Department for
Communities and
Local Government

The decapitalisation rates for the 2017 business rates revaluation

A technical discussion paper on the rates to be adopted in England for properties assessed on the contractor's basis of valuation.

September 2015
Department for Communities and Local Government

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Introduction

1. The next revaluation for business rates takes effect from 1 April 2017. Rateable values will be updated by the Valuation Office Agency using market rental values at 1 April 2015[1]. But for some properties where rents do not exist they will use the "contractor's basis" of valuation. This technical discussion paper seeks views on setting the decapitalisation rates to be adopted when properties are valued using the contractor's basis of valuation for the 2017 revaluation in England.

2. The issues considered by this paper include whether the Government should prescribe the decapitalisation rates, how many rates should be prescribed and the appropriate methodology for arriving at the rates, but does not propose a preferred option. Decisions will be taken in light of responses to this discussion paper.

Background

3. Business rates are a tax based on property values which help to pay for local services. In England, business rates will raise around £24 billion in 2015-16. They are charged on all non-domestic properties (e.g. shops, offices and factories) that do not qualify for an exemption. A business rates bill is worked out by multiplying the rateable value of a property (set by the Valuation Office Agency) by the business rates multiplier (set by central government)[2].

4. The rateable value represents the open market annual rental value of a property at a set point in time. This means the rent the property would be let for on the valuation date (1 April 2015 for the 2017 revaluation), if it was being offered on the open market. For most properties the Valuation Office Agency will use evidence of actual rents to prepare valuations. But for some specialist properties where rents do not exist they use the contractor's basis of valuation.

5. The contractor's basis works on the principle that, in theory, the tenant in the rating world could build their own property rather than rent the actual property and this will inform their rental bid. Therefore they will not pay more in rent than the annualised cost of buying land and building a similar property nearby.

6. Using this principle, the method broadly:

    - examines the cost of building a similar property (stage 1),

    - makes some adjustments for the obsolescence of the actual property (stage 2),

[1] For the 2017 revaluation all property will be valued by reference to matters as they existed on 1 April 2015 to ensure that properties are valued on the same basis. See the Rating Lists (Valuation Date) (England) Order 2014 (S.I. 2014/2841).

[2] There are two multipliers set by the Secretary of State in England and determined by reference to formulae set out in Schedule 7 to the Local Government Finance Act 1988.

- adds the land value (stage 3),
- decapitalises the result to reach an annual value (stage 4), and
- stands back to check the result (stage 5).

7. The decapitalisation rate (stage 4) may be prescribed by the Secretary of State in regulations. It is currently[3]:

- 3.33% for educational, healthcare and defence properties, and
- 5% for all other properties assessed on the contractor's basis (such as specialist local government properties and heavy industry properties).

8. It is estimated that about £3bn of rates bills are currently valued under the contractor's basis (and are therefore based on the decapitalisation rates). See table 1 below[4].

Table 1: Properties assessed on the contractor's basis of valuation

Sector	Rates bill (£m p.a.) 2015/16 terms
Education	£1,263
Health	£340
Industry	£402
Utilities and transport	£452
MOD	£148
Other public sector	£421
Other	£38
Total	£3,062

9. The lower the decapitalisation rate the lower the rateable value and the rates bill. A contractor's valuation with £1m total at stage three would "decapitalise" to £50,000 at 5 per cent and £33,300 at 3.33 per cent. Therefore, the decapitalisation rates will have a direct impact on the rateable value, and therefore, rates bill, for all ratepayers assessed using the contractor's basis of valuation. Furthermore, because the multiplier is reset at the revaluation to reflect overall changes in rateable values, it follows that decisions on the decapitalisation rate affect all ratepayers.

The decapitalisation rates for the 2017 revaluation

[3] The current rates are prescribed in regulation 2 of the Non-Domestic Rating (Miscellaneous Provisions) (No. 2) Regulations 1989 (S.I. 1989/2303).

[4] Based on rateable value estimate from the Valuation Office Agency. Rates bill is in 2015/16 terms and ignores reliefs.

10. Decapitalisation rates have been prescribed by the Government since 1990. For the 2017 revaluation in England the Government could end prescription and allow the rates to be determined by the Valuation Office Agency. Alternatively it could decide to again prescribe decapitalisation rates.

