 year bond rate;
- Road Construction and Maintenance 2.5 to 3.1% plus 10 year bond rate; and
- Cultural / Recreation / Leisure 2.7 to 3.3% plus 10 year bond rate.

Some business activities have negligible or no assets. Such organisations in the private sector often aim for a return on revenue instead of a return on capital. Eg. a 5-10% return on revenue for service companies and 2-5% for construction works. There is no QCA requirement to do this provided the return on capital is incorporated in the lease charges of any indirectly used capital. However, Councils may add a return on revenue if desired, as long as they remain competitive.

### Key Steps

1. Review the capital structure and implement a debt swap up to a 60% debt to equity split, if desired;
2. Apply a rate of return based on the above factors to be achieved over a period of up to five years; and
3. Determine price paths to achieve the required rate of return (taking all FCD factors into account, including CSO's).

### Further Information

PG 2.5.4, 3.4.5, 3.4.5.2, 3.4.5.7, TA 2, 3, 4, 8, LGAQ-FCP 12, { HYPERLINK "<http://www.rba.gov.au/Statistics/indicative.html>" } (for 10 year bond rate)

### QCA Documentation Standard

Budget, Chart of accounts or use of Full Cost Pricing software