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Consultation Document

Technical consultation on setting the decapitalisation rates for the Non-Domestic Rates Revaluation 2017

Date of issue: 14 August 2015

Action required: Responses by 25 September 2015

Overview

This consultation seeks views from stakeholders on whether the Welsh Government should continue to prescribe decapitalisation rates, how many rates should be prescribed, the methods for setting the rate and how the rates should be calculated.

How to respond

To respond to this consultation, please complete the online form which can be accessed here:

<http://gov.wales/consultations/forms/setting-decapitalisation-rate-for-non-domestic-rate/?lang=en>

Alternatively, respondents may use the form provided at the end of this document.

Responses can be e-mailed or sent directly to address given below.

Further information and related documents

Large print, Braille and alternative language versions of this document are available on request.

Contact details

For further information, or queries regarding this consultation, please contact:

Local Government Finance Policy Division

Local Taxation Branch

Welsh Government

Cathays Park

Cardiff

CF10 3NQ

E-mail:

LGF1Consultations2015@wales.gsi.gov.uk

Data protection

How the views and information you give us will be used

Any response you send us will be seen in full by Welsh Government staff dealing with the issues which this consultation is about. It may also be seen by other Welsh Government staff to help them plan future consultations.

The Welsh Government intends to publish a summary of the responses to this document. We may also publish responses in full.

Normally, the name and address (or part of the address) of the person or organisation who sent the response are published with the response. This helps to show that the consultation was carried out properly. If you do not want your name or address published, please tell us this in writing when you send your response. We will then blank them out.

Names or addresses we blank out might still get published later, though we do not think this would happen very often. The Freedom of Information Act 2000 and the Environmental Information Regulations 2004 allow the public to ask to see information held by many public bodies, including the Welsh Government.

This includes information which has not been published. However, the law also allows us to withhold information in some circumstances. If anyone asks to see information we have withheld, we will have to decide whether to release it or not. If someone has asked for their name and address not to be published, that is an important fact we would take into account. However, there might sometimes be important reasons why we would have to reveal someone's name and address, even though they have asked for them not to be published. We would get in touch with the person and ask their views before we finally decided to reveal the information.

Contents

1. Summary	2
2. What is the Decapitalisation Rate?	3
3. The prescription of the decapitalisation rate in legislation	5
4. How many rates should be prescribed?	7
5. How to calculate the decapitalisation rates ...	8
6. Next Steps	11

1. Summary

- 1.1 A revaluation of non-domestic properties usually takes place every five years. A revaluation was due to take place in 2015. A decision was taken by the Welsh Government to postpone the revaluation until 2017 following a decision by the UK Government to defer the revaluation in England.
- 1.2 The primary purpose of revaluation and the setting of the multiplier is to adjust the liability of properties *relative* to others within the NDR tax-base. This ensures the rate liability is spread fairly between ratepayers, and is based on up-to-date rental values. At each revaluation, all properties are assigned a new up-to-date rateable value. The multiplier is then reset by the Welsh Government to ensure the NDR tax-base can broadly generate the same level of funding after revaluation as before.
- 1.3 Preparations are now underway for the 2017 revaluation for a new ratings list to be introduced in Wales from 1 April 2017. The VOA is responsible for compiling and publishing the new ratings list and will ensure all non-domestic properties are assigned a new rateable value based upon their estimated annual rental value as at the Antecedent Valuation Date (AVD) of 1 April 2015.
- 1.4 The VOA uses three methods for calculating the rateable value of a non-domestic property depending on the available evidence. The Contractor's Basis is used for specialised properties, when there is little or no direct evidence of actual rents available. Approximately 20% of non-domestic properties are valued on the Contractor's Basis in Wales. These properties include utilities, schools, hospitals, heavy industry, fire and police stations, and airports, amongst others.
- 1.5 The decapitalisation rate is a key part of the Contractor's Basis. It is a percentage figure which is used to convert capital value into an annual rental value. It also ensures the costs and benefits of owning a property, compared to renting a property, are taken into account when calculating the rateable value of a property.
- 1.6 This consultation seeks views on whether the decapitalisation rate should be prescribed in legislation, how many rates should be prescribed and how the rate(s) should be calculated.