11. Ending prescription would allow the Valuation Office Agency to more precisely reflect the specific circumstances of individual properties valued on the contractor's basis. It would allow them to adopt different rates for different properties depending upon the valuation factors they considered relevant. It would, therefore, ensure that Ministers were separated from the valuation process. Some stakeholders have also suggested that if prescription of the decapitalisation rates were ended then it would, over time, allow for agreements with ratepayers and court decisions on the rates which, in turn, would reduce uncertainty.

12. However, prior to prescription in 1990, determination of decapitalisation rates by the courts led to significant litigation and delays in resolving individual rateable values and rate bills. And it is possible that pre-1990 case law on the decapitalisation rate now has limited application to modern approaches to financing properties and investment. Ending prescription could, therefore, introduce new uncertainty into business rates for those properties valued on the contractor's basis. That uncertainty would impact on ratepayers (who could not plan for their true business rates bill) and local government (who would not know how much rates income they could spend on local services). Prescribing the decapitalisation rates would protect ratepayers and local government from that uncertainty.

Question 1: Do you think the government should prescribe the decapitalisation rates for the 2017 revaluation?

Question 2. What would be the implications for the rating system if the government did not prescribe decapitalisation rates for the 2017 revaluation?

13. Currently, the government prescribes two different rates – one lower rate for education, healthcare and Ministry of Defence properties and one higher rate for all other properties valued on the contractor's basis. In England two different rates have been prescribed for these groups of properties since 1990[5]. If the government decided to continue with prescription, it could retain these groups, adopt different rates for different groups of properties or move to a single rate.

14. Retaining the current groups would preserve the existing system and provide certainty for those ratepayers assessed on the contractor's basis. Moving properties between the current groups or to new groups could mean large changes in rate bills for those affected (all other things being equal moving a property from the current lower rate to the current higher rate would increase their bill by 50%). Therefore, retaining the current groupings would ensure those ratepayers did not face sudden and large changes in their rate bills for reasons unconnected to the revaluation.

[5] Prior to the ending of the Crown Immunity from rates in 2000, the MOD were assessed on the lower rate on the Crown list.

15. Moving types of properties between these two groups or introducing new groups might allow the government to adopt rates more specific to the circumstances of the properties within each group. But it would also add new uncertainty and complexity to the system through having to define and apply new categories of properties for the rates. It may, in turn, lead to increased litigation for those valuations around the margins of each rate leading to more uncertainty.

16. Alternatively, adopting a single rate for all properties valued on the contractor's basis would be a much simpler system and provide more certainty for ratepayers than the current system. But the transition to a single rate could mean potentially large changes in rate bills for reasons unconnected to the revaluation.

Question 3. Do you think the government should continue to prescribe two different rates – one lower rate for education, healthcare and Ministry of Defence properties and one higher rate for all other properties valued on the contractor's basis?

Question 4. Do you think the government should adopt different groups of properties for different prescribed rates? If so why and do you have suggestions for how the different groups would be defined?

17. If the Government decided to prescribe decapitalisation rates, the Government would have regard to all methodologies and factors which it considered relevant. These are explained at the Annex but in summary:

a) there remains a great deal of uncertainty regarding the appropriate decapitalisation rates and the range of views regarding the appropriate rates is likely to be very wide,

b) the analysis for method 1 (based upon the cost of debt) produces a range of 1% to 4% for education, healthcare and the Ministry of Defence and 1% to 7.5% for all other properties. This is the approach which has traditionally been adopted in England,

c) the analysis for method 2 (based on debt and equity) produces a range of 4% to 11% for the higher rate. However, debt and equity has no application for the lower rate and only limited relevance to many of the properties on the higher rate,

d) setting the rates based on property investment yields suggests a range of 5% to 15%. However, no direct evidence for this approach exists for properties valued on the contractor's basis and it was rejected by the courts in England before prescription, and

e) having regard to likely movements in rental values at the revaluation, a reduction in the decapitalisation rates from their levels at the 2010 revaluation would keep the movement of rateable values for properties assessed on the contractor's basis broadly in line with the general movement of rental values.

Question 5. What are your views on the methodologies set out at the Annex for setting prescribed decapitalisation rates and can you provide further evidence?

Question 6. Do you have suggestions for different methods for setting the decapitalisation rates?

Question 7. If the Government decided to prescribe decapitalisation rates, what should those rates be?

How to respond

18. The government is seeking views on the issues raised in this discussion paper from ratepayers in all sectors, their agents, their representatives and from local authorities.

19. Responses to this paper are requested by 9 November 2015 and should be sent by email to the team using the following title and address:

Title: Decapitalisation Rate Technical Discussion Response

Address: NDR@communities.gsi.gov.uk

SETTING AN APPROPRIATE DECAPITALISATION RATE

1. The Government last considered the decapitalisation rates for England for the 2010 revaluation having regard to circumstances at 1 April 2008. If the Government decides to prescribe decapitalisation rates for the 2017 revaluation then it will consider the circumstances at 1 April 2015 (the valuation date for the 2017 revaluation). These rates would then apply for the 5 years of the 2017 rating list.

Broad principles in determining the decapitalisation rate

2. Prior to the rates in England and Wales being prescribed in 1990, the courts[6] adopted the following approach to setting the decapitalisation rate:

- examine the cost of securing the capital to build the alternative property,
- make an adjustment from that figure to reflect the difference between ownership and renting. This is known as the “Denning Discount”.

3. In Scotland, the courts looked more towards the returns (or “yields”) on property investment. The principle being that a yield (the amount in rent in relation to the capital value of the property) provides more direct evidence of the rental value of a property set against its capital value.

4. Since 1990 the Government has had regard to these approaches when setting the decapitalisation rates and they are examined below for the 2017 revaluation having regard to the economic circumstances at the valuation date for the revaluation – 1 April 2015.

5. In the rating world, the hypothetical tenant would have to pay a nominal rate of interest reflecting interest in the usual way (assuming that the capital sum they repaid remained the same)[7]. Therefore, the starting point for the decapitalisation rate is a nominal rate of interest (unless otherwise stated). To the extent that the effects of inflation should be adjusted or ignored in reaching a decapitalisation rate, this is reflected in the Denning Discount (explained below).

The Denning Discount

6. As mentioned above, an adjustment may be made to the rate to reflect the difference between owning and renting known as the Denning Discount. This adjustment could reflect a number of factors such as:

    - the tenant does not benefit from capital growth on the asset which it rents (neither real nor inflationary growth),
    - the tenant does not suffer from capital loss on the asset,

[6] The principle case being Cardiff City Council v Williams (VO) 1973 RA 46
[7] See Imperial College of Science and Technology v Ebdon (VO) and Westminster City Council 1986 RA 233

- the tenant does not have the full flexibility to adapt its building to changing circumstances,
- the tenant does not have title to the land – a non wasting asset,
- the tenant does not hold the hereditament as a saleable asset which is capable of being realised at a time of his choosing,
- the tenant is unaffected by any additional obsolescence which impacts on the hereditament during the currency of his tenancy (except in so far as it increases his repairing obligation). In other words, if the value of the property falls for any reason (for instance, technological change) the landlord cannot escape this loss whereas the tenant can, with due notice, determine the tenancy and seek another property, or negotiate a new tenancy at a lower rent,
- the tenant does not have the burden of managing rent collection and bearing the risk of a defaulting tenant,
- the tenant does not run the risk of void periods. In other words, the landlord faces the risk of his property being empty and, therefore, not generating rent whereas this is not relevant to the tenant.

7. The first five of these factors increase the discount and the last three reduce the discount. Whilst some of these factors are capable of being analysed, the value effects of all of them are, to some extent, subjective and may also vary by the type of property, the type of hypothetical tenant and the method adopted below. And in more recent years, the returns from owning property have become less certain and the risk of losses in some sectors has risen. This in turn has increased the uncertainty over the Denning Discount and could also reduce the discount compared to previous revaluations. The absolute discount will also vary depending upon the percentage to which it is being applied.

8. In general, the Denning discount could vary from a 4% discount to a 2% increase and this range is adopted for each of the methods discussed below for assessing the decapitalisation rates.

<u>Method 1: The cost of securing capital to build the alternative property from borrowing</u>

9. Prior to 1990, the courts looked towards debt as the principle means of finance. Therefore, whilst the leading case (the Imperial College case) looked at various methods of reaching a decapitalisation rate, all those methods were based to some extent upon the minimum lending rate of the Bank of England (now the official bank rate) with adjustment for inflation and a borrower’s premium.

10. The Bank of England base rate on 1 April 2015 was 0.5% but this is at an historically low level so we have adopted a range of 0.5% to 1.5%. To this we have added a borrower’s premium of between 2% and 4%. This gives a range before the Denning adjustments of 2.5% to 5.5%. After allowing for the range of outcomes on the Denning discount, the resulting range from this methodology is -1.5% to 7.5%. This wide range reflects the current climate of low underlying interest rates and different premium likely to be attached to different sectors and tenants for those properties assessed on the contractor’s basis.

11. In the public sector, debt may be secured from the Public Loans and Works Board whose rate for borrowing at 1 April 2015 was 2.15% for 5 years. After the Denning Discount this gives a range of -1.86% to 4.14% for the public sector.

12. However, setting a decapitalisation rate at nil or close to nil would imply that a large group of properties providing valuable on-going public services and commercial operations would not commend a rent. This suggests that the range of possible decapitalisation rates would not fall below 1%.

13. Therefore, the analysis for method 1 produces a range of 1% to 4% for education, healthcare and the Ministry of Defence and 1% to 7.5% for all other properties.

14. The merits of this approach are that:

- it is consistent with rating case law prior to prescription in 1990,
- it reflects the fact that in the public and private sector, debt is used to fund property (although not always exclusively).

15. The drawbacks of this approach are that:

- it includes a number of variables which are sensitive to small changes in economic circumstances. This may make the method less reliable in times of economic change,
- in the private sector, it is unlikely that a project would be funded entirely from debt, and
- in the public sector, borrowing from the PWLB may only constitute part of the cost. Other sources could include receipts or Government grant.

<u>Method 2: The cost of securing capital to build the alternative property from debt and equity</u>

16. In the private sector capital maybe raised from a balance of equity and debt. The common method of determining the cost of finance from equity and debt is to use a Weighted Average Cost of Capital (WACC). This is also the approach commonly adopted by regulators to assessing returns allowed on capital for regulated industries (e.g. utilities).

17. Since the 2010 revaluation, the WACCs adopted for utilities have fallen. For illustration, OFWAT for their 2015-2010 price control[8] considered a cost of equity range of 4.9% to 5.7% for water companies. The cost of debt for the water companies found by OFWAT was 2.7% to 2.9%. OFWAT adopted a balance of 62.5% debt and 37.5% equity to give a WACC range of 3.6% to 3.9%[9]. Other regulators have recently considered or adopted similar numbers. In their Q6 Price Control Final Proposals, the

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[8] OFWAT, Setting price controls for 2015-20 – risk and reward guidance January 2014.
[9] .This is a "vanilla" WACC (pre-tax cost of debt and post-tax cost of equity).

Civil Aviation Authority adopted WACCs for Heathrow of 4.85% and for Gatwick of 5.1%[10].

18. The WACCs on these relatively secure industries would be at the lower end of WACCs for all commercial occupations assessed on the contractor's basis. In contrast, the Competition and Markets Authority have estimated that the WACCs in the electricity generation and supply market range from 7.7% to 11%[11]. Furthermore, adjustments would be required for some aspects of the Denning discount, such as real growth, depreciation, management expenses and the risk of voids. These factors would widen the range. Therefore, the analysis for method 2 produces a range of 4% to 11%.

19. The merits of this approach are that:

- it reflects the true picture of how property is funded in large industry, and
- it reflects modern theory on cost of capital and has been adopted in other rating cases. This suggests that it would be considered by the courts today.

20. The drawback of this approach is that:

- the cost of equity and the balance between debt and equity can vary significantly between sectors and over time. For example, assumptions as to gearing have changed significantly since the 2010 revaluation. This suggests the range for those ratepayers which use debt and equity could be wide,
- some of the rateable value in the main rate is public sector for which equity is not relevant, and
- it has no application to the educational, healthcare and Ministry of Defence rate.

Method 3: property investment yields

21. Historically, investment yields have added little weight to the decapitalisation rate. This was because, by definition, properties assessed on the contractor's basis were not let and, therefore, no rents were available. As such, the only yields available were from different types of properties to those assessed on the contractor's basis – the closest sector was generally industrial yields.

22. Nevertheless, there is an argument for the use of industrial yields. Various surveyors have reported industrial yields in the months leading up to April 2015 ranging from 4.75% for prime sites to over 14% for secondary and tertiary locations[12]. This suggests that the range from method 3 is between 5% and, say, 15%.

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[10] Estimating the cost of capital: a technical appendix for the economic regulation of Heathrow and Gatwick from April 2014: Notices of the proposed licences, CAA January 2014. This is a vanilla WACC (i.e. with post tax cost of equity). Pre-tax WACC is 5.6% for Heathrow and 5.95% for Gatwick.

[11] Energy Market Investigation: Analysis of cost of capital of energy firms, February 2015. Pre-tax WACC covering generation and supply.

[12] E.G Cushman & Wakefield Industrial Snapshot Q1 2015, Knight Frank Yield Guide May 2015, Lambert Smith Hampton Yield and void matrix Q1 2015.

23. The merits of this method are that:

- it uses evidence from the market of what is, in effect, the decapitalisation rate, i.e. the relationship between annual value and capital value, and
- it is less subjective than others methods as it is based around observation of the market.

24. The drawbacks of this approach are that:

- prior to prescription in 1990, the use of investment yields as a means of determining the decapitalisation rate was generally rejected by the courts in England and Wales,
- by definition, yields are only available on classes in which there is rental evidence and, therefore, not valued on the contractor's basis. For classes assessed on the contractor's basis, little or no evidence of yields exists, and
- it is unlikely to have any relevance for the education, healthcare and Ministry of Defence rate.

<u>Relative movement in rents between the valuation dates</u>

25. The contractor's basis is used where there is little or no evidence of rental value and, generally speaking, where the receipts and expenditure method is not available. It is used because it is the best method available but it is far from perfect.

26. Central to the contractor's basis is the assumption that cost equates to value but that is not always the case. Certainly, there are examples in some sectors where construction costs have increased but returns have fallen. And the decapitalisation rate is the central part of the valuation which translates cost into value.

27. A wider view of the relative movement in rents between the valuation dates for the 2010 and 2017 revaluations would, therefore, assist with the consideration of the decapitalisation rates. The movement of rateable values for properties assessed on the contractor's basis should not, overall, fall significantly out of line with the general movement of rental values. If it were the case that movements of rateable values on the contractor's basis were significantly out of line with movements for other properties then this would indicate that the results of the method had departed, to some extent, from the value of the properties. Since the decapitalisation rate is the principal tool in the contractor's basis for translating cost into value then it follows that it should be set having some regard to those relative movements in rents.

28. However, it is unlikely that consideration of relative movement in rents would provide anything more than a general indication of the decapitalisation rate. By their nature, properties valued on the contractor's basis are unlike other properties. The main groups of properties valued on the contractor's basis such as schools, hospitals, Ministry of Defence bases and large industrial complexes have no comparative properties which are rented. Furthermore, the majority of rental information published in rental indices is only available on prime properties and not upon lower value properties. Therefore, it is not possible to draw any direct conclusions on the decapitalisation rate from analysing rental movement. Instead, examination of the relative movement in rents could provide a check upon the methods described above.

29. Whilst it is too early to say how individual rateable values will move at the 2017 revaluation, rating surveyors have, in broad terms, indicated that they believe rateable values will fall by a few percentage points at the 2017 revaluation[13].

30. In contrast the values at stage 1 and 2 of the contractor's basis of valuation (principally the cost of construction) are likely to increase at the 2017 revaluation. This suggests that if the decapitalisation rate is unchanged from the 2010 revaluation then, overall, rateable values from the contractor's basis would increases (compared to reducing rateable values elsewhere). This suggests that a reduction in the decapitalisation rates from their levels at the 2010 revaluation would keep the movement of rateable values for properties assessed on the contractor's basis broadly in line with the general movement of rental values.

Summary and conclusions

31. In summary:

a) there remains a great deal of uncertainty regarding the appropriate decapitalisation rates and the range of views regarding the appropriate rates is likely to be very wide,
b) the analysis for method 1 (based upon the cost of debt) produces a range of 1% to 4% for education, healthcare and the Ministry of Defence and 1% to 7.5% for all other properties. This is the approach which has traditionally been adopted in England,
c) the analysis for method 2 (based on debt and equity) produces a range of 4% to 11% for the higher rate. However, debt and equity has no application for the lower rate and only limited relevance to many of the properties on the higher rate,
d) setting the rates based on property investment yields suggests a range of 5% to 15%. However, no direct evidence for this approach exists for properties valued on the contractor's basis and it was rejected by the courts in England before prescription, and
e) having regard to likely movements in rental values at the revaluation, a reduction in the decapitalisation rates from their levels at the 2010 revaluation would keep the movement of rateable values for properties assessed on the contractor's basis broadly in line with the general movement of rental values.

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[13] GVA "The rating revaluation that never was" Spring 2015 forecast a 3.3% drop. GL Hearn Report & MSCI "UK Rating Revaluation 2017" April 2017 forecast a 4.8% drop.