2. What is the Decapitalisation Rate?

The Valuation Process and the Contractor's Basis

- 2.1 The VOA uses three methods for calculating the rateable value of a property depending on the available evidence. Rental Comparison is used whenever there are sufficient numbers of comparable properties to provide reliable evidence on rental values.
- 2.2 The Receipts and Expenditure method is used when there is insufficient information to compare rental values and when rent is likely to be based on the profits made from the business occupying the property, for example pubs and hotels.
- 2.3 The Contractor's Basis is used when no such evidence exists. It is generally used for specialised properties, for example large industrial buildings, schools and hospitals. Properties such as these are rarely let and therefore their rental values are determined by reference to construction costs.

Rateable value on the Contractor's Basis

- 2.4 At the last revaluation in 2010, about 22% of all non-domestic properties in Wales were valued using the Contractor's Basis. These properties had a total rateable value of approximately £461m. This comprised:

Sector	Rateable value
Utilities	£123m
Education	£122m
Industry	£80m
Local Government	£55m
Health	£38m
Other Government	£22m
Defence	£10m
Other	£11m
Total	£461m

The Contractor's Basis

- 2.5 The Contractor's Basis has evolved through rating case law over some 200 years. It is based on the premise that the hypothetical tenant has an alternative to renting and they could purchase land and build a similar hereditament.

2.6 Rating Case Law has established six principle stages of a Contractor's Basis of valuation:

- i. Estimate the cost of replacing the building and any rateable items such as certain types of plant and machinery;
- ii. Make deductions to reflect the actual property being valued to adjust for age and obsolescence;
- iii. Add the land value to arrive at the total capital sum;
- iv. Decapitalise the total capital sum at the appropriate decapitalisation rate (or interest on capital rate). This converts capital value into an annual equivalent, or rental value;
- v. Stand back and look at the resultant answer to reflect any matters which would affect the rental value, as opposed to the capital cost; and
- vi. Consider the differences between the landlord's and tenant's viewpoints (in practice this stage is often combined with stage 5).

2.7 Stage (iv) of the Contractor's Basis above is the decapitalisation rate. It is a percentage figure which is used to convert capital value into an annual rental value. It ensures the costs and benefits of owning a property, compared to renting a property, are taken into account when calculating the rateable value of a property. The higher the decapitalisation rate, the higher the resultant rateable value will be.

3. The prescription of the decapitalisation rate in legislation

Why is the decapitalisation rate prescribed in legislation?

- 3.1 Before 1990, the Courts had great difficulty in deciding how the decapitalisation rate should be derived and at what level it should be set when determining the rateable value of a property. This gave rise to a series of appeals which created uncertainty as to the rates liability for these properties and, ultimately, the level of non-domestic rates income.
- 3.2 For the previous five Revaluations – 1990, 1995, 2000, 2005 and 2010 – the decapitalisation rates have been prescribed in legislation by Ministers, via amendments to the Non-Domestic Rating (Miscellaneous Provisions) (No.2) Regulations 1989.
- 3.3 The primary purpose of setting the decapitalisation rate in legislation is to standardise the way that Valuation Officers convert capital value into rateable value when using the Contractor's Basis. It therefore eliminates any uncertainty regarding the rate which should be used.
- 3.4 If the decapitalisation rate is prescribed in legislation, it has a fixed value and therefore has a demonstrable effect on the rateable value of those properties valued by the Contractor's Basis – the higher the decapitalisation rate, the higher the rateable value of these properties. In turn, therefore, the decapitalisation rates will also have an indirect effect on how the rating burden is distributed by exerting pressure on the multiplier. If the decapitalisation rate increases, it exerts a downward pressure (albeit minor) on the multiplier, and visa versa.
- 3.5 Prescribing the decapitalisation rate in legislation ensures that ratepayers are able to predict their NDR liability following a revaluation, with a reasonable degree of certainty. This helps to avoid large numbers of legal challenges on valuation decisions, which can be costly. It also reduces the risk for the Welsh Government and Public Services which require NDR income to remain relatively stable in order to set their budgets and plan effectively for future years.
- 3.6 It has been argued that decapitalisation rates should not be prescribed in legislation and that, in the long term, uncertainty over the rate is best dealt with by allowing the Courts to consider the right rates for different classes of property. In turn, this should allow valuations to fit the circumstances of each case. However, it is far from clear that the Courts could deliver long-term stability through the consideration of individual cases.
- 3.7 In fact, such an approach may give rise to more uncertainty largely because finance is secured from a range of sources ranging from private equity, public equity, commercial borrowing and the Public Loans and Works Board. As a result, the Valuation Office Agency would have to assess the mix and nature of

that finance, to value individual properties. This means ending prescription of the rate may give rise to extensive litigation.

Proposal

3.8 It is likely ending the prescription of the decapitalisation rate would lead to an unacceptable level of uncertainty for those valued on the Contractor's Basis. It is therefore proposed that the Welsh Government continues to prescribe the decapitalisation rate used in the Contractor's Basis of valuation.

Question 1: Do you agree Welsh Government should continue to prescribe the decapitalisation rates used in the Contractor's Basis of Valuation?

4. How many rates should be prescribed?

Should a lower and a standard rate continued to be prescribed?

- 4.1 Since 1990, two decapitalisation rates have been prescribed in legislation – a standard and a lower rate. At the 2010 revaluation, a lower rate was applied for educational, healthcare, defence and public convenience hereditaments, while the standard rate applied to all other properties.
- 4.2 A lower rate applied for certain public sector properties to reflect the fact that the occupiers of these properties have access to cheaper forms of financing such as public loans or grants, and in some cases donations. As a result, the decapitalisation rate (which in part reflects the cost of financing) should be lower compared with those hereditaments on the higher rate.
- 4.3 In the past, there have been calls for a single decapitalisation rate for all properties. This would simplify matters but would also mean the special characteristics of those public sector bodies (such as schools and hospitals) on the lower rate would no longer be taken into account when calculating the rateable value of these properties.
- 4.4 Conversely, it has also been argued that more than two decapitalisation rates should be prescribed in legislation. More rates would enable the system to better reflect the circumstances and characteristics of different types of properties but adding new rates would also increase complexity and could result in litigation around the boundaries of the rates.

Proposal

- 4.5 It is proposed that a standard and a lower decapitalisation rate continue to be prescribed in legislation and that the existing groupings will remain unchanged. Moving to a single rate, moving to multiple rates or altering groupings would lead to ratepayers facing significant changes in their rates bill for reasons unconnected to revaluation. A change in approach would also disturb a system which has worked well and is widely understood.

Question 2: Do you agree that the Welsh Government should continue to prescribe two decapitalisation rates in Wales?

5. How to calculate the decapitalisation rates

The Appropriate Rates for the 2017 Revaluation

- 5.1 The Welsh Government last set the decapitalisation rates for Wales for the 2010 revaluation having regard to circumstances at 1 April 2008. A lower rate of 2.97% was set and a standard rate of 4.5%. For the 2017 revaluation, the Welsh Government will consider the circumstances at 1 April 2015 (the Antecedent Valuation Date for the 2017 revaluation).
- 5.2 Determining the decapitalisation rate is a complex matter. There are a number of different methodologies which have their own advantages and disadvantages, as well as a number of other factors such as changes in the value of land or in building costs. In setting the rates, the Welsh Government will have regard to all the methods and factors which it considers relevant.

Factors which need to be taken into Consideration

- 5.3 Central to the Contractor's Basis of valuation is the assumption that cost equates to value but this is not always the case. The costs and benefits of owning a property will depend on a range of factors, such as building costs and the ongoing cost of financing, as well as the economic situation and the availability of similar properties. For example, there may be instances in some sectors where construction costs have increased but returns have fallen.
- 5.4 Since the Revaluation in 2010, there has been a sharp fall in land value and property prices in the UK, driven by the financial crisis. Concurrently, building costs have also fluctuated significantly – falling dramatically in 2009, but recovering steadily since. Whilst interest rates have remained low, the fall in property values has led to increased costs and risks for building and owning property. As a result, the cost of building and financing a property will not necessarily be equal to its current value, and may fluctuate significantly over time.
- 5.5 Whilst a more stable economic situation seems to be emerging, with relatively low and stable interest rates along with low rates of inflation, UK property values have not yet fully recovered to their pre-recession levels and the prospects for future growth remain uncertain. The property market in Wales also appears to be recovering more slowly than those in England and Scotland, particularly the industrial and retail sectors¹. These factors suggest that lower decapitalisation rates should apply for the 2017 Revaluation than the rates which applied for the 2010 Revaluation.

¹ Morgan Stanley Capital International (MSCI) (2015) The UK Revaluation 2017 (in association with GL Hearn) <https://www.msci.com/documents/10199/8fa3e947-70ef-481c-9a81-3ffa70c3bf33>

Methodology

5.6 There are a number of academic methods available for calculating the decapitalisation rates to be prescribed in legislation. Each method produces a wide range of possible percentage rates, largely because they all rely on an array of economic variables.

5.7 **Annex A** provides a description of these methods, an outline of their strengths and weaknesses, and the range of values they produce to inform the decapitalisation rate.

Relative Movement in Rents between the Valuation Dates

5.8 The academic methods detailed in Annex A provide a broad range of possible values and do not therefore offer a definitive answer as to what the decapitalisation rate should be.

5.9 As the primary function of the decapitalisation rate is to translate cost into value, the relative movements in rents between the valuation dates for the 2010 Revaluation and the 2017 Revaluation in Wales should also be taken into consideration. This acts as a check upon the results of the academic methods.

5.10 In principle, the movement between the valuation dates for properties assessed on the Contractor's Basis should not, overall, be significantly out of line with the general movement in rental values. If it were the case that movements in rateable values on the Contractor's Basis were significantly out of line with movements for other properties, this might indicate that the results of the method had departed, to some extent, from the value of the properties. Since the decapitalisation rate is a principal tool in the Contractor's Basis for translating cost into value, it follows that it should be set having some regard to those relative movements in rents.

5.11 This check was used when setting the decapitalisation rates for England, Scotland and Wales in respect of the 2010 Revaluation, and also for Northern Ireland in respect of its Revaluation in 2015. Whilst England and Scotland aligned their decapitalisation rates, the Northern Ireland Executive and the Welsh Government prescribed their own decapitalisation rates with reference to the rental movements within their own tax-bases.

Proposal

5.12 Since the 2010 Revaluation non-specialised properties in Wales, such as retail and office accommodation have declined in value². On the other hand, the value of specialised buildings (which include properties such as schools, hospitals and 'heavy' industrial buildings) appears to have remained fairly stable through the same period.

² Morgan Stanley Capital International (MSCI) (2015) The UK Revaluation 2017 (in association with GL Hearn) <https://www.msci.com/documents/10199/8fa3e947-70ef-481c-9a81-3ffa70c3bf33>

5.13 Having regard to the range of results produced by the methods detailed in Annex A and taking changes in rental movements between revaluations into account, it is proposed that:

- The lower decapitalisation rate for education, healthcare, defence and public convenience hereditaments is set at 2.1%.
- The standard decapitalisation for all other properties is set at 3.8%

Question 3: Do you have any views on the methods for setting the decapitalisation rates (including any suggestions for alternative methods), the range of values generated by each method, and the merits or otherwise of each method?

Question 4. Do you agree with the Welsh Government proposed approach for setting decapitalisation rates in Wales?

6. Next Steps

The Welsh Government invites respondents to submit views and any evidence relating to all aspects of this consultation by **25 September 2015**. In particular, comments are welcomed on the following questions.

Question 1: Do you agree Welsh Government should continue to prescribe the decapitalisation rates used in the Contractor's Basis of Valuation?

Question 2: Do you agree that the Welsh Government should continue to prescribe two decapitalisation rates in Wales?

Question 3: Do you have any views on the methods for setting the rate (including any suggestions for alternative methods) and the range of values generated by each method, and the merits or otherwise of each method?

Question 4: Do you agree with the Welsh Government proposed approach for setting decapitalisation rates in Wales?

Returning the form:

You can submit your comments in a number of ways.

The online form, which can be accessed here:

<http://gov.wales/consultations/forms/setting-decapitalisation-rate-for-non-domestic-rate/?lang=en>

Alternatively, respondents may use the separate response provided which can be emailed to: lgf1Consultations@wales.gsi.gov.uk

You may also give us your views by post:

Post: Local Taxation Branch
 Local Government Finance Policy Division
 Welsh Government
 Cathays Park
 Cardiff
 CF10 3NQ

Responses to consultations may be made public – on the internet or in a report. If you would prefer your response to be kept confidential, please say so at the time of responding. If responding on behalf of an organisation or group, also state if you do not wish for your name to be published.

Your views are important. Your comments and views are needed and welcomed in response to this public consultation